The performance of Islamic mutual funds, why is it not better than conventional?

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Abstract

The Islamic mutual funds aim to safeguard the Moslem community from riba, masyir, and gharar. However, the product still has a problem related to the performance. Based on the literature review, Islamic mutual funds cannot outperform the market benchmark and the conventional mutual funds. It happens because of some factors in the Islamic mutual funds product. Unskilled manager is the internal factor causing the lack of Islamic mutual funds’ performance. It is because the manager does not have many choices in making portfolio aligned with Sharia. Then, the external factor is about the regulation itself relating to the government policy. In this paper, the writer aims to offer the solutions. Firstly, Islamic mutual funds have to be bravely different to give clear identity as fully Sharia-compliant in purpose to attract Moslem communities to invest. Secondly, the government has to promote Islamic funds market to be more developed.

Key words: Islamic Mutual Funds, Conventional, Performance Comparison

Introduction

Islamic economics is a meeting point between the value of Islam and the economics itself. Islam views that economic activity has to be shariah compliance. It means free from usury, gharar, and masyir. On the other words, it has to be done in halal way which is allowed in Islam. Nevertheless, being halal and permissible in Islam are not enough for the investor. Because one of the ultimate reason for the person who invests his money in the market, especially in mutual funds, is willing...
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to earn money. With earning a good return, he will have a lot of money to accumulate his wealth and it can be used to invest in another market which will contribute to economic life.

Based on the main reasons mentioned above, it is very important to the investors to know the return and the risk faced in Islamic mutual funds. In this case it can be seen that actually Islamic mutual funds return gives a less return than conventional counterpart. The risk also exhibits that it is higher than conventional counterpart in many markets except sukuk or Islamic bond market which has less risk. Hence it is current issue which is interesting to be discussed among Islamic scholars related to how makes Islamic mutual funds more profitable than conventional counterpart. Amin (2013) explains that the motivation of the consumers when choose Islamic product is based on the reasons which are attitude, subjective norm, and perceived financial cost. Those of the reasons influence the intention of the consumers significantly. Another research related to the intention of consumers was conducted by Dasuk & Abdullah (2006) saying that the main motivation of the consumers depended on a combination of Islamic and financial reputation and quality service offered by Islamic institution. Other factors which also influenced are responsibility practices, convenience, and product price.

Then, it is very urgent to make as discussion, in order to have a enough knowledge in analysing the reasons making the return and the risk of Islamic mutual funds which are lower and higher than conventional counterpart respectively. Hence, with analysing this issue, Hopefully it can give a point of view related to the reasons aligned to the fact finding. By using the fact and the reason which are available, it can be made a solution as a insight to solve the problem.

In this research paper, the researcher is divided into five sections. Section one briefes the background of the research. Section two and three delineate literature review and methodology respectively. Section four is about the discussion of the issue in term of looking for of the best solution of the issue. Then, the last section tells about the conclusion of the paper.

Islamic Mutual Funds

Every person having money needs to accumulate his money with investing it in many sectors such as capital market. One of the capital market product is mutual fund. Barom (2015) defines mutual fund as subset of capital market which is collective investment and it consists of many securities with pooling it from the investors. In detail, mutual fund will be managed by fund manager of the company. As the manager, he will make portfolio consisting many securities which will give investors certain return.

Based on the structure, mutual fund is three parties agreement which engage trustee, fund manager, and investors. As it was explained before, the fund manager has a duty to make portfolio which will be offered to the investors. Then, the manager has to promote the funds, service the the investors and prepare to buy back the shares. In the other hand, if the fund manager wants to offer the shares to the investors, it needs trustee who will guarantee the earning got by the investors and make sure that the objectives of the investment will be done by the fund manager as well. In issuing the shares, the fund manager will not hold the asset but it is held by the trustee. As a part of parties, the investors are entitled to earn return based on how much they invest in mutual funds.

In case of Islamic mutual fund, shariah committee has to be provided to oversee that the offered products are fully shariah compliance. Shariah committee will guide the fund manager to choose the products categorised shariah compliance. The shariah compliance products commonly will be screened by security commission with using certain indicator or methods consisting qualitative and quantitative method. On the other words, Shariah committee has a big task to ensure that the fund manager will commit to the provisions aligned with shariah compliance products in providing units to the investors.
In general, shariah principle encourages the business activity especially in Islamic capital market to be free from usury (riba), gambling (maysir), and ambiguity (gharar) activities (Abdullah et al., 2007). It means, the investment activities have to adhere in shariah principle, such are firstly, the investment must be made in ethical sectors and the profit got is not allowed in prohibited activities like liquor, pornography and others. Secondly, return of the investment activity should be gained based on the risk and profit sharing and freed from interest, gambling, and ambiguity. In the kind of Islamic mutual funds point of view, actually it is same as conventional in addition the securities within the market are totally shariah compliance. The kinds of Islamic mutual fund which exist are equity funds, bond funds, balanced funds, index funds, money market funds, fixed income funds, feeder funds, and mixed asset funds.

In studying about measurement of the risk and return in the market, the portfolio measurement can use certain methods to know it is appropriate investment or not. Ferdian & Dewi (2012) suggest that to measure the performance, a fund manager or the investor can use treynor index and sharpe index to know the return which will be got compared to the risk. Treynor is defined to measure return gained in excess of portfolio average return and risk-free rate average return towards beta of the portfolio (Investopedia, 2015). It means that treynor tries to adjust the return earned by the company to the systematic risk in the market. Of course, after calculating the return adjusted to the market, it will have a different to the return before adjusting to the market. Commonly, the return adjusted market risk will be smaller because it will be divided by beta exhibiting the market risk or volatility of the market.

However, actually many practitioners and academics usually use sharpe ratio to measure the performance of the portfolio especially mutual fund. Abdullah et al. (2007) define the sharp measurement with using formula explaining that excess return between portfolio return and market return divided by standard deviation. In the sharp measurement, the excess return will be divided by total risk which is from portfolio itself and market risk. So, the result of the measurement is considered more accurate in calculating the return adjusted to the risk.

**The performance of Islamic and Conventional funds**

Talking about the performance of mutual funds, it will correlate to funds market such as equity market, money market, commodity market, and others. Based on Global Islamic Fund issued by Malaysia International Islamic Finance Centre (MIIFC) in 2013, it was noted that the growth of mutual funds was developing fastly. It could be seen from Asset Under Management (AuM) reaching USD73.7 billion in December 9th 2013 at CAGR of 9.41%. It grew faster which reached at USD29.2 billion AuM market in 2004 previously. It means that the AuM grew almost triple over 9 years. The number of funds also grew sharply with having 285 funds in 2004 to have 1053 in 2004. It means that it had grown almost fourth times over 9 years.

The impressive performance experienced by Islamic funds is dominated by two countries which are Malaysia dan Saudi Arabia. According to that report, Malaysia and Saudi Arabia had 28% and 20% in case of Islamic fund numbers. It can be interpreted that both of two countries have barely a half of total Islamic fund numbers around the world. Actually, the higher number of Islamic funds in Malaysia is caused by Malaysian government’s support to make Malaysia as a hub of Islamic finance in the world. It is because the Malaysian government tries to stimulate the market with not giving any strict regulation in making Islamic funds market framework. However, it is different from asset domination which was controlled by Saudi Arabia with having 41% Islamic funds assets followed by Malaysia with 22%. It can be seen that although Malaysia has the higher number of product, the value of the asset was less than Saudi Arabia in 2013. In Islamic funds market, equity market was still dominant with having 34% of the market proportion followed by money market and commodity with 19% and 15% respectively.
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Compared to conventional mutual funds market, actually it has a big gap between conventional and Islamic mutual funds itself. Based on the global Islamic finance forum report 2013 by MIFC only had less than 1% asset value compared to global asset under management. Investment factbook report noted that the asset of mutual funds reached USD$ 30 trillion globally (Investment company fact book, 2013) in which USA had the biggest asset with around a half of global asset in conventional mutual funds followed by Europe, Africa and Asia Pasific and other America with 31%, 12%, and 7% respectively in 2013. The same as Islamic mutual funds, In the conventional, domestic equity funds was the main market used to make portfolio. But there is any different in which the growth of the market of Islamic mutual funds is higher than conventional peer, then the return is less and the risk is higher than conventional mutual funds.

The Study of contemporary Islamic Scholar

Researchs discussing about Islamic mutual funds market have so many perspectives in which commonly compare between Islamic mutual funds to conventional counterpart. But by using those widely, many researchers tried to divide it more specific. Some of them tried to analyse the performance between Islamic mutual funds and its peer. On the other hand some researchers also tried to discuss the Islamic mutual funds performance in certain country, such are in Saudi Arabia, Malaysia, and others. By giving different point of view in this paper, the reader will acquire a references in evaluating the performance of both Islamic and conventional mutual funds deeper.

Kraeussl & Hayat (2013) started to research the mutual funds based on the characteristics risk and return of Islamic equity funds. This research used 145 Islamic Equity Funds (IEFs) in weekly period from January 2000 to Februari 2009 which had 475 weekly returns. The samples consisted to many ETFs which was from many countries. But, most of the sample were from Malaysia. It was studied because Malaysia is well-known as the leading country in issuing sukuk with having the highest number of sukuk in the world. In evaluating globally, Dow Jones Islamic Index (DJII) and Dow Jones World Stock Index (DJWSI) were used as benchmark and Kuala Lumpur Composite Index (KLCI) was also used as local benchmark. For other countries such as Saudi Arabia and others would use its benchmark depending on the benchmark used in the country itself.

The research, which used regression analysis, related to the IEFs performance and conventional counterpart found that IEFs did not outperform towards the conventional performance and the benchmark IEFs itself. It was found also that IEFs manager underperformed when comparing to conventional counterpart in making a good portfolio for the shares although the result was not totally significant. Those findings were caused by Malysian IEFs which slightly outperformed to its benchmark. Meanwhile, the risk of the IEFs including benchmark risk was higher than conventional counterpart. It could be portrayed from the number of alpha and beta which were totally higher than conventional risks.

When the crisis came in 2008, the evidence of the data in the reseach revealed that IEFs market was tougher than conventional equity funds market. It could be exhibited from the risk which was the beta and alpha that the IEFs market was lower than conventional counterpart. But, it still had to be noted that both of two underperformed. Although it was better than conventional, the IEFs had a big problem with the skill of the manager when the crisis happened in 2008. The big loss experienced by IEFs. It was caused by many factors, firstly, the fund manager was a poor stock pickers when turmoil financial market happened. Secondly, the number of the IEFs was still small which meant that the fund manager could not diversify the portfolio as well as in conventional equity funds market. The thirdly, the fund manager was forced to sell the securities with a big loss because avoiding the Islamic screening proces which
is not allowed to have unislamic equity in the portfolio. The main reason was because the company tended to have a bigger ratio in debt during the crisis compared to to normal condition.

Risk and return analysis on performance Islamic mutual funds was also studied by Bhatti & Mansour (2011). This research tried to examine the performance of Islamic mutual fund in Malaysia when it was compared to the conventional peers and the market benchmark. The researchers took the monthly data of average return from January 1996 to April 2009 and KLSI Index was used as the market benchmark. That period was chosen because the Islamic mutual funds was considered to be mature relatively at that time. The finding of the research is that the Islamic and conventional mutual funds got the positive return and they could outperform to the market benchmark if it was calculated by using average value. Actually there was a fluctuative value over the observation over the research time. Compared to the previous result, it was slightly different than the research done by Krausell & Hayat (2013).

It has to be noted that there also had the same result saying that conventional mutual funds was better than Islamic. But in the test of the difference by using independent sample t-test, there was no significant different between conventional and Islamic return. In the risk case, Islamic mutual funds got the higher value than conventional counterpart. It had a significant different also between those in the risk case. It proved that Islamic mutual fund had been worse performance, in term risk and return, if it was compared to conventional counterpart. The study also revealed that between Islamic and conventional mutual funds had a strong correlation to the market. It meant that the condition of the market would give the big and significant impact to the Islamic and conventional mutual funds as well.

The unique result of the research was found by Haron & Ahmad (2004). In the introduction of the research, they said that honestly mutual funds had inconsistent performance in the market. It is caused by the conventional and Islamic funds tended to outperform only during their market bearish period but they would be underperform when the market was bullish. It is also said that in the West, Malaysia, and Singapore were not able to outperform in the market. Based on the fact had found by them before, they did research related to the topic which wanted to compare the performance between Islamic and conventional mutual funds deeply.

The data used was 12 Islamic mutual funds and 77 conventional mutual funds as a sample from Islamic and conventional mutual funds products which were available in the market at the time. Besides of that, the researchers also used secondary data got from fund manager’s selling price, KLSE composite index (KLCI), syariah index (KLSI) and Bank Negara 3-month treasury bill over period of 36 month from February 2000 to January 2003. In this case, the time of observation was divided into three separated time which were year 1 (February 2000 to January 2001), year 2 (February 2001 to January 2002), and year 3 (February 2002 to January 2003). Then, the source of the data also used daily quotations from many news papers and statistic data which were provided in Malaysia. The performance of the mutual funds was measured by using many theoretical models such as treynor, sharp, and jensen model.

The result revealed that by using Sharp measure, both of Islamic and conventional mutual funds could not outperform the market. But the Islamic mutual funds had better result than conventional counterpart with 25% and 16% which were managed better than the market respectively. On the other sides, when the researchers used Treynor and adjusted Jensen indices, the result was different. Only 10 conventional mutual funds were able to show positive indices while Islamic indices had a negative performance indices. It could be concluded that Islamic return tend to be losers because it was unable to outperform the conventional funds and the shariah index benchmark over the period of study. The finding of the result aslo described that Islamic mutual funds had less risk than conventional. It was also effected to the performance, based on the theory also, of Islamic mutual funds which would outperform in market bearish and underperform in market bullish. In the diversifying securities point of view, both Islamic and
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conventional were bad in doing it. In the end of the observation, the researchers finally concluded that actually the conventional mutual funds performance was a bit more appealing than Islamic mutual funds, but for the investor which tended to seek security and ethical conscious, Islamic unit trust was recommended to be chosen.

In Saudi Arabia, as the second largest industry of mutual funds based on the number of provided mutual funds and the largest in the asset around the world, the development of mutual funds are growing onward. Asahraf (2013) tried to evaluate the relative performance of IMFs and conventional funds during the global economic crisis in the context of the Saudi Arabian Capital Market. The data used was from mutual funds listed on TAWADUL with calculating the return from NAV monthly. The researcher observed 159 mutual funds which was consisted to 43 conventional and 116 Islamic Mutual funds. Then, it was separated to three categories: Saudi Arabia, International, and GCC/Arab funds. The indeces used were TAWADUL All Share Index (TASI), Global GCC Investable index 100, and All World Index for regional benchmark in Saudi Arabia, GCC benchmark, and International benchmark respectively. For the shariah indeces, it would be aligned with related index and category.

The research found that the Islamic Mutual Funds had a good choice when selecting the available securities in the market compared to conventional counterpart. It was indicated by the result showing the negative finding in case of stock selection capability done by conventional mutual fund manager. But in the statistic test, the difference between Islamic and conventional mutual funds in this case was not significant. In standard deviation point of view, it could be found that there had a difference between conventional and Islamic mutual funds significantly. It revealed that Islamic mutual funds performed better in the excess return but it had a higher volatility and more risky to the market volatility.

In general, the result of the research highlighted the performance of Islamic mutual funds and conventional funds, but the researcher was more focusing the issue in the Islamic mutual fund point of view. It can be concluded that in the crisis condition, Islamic mutual fund could perform better. Unfortunately, in normal condition the conventional performance was better than Islamic. The finding telling that the mutual fund manager could make a good portfolio in mutual funds distinguished from another research such as what happened in Malaysia. However, the research finding also revealed that the market timing of the manager when trying invest in the market was not better as conventional mutual fund manager who made a good decision when facing with lower market return or in the certain condition of the market.

Hopner et al. (2010) tried to research unit trust by using wider sample which wanted to look for an evidence from 20 countries which involved 256 Islamic equity funds. In this research, the researchers tried to answer three big questions. Firstly, the difference of equity mutual funds performance from equity market benchmark. Secondly, looking for a style which was appropriate in Islamic equity funds, and thirdly, searching the explanation if the performance of Islamic equity funds in each countries were different.

In analysing data, the researchers criticize the previous researches which were viewed having lack in analysing data. So, in the first path the researchers tried to know the characteristic of the data using descriptive statistic analysis. It was used to understand the nature of the performance of Islamic equity fund in each countries. In detail, the researchers tried to describe the nature of law with concluding the suprised result showing that in the muslim countries, the development of mutual funds was lower than non-muslim countries, in case of UK, although the regulation of muslim countries used to be prescribed to Islamic law. The different performance was also influenced of the restriction done by each countries which would affect to cash inflow and outflow in investing mutual funds.

The result of this research portrayed the strong influence of the Islamic market development to the performance of Islamic mutual funds. It could be categorized into two types.
First, the Islamic equity fund could be delivered significantly positive abnormal return in six countries having the best developed Islamic financial market which were Bahrain, Kuwait, Malaysia, Qatar, Saudi Arabia, and UAE. Even in Qatar and UAE, they could outperform their international benchmark. Second, In contrast, the eight of the fourteen countries with lesser developed Islamic financial market did not significantly ourperform to their benchmark. The countries meant were Australia, Germany, Liechtenstein, Luxembourg, Morocco, South Africa, and UK. In the other words, it could be interpreted that the development of Islamic financial market had a positive effect on Islamic fund performance.

Uniquely, In the end of the research the writers did not want to generalise the research about the performance of Islamic funds around the world. It was because the researchers realized that the performance of Islamic funds in each countries had its specific factors which would give the different result for each observation. It was assumed that its factors would explain the heterogenity of Islamic funds performance around the world. But, the researchers also acknowledged that six largest Islamic financial centres in GCC and Malaysia could outperform of their international benchmarks. Vise verca from those facts, in the west country such as UK and others, they still trailed their benchmark.

Method

This research uses qualitative method as the main methodology especially by using library research and comparative analysis. In this study, the sources of the data were got from the journals, books, the recent data which is available in websites coming from Security Commission of Malaysia, Malaysian International Islamic Finance Centre (MIFC)'s data publication, and Investopedia.

Result and Discussion

The some of literature reviews discussed previously exhibit that the performance of Islamic mutual funds is still lack than the conventional counterparts. It is not only in the return, but also the risk. Yet, some of the literatures says that when the bearish economic condition, the performance of Islamic finance is better than another. In the other finding is also said that the unskilled manager of Islamic mutual funds is one of the main problem to get better efficiency in managing Islamic portfolio. It is because, the Islamic fund manager does not have many choices in making portfolio caused limited available securities in Islamic funds market. It is also said by Abderrezak (2008) saying that when the economic condition declined, the ratio of the debt in Islamic company would be higher, then it tended to pass the limitation ratio of debt causing that company could not keep that limitation itself. Because of that, the company was not shariah compliance anymore. In Islamic manager point of view, of course it is difficult situation which force the manager to sell the security relating to that company. In the other words, the shariah mutual funds has a bigger turnover than conventional counterpart.

Based on the problem which is already elaborated before, it can be arranged some paths to solve those faced problems. The offered problem solvings are not for the short-term only, but it is for the long-term to build and strengthen the mutual funds around the worlds. The first problem solving is building the identity of mutual funds itself. In the begining of this article, the writer already said that the main motivation of the people to choose Islamic product is the shariah reason itself (Dasuki & Abdullah, 2006). Building identity means that the unit trust product has to make a big different to the conventional. The difference means that the practical activitities such as how to treat the customers are will be very important to the customers.
Because nowadays, the customers still see that between the Islamic and conventional mutual funds or Islamic financial products in general are almost fully same. This perception happened in the west country applying Islamic finance like United Kingdom. Akbar et al. (2007) found the fact from Islamic banking practice that the moslem customers felt the Islamic banking did not fully align with the shariah although they appreciated to profit-sharing concept in Islamic finance. Then, they also realized that the complicated practical activity in Islamic banking was the main cause not to do fully shariah compliance activities. By using a simple words, in building the identity of Islamic mutual funds also means that the Islamic mutual funds have to take a distance away from the conventional mutual funds. With almost two billion moslem population, Islamic mutual funds will have a big chance to develop better if it can built its own identity. But, it has to be balanced with promoting Islamic unit trust to people as well.

The second problem solving is enhance the role of the government as the pivotal party which can build the Islamic financial industry. A study done by Hoepner et al. (2010) found the fact telling about the differences of characteristic among in each countries. Those difference is caused by regulation used especially in restriction point of view. As we already discussed before, there are two types of restriction ; inbound and outbound restricton. When we look malaysia as the biggest industry in mutual fund base on number of product, it can be known that the development of Islamic mutual funds industry is effected by the policy using outbound restriction. It means, Malaysia open its hands to accept all foreign investment to the country but restrict local investment to go abroad. So, the effect of those things make internal Islamic mutual funds market in Malaysia can develop well. It can be felt the fast development in increasing the number of equity funds sharply. Based on the data issuing by Security Commision in 2015, especially in term of equity fund, 80% of stocks are shariah compliance. But, it has to note also that the Malaysian government gives incentive of regulation such as tax for the company trying to be shariah compliance company specifically in financial sector.

Inversely, Some country such as GCC countries, Egypt, Indonesia, Pakistan, and Singapore use outbound restriction (Hoepner et al., 2010). It means that the those countries make some of regulations to give a burden for foreign investors to invest inside the country. For example in Bahrain Stock Exchange (BSE) allow GCC’s people to have 100% in ownership but for foreign investors coming from non GCC countries, they are only allowed to have 49% in ownership. With using this policy, It has a big disadventgae for the economic development inside the countries. Because, the economic of the country will not have a big source to develope well. Based on those policy, the countries using it does not have a high number in Islamic funds except of Saudi Arabia which is well-known as rich country.

according to those decision, it can be highlighted that the development of Islamic mutual fund will depend on the policy. For the rich country, making a big restriction may not be a big problem because the country has a lot of money got from state owned industry. But, with making less restriction, it can help the Islamic mutual funds market more developing. Making less restriction is still needed remembering the asset of Islamic mutual funds is less than 1% compared to conventional mutual funds as a whole. So, by opening market with less restriction, it can increase the number of asset and products in Islamic mutual funds industry. By having a big size in market tends to have a better efficiency (Fakhrunnas and Arifin, 2014)

By increasing the number of mutual funds, the company manager will have many securities to be chosen. It means, the company manager can also create the portfolio which has a good return and less risk to the investors. If it is already created, the chance of Islamic mutual funds is very big to outperform the market and the conventional peer. So, by building identity of Islamic mutual funds and having a good support from the company, Insha Allah it will make the Islamic mutual funds better. But, we have to remember that those solutions it for long-term
solution. So, it will take a lot of time to do it in reality and the result of the solution can be seen step by step.

Conclusion

Islamic mutual funds is one of the product on Islamic capital market which tries to safeguard the moslem community from usury, maysir, and gharar. But, the task of Islamic scholars and people in engaging to that product still do not finish yet. This is because the performance of Islamic mutual funds is not better than conventional counterpart and the market itself. Regarding to the literature reviews, the performance of Islamic funds toward conventional funds rely on the internal (the skill of manager and the number of products) and external (economic turmoil, government’s policy) as the prominent factors. In this paper, there are two solution which are offered. First, Islamic mutual funds has to be brave to be different. It mean, it has been different from conventional concept significantly. It is used to attract the moslem community to invest in the fully shariah compliance product. Second, the government has to promote Islamic mutual funds to the market. The promotion that has to be done by the government is giving many incentives to the market players when they invest in the market such as what happen in Malaysia. If the Islamic capital market can develop well, the Islamic mutual funds tends to develop as well because the available products in market funds are available.

References


