

A Review of Securities Commission of Malaysia's Revised Shariah Stock-Screening Criteria

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Abstract

This paper addresses the perceived more tolerant Shariah-screening criteria by the Securities Commission of Malaysia (SCM). Recently, in 2013, SCM introduced the "two-tier" screening process of the stocks traded on Bursa Malaysia. Despite this revision, the two-tier process is seen as being less stringent than the Shariah-screening process of e.g. Dow Jones and MSCI. Such perception may affect the credibility of the SCM in determining Shariah-compliant securities compared to international standards. Proponents of SCM screening criteria argue that since Shariah screening in Malaysia only includes Malaysian listed stocks, more rigid screening process may limit the list of investible stocks, and may further restrict the benefits of diversification, i.e. one may not be able to form efficient portfolios or achieve appropriate risk-return portfolios while complying with the Shariah principles. This paper argues that the justification for the less-stringent screening process adopted by the SCM does not seem to be corroborated by theoretical or portfolio diversification studies, and evidence from the socially-responsible investing and Shariah-compliant empirical findings.

Keywords: Shariah screening; Islamic stocks; Malaysian stock exchange; Shariah-compliance.

1. Introduction

This paper reviews the Shariah-screening criteria by the Securities Commission of Malaysia (SCM), which is considered to be more tolerant towards "mixed" business activities by companies, compared to the more stringent screening process of other Shariah screening providers, e.g. Dow Jones², and Morgan Stanley Capital International (MSCI)³.

With the substantial growth of the equity markets in Islamic countries, a specific need has arisen to provide a proper guide for Muslim investors in participating in equity investments. At the moment, several securities market authorities (e.g. Securities Commission of Malaysia) or private financial institutions (e.g. Meezan Bank in Pakistan) have taken the initiatives to set up a local Shariah advisory council or committee to facilitate the creation of the so-called Shariah stock index, by coming up with the Shariah screening procedures and guidelines for local stocks.

In addition, to cater for the needs of international investors in the international stock markets, a few other well-known stock index providers have also come up with their own Shariah-approved stock indices, e.g. Dow Jones, MSCI, and Standard and Poor (S & P). However, with the absence of an internationally-recognized Shariah screening standard, the decisions to list a stock as Shariah-compliant or not are left to the provider to decide, due to the discrepancies in the process of screening the stocks.

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²<http://www.djindexes.com/islamicmarket/>

³<http://www.msci.com/products/indexes/thematic/faith-based/islamic/>

Shariah-screening process of stocks began as early as the 1990s in Malaysia, followed by other stock markets and providers as we observe today. In Malaysia, this task currently is officially undertaken by the SCM,⁴ which sets up and appoints a group of scholars in Islamic jurisprudence, economics and banking to sit on its Shariah Advisory Council, who then advises SCM in drawing up the guidelines on the Shariah screening process. Recently, in 2013, SCM introduced the “two-tier” screening process of the stocks traded on Bursa Malaysia. Despite this revision, the two-tier process is seen as being more “friendly” towards companies which are involved in “mixed” business activities. As suggested by Sani and Othman (2013), the perception of “liberal” screening criteria applied by the SCM also affects the credibility of the SCM in determining Shariah-compliant securities compared to the international standards.

A company is considered to be involved in mixed business given that it is involved in some prohibited business activities, e.g. from non-halal business or from interest-based earnings. While Dow Jones and MSCI are more stringent in treating mixed business companies from the Shariah-compliant consideration, SCM does not do so under its new guidelines. Instead, under its two-tier screening process, it retains these companies for further investigation and screening, before a final decision is made regarding their Shariah-compliant status.

Proponents of SCM screening criteria argue that the decision to liberalize the screening process is understandable given the economic realities of the Malaysian stock market. Since Shariah screening in Malaysia only includes Malaysian listed stocks, more rigid screening process will further limit the investible universe of stocks eligible for Shariah-compliant investors or funds, unlike Dow Jones which include a much larger set of compliant stocks from around the global markets.

Proponents of Malaysia's screening methodology further argue that from a portfolio theory viewpoint, a smaller investible group of stocks restricts diversification and limits the benefits of diversification. Having a limited number of investible stocks (arguably), means that one cannot form efficient portfolios or achieve appropriate risk-return portfolios from the very restrictive number of stocks available for trading while complying with the Shariah principles. The net result would be portfolios that may be purer but not necessarily efficient from a risk-return viewpoint. In other words, stringency in stock screening is not costless. As with everything else in economics, there is a tradeoff. In this case, the cost may be less efficient portfolios.

This paper argues that the justification for the less-stringent screening process adopted by the Securities Commission of Malaysia does not seem to be supported by empirical evidence or theoretical explanations. We provide discussions from the portfolio theory and studies of the optimal number of stocks needed to fully diversify a portfolio of investments, as well as empirical evidence from studies which have investigated the performance of socially-responsible investing (SRI) and Shariah-compliant investments from several stock markets.

The rest of this paper is organized as follows. Section 2.0 compares the different Shariah-screening criteria between Securities Commission of Malaysia, Dow Jones, and MSCI. Section 3.0 provides the theoretical arguments and empirical evidence in favor of or against the perceived less stringent Shariah-screening, criteria in Malaysia compared to the international index screeners. Section 4.0 concludes the paper.

2. Comparisons of Stock Screening Process Across Islamic Index Providers

Shariah stock screening process represents the process of identifying Shariah compliant equity investments incorporating certain compromise or tolerance. In general, several major elements are typically addressed when performing Shariah screening of shares, which include business activity or sector screening, debt financing or leverage screening, interest-based revenue screening, and dividend or income purification screening.

Currently, there is an absence of international Shariah standard for equity screening (Jamal et al., 2010). Therefore, different Shariah index providers or different Islamic equity funds have set up their own Shariah advisory committees to formulate the Shariah screening criteria, which tend to be slightly different from one another. One of the major issues resulting from the non-unification of Shariah screening criteria is when a company's core business is permissible, but at the same time, it is also involved in some prohibited business (Jamal, et al., 2010).

⁴<http://www.sc.com.my/>

In this matter, Dow Jones, MSCI, and the Securities Commission of Malaysia for example, apply different treatments when dealing with the mixed companies. Dow Jones immediately drop the mixed business company from compliance consideration, whereas MSCI and SCM impose additional screening but with different criteria. Among these three screeners, SCM's criteria are considered to be the least stringent. The Shariah screening methodologies of Dow Jones, MSCI, and Securities Commission of Malaysia are described below.

2.1 Dow Jones Islamic Index⁵

The Dow Jones Islamic Indices represent global Shariah-compliant indices which are classified under four main categories, i.e. the Blue Chip Indices (e.g. Dow Jones Islamic Market Asia/Pacific Titans 25 Index, Dow Jones Islamic Market U.S. Titans 50 Index, and Dow Jones Islamic Market International Titans 100 Index), the Broad Market Indices (e.g. Dow Jones Islamic Market Emerging Markets Index, Dow Jones Islamic Market Europe Index, and Dow Jones Islamic Market GCC Index), the Fixed Income Indices (e.g. Dow Jones Sukuk Index), and the Strategy and Thematic Indices (e.g. Dow Jones Islamic Market BRC Index, Dow Jones Islamic Market and Global Finance and Takaful Index, and Dow Jones Islamic Market Sustainability Index). Each index represents stocks and fixed income investments from global markets which have been screened for their Shariah compliance. By screening stocks for consistency with Shariah principles, the indices help to reduce research costs and compliance concerns for Muslim investors who wish to participate in stock investments around the world.

Dow Jones begins the screening process by eliminating companies which are involved in any of the following business activities or products, which include alcohol, pork-related products, conventional financial services such as banks and insurance companies, entertainment business such as cinema and music production, gambling and gaming, tobacco manufacturing and sales, hotels, weapons and defense, and real estate holding and development companies. Companies which are involved in any of the above activities are immediately excluded from the investable stock list.

In addition, stocks of companies are financially screened to ascertain the (excessive) level of (interest-based) debt utilization, as well as interest-based income and expenses. In this context, stocks are screened based on the following ratios, i.e. the ratio of total debt divided by trailing 24-month average market capitalization, the ratio of the sum of a company's cash and interest-bearing securities divided by trailing 24-month average market capitalization, and, the ratio of accounts receivables divided by trailing 24-month average market capitalization. For each of these financial ratios, the threshold allowed by Dow Jones is 33 percent. In this regard, even for companies which have met the qualitative screening in terms of their business activities, they will be eventually classified as non-Shariah compliant if any of the above financial ratios exceeds the threshold allowed.

2.2 MSCI Islamic Indices⁶

The Morgan Stanley Capital International or MSCI Islamic Indices are constructed from underlying stocks of more than 70 countries – developed markets, emerging markets and frontier markets. In screening for Shariah-compliant securities to form the global indices, MSCI applies two types of screens which include the business activity screening, the financial ratio screening, and also the dividend purification process. MSCI's screening process begins with the business activity screening, i.e. to exclude any company which are involved in any of the following business activities, which include conventional financial services, alcohol, pork-related products, tobacco manufacturing and sales, weapons and defense, gambling and casinos, entertainment such as cinema and television (including cable and satellite services), and pornography and adult entertainment. However, unlike Dow Jones, MSCI only screens out companies that are directly involved in, or that derive five percent or more of their cumulative revenues from any of these activities.

In addition, stocks of companies are financially screened based on selected financial ratios to filter out companies with excessive level of (interest-based) debt, as well as companies which derive a significant level of interest-based income.

⁵Refer to: <http://www.djindexes.com/islamicmarket/> for more details.

⁶For more details, refer to: <http://www.msci.com/products/indexes/thematic/faith-based/islamic/>

To assess for this compliance, stocks are screened based on the ratio of total debt to total assets, the ratio of sum of cash and interest-bearing securities over total assets, and the ratio of sum of accounts receivable and cash over total assets.⁷ For each of the above financial ratios, the threshold allowed by MSCI is 33.33 percent. However, a lower 30 percent threshold is applied for new inclusions to the MSCI Islamic indices. In addition, in calculating the above ratios, only interest-based debt and instruments are included, whereas Shariah-compliant debt and instruments are excluded from these calculations.

2.3 Securities Commission of Malaysia's Shariah Screening Criteria

In Malaysia, the Securities Commission of Malaysia (SCM) provides the guidelines for its Shariah screening process on stocks listed on Bursa Malaysia (previously known as the Kuala Lumpur Stock Exchange) since 1995. In June 2013⁸, SCM announced a newly-revised Shariah screening methodology which would be effective from the list issued on November 2013. In addition to the existing qualitative assessment of prohibited core business activities of the companies, the newly revised screening criteria involves a two-tier quantitative approach which is concerned with the business activity benchmarks and a set of updated financial ratios.

Under the revised SCM screening criteria⁹, a stock is deemed ineligible if the company is primarily involved in the prohibited business activities, which include manufacturing or sale of haram products such as liquor, pork or non-halal meat (or meat not slaughtered based on Islamic rites); operations based on riba such as activities of conventional financial institutions, operations involving gambling and gaming, alcohol production and sale; and tobacco manufacturing and sale.

One of the main differences between SCM and Dow Jones is in terms of the treatment of companies involved in "mixed" business. A company is considered to be involved in mixed business if some portion of its business is derived from forbidden activities. While Dow Jones simply dismisses these "mixed" companies from its Shariah-compliant consideration, and MSCI excludes companies which are directly involved in or have earned more than five percent from disallowed business activities, SCM gives these companies another look. In particular, SCM qualitatively gauges whether the mixed companies have good public perception or image, and whether the core activities are in line with "maslahah" of the public, the non-permissible activities are very small ("umum balwa") and difficult to avoid, or if the business activities involve the rights of non-Muslims.

In addition, the level of prohibited activities is assessed based on the following quantitative guidelines:

- A five percent benchmark is applicable to the following business activities, i.e. conventional banking, conventional insurance, gambling, liquor and liquor-related activities, pork and pork-related activities, non-halal food and beverages, Shariah non-compliant entertainment, interest income from conventional accounts and instruments, tobacco and tobacco-related activities, and other similar activities deemed non-compliant according to Shariah.
- For activities which include hotel and resort operations, share trading, stock broking business, rental received from Shariah non-compliant activities, and other similar activities deemed non-compliant according to Shariah, the level of compliance is capped at 20 percent.¹⁰

⁷MSCI explains that using total assets rather than market capitalization (as utilized by Dow Jones in the ratio calculations) for the three financial ratios is expected to result in lower index volatility and lower index turnover, as market capitalization tends to be more volatile than total assets, which is an accounting number

(http://www.msci.com/resources/factsheets/MSCI_Global_Islamic_Indices.pdf)

⁸http://www.sc.com.my/post_archive/malaysia-to-revise-screening-methodology-determining-shariah-compliant-status-of-listed-companies/

⁹ The rest of this section is an excerpt taken from: <http://www.sc.com.my/frequently-asked-questions-on-revised-shariah-screening-methodology/>

¹⁰ Previously, a 5 percent benchmark was imposed on activities involving e.g. conventional banking and insurance, gambling, liquor and liquor-related activities, pork and non-halal food and beverages, Shariah non-compliant entertainment, and other similar activities deemed non-compliant; a 10 percent benchmark was imposed on interest income from conventional accounts and instruments, tobacco and tobacco-related activities, and other similar activities deemed non-compliant; a 20 percent benchmark was imposed on rental received from non-compliant activities, and other similar activities deemed non-compliant; and

In both criteria above, the contribution of Shariah non-compliant activities to the overall revenue and profit before tax of the company will be calculated and compared against the relevant business activity benchmarks. Listed companies in Malaysia are further assessed based on the following two financial ratios, i.e. ratio of cash over total assets, and debt ratio (i.e. total debt over total assets). For the first ratio, only cash placed in conventional accounts and instruments are accounted for, with the benchmark set at 5 percent. In calculating the leverage or debt ratio, only interest-bearing debt is included, in which the ratio needs to be less than 33 percent for a company to be Shariah-compliant.

3. Does (Shariah-) Screening Affects the Ability to Form Efficient Portfolios and the Performance Compared to Unscreened Portfolios?

It has been argued that by having a limited number of stocks available for trading while complying with the Shariah principles or ethical screening, one may not be able to form efficient portfolios or achieve appropriate risk-return portfolios. The net result would be portfolios that may be purer but not necessarily efficient from a risk-return viewpoint. In other words, stringency in stock screening may be costly for investors.

Essentially, therefore, there are two main issues possibly affecting Shariah-compliant investments which are consistent with the limitations faced by ethical- or socially-responsible investment:

- . The impact of Shariah screening on the universe of compliant stocks available to form efficiently diversified portfolios, and,
- . Is Shariah screening costly to Muslim investors, i.e. does Shariah screening affect the performance of portfolios formed by Islamic investors compared to un-screened portfolios?

The first issue above can be addressed by looking at the number of approved investable stocks from Bursa Malaysia before and after the revised Shariah screening criteria in 2013, as well as findings from Sani and Othman (2013). In addition, we discuss findings from several studies which have attempted to identify the minimum number of stocks required to fully diversify a portfolio. Next, to address the second issue, this paper provides findings from studies comparing Shariah-compliant investments and socially-responsible investment's performance with unscreened and other market benchmarks which indicate that in general, there is a lack of evidence to support the notion of substantial disadvantage or underperformance of ethical or Shariah-screened investments.

3.1 Impact of Shariah Screening on the Number of Eligible or Investable Stocks

One of the concerns regarding ethical or Shariah screening is about the shrinking size of eligible investments following the screening process, particularly if the screening is applied to an already relatively small number of stocks as in the Malaysian stock market.¹¹ Arguments can be made for the more stringent screening criteria of Dow Jones and MSCI, since the original pool of available securities (i.e. from global stock markets) used by these two providers are much larger. If the same level of stringency is applied to the Malaysian stock market, the outcome may be devastating and affect the ability of Islamic investors in Malaysia in forming well-diversified portfolios.

To illustrate the effect of the more stringent Shariah screening process on Malaysian stocks, the following Table 1 shows the number of eligible stocks before and after the screening criteria revision by the SCM effective November 2013.¹² The table below shows that after the application of the revised screening methodology at the end of 2013, the percentage of approved stocks declines from close to 90 percent of all listed stocks on Bursa Malaysia to only slightly above 70 percent, which brings down the number of eligible or Shariah-approved stocks to less than 700 stocks out of more than 900 stocks traded on Bursa Malaysia.

a 25 percent benchmark was imposed on hotel and resort operations, share trading and stockbroking business, and other similar activities deemed non-compliant.

¹¹ The number of listed stocks on Bursa Malaysia is less than 1,000 at the end of 2014.

¹² According to the SCM, the motivation for the revision is to further scale in the Shariah-compliant equity and investment management segments, as well as expand the Islamic capital market's international reach. The revised screening methodology is also expected to enhance the robustness of the screening process to increase the competitiveness of the Malaysian Islamic equity market and Islamic fund industry (www.sc.com.my/frequently-asked-questions-on-revised-shariah-screening-methodology/).

Table 1: Number of Shariah-Compliant Securities on Bursa Malaysia (2010 – 2014)

Date	Number of Shariah-Compliant Securities	Total Listed Securities on Bursa Malaysia	Percentage of Shariah-Compliant Securities
November 2010	846	961	88 %
November 2011	839	946	89 %
November 2012	817	923	89 %
November 2013	653	914	71 %
November 2014	673	905	74 %

Source: <http://www.sc.com.my/data-statistics/list-of-shariah-compliant-securities-by-scs-shariah-advisory-council/>

However, even though the number of eligible stocks decline since the new criteria were introduced at the end of 2013, totals of 653 and 673 Shariah-compliant stocks in 2013 and 2014 respectively are not a small number. In addition, based on the list of Shariah-compliant stocks in both years, they are reasonably distributed across industries, as shown in Table 2, except for several under-represented sectors such as infrastructure, finance, hotels, and mining.

Table 2: List of Shariah-Compliant Securities Based on Industry Classification on Bursa Malaysia (2010 – 2014)

Date	2010	2011	2012	2013	2014
Consumer Products	131	133	125	106	107
Industrial Products	273	268	253	194	200
Construction	48	42	43	36	35
Trading/Services	170	168	178	143	146
Properties	71	77	74	59	67
Plantation	38	39	39	34	37
Technology	104	101	95	71	73
Infrastructure	7	7	7	5	4
Finance	3	3	2	2	2
Others – Mining, Hotels, Closed-end Fund, SPAC	1	1	1	3	2
Total	839	839	817	653	673

Source: <http://www.sc.com.my/data-statistics/list-of-shariah-compliant-securities-by-scs-shariah-advisory-council/>

Sani and Othman (2013) provide further evidence of the direct impact of the revised SCM criteria on the number of eligible stocks, by looking at the status of previously Shariah-compliant stocks (i.e. before November 2013) of companies listed on Bursa Malaysia after the revision. They find that based on the new screening criteria, 23 percent of their sampled companies fail to meet the new Shariah compliance requirements. More interestingly, they also apply MSCI's screening criteria (which are considered to be more stringent than SCM's) on the same stocks, and find that only 39 percent of the sampled companies would have achieved the Shariah-compliant status of MSCI Islamic index. Findings from their study therefore provide some support to the contention that stringency of screening criteria negatively affects the pool of eligible investments for Islamic investments.

3.2 How Many Stocks to Efficiently Diversify a Portfolio?

Will limiting the number of investable stocks (i.e. via Shariah screening) impact the ability of investors to form efficiently diversified portfolios? The idea behind diversification is to allocate resources across several stocks in an attempt to eliminate risks as much as possible, by taking advantage of the imperfect correlations between stocks. In essence, by investing in a portfolio of stocks, variability or risk can be reduced without compromising returns, thus increasing risk-adjusted returns from the perspective of the investor. However, what is the minimum number of stocks needed in order to fully diversify a portfolio then? There have been a few studies undertaken to identify the minimum number of stocks which ought to be held in a portfolio to fully diversify the risks. However, there is no clear consensus in terms of this "magic" number.

While a number of studies (e.g. Alekneviene et al., 2012; Elton and Gruber, 1977; Evans and Archer, 1968; Statman, 1987) suggest that investors need to invest in between 10 to 40 stocks to fully diversify their portfolios, a few other authors suggest that investors may need a much higher number of stocks to achieve the full benefits of diversification (e.g. Cleary and Copp, 1999;

Newbould and Poon, 1993). Moreover, a survey of a number of finance and investment textbooks by Newbould and Poon (1993) indicates different recommendations in terms of the minimum number of stocks for a portfolio to be fully diversified, i.e. between 8 and 20 stocks. Evans and Archer (1968) employ 470 stocks included in the Standard and Poor Index in 1958, and estimate the relation between diversification and variability of portfolio returns. According to their analysis, much of the unsystematic risk is eliminated by the time the 8th security is added to their portfolios. Furthermore, they suggest that portfolios with as few as 10 securities have the same level of risk as that of the market portfolio. Their findings to an extent are corroborated by Elton and Gruber (1977), who show that most of the benefits expected from diversification are achieved from the first few stocks added to a portfolio. For example, they show that adding just a few more stocks to a 1-stock portfolio reduces more than two-third (or almost three-fourth) of the variability compared to the market portfolio, but not as much to be gained by adding more stocks afterwards. Statman (1987), comparing the benefits of diversification relative to additional costs incurred as more stocks are added into a portfolio, show that a well-diversified portfolio must include between 30 stocks for a borrowing investors, and 40 stocks for a lending investor.

In a more recent study by Alekneviene, Alekneviute, and Rinkeviciene (2012), they provide additional support to the above findings from the Lithuanian stock market. Specifically, they carry out an analysis on the effect of diversification from portfolios formed from the relatively few stocks traded on the Lithuanian stock exchange, a small market which consists of only 40 stocks (at the time of their study). Beginning with a portfolio of two stocks which are selected based on their largest pair wise negative correlation coefficient, they keep adding stocks one at a time based on additional two criteria, i.e. the quantitative characteristics of the negative correlations with the original stocks in the portfolio, and the sector to which the stocks belong. They assess the diversification effect by measuring the percent of diversified risk elimination each time they add another stock into their portfolios. Using two diversification strategies, i.e. naive diversification and value-weighted, they find that the benefits of diversification are optimized by forming portfolios of between 22 (naive diversification) to 25 stocks (value-weighted). Interestingly, this study also shows that adding more stocks (past the minimum number) under the value-weighted scheme results in unstable diversification benefits (up and down in terms of risk elimination effects).

Newbould and Poon (1993), on the other hand, suggest that the minimum portfolio size surpasses the previously accepted recommendations. They claim that at 8 to 20 stocks as recommended by some earlier studies, the average performance of the portfolios is very volatile. For example, at the eight-stock portfolio size with small stocks, investors would end up between 41 to 159 percent of the average market return. They recommend that rather than selecting a specific number of stocks, investors should first decide on the probability of success they are comfortable with, and then decide on how many stocks are required to achieve such goal. For example, an investor who is comfortable being within 20 percent of the average return and risk of the market will need a minimum of 25 stocks in his portfolio. However, if an investor wants to be even closer to the market average, he may need to invest in a lot more stocks, even up to 100. In other words, the closer to the market (risk-return) average wished-for by an investor, the larger will be the portfolio size required. Their findings provide some explanation to the practice of most individual investors, who tend to hold relatively smaller number of stocks than required (see also Statman, 1987). This behavior could partly be due to several limitations such as limited amount of capital owned by investors, lack of time to monitor so many investments or stocks, and the increased in transactions costs which may offset the benefits earned from doing so.

Cleary and Copp (1999) examine this issue using Canadian stocks using a more recent time period data in order to provide updated general results that can be used as a reference point particularly for the Canadian market. Using monthly arithmetic mean rate of returns and the monthly standard deviations of these returns for the periods between January 1985 to December 1997, they form equally-weighted portfolios ranging from one stock to more than 200 stocks. For each portfolio, 5,000 simulated portfolios are constructed, and the results are averaged.

Based on their analysis, it appears that between 30 to 50 stocks are required to capture most of the benefits associated with diversification. However, substantial benefits occur by diversifying across as few as 10 stocks. Their results are fairly consistent with previous U.S. evidence, although it appears that stocks that are slightly more Canadian are needed for equivalent diversification benefits. In addition, they conclude that holding 10 stocks in a portfolio already provides about two-thirds of the potential benefits of diversification.

3.3 Do Shariah- or Ethically-Screened Investments Underperform?

Is Shariah screening costly to Muslim investors, i.e. does Shariah screening affect the performance of portfolios formed compared to un-screened portfolios? A lot of studies have examined whether the performance of socially-responsible investments (SRI) or Shariah-compliant investments is inferior compared to the market benchmark. Most of these studies have shown that the underperformance claim cannot be corroborated using empirical investigation. Even though a few of these studies may have detected underperformance of SRI investments, but they are statistically insignificant. In fact, a few other studies have actually shown over performance of SRI returns over unscreened investments.

In one of the studies which have compared the performance of the Shariah stocks to the market benchmark, Hakim and Rashidian (2004) study the relative performance of an Islamic index by comparing the performance of the Dow Jones Islamic Market Index (DJIMI) with Wilshire 5000 index. They find that on a risk-return basis, there is no loss from the screening process used for DJIMI stocks, and conclude that Shariah-adhered investors are not worse off by investing in an Islamic portfolio.

In another study, Hussein (2005) examines the impact of ethical screening on the performance of FTSE Global Islamic index and Dow Jones Islamic Index (DJIMI). In particular, he studies whether returns earned by investors who purchase shares in the FTSE Global Islamic and DJIMI indices are significantly different from their indices counterparts, both in the short- and long-run. He addresses the argument that due to increased monitoring costs, availability of a smaller investment sets, and restricted potential for diversification, the unscreened benchmarks should outperform Islamic indices. In other words, it is argued that returns from investing in Islamic-compliant funds may be lower than similar investments in unscreened funds. His findings indicate that the application of Shariah screening does not have an adverse impact on the performance of the Islamic indices.

Sadeghi (2008) investigates the impact of the introduction of Bursa Malaysia's Shariah Index (SI) on the financial performance and liquidity of securities included in the index, in comparison to the performance of Bursa Malaysia Composite Index (BMCI). Testing several theories to explain the performance of the Islamic index, such as the substitution hypothesis and the information hypothesis, and employing the event study methodology, he provides evidence of significant negative abnormal returns after the introduction of the SI. However, he finds that there is also a significant percentage decrease in the bid-ask spread over the same time interval and that over longer periods, the abnormal returns become positive and increasing over time.

One of the most direct evidence of Shariah-compliant returns has been presented by Albaity and Ahmad (2008). They study the financial performance of Shariah-screened portfolios and compare their performance with the conventional stock market index in the Malaysian stock market. Specifically, they utilize the Kuala Lumpur Shariah Index (KLSI), which is the average price of 100 Shariah-compliant stocks traded on Bursa Malaysia. In examining the performance of the portfolios against the market benchmark, they use several risk-adjusted measures such as the Sharpe ratio, the Treynor index, the modified Sharpe ratio, and the adjusted Jensen's alpha. In general, they find no significant difference between the return of both the KLSI and the broad market index. Even though they find that returns of KLSI is lower than the benchmark index, but KLSI has lower risk as well. Therefore, results from their study do not seem to support the claim that ethically screened portfolios tend to underperform the market benchmark. Brzeszczynski and McIntosh (2014) provides additional evidence to reject the notion of limitations suffer by ethical investment. They investigate the performance of SRI portfolios formed by private investors using the British stocks listed in the Global 100 Most Sustainable Corporations in the world index. In essence, they compare the performance of the SRI portfolios with two market benchmarks, i.e. FTSE100 (an unscreened index) and FTSE\$GOOD (a SRI index) from 2000 – 2010, using raw returns as well as risk-adjusted return measures, i.e. the modified Sharpe ratio and certainty equivalent returns.

They find that the SRI portfolios in their sample insignificantly outperform both benchmark indices for the entire sample period as well as in most sub-periods studied. They also find that their SRI portfolios perform better than the benchmarks by even higher margins during periods of economic recession than during economic growth. However, again, the difference is not statistically significant. Perhaps the stronger rejection of the possible cost of ethical screening, and the closest comparison to Bursa Malaysia in terms of a small universe of stocks to begin with is provided by findings of a study undertaken by Humphrey and Lee (2011), who examine whether Australian SRI funds perform as well as or worse than a group of conventional or non-SRI funds.

Relative to the U.S. stock markets, Australian SRI funds have fewer stocks to choose from when forming their portfolios. This is due to the fact that most SRI funds in Australia exclude environmentally unfriendly stocks (e.g. resource stocks) from their portfolios. The problem is, the Australian stock market is dominated by large resource stocks. Therefore, it is likely that SRI funds in Australia find it difficult to obtain full diversification. However, when they compare their SRI performance to a group of Australian conventional funds, it seems that investing in SRI does not result in a financial penalty of financial benefit for SRI fund investors.

One of the studies which provide some support to the questions of whether screening is costly is Chang and Witte (2010). They look at the risk and return performance of 184 socially-responsible funds (SRF) in the U.S. for 15 years ending March 2008. Specifically, they attempt to provide answers as to whether the performance of SRF in their sample is at par with the average of all mutual funds in their respective categories. Results of their study are mixed at best. Overall, they find that SRI funds have lower risk-adjusted returns compared to the average of the market. However, they also show that most SRF in their sample have lower standard deviation in six of the nine categories of domestic stock funds, and in four out of five categories of the balance funds. However, Humphrey and Tan (2014) in another paper provide strong evidence of no significant difference in the risk-adjusted returns of SRI portfolios in their sample of U.S. stocks from 1996 – 2010 after comparisons with the performance of S&P500. In their study, they also investigate whether the application of positive and negative screens have different effects on screened-investment portfolio's risk and return. They find no evidence to support this proposition. In addition, they address the concern about the impact of SRI on the idiosyncratic risks of the screened portfolios. Again, they do not find enough evidence to support the notion that the non-systematic risks of the screened portfolio is significantly higher than the benchmark.

Conclusions

The need to screen a stock before making investment is derived from Shariah principles that Muslims should never participate in any activity, investment, or non-investment, which is prohibited by Shariah. In the equity investment world, Shariah-compliant investments can be considered along the line of the socially-responsible investments (SRI) or ethical investments, in which stocks are screened on certain qualitative and quantitative criteria before selection is made. The screening process therefore narrows down the number of eligible stocks for investment, thus resulting in a fewer number of stocks available to form an efficient portfolio. In other words, the benefits from diversification may not be maximized by the ethical investors. Based on this notion, the general perception of ethical investment and Shariah investment is that ethical or Shariah-compliant investors may earn lower returns than the unscreened portfolios or market benchmarks.

This paper discusses the perception of the more liberal screening criteria of the Securities Commission of Malaysia, despite its revision in 2013. Comparisons of the SCM screening criteria with Dow Jones and MSCI are discussed, and differences and similarities among all three standards are pointed out. One of the possible reasons of the more liberal screening process of SCM is to avoid limiting the universe of investable stocks to Muslim investors by too much, as it might hurt the ability of the investors to form efficient portfolios. The paper addresses this concern by providing empirical evidence from SRI and Shariah investment studies which in general indicate that such a claim is not corroborated by empirical results using various Islamic indices or Islamic funds. Returns from SRIs have been found to be not significantly different from returns of the market benchmarks, and in some cases outperform the benchmarks (even though not significant statistically). In addition, the paper provides the findings from studies that have attempted to identify the minimum number of stocks required to achieve full diversification. In general, a review of these related papers indicates various opinions, ranging from a size as small as about 10 stocks, to as large as 100 stocks or more to fully diversify a portfolio.

Nevertheless, from the Shariah viewpoint, the success or benefits of an investment cannot be evaluated merely on financial gains or financial performance alone. As a matter of fact, the evaluation of any investment activities always needs to be examined from at least two angles, i.e. whether the investment follows the guidelines or investment policy as established, and whether the return achieved matches the risk associated with the investment. In complying with Shariah principles, the achievement of avoiding the prohibited elements is more important than the financial performance itself.

It is hard to deny that the ultimate goal for a Muslim investor is the success in the hereafter which is eternal and everlasting, rather than simply the worldly gains represented by monetary profits or capital gains, which are temporary.

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