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Performance of the Islamic Market Indexes

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Abstract:

Islamic finance is a finance which wants to be ethical, it draw her principles from Islamic jurisprudence who judge « prohibited » all illicit activities that affect the health, the population or their properties. Since Islam admits a social aspect, it requires criteria for the type of investment, from where the prohibition of the investments in the armament, pornography, alcohol, tobacco and all forms of speculative financial investment. These sectors are generating strong profitability. Therefore, if we ignore these activities, finance will be equally performant?

The objective of this work is to study the performance of Islamic banks and Islamic industries by establishing a comparison between those above and conventional banks and industries. To conduct our study we began by studying the performance of the best banks in 2004 over 7 years from 2004 to 2010 through the ROE, ROA, the price of human capital, the price of financial capital and the loans to deposits. The result of this first part suggests that Islamic banks are more efficient. In the second part we used the DJ index over a period ranging from 2005 to 2012 and we found that Islamic industries are more performant than conventional ones. We could also infer that, because the socio-political aspects impact the investor opinion about the placement according to sharia, Islamic indices are more volatile than conventional indices.

Keywords: conventional finance, Non-inflationary finance, Performance, Stock index

1. Introduction

The riba is the result of a transaction with a surplus not warranted or justified by the simple Exchange. Islamic finance prohibits the riba because it's sound in its terms and participatory in its principles. Islamic finance is an ethical finance because of its allocation of resources to socially responsible sectors, it aims the general and not the individual welfare. It introduces the notion of solidarity in finance, it aims to increase employment, equitable distribution of wealth and seeks to reconcile economic development, respect for the environment and society.

Islamic finance has emerged in the 70s, it's based on the real economy, its assets are¹ 1080 billion dollars in 2010, 1300 billion dollars in 2011, 1,540 billion dollars in 2012 and 1811 Billion in 2013. Current assets on Islamic bond markets (sukuk market) were 70 billion dollars in 2006, 243 billion dollars in 2012 and will attain 900 billion dollars in 2017².

En 2007, le monde économique a connu un effondrement suite à la crise des subprimes. The first cause of the crisis is the reduced rate of interest shown by conventional banks, they concealed its dependence on financial market and its rechargeability while putting the focus on the sensitivity of ownership. La deuxième cause est la spéculation et prise de risque excessive par les banques. Paradoxalement banques islamiques ont été épargnés face à ce dernier. La présente recherche propose d'explorer les questions suivantes:

- Islamic banks are they more performant than conventional banks?
- Islamic industry³ is more performant than conventional industry?
- The association of Islamic finance with the movement of Islamic ideologies and Islamophobia who accompanying wears harm to the Islamic finance?

We are focusing on the two popular method used in the study of performance, that based on ratios and that based on indices. To do this, we will base ourselves on the top 100 Islamic banks and top 100 conventional banks in 2004 according to the size of their capital and we used data from 50 banks including 25 Islamic and 25 conventional.

In following, we will use the information published in the Dow Jones Index Analytics on the cumulative performance of Islamic and conventional indices.

This work will be divided into two parts such that the first part is devoted to the study and the comparison between the performance of Islamic banks and conventional banks, while the second part will be devoted to the study and the comparison

¹ Ernst and young annual report 2012.2013.

² CIFA : Company independent of Islamic finance.

³ The term of Islamic industry covers all economic sectors (Technology, Healthcare, Oil & Gas, consumer goods, consumer services, telecommunications, financial ...) except those prohibited by Islam (Tobacco, pork , alcohol ...)

between the performance of Islamic industries and traditional industries while testing the impact of certain terrorist acts on the performance of Islamic industries.

2. Literature Review

The Comparative studies between Islamic finance and conventional finance are abundant in the literature. Some researchers have focused on financial institutions like Sehrish.S (2012), Rochmah.IS and Norhayti.A (2011), Mariani AM (2010), Weil, L (2010) and Hassoun. A (2002). Others researchers have laced on Islamic industry as Zamzamin.Z et al (2013) al-Baity. M and Mudor. H (2012), Al-baity. M and Rubi.A (2011).

In line with these studies we chose to investigate the performance of the best Islamic banks and Islamic industries in general while conducting comparative analyzes through ratios and indices.

In their work Rochmah. IR and Norhayti .A (2011) have made a comparison between Islamic banks and conventional banks in Indonesia before and after the tax reform of 2008. They concluded that there is no difference performance, only the liquidity of Islamic banks has improved which is logical because any improvement in the legal framework attracts investors.

Mahmoud. Z (2005) examined the rentability, performance, risk and liquidity of banks Pakistan and the results were more favorable for Islamic banks. Similarly Sehish. S and Al (2012) state that Islamic banks in Pakistan are more performant , less risky, but they are less effective than conventional banks.

Akkas. A (1982) states that Islamic principles are always in favor of non-inflationary economy. For this reason, Islamic financial institutions provide more stability in the Islamic financial system through the interaction of supply and demand, Siddiqui SA (2010).

Across analyzing the performance of 18 banks between 1997-2000 Yudistira. D (2004) shows that Islamic banks are more performant than conventional banks but they are inefficient.

Abdus. S (2004), wibowo. E and Saptutyningasih. E (2004) indicate that there is a big difference in profitability between the two types of banks but Islamic banks show a better performance compared to conventional banks.

Still using the ratio method Iqbal. M (2001) showed that Islamic banks are more performant than conventional banks between 1990-1998. However, Metwally. S.A. and Al-Mossawi. M (1998) argue that there are not significant differences in terms of efficiency and performance between the two types of banks but the difference lies in the level of liquidity and credit risk.

Currently, the research is oriented towards the study of the performance of industries across the Islamic indices.

The results of studies in different periods have been learned some teach. Thus Khazali and al (2013) state that in the period of crisis and post-crisis (2007-2012) Islamic indexes dominate traditional indices unlike between 1996 and 2006. Thus it appears that Islamic assets are safer than the indices conventional in periods of highly turbulence [Milly. Sultan.J and M (2012)].

In the same vein, Zamzami.Z and Al (2013), Merdad. H and Al (2010) argue that Islamic indexes do not outperform traditional indices, but in times of crisis trends are reversed.

Al-Baity. M and Rubi. A (2011) tried to verify if there is a difference in performance between the DJIM⁴ index, FTSEGI index and the KLSE index and if there is a risk premium for each scholarship. This study shows no significant differences between the risk and the return of the three indices, the absence of risk premium in the three stock exchanges and the existence of leverage in the DJIMI and FTSEGI, the lack of leverage for KLSEI. Moreover, this work shows a contingent effect of DJIMI and The FTSEGI to KLSEI.

Hussein. K and Omar. M (2005), Hussein. K (2005 and 2004) have shown that DJIM index is more volatile and more sensitive to change than the DJ index. This is why in the upward periods, it grows rapidly and underperformed the overall index DJ in the bearish periods.

Atta. H (2000) states in his study comparing DJIMI to DJ index from 1996 to 1999, the Islamic index is more performant than conventional index and this result was also confirmed by Statman. M (2000) in his study on the DSI and S & P 500.

Enfin, des études ont montré que les banques islamiques sont plus performantes mais moins rentables que les banques conventionnelles. Pour les indices boursiers, les résultats sont mitigés.

In this study we will situate ourselves in this empirical wake, forming a sample of banks to study the performance and identify the causes of the excessive volatility of Islamic indices observed.

3. Methodology

Through a ratios analysis we will study the performance of the best 25 Islamic banks while leading compared with the top 25 conventional banks in 2004 classified by size of their capital.

Ensuite, nous allons étudier la performance des industries islamiques à travers les indices de marché tout en effectuant une comparaison avec les indices classiques.

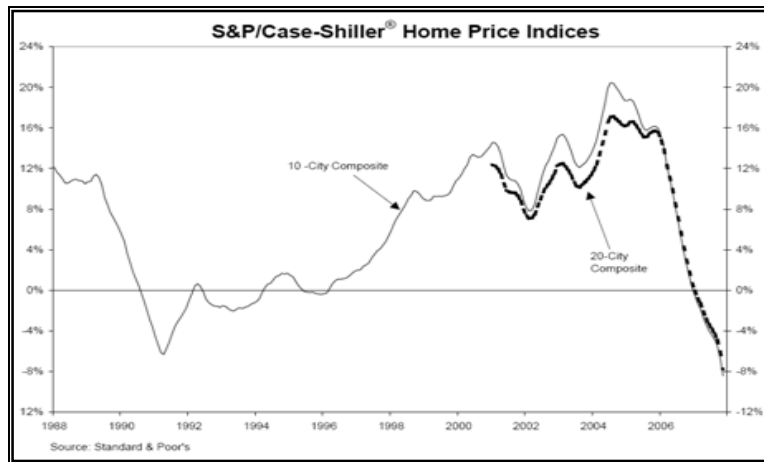
We choose the classement of 2004 because the premise of the credit subprime was observed in 2005 when the rate of risk⁵ aversion have decreased , when the mortgage bubble⁶ and index mortgage rates have reached their maximum value as shown in the following figure⁷.

⁴ The DJIM index is listed in USA, FTSEGI index in UK and KLSE index in Malaysia.

⁵ Donal. D and all (2009). Who's behind the financial meltdown: centre for public integrity report.

⁶ Ricol.R (2008). Presidential report of mission on the financial crisis.

⁷ Standard and poor's.



3.1. Return On Asset « ROA ».

The return on asset is defined as the relation between net income and total assets, higher it is more the assets allocated have been used effectively;

$$ROA = \frac{\text{Net Income}}{\text{Total assets}}$$

Because the ROA represent the ability of a firm to produce a result using all its means, Ika. S.R and Abdullah. N (2011), Saba. S and al (2012) and Muhammad SM (2013) have used it to get an idea about the efficiency of banks in their sample.

3.2. Return on Equity « ROE ».

ROE can be defined as the relation between net income and the sum of equity and it was used by Miniaoui. H and Gohou. G (2011), Hanif. M (2012), Nor EH et al (2012) and Limon MR (2013) to express the ability of a bank to generate profits.

Indeed, some analysts do not use the ROE but rather the ROCE because it represent yield depending on the capital knowing that it must be composed of common shares and is calculated using the following formula:

$$ROCE = \frac{\text{Net Income} - \text{Dividend on preferred share}}{\text{Own capital} - \text{Preferred Shares}}$$

However, we need to know than more ROE is higher more the allocated funds were used effectively.

3.3. Loans To Deposit

LTD is a prudential ratio, it evaluates the banks liquidity, check if it can finance its loans with the savings of its customers and it is written in the following form:

$$LTD = \frac{\text{Loans}}{\text{Deposits}}$$

This ratio should not exceed 80%. However, a low level will impact the profit margin of banks (shortfall).

Some analysts do not use the LTD to use the money multiplier which is $\frac{1}{1-LTD}$. The money multiplier must not exceed unity, in other words the LTD should never exceed 99%.

3.4. Inventory of Islamic indices

3.4.1. S&P 500 shariaa⁸

It is a part of S & P Global inventable shariah index that is conceived to offer a range of investment solutions in accordance with the Sharia index. The S & P 500 is widely regarded as the better indicator of the U.S. market, it includes 500 leading companies in U.S. economy.

3.4.2. Global Islamic Index Series (GIIS)⁹

It was created in 2006, derived from the Financial Times Stock Exchange, reflects the shares of 100 companies whose business is consistent with Islamic law and it is intended for those who wish to invest according to Islamic investment principles.

⁸ www.standardandpoors.com

⁹ www.invest-at.com

In essence, it is the performance indicator of global stocks destined for an investor in Islamic product. FTSE has created other indices also represent the performance of Islamic indicators such as:

- FTSE SGX Shariaa Index Series.
- FTSE DIFX Shariaa Index Series.
- FTSE Bursa Malaysia Series Index.

3.4.3. Socially Aware Muslim Index (SAMI)¹⁰

This is the first index that processes the listing of shares consistent with the Sharia, it was created in 1998 to represent the quotes of 500 Islamic firms.

3.4.4. Dow Jones Islamic Market DJIM

It's created in 1999 and it's the second Islamic index available to investors who want to invest in accordance with Sharia. This index is calculated on the basis the Laspeyres formula.

$$L_t = \frac{\sum_{j=1}^n p_{jt} q_{j0}}{\sum_{j=1}^n p_{j0} q_{j0}}$$

Where:

- p: price of the share j.
- q: number of the share j.

The DJIM index is always calculated on the basis of last price realized, conversions are made on the basis of the last exchange realized and excluded dividends reinvested.

Indeed, the DJIM index filter the prices in two times. The first is in accordance with Sharia, eliminating companies that invest in alcohol, weapons, pornography, tobacco and meat pork.

In the second time filtering is based on some ratios and has three levels:

- Excluding companies whose total debt exceeds 33% of the market capitalization or total assets.
- Exclusion of companies whose cash exceeds 33% of their market capitalization.
- Exclusion of companies whose receivables exceed 45% of total assets.

However, we should mention that these rates are not mentioned in the Koran or in the Sunnah but they are based on Ijtihad¹¹.

The Dow Jones has created other indices arising from DJIM such as:

- Dow Jones Islamic Market International Titans 100 Index: it contains the top 100 companies in accordance with the Sharia outside the United States.
- Dow Jones Islamic Market Titans 100 Index: measures the performance of the 100 best companies conform to the Sharia worldwide.

3.5. The Sharpe ratio¹²

The Sharpe¹³ index reflects the total portfolio risk (instead of the Beta coefficient). Under this method, the portfolio had the best performance was the one who provided the investor exceed the highest performance per unit of total risk.

It measures the profitability gap between a portfolio of financial assets and a placement in risk-free, it's calculated with the following formula:

$$S_p = \frac{\bar{R}_p - R_f}{\sigma(R_p)}$$

Where:

- \bar{R}_p = The expected return of the portfolio.
- R_f = Risk-free rate = 2.8.
- $\sigma(R_p)$ = Standard Deviation of the portfolio.

3.6. Jensen's alpha¹⁴

It determines the outperformance of the portfolio compared to that determined by the CAPM based on the following formula:

$$\alpha_p = \bar{R}_p - E(R_p)$$

¹⁰ Hélène. M (2010); Takaful in France tomorrow: fiction or reality?

¹¹ Ijtihad is a dynamic key of Sharia [HOSEN. N (2004)]. This is the ongoing process of developing the Islamic law that provides answers to questions of their times by the Koran and sunnah [Kayadibi.S (2007)].

¹² Andrew W.L (2002); The statics of sharpe ratios. Financial analysts journal ; pp36-52

¹³ Lahmeur. B (2009);The analysis of the financial performance of socially responsible funds in France.

¹⁴ Le Sourd. V (2007); Performance mesurement for traditional investment literature survey ; EDHE Risk and asset management research centre.

Where:

$$E(R_p) = R_f + \beta_p * [E (R_m) - R_f]$$

Where :

$$\beta_p = \frac{Cov (R_p ; P_m)}{\sigma^2_m}$$

- E (R_m): Market expected return.
- R_f: Risk-free rate.
- β_p * [E (R_m) – R_f] : Risk premium.

3.7. *Sortino's ratio*¹⁵

It expresses the return of a portfolio compared to minimum accrual risk and is determined using the following formula:

$$\text{Sortino ratio} = \frac{E(R_p) - R_f}{\sigma^2_d}$$

- R_f : Minimum acceptable yield.
- σ²_d : Down Side Risk.
- E(R_p) : Return expectation .

The difference between the Sharpe's ratio and the Sortino's ratio is that Sharpe uses standard deviation, denying if it's in rise or in fall , but the Sortino's ratio takes account into the standard deviation, i's to the decrease, but only common point is that both measure the compensation risk involved.

4. Results and Interpretations

4.1. *Performance of Islamic and conventional banks*

Total assets and total equity are size indicators because they cover the employment, the resources and the capital of a financial institution.

The difference between these posts, from one bank to another, giving rise to a large volume of business and this is why there is a difference in profitability between Islamic and conventional banks.



¹⁵ Tazé-Bernard. E (2006); Methods of risk portfolio control ; INVESCO circle.



Graph N°2- Potentiality of Islamic banks and conventional banks

The review of these posts return us to the study of rentability of both banks, to do this we based this part on the work of Kym Brown (2003)¹⁶ in which he makes a comparison between Islamic banks using the ROA and ROE. Based on same ratios Munawar Iqbal, Ausaf Ahmad and Tariqullah Khan¹⁷ made a comparison between shariah banks and conventional banks.

	ROA		ROE	
	IB	CB	IB	CB
2004	8,4%	7,2%	8,77%	12,90%
2005	10,6%	8,0%	8,66%	15,36%
2006	11,2%	8,2%	9,37%	16,02%
2007	11,0%	6,4%	8,20%	13,02%
2008	10,5%	0,5%	8,36%	1,01%
2009	9,5%	2,2%	7,78%	3,92%
2010	9,1%	3,0%	7,51%	4,92%
Average	10,0%	5,1%	8,38%	9,59%

Table 1: Rentability of Islamic and conventional banks

The exam of the above table shows that the ROA of Islamic banks follows an increasing rate until 2007 and from this date is decreased to 9.1%.

Indeed, the revenues of traditional banks represent 24 times that of Islamic banks and 28 times of total assets in 2004. This gap has narrowed and he reached 18 times of total assets and 2 times viewpoint income which can be explained by the high rate of growth of Islamic banks reached 20.5% on average.

In fact, although the CFI are making huge profits, they have not been able to achieve a greater ROA than the IFI.

Viewpoint ROE, Islamic banks follow the same rhythm as the ROA but at this time the ratio of conventional banks is better than that of Islamic banks by 1.21% because they have made respective average yields of 9.59% and 8.38 %.

However, we note that Islamic banks have been affected by the crisis, but this loss is neglected compared to conventional banks. In fact, the negative effect of crisis admits as origin the funds of Islamic companies and especially oil companies who are the main generator of funds for Islamic banks who have experienced a collapse during the crisis.

Finally, we note that conventional banks have an advantage over those Islamic but improving banking services and the creation of new financial instruments can improve the situation of Islamic banks.

After analyzing profitability we will study banks charges using two activities ratios, namely:

- Price of human capital = $\frac{\text{Employees expenses}}{\text{workforce}}$
- Price of financial capital = $\frac{\text{Interest expense}}{\text{Total deposits}}$

¹⁶ Brown.K (2003); Islamic Banking Comparative Analysis The Arab Bank Review Vol.5, No.2.Pp:43-50.

¹⁷ Iqbal. M, Ahmad. A et Khan. T (2007) : Challenges in the Islamic banking system. Occasional Paper No. 2 establishes the Islamic Research and Training, Islamic Development Bank; pp :1-99.

	Price of financial capital		Price of physical capital	
	IB	CB	IB	CB
2004	1,74%	3,11%	1,55%	9,23%
2005	1,97%	3,70%	2,20%	8,61%
2006	2,33%	5,20%	2,48%	10,13%
2007	2,54%	6,00%	2,87%	10,67%
2008	2,23%	5,22%	3,08%	8,42%
2009	2,01%	3,19%	3,04%	10,41%
2010	0,99%	2,37%	3,08%	10,08%
Average	1,97%	4,11%	2,61%	9,65%

Table 2: Cost of Islamic and conventional banks

Based on the graphic Number 2 we note that charges of Islamic banks are significantly lower than ones conventional and this is mainly due to the average size of banks whose based on Sharia. Islamic banks recorded an average rate of 2.61% against 9.65% for conventional banks and the difference between the two ratios is explained by the importance of the size of conventional banks. The price of financial capital is 1.97% for Islamic banks against 4.11% for conventional banks, these values are almost similar. However, if we assume that IB share the profits and losses in certain contracts and absorb all losses in other contracts that rate becomes completely logical.

That Islamic banks are facing to several types of risks they must meet prudential ratios like «Loans to deposit ratio» «LTD» which must not exceed 80%.

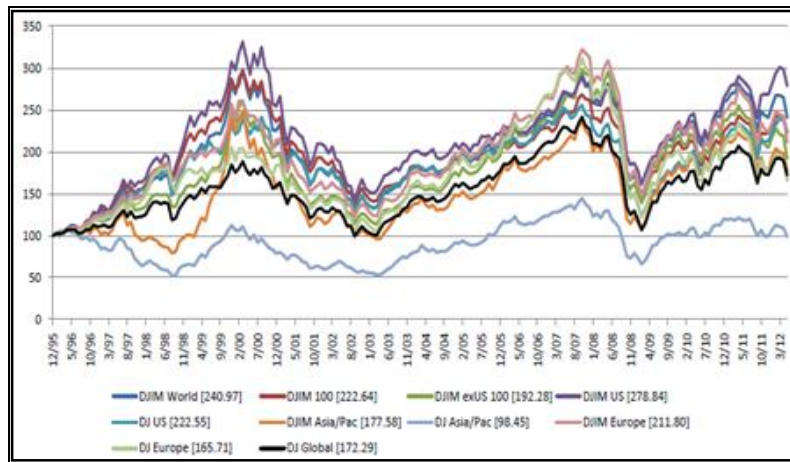
	LTD	
	IB	CB
2004	42,43%	88,42%
2005	41,14%	87,73%
2006	42,68%	91,98%
2007	47,12%	96,04%
2008	47,82%	103,63%
2009	46,49%	101,72%
2010	24,28%	99,35%
Average	41,71%	95,55%

Table 3: LTD of Islamic and conventional banks

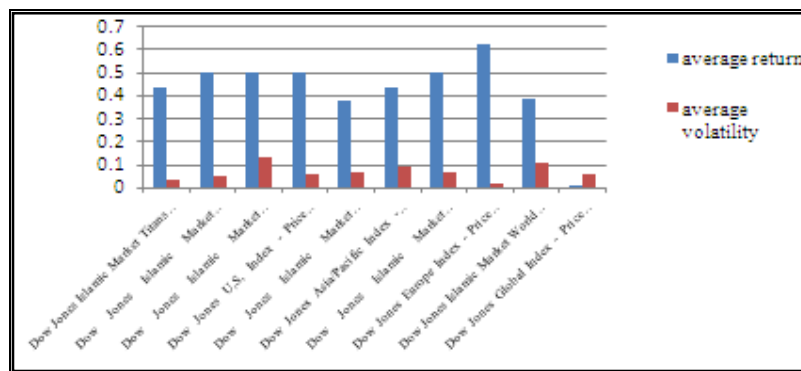
This ratio explain that conventional banks can not cope their customers requests in the short term because they have an average of 95.55% against 41.71% for Islamic banks. During the 2007 crisis, conventional banks have experienced a critical situation and they could easily go bankrupt because their LTD has reached 100% and even exceeded in 2008 and 2009 with 3.63% and 1.72% respectively.

4.2. Performance of Islamic index

Inspiring from the work of Sherif. K (2008), Hakim. S and Rashidian. M (2002) and the Hassan. MK (2002) we will study the performance of the Dow Jones Islamic Market World Index and the Dow Jones Global Index and their subdivisions.



Graph N°3- Cumulative performance of Islamic and conventional indexes¹⁸



Graph N°4- Average return and volatility of Islamic and conventional indexes¹⁹ (2005-2012)

Based on these two graphs we see that the DJIM index is less efficient in Europe and Asia. They are in phase in America but in overall DJIM index is more efficient. This result is not logical but it can be justified by the filtering system that eliminates commercial and Islamic banks because they are not many in Europe.

Viewpoint volatility, Islamic banks are more volatile because Islamic finance is the victim of its name and any terrorist activity impact instantly Islamic Courts.

In essence, we can say that the DJIM index shows a better performance than DJ index, but it is more volatile. To verify these results and to eliminate measurement bias in these indices we examine the performance of the two portfolios using three ratios namely:

- Sharpe Ratio.
- Jensen's alpha.
- Sortino ratio.

	Sharpe Ratio	Jensen's alpha	Sortino ratio
Dow Jones Islamic Market Titans 100 Index - Price Return	0.17	1.97%	0.12
Dow Jones Islamic Market International Titans 100 Index - Price Return	0.07	0.87%	0.05
Dow Jones Islamic Market U.S. Index - Price Return	0.27	3.30%	0.19
Dow Jones U.S. Index - Price Return	0.16	1.80%	0.11
Dow Jones Islamic Market Asia/Pacific Index - Price Return	0.04	0.70%	0.02

¹⁸ Dow jones index analytics (2012).

¹⁹ Dow jones index analytics (2012).

Dow Jones Asia/Pacific Index - Price Return	-0.27	-2.69%	-0.17
Dow Jones Islamic Market Europe Index - Price Return	0.12	1.57%	0.09
Dow Jones Europe Index - Price Return	0.00	-0.12%	0.00
Dow Jones Islamic Market World Index - Price Return	0.19	2.15%	0.14
Dow Jones Global Index - Price Return	0.02	0.00%	0.02

Table 4: Performance of Islamic and conventional indexes

Based on this table we can conclude that the securities in accordance with the Sharia are more efficient than ones conventional and Asian industries must rely on traditional savings because it gives them access to a better profitability than that provided on the market.

The Sharpe ratio row to DJIM index is better than who's allowed to DJ index and this is owing to better asset allocation. The Sortino ratio is able to confirm the results of the Sharpe ratio by displaying the same result structure.

Moreover, the DJIM index outperformed the return required from the CAPM by 2.15%.

According to the work of Hakim. S and Rashidian. M (2002) we can say that Islamic indices are more efficient than traditional indices in the period of crisis and they are also more sensitive to changes in trajectory because their growth and decay seem faster than conventional indices.

In contrast the work of Hassan MK (2002) concluded that the volatility of Islamic securities is linked to the operational inefficiencies but we have linked the volatility of returns to socio-political and psychological phenomenon of investors.

In the following we will consider some events that could divert Islamic investment. To do this we set the variation in yields of Islamic securities as a function of the number of attacks, number of dead and injured in non-Muslim countries (Europe and America) and in the entire world.

Knowing that the Durbin Watson in our work is 1.54 and 1.56 we can say that the variables selected in this study are relevant. To remove any doubt we made the cointegration test variables and got the following tables:

Throughout the world	R	M	B	A
R	1.000000	-0.265248	-0.291532	-0.572273
M	-0.265248	1.000000	0.982498	0.557062
B	-0.291532	0.982498	1.000000	0.449352
A	-0.572273	0.557062	0.449352	1.000000

Table 5: Variables Cointegration

In non-Muslim countries	R	M	B	A
R	1.000000	-0.713944	-0.917313	-0.905221
M	-0.713944	1.000000	0.686810	0.817512
B	-0.917313	0.686810	1.000000	0.908259
A	-0.905221	0.817512	0.908259	1.000000

Table 6: Variables Cointegration

This work show that actions perceived as terrorist in Europe and America impact the return on Islamic securities by 87.11% and 73.02% in the world which validates our hypothesis (see following table).

Variable	Throughout the world	In non-Muslim countries
M	0.052* (0.125)	0.032 (-0.001)
B	0.024* (-0.057)	0.016 (-0.02)
A	0.119** (-3.645)	0.381 (-0.272)
C	9.871*** (20.716)	5.663*** (22.735)
R-squared	0.732044	0.871182

Ajusted R-squared	0.531078	0.774569
Log likelihood	-29.81890	-26.88921
DW Stat	1.562521	1.545131
F-statistic	3.642614	9.017191
Prob (F-statistic)	0.121921	0.029744

Table 7: Estimation of variables

5. Conclusion

The objective in this work was to study the performance of Islamic banks and Islamic index and compared them to conventional banks and conventional index.

Through the analysis of different ratios we have determined that, despite the fact that Islamic banks are less profitable, they are more efficient and more robust than conventional banks so they are more performant.

Islamic finance, however, remains dependent on some acts attributed to the violence practiced by the entities claiming terrorism and belonging to "Islamic" movements. Indeed, the study showed that after some terrorist events excessive volatility was observed.

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