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ETHICAL INVESTING: EXAMINING THE PERFORMANCE OF INDIAN SHARIAH FUNDS VIS-À-VIS SHARIAH INDEX

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Abstract *Ethical investment is an important part of 'Socially Responsible Investment' (SRI) that is based on investors' ethical beliefs and values. Shariah-compliant investment (SCI) is one such practice. In this backdrop, the primary objective of the study is to explore the performance of the existing two actively managed Shariah-compliant equity funds, namely, Tata Ethical Fund and Taurus Ethical Fund, from the perspective of risk-return parameters. Another objective is to analyse the performance of the Shariah index CNX 500 Shariah in relation to these two funds. The study is based on secondary data. The period of study is from March, 2010 to March, 2015. Measures like Annual return, Compound Annual Growth Rate (CAGR), Risk-adjusted CAGR, Jensen alpha, R-squared (R2), and beta have been used. The funds have exhibited superior risk-adjusted return. Further, funds are defensive in nature in most of the times, and are adequately diversified. Again, fund managers have superior stock selection skills. Returns from "Systematic Investment Plan" (SIP) are very much satisfactory. Moreover, the performance of Shariah index is inferior to that of the Tata Ethical Fund in respect of all parameters. Shariah-compliant funds have great potential to garner more investment from Shariah-conscious Indian investors.*

Keyword: *CAGR, Ethical Fund, Shariah-Compliant Fund, Shariah Index, SIP*

INTRODUCTION

Socially Responsible Investment (SRI) is a broad concept that incorporates social, environmental, and governance issues into the investment process. Although the term SRI and ethical investment have been used interchangeably, the latter better describes the process in which a value-based organisation applies internal ethical rules to an investment strategy. Unlike conventional funds, maximisation of the financial returns is not the prime objective of ethical funds. Rather, they offer investors the chance to invest in a menu of securities which might accord more with their ethical beliefs and values. One example of ethical investment is Shariah-compliant Investment (SCI) which is gaining importance across the globe. The word *Shariah* indicates moral code and religious law of Islam. Naturally, a Shariah-compliant fund is organized on the basis of Shariah rules. Such funds restrict the companies from investment that are engaged in the business of alcohol, tobacco, pork products, pornography, gambling, weapons etc.

Investors in Gulf Cooperation Council (GCC) have demonstrated increasing preference for Shariah-compliant products, which is evident from the increasing numbers of Islamic banks in the region (Hela, Hameedah & Anissa, 2015). When it comes to Islamic Financial Institutions (IFIs), social responsibility and ethical investment are embedded in the very soul of this growing financial sector (Shakir & Dima, 2010). Williams (2005) and Rosen, Sandler and Shani (1991) have tried to characterise SRI investors in terms of demographics and investor attitudes toward social aims. Shariah funds are mostly seen in Asia, Saudi Arabia, and Malaysia. Internationally, other prominent markets for Shariah products are Middle-East countries, Indonesia, Pakistan, United States, and South Africa (Davis, 2008). The concept of Shariah-compliant funds, however, has not yet got the desired momentum in India. Shariah-compliant funds in India have the following major characteristics:

(1) These are open-ended equity funds. It means that an investor can enter into or exit from the fund at any point of time.

(2) Such funds invest in a variety of equity and equity-related instruments on the basis of principles of Shariah.

(3) Capital appreciation is the main objective of such funds.

(4) There will be no long term capital gains (LTCG) tax if the units of these funds are held for a period of more than one year.

(5) These are actively managed funds. Consequently, stock-picking abilities and market-timing skills of the fund managers are important factors in determining the performance of such funds.

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It is encouraging that Shariah funds in India are attracting sizeable chunk of investors from the Jain community too. Though crafted on the Shariah principles, Indian Shariah funds (Tata Ethical Fund and Taurus Ethical Fund) are also in sync with the beliefs of and ethics practised by the Jain community. Moreover, it is observed that Muslim communities have a high proportion of young people in the workplace and this group is among the most exuberant adopters of Islamic products. This augurs well for the long-term growth of Shariah finance in general and Shariah-compliant funds in particular as this group of new 'baby boomers' starts to save for retirement (www.pwc.com).

REVIEW OF LITERATURE

A brief literature review is presented below.

The study by Luther and Matatko (1994) demonstrates that ethical funds perform much better when evaluated against a small company benchmark, as against the benchmark of Financial Times All Share index (FTSA). Mallin, Saadouni and Briston (1995) study the returns earned by 29 UK ethical funds and 29 UK non-ethical funds between 1986 and 1993. They observe that ethical funds tend to outperform their matched non-ethical pairs although this effect is weak. Gregory, Matatko and Luther (1997), while examining the performance of UK ethical fund, concludes that there is no significant difference between the returns earned by the ethical and non-ethical funds, and that both groups under-perform the FTSA benchmark index. Hakim and Rashidian (2002), after comparing the performance of the Dow Jones Islamic Market Index (DJIMI) with Wilshire 5000 Index for period from 10/12/1999 to 9/4/2002, have found that on a risk-return basis, there is no loss from the screening process used for DJIMI stocks, and Muslim investors are not worse off by investing in an Islamic index as a subset of a much larger market portfolio. Kreander, Gray, Power and Sinclair (2002) find that the performance of European ethical funds is more or less similar with that of the Morgan Stanley Capital International (MSCI) World Index. Further, when Swedish ethical funds are evaluated against a Swedish benchmark, their performance is outstanding; while it is much more modest when compared to a global index. Hassan and Tag el-din (2005) apply duration dependence tests to analyze the Dow Jones Islamic Index and Islamic Mutual Funds. They use both weekly and monthly data of Dow Jones Islamic Market Index (DJIMI), Amana Income Fund (AMANX), and Amana Growth Fund (AMAGX) to test the speculative bubbles in these markets. The results depict that none of the weekly and monthly returns of AMANX, AMAGX, and DJIMI show statistically significant evidences of speculative bubbles during the study period between January, 1996 and November, 2005**.**Girard and Hassan (2005) compare the performance of Dow Jones Islamic Indices and its seven indices with their non-Islamic counterparts. The study shows that there is no difference between Islamic and non-Islamic indices in the sense that there exist similar reward-to-risk and diversification benefits for both indices. Elfakhani, Hassan and Sidani (2005) have examined the performance of Islamic mutual funds in order to verify whether the application of the Islamic investment guidelines in asset allocation and portfolio selection has had downside effect on investors' wealth in terms of risk-adjusted returns relative to the market benchmark. The results have not found statistically significant risk-adjusted abnormal reward or penalty associated with investing in Shariah compliant mutual funds. Davis (2008) has observed that Shariah-compliant investment vehicles take socially responsible investing to a new level, proving that conscious investing does not necessarily depress returns. The study by Mansor and Bhatti (2011) uses monthly aggregate returns to evaluate performance of the mutual funds for the Islamic and conventional portfolios in Malaysia, from 1996 to 2009. The result shows that the Islamic portfolio provides slightly less returns than the conventional portfolio. Moreover, the result reveals a statistically significant difference between the standard deviation of the portfolios, indicating that the Islamic portfolio is riskier than the conventional portfolio. This apart, it has also been noticed that the Islamic portfolio almost mirrors the market movement in comparison to the conventional portfolio. Dharani and Natarajan (2012) have empirically examined the risk and return of the Nifty Shariah index and Nifty index during the period from 2nd January 2007 to 31st December 2010. The study concludes that Nifty Shariah and Nifty indices in India are performing in a similar manner. Khan (2013) has opined that there is adequate number of Shariah-compliant stocks in the Indian market offering better return on investment. Financial institutions like mutual funds, insurance, portfolio management services, etc. can use these Shariah-compliant stocks to build profitable Shariah-compliant portfolios and offer Shariah-compliant investment products to Shariah-conscious investors. Habib and Islam (2014)have observed that Islamic Index has underperformed unscreened index in India during the period under study (2003-2013) on the basis of risk-adjusted returns but risk involved in case of Islamic Index has been relatively less than that of conventional Index. Malaysia exhibits totally opposite picture wherein the Islamic Index has yielded high returns and exhibited high risk than its counterpart index. However, in both the cases, Islamic Indices have performed better during crises period.

RESEARCH QUESTIONS

The study endeavours to address the following research questions:

(1) Are the returns from "SIP" satisfactory?

(2) Are the funds able to generate superior risk-adjusted return?

(3) How is the stock selection skill of the fund managers?

(4) Whether the funds are defensive in nature with respect to the benchmark?

(5) Are the funds reasonably diversified?

(6) Have the funds performed better than the benchmark / index?

OBJECTIVE OF THE STUDY

The primary objective of the study is to explore the performance of two actively managed Shariah-compliant equity funds in India, namely, Tata Ethical Fund and Taurus Ethical Fund, from the perspective of risk-return parameters. Another objective is to analyse the performance of the Shariah index CNX 500 Shariah in relation to these two funds.

DATA AND METHODOLOGY

The study is based on secondary data. The period of study is from March, 2010 to March, 2015.The effect of 'Entry Load', brokerage, and 'Exit Load' has not been taken into consideration. CNX 500 Shariah has been chosen as the benchmark index. For the purpose of analysis, average annualised risk-free rate is taken as 8.7%. It is the rate of return offered by Public Provident Fund (PPF) scheme of the Government of India for the financial year 2014-15. The 'growth' option of the funds has been considered, and not the 'dividend' option. 'Regular Plans' of the funds are chosen for the purpose of the study, and not the 'Direct Plans'. The month-end Net Asset Values (NAVs) of each fund have been obtained from the website of the Blue Chip (http://bluechipindia.co.in). The month-end closing values of the benchmark index have been collected from the official websites of National Stock Exchange (NSE). The monthly returns of the schemes (R_p) and that of the benchmark (R_m) have been computed as follows:

$R_p = [(NAV_t\text{-}NAV_{t\text{-}1})/NAV_{t\text{-}1}] *100$

$R_m = [(Value_t\text{-}Value_{t\text{-}1})/Value_{t\text{-}1}] *100$

where, NAV_t = Closing NAV of the fund for month t, NAV_{t-1} = Closing NAV of the fund for the preceding month (t-1), $Value_t$ = Closing Value of the Benchmark Index for month t, $Value_{t-1}$ = Closing Value of the Benchmark Index for the preceding month (t-1).These monthly returns have been used for calculating Standard Deviation (S.D.). Further, Compounded Annual Growth Rate of Schemes ($CAGR_p$) and that of the Benchmark ($CAGR_m$) have been calculated with the following formula:

$CAGR_p$= (Ending NAV for the period / Opening NAV for the period)$^{(1 / \text{no. of year})}$ -1

$CAGR_m$= (Closing benchmark value for the period / Opening benchmark value or the period)$^{(1 / \text{no. of year})}$ -1

While calculating returns from SIP, it is assumed that INR 1000 is invested at the end of each month at respective closing NAVs of the funds. Further, for measuring consistency in performance, the period of study has been broken down into different time periods of 1-year, 2-year, 3-year, 4-year and 5-year. Measures like CAGR, Standard deviation, Risk-adjusted CAGR and Jensen alpha have been applied. In addition, R-squared (R^2) and beta have also been used.

ANALYSIS AND FINDINGS

Portfolio of the Funds

Portfolio Snapshot

Portfolio snapshot of the funds is presented in Table 1.

It is noticed that both the funds are inclined heavily towards equity. Debt component is nil in both the funds. So far as cash component is concerned, Tata Ethical Fund has cash component in excess of 10%. Stocks held by the funds are more than 50. Taurus Ethical Fund has lower expense ratio in spite of lower net assets than Tata Ethical Fund in 2013 and 2014. Only exception is the year 2012, when Taurus Ethical Fund has marginally higher expense ratio than Tata Ethical Fund. Further, the expense ratio of Tata Ethical Fund has exhibited increasing trend. However, Taurus Ethical Fund has succeeded in slightly reducing the expense ratio in 2014 as against 2013.

Table 1: Portfolio Snapshot

Fund	Net Assets as on 31/03/2015 (INR crore)	Total Stocks	Expense Ratio (%)			Equity (%)	Debt (%)	Cash (%)
			2012	2013	2014			
Tata Ethical Fund	Rs. 296.3 crore	52	2.48	2.97	3.04	89.99	0.00	10.01
Taurus Ethical Fund	Rs. 27.4 crore	54	2.50	2.88	2.86	99.42	0.00	0.58

Source: www.valueresearchonline.com

Top 10 Holdings

Table 2 incorporates the top 10 holdings of the funds as on 31st March, 2015.

Table 2: Top 10 Holdings

Tata Ethical Fund		Taurus Ethical Fund	
Stock	% of Assets	Stock	% of Assets
Lupin	4.66	Info Edge (India)	6.11
Tata Consultancy Services	4.63	Infosys	4.14
Alstom T&D	4.35	Maruti Suzuki India	4.00
Shree Cement	3.51	Bharat Forge	3.43
Divi's Laboratories	3.47	Blue Dart Express	3.39
Britannia Inds.	3.28	ONGC	3.15
Amara Raja Batteries	3.14	Bosch	3.11
HCL Technologies	3.07	Container Corp.	3.07
Infosys	3.05	Siemens	2.99
Colgate-Palmolive (I)	2.93	Lupin	2.95

Source: www.valueresearchonline.com

It is revealed from Table 2 that top 10 holding accounts for more than 36% for the funds. Lupin and Infosys are the common stocks in the funds in top 10 holding.

Sector-wise Break-up of Equity Component

Break-up of equity component of the chosen funds among different sectors is depicted in Table 3.

Table 3: Break-up of Equity Component

Tata Ethical Fund		Taurus Ethical Fund	
Sector	Weight	Sector	Weight
Technology	17.10	Services	19.64
Engineering	16.08	Automobile	13.88
FMCG	15.81	Technology	12.97
Healthcare	14.70	Engineering	11.02
Automobile	9.49	Healthcare	8.71

Source: www.valueresearchonline.com, Note: Weights are in percentage

It appears that technology sector is the most preferred sector comprising more than 17% in Tata Ethical Fund while it accounts for more than 12% in the Taurus Ethical Fund. Healthcare sector accounts for more than 14% in Tata Ethical Fund but its share is only more than 8% in the Taurus Ethical Fund. Automobile sector is the second largest in the portfolio of Tauras Ethical Fund while engineering sector is the second largest in the portfolio of Tata Ethical Fund. Further, Technology, Engineering, Healthcare, and Automobile are the four common sectors.

Return of the Fund

In the following section, performance of the funds is analysed on the basis of three parameters viz., annual return, Compound Annual Growth Rate (CAGR), and returns from Systematic Investment Plan (SIP).

Annual Return

Table 4 shows percentage annual return of the funds and that of the benchmark during the period 2011-2014.

Table 4: Annual Return (%)

Fund	2011	2012	2013	2014
Tata Ethical Fund	-16.65	25.69	16.37	41.48
Taurus Ethical Fund	-16.81	12.91	14.86	42.65
CNX 500 Shariah	-21.29	18.01	15.56	33.09
Outperformance / Under-performance of Tata Ethical Fund (O / U)	O	O	O	O
Outperformance / Underperformance of Taurus Ethical Fund (O / U)	O	U	U	O

Source:Computed by the researchers

Table 4 indicates that, in terms of annual return, Tata Ethical Fund is superior compared to Taurus Ethical Fund. Tata Ethical Fund outperformed the benchmark over the entire period of study (2011-2014) whereas Taurus Ethical Fund outperformed the benchmark in 2011 and 2014 but it underperformed the benchmark during the year 2012 and 2013.

Compound Annual Growth Rate (CAGR)

CAGR of the funds and that of the benchmark are shown in Table 5.

Table 5: CAGR (%)

Fund & Benchmark	1-yr	2-yr	3-yr	4-yr	5-yr
Tata Ethical Fund	47.24	35.49	25.83	19.22	16.68
Taurus Ethical Fund	47.01	39.12	24.30	16.05	14.70
Benchmark Return	32.19	27.38	19.66	12.50	10.98

Source: Computed by the researchers

Table 5 shows that both the funds have generated CAGR in excess of the benchmark during the entire study period. Taurus Ethical Fund has outperformed Tata Ethical Fund in 2-year period; whereas Tata Ethical Fund has performed better than Taurus Ethical Fund in 1-year, 3-year,4-year and 5-year period.

Returns from 'Systematic Investment Plan' (SIP)

SIP returns are presented in Table 6.

Table 6: SIP Return of the Funds (Annualised)

Fund & Benchmark	1-yr	2-yr	3-yr	4-yr	5-yr
Tata Ethical Fund	40.68	41.09	34.21	28.62	23.82
Taurus Ethical Fund	39.78	43.17	34.52	27.29	21.88
Benchmark	21.40	29.04	25.48	21.39	17.40

Source: Computed by the researchers

Taurus Ethical Fund has produced the best SIP returns during 2-year, and 3-year period. However, Tata Ethical Fund has generated the best SIP return in 1-year, 4-year, and 5-year time period. In 1-year, 2-year, and 3-year time period, the funds have delivered spectacular SIP return which is in excess of 34%. The figures also reveal that SIP is really a good instrument for wealth creation. Another important observation is that both the funds have outperformed the benchmark index during the entire period of study.

Measurement of Risk and Risk-adjusted Return

Annualised Standard Deviation

The total risk associated with the funds and the benchmark index, expressed in terms of annualised standard deviation, is presented in Table 7.

Table 7: Annualised Standard Deviation

Fund & Benchmark	1-yr	2-yr	3-yr	4-yr	5-yr
Tata Ethical Fund	9.11	8.46	9.86	10.86	12.49
Taurus Ethical Fund	11.24	10.74	12.04	12.15	12.59
Benchmark Standard Deviation	9.92	10.24	10.65	12.39	13.70

Source: Computed by the researchers

Table 7 reveals that Tata Ethical Fund has outperformed the benchmark and Taurus Ethical Fund throughout the study period in terms of total risk. However, Taurus Ethical Fund has taken more risk than the benchmark in 1-year, 2-year, and 3-year period.

Risk-adjusted CAGR

Table 8 depicts risk-adjusted CAGR of the funds and that of the benchmark index for different time periods.

Table 8: Risk-adjusted CAGR (%)

Fund & Benchmark	1-yr	2-yr	3-yr	4-yr	5-yr
Tata Ethical Fund	42.94	32.49	23.28	17.13	14.60
Taurus Ethical Fund	41.72	34.92	21.37	14.10	12.85
Benchmark	28.99	24.57	17.57	10.95	9.48

Source: Computed by the researchers

It is clear from the Table 8 that both the funds have generated superior risk-adjusted return than the benchmark during the entire study period. Here, Tata Ethical Fund has remained the best performer in 1-year, 3-year, 4-year, and 5-year periods. However, Taurus Ethical Fund has outperformed Tata Ethical Fundin 2-year period.

Other Performance Measures

Stock Picking Skill of the Fund Managers (Alpha)

Jensen Alpha is expressed as:

$$\text{Alpha} = R_p - [R_f + \text{Beta}_p * (R_m - R_f)]$$

Where Alpha= Differential return earned by the fund out of the ability of the fund manager in selecting correct stocks. A positive alpha value signifies positive stock selection skill on the part of the fund manager. Table 9 incorporates computed values of alpha of the chosen funds.

Table 9: Alpha

Fund & Benchmark	1-yr	2-yr	3-yr	4-yr	5-yr
Tata Ethical Fund	19.22	13.59	8.28	7.57	6.10
Taurus Ethical Fund	14.09	13.86	4.68	4.06	4.16

Source: Computed by the researchers

It is clear from the table that both the funds have generated positive alpha values during the entire study period which, in turn, signify that fund managers have superior stock-picking skills. Here, Tata Ethical Fund has outperformed Taurus Ethical Fund in 1-year, 3-year, 4-year, and 5-year periods. However, Taurus Ethical Fund has outperformed Tata Ethical Fund in 2-year period.

Table 10: Various Risk Measures

Fund	BETA					RSQ				
	1-yr	2-yr	3-yr	4-yr	5-yr	1-yr	2-yr	3-yr	4-yr	5-yr
Tata Ethical Fund	0.82	0.71	0.81	0.78	0.83	0.80	0.73	0.76	0.78	0.82
Taurus Ethical Fund	1.03	0.89	1.00	0.86	0.80	0.83	0.71	0.78	0.78	0.77

Source: Computed by the researchers

Systematic Risk and Diversification of the Fund (Beta and RSQ)

Beta measures the systematic risk or market risk associated with the fund. A beta value greater than 1 indicates the aggressive portfolio and beta value less than 1 signifies defensive or conservative portfolio. Market or benchmark beta is taken as 1 and beta of a risk-free investment is 0. The extent or degree of diversification is measured by RSQ. The value of RSQ ranges between 0 and 1. RSQ value of 1 implies completely diversified portfolio having zero unique risk. Moreover, a high RSQ value implies that the fund is adequately diversified. Table 10 incorporates computed data on two measures, namely, beta and r-squared (RSQ).

Beta values imply that Tata Ethical Fund has remained the defensive fund throughout the period of study; whereas Taurus Ethical Fund has remained the conservative fund in 2-year, 4-year, and 5-year period. RSQ values range between 0.71 and 0.83 which signifies that the funds are well diversified. In other words, such a high RSQ value implies that fund managers have succeeded in minimising the unique or unsystematic risk component to a great extent.

CONCLUSION

Based on research questions, the findings can be summed up as follows.The SIP returns are quite satisfactory because both the funds have outperformed the benchmark index during the entire period of study. The funds have generated superior risk-adjusted return during the study period. It is evident from Jensen alpha values that fund managers have superior stock picking skills. Beta values reveal that Tata Ethical Fund is defensive in nature throughout the study period while Taurus Ethical Fund has remained conservative in 2-year, 4-year, and 5-year period. RSQ values signify that the funds are adequately diversified.Tata Ethical Fund has outperformed the benchmark index (CNX 500 Shariah) in terms of return (annual return, SIP return, and CAGR), risk (standard deviation), and risk-adjusted return (risk-adjusted CAGR) during the entire period of study. On the other hand, Taurus Ethical Fund has performed better than the benchmark index in terms of SIP return, CAGR, and risk-adjusted CAGR during the entire study period.

The study suffers from certain structural limitations that need to be pointed out. Firstly, Mergers and Acquisitions (M&A) between the schemes and the same between the AMCs are not taken into account. Secondly, the impacts of brokerages, entry load, exit load, taxes, and inflation are not taken into consideration. Lastly, the effect of change in fund managers is not considered.

Further research can be carried out in the several areas. For example, researchers can investigate the investor's perception towards investment in ethical or Shariah-compliant funds. An in-depth study can also be carried out to compare the performance of diversified equity funds with that of Shariah-compliant funds in the Indian context. Again, comparative analysis between Indian Shariah funds and Shariah funds of other countries can be another area of research. Similarly, researchers can investigate the performance of Shariah funds against the performance of other Shariah investments.

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