

# A Comparative Study on Financial Performance of Shariah Compliant Stocks and Conventional Stocks in India

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## Abstract

The Islamic equity market consists of the companies that follow the Shariah norms in their business activities to be Shariah compliant. The objective of this study is to examine the performance of select Shariah-compliant shares listed in Bombay Stock Exchange (BSE), India and to compare the performance of Shariah-compliant stocks with select conventional stocks. The study reveals that the performance of Shariah-compliant stocks is better than conventional stocks during the select period of study and the return of Shariah-compliant securities is less volatile than the conventional securities.

**Keywords:** Islamic Finance, Shariah Indices, Islamic Capital Market

## Introduction

Islamic finance is a finance based on Shariah principles. Shariah means the principles of Islam that guide every aspect of a Muslim-life ranging from social to economic. Shariah-compliant finance constitutes financial practices that fulfill the Islamic law. Islamic finance is not only based on an interest-free financial system, but also it involves other important principles that encourage social trust, transparency, entrepreneurship, risktaking, protection of property rights and ethical values such as justice, fair dealing and fair pricing, mutual co-operation and respect of other contracting parties (Usmani, 2002; Ayub, 2009).

Capital market plays a pivotal role in the financial system for raising funds for long-term investment as it is a platform to channelize the funds from investors to the seeker of funds for the growth of the economy and efficient utilization of idle fund (Hassan & Bashir, 2005; Harris & Raviv, 1991). Islamic capital markets are an integral part of Islamic financial system for efficient

mobilization of funds and their optimal utilization and these markets complement the investment role of the Islamic banking sector (Hearn, Piesse, & Strange, 2011; Imam & Kpodar, 2016). They are more relevant in an Islamic economy because the prohibition of interest entails a greater reliance on equity and asset-based finance (Ayub, 2009; Karim, Lee, Karim, & James, 2012). The Islamic capital market attracts funds from outside and inside the market. The international sources might include high-net-worth individuals, predominantly Muslim from the oil-rich countries, and others involved in the corporate and business sectors (Khan, 2010; Ariss, 2010). The Islamic capital market does not prohibit participation by non-Muslims, which has increased the growth potential for Islamic products (Munuswamy, n.d.; Masih, 2017; Zaher & Kabir Hassan, 2001). The Islamic equity market consists of the companies meeting the Shariah norms. In Islamic equity market, the indices of this market are made up of the companies which are following the Shariah norm in their business activities to be Shariah Compliant (Wajdi Dusuki, 2008). It is similar to the Conventional Equity Market where funds are channelized from people with a surplus fund to those who need funds, such as companies, government, and other financial organization. It is a platform which helps in proper utilization of the fund for Shariah investors (Chong & Liu, 2009; Shamshad, 2011). A Shariah Index in an index of companies which are found to be compliant with Shariah laws (Abdul Rahman, Azlan Yahya, & Herry Mohd Nasir, 2010). Most of the Shariah indices which have been created so far have been based on an existing or an underlying index, whose constituents have been screened for compliance by a board that is well-versed in the principles of the Quran and Sunnah (Dixon, 1992; Beck, Demirgüç-Kunt, & Merrouche, 2013). Islamic stock markets have the following features,

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it permits shares of companies not involved in interest-based business, shares of companies dealing in only halal products, shares of the companies ethically transparent, interest-based debt should be less than or equal to 25% of total assets (Abedifar, Molyneux, & Tarazi, 2013; Mahdy, 2012; Dusuki & Abdullah, 2007).

The increasing popularity and growing demand for Shariah indices have motivated the researchers to examine the performance of Shariah Stocks. The existing literature on the subject of Islamic indices is limited, although (Hakim & Rashidian, 2004; Hussein, 2004; Mohamed & Rubi, 2008) have analyzed the performance of Islamic indices vis-à-vis conventional stock market indices using stock market data. The studies such as of (Shakrani), Abdullah, Bakar, & Taib, 2005; Yusof & Majid 2007; Beik & Arsyianti, 2015) evaluate the volatility and forecasting ability of Islamic indices. These studies were conducted in the developed capital markets, GCC and Malaysia etc. but very few in emerging markets like India. To fulfill this research gap, the present study was conducted to analyze the performance of Shariah-compliant stocks against the conventional stocks. The study would contribute an additional knowledge to the Islamic stock market, will provide insights to those who are seeking the alternative type of investment that is ethical, interest-free and have potential to hedge the risk and will help Sharia-compliant investors in India to take a better investment decision. This study enhances the research on Islamic Capital Market which is at its early stage in terms of research.

Taqwaa Advisory and Shariah Investment Solutions (TASIS) Pvt Ltd is the leading Shariah advisory institution in India; it has formulated norms for Shariah screening of Indian stocks, which are widely acknowledged and accepted in the country. Shariah screening norms formulated by TASIS divided into two steps. 1) Screening based on business activity: The companies which are primarily into the following activities are screened out on the business sector parameter such as conventional financial services such as banks, insurance companies, finance and investment companies, stock broking etc., production, sale and marketing of non-Halal food and beverages such as Pork, Alcohol, Tobacco and such other items etc., companies involved in production or distribution of vulgar entertainment, such as film and other recreational activities where vulgarity, promiscuity is a part and parcel of the business undertaken/promoted, Advertising and Media (except Media and advertising

companies generating revenues in excess of 65% of total income from the GCC countries, News Channels, Newspapers, Sports Channels), Gambling, Narcotic drugs, etc. and trading of gold and silver as cash on deferred basis. 2) Screening based on the financial ratio of the company: After passing the business screening, companies further go through the financial screening to ensure that earnings out of the deployment of funds into interest-based debt are within the tolerance limit set by Shariah scholars. There are certain variations in these tolerance limits based on place and time. To remain on the conservative side from a Shariah adherence perspective, TASIS has adopted financial screening norms which are more conservative than those followed by its peers and also justified by empirical studies of the Indian environment. TASIS norms are given as, interest based-debt should be less than or equal to 25% of total assets, interest income plus returns (currently considered @ 8%) from interest-based investments should be less than or equal to 3% of the total income and receivables plus cash and bank balances should be less than or equal to 90% of total assets.

## Research Methodology

The objectives of the study are to analyze the risk and return associated with Shariah-based stocks listed in BSE (Bombay Stock Exchange), to analyze the risk and return associated with conventional stocks listed in BSE, to evaluate the portfolio performance of Shariah stocks using Sharpe, Treynor and Jensen's Alpha measures and to evaluate the portfolio performance of conventional stocks using Sharpe, Treynor and Jensen's Alpha measures to compare the performance of Shariah-based stocks and conventional stocks. The study has taken into account the 10 consistently Shariah-compliant stocks listed on S&P BSE Shariah 50 Index. Stocks listed on S&P BSE Shariah Index were taken for the study for the period from Jan 2013 to Dec 2017. The selection criteria of conventional stocks were based on its market capitalization. The 10 stocks with the highest market capitalization listed on S&P BSE 500 Index were considered for the study. The daily closing prices of stocks for the study period were downloaded from the BSE website. Similarly, the closing prices of common stocks were downloaded from the BSE website for the period from Jan 2013 to Dec 2017. The interest rate on Treasury bill was obtained from RBI (Reserve Bank of India) website which was used as a proxy for risk-free rate during the study period.

The study is based on secondary data. Data have been collected from various sources as annual reports of the company, journals, and concerned websites. The data collected from such sources includes both financial data and non-financial data. The study employed risk-adjusted performance measures namely Sharpe, Treynor, and Jensen's Alpha measures to analyze the performance of stock. Risk-adjusted return means the return on investment by measuring the quantity or level of risk involved to yield the return. Risk-adjusted returns are applicable to both individual securities and portfolio. There are three risk-adjusted measures such as (1) Sharpe ratio which is the measure of risk-adjusted return of a portfolio. It calculates investment excess return above the risk-free rate relative to its standard deviation. It is calculated by taking the return of the investment, subtracting the risk-free rate, and dividing this result by the standard deviation of the investment portfolio. Higher the Sharpe ratio better the risk-adjusted portfolio return. (2) Treynor ratio which measures excess return above the risk-free rate per unit of the systematic risk called as beta. The Treynor ratio is calculated in the same way as the Sharpe ratio, but it uses the investment's beta in the denominator. Higher the Treynor ratio better is the risk-adjusted return. Using the previous fund example, and assuming that each of the funds has a beta of 0.75, the calculations illustrated below and (3) Jensen's Alpha which is used to measure the risk-adjusted performance of a security or portfolio relative to the expected market return based on the capital asset pricing model. The higher the Alpha, the more a portfolio has earned above the level of risk predicted. This measure was first used by Michael Jensen in 1968 and was originally designed to evaluate fund managers whether it was possible for them to consistently outperform the market or not. Jensen's results revealed it rarely happens.

## Findings

Performance Analysis of Shariah Based and Conventional Securities using Risk-Adjusted Performance Measures:

**Table 1: Comparative Performance Analysis of Shariah-based and Conventional Stocks Based on Sharpe Ratio**

Year	Average Sharpe Ratio of Shariah-based Companies	Average Sharpe Ratio of Conventional Companies
2017	-0.924	-1.247
2016	-0.799	-1.079
2015	-1.014	-1.737

Year	Average Sharpe Ratio of Shariah-based Companies	Average Sharpe Ratio of Conventional Companies
2014	-0.836	-1.074
2013	-0.966	-0.901

Source: (<https://www.bseindia.com/indices/IndexArchiveData.aspx>, 2018)

Table 1 shows the average Sharpe ratio of securities of Shariah-based and conventional stocks for the period of study. In 2017, the average Sharpe ratio of all the Shariah-based securities is -0.924 whereas the average ratio of conventional securities for the same period is -1.247. Comparatively looking at the average Sharpe ratio of Shariah and conventional securities, Shariah-based securities performed better for the period 2017. In 2016, the average Sharpe ratio of Shariah-based securities is -0.799 while the average Sharpe ratio of conventional securities is -1.079. The ratio of both Shariah and non-Shariah securities are in negative value but comparatively, the Shariah-based securities had better performance than the non-shariah securities. In 2015, the table above shows that the average Sharpe ratio of Shariah-compliant securities is -1.014 while the average Sharpe ratio of conventional securities is -1.737. The performance of Shariah-based companies based on Sharpe ratio again outperformed the conventional securities for the year 2015. In the table above, it is observed that the average Sharpe ratio of Shariah-based companies is -0.836 whereas the average Sharpe ratio of conventional securities is -1.074 for the year 2014. The Shariah-based securities had better performance than the conventional securities. In 2013, the average Sharpe ratio of Shariah-based securities is -0.966 and the average Sharpe ratio of conventional securities is -0.901. Hence, the conventional securities performed better than the Shariah-based securities in 2013.

**Table 2: Comparative Performance Analysis of Shariah-based and Conventional Stocks Based on Treynor Ratio**

Year	Average Treynor Ratio of Shariah-based Companies	Average Treynor Ratio of Conventional Companies
2017	-0.065	-0.076
2016	-0.545	-0.107
2015	-0.180	-0.102
2014	-0.007	0.053
2013	0.238	-0.018

Source: (<https://www.bseindia.com/indices/IndexArchiveData.aspx>, 2018)

In Table 2, it is observed that the average Treynor ratio of Shariah-based securities for the year 2017 is -0.065 and the average Treynor ratio of conventional securities is -0.076. Shariah-based securities had better performance than the conventional securities comparatively. In 2016, the Shariah-based securities had the average Treynor ratio of -0.545 while the average Treynor ratio of conventional securities is -0.107 which indicates that the Shariah-based securities had better performance than the conventional securities. In 2015, it is observed that the Treynor ratio of Shariah-based securities is -0.180 whereas the average Treynor ratio of conventional securities is -0.102. In this year, based on ratios of both the securities the performance of conventional securities is better than the Shariah-based securities. In 2014, the average Treynor ratio of Shariah-based securities is -0.007 while the average Treynor ratio of conventional securities 0.053 which clearly says that the conventional securities had far better performance than the Shariah-based securities. In 2013, the average Treynor ratio of Shariah-compliant securities is 0.238 and the average Treynor ratio of conventional securities is -0.018. It clearly indicates that the Shariah-based securities had the far better performance than the conventional securities.

**Table 3: Comparative Performance Analysis of Shariah-based and Conventional Stocks Based on Jensen Alpha Ratio**

Year	Average Jensen Alpha Ratio of Shariah-based Companies	Average Jensen Alpha Ratio of Conventional Companies
2017	0.092	0.061
2016	0.12	0.076
2015	0.075	0.053
2014	0.084	0.105
2013	0.054	0.099

Source: (<https://www.bseindia.com/indices/IndexArchiveData.aspx>, 2018)

In Table 3, the average Jensen's Alpha ratio of Shariah-based securities for the year 2017 is 0.092 whereas the average Jensen's Alpha ratio of conventional securities is 0.061. The performance of Shariah-based securities comparatively is better than conventional securities. In the year 2016, the average Jensen's Alpha ratio of Shariah-based securities is 0.12 and the average ratio of conventional securities is 0.076. The performance of Shariah-compliant securities based on the average

Treynor ratio is found to be better than the conventional securities. In the year 2015, the average Jensen's Alpha ratio of Shariah-based securities is 0.075 and average Jensen's Alpha ratio of conventional securities is 0.053, the Shariah-based securities had slightly performed better than conventional securities. In 2014, the average Jensen's Alpha ratio of Shariah-based securities is 0.084 whereas the average of Jensen's Alpha ratio for the same period is 0.105. The conventional securities had far better risk-adjusted performance than the Shariah-based securities for the year 2014. In 2013, it is observed in table 4.3 that the average of Jensen's Alpha ratio of Shariah-based securities is 0.054 and the average Jensen's Alpha ratio of conventional securities is 0.099. Looking at the calculated ratio of both Shariah-based and conventional securities, the conventional securities had better performance than the Shariah-based securities.

## Discussion

This study was intended to understand the risk and return associated with Shariah-based stocks listed in BSE, to analyze the risk and return associated with conventional stocks listed in BSE, taking into account the 10 consistently Shariah-compliant stocks listed on S&P BSE Shariah 50 Index. It is observed that based on Sharpe ratio, the performance of Shariah-compliant stocks is better than the conventional stocks in the year 2017, 2016, 2015 and 2014, based on the Sharpe ratio, the performance of the conventional stock is better than the Shariah-compliant stocks in the year 2013. It is also submitted that while based on Traynor ratio, the performance of Shariah-compliant stocks is better than the conventional stocks in the year 2013 and 2017. Based on Traynor ratio, the performance of conventional stocks is better than the Shariah-compliant stocks for the year 2016, 2014 and 2013. Based on Jensen's Alpha ratio, the performance of Shariah-compliant stocks is better than conventional stocks in the year 2017, 2016 and 2015 and based on Jensen's Alpha ratio, the performance of the conventional stock is better than the Shariah-compliant stocks in the year 2013 and 2014. The study also observes that BHEL security yielded the highest risk-adjusted return among the other Shariah-compliant securities based on the Sharpe ratio whereas the Infosys security among the conventional securities yielded the highest risk-adjusted return and Asian Paints has the highest risk-adjusted return among other Shariah-compliant securities based on Traynor ratio while the TCS has the highest risk-adjusted return among the conventional securities. The study

reveals that MRF security yielded the highest risk-adjusted return among other Shariah-compliant securities based on Jensen's Alpha ratio while the ICICI Bank has the highest risk-adjusted return among conventional securities.

This study contributes to the Islamic finance and capital market literature. Alike the observations of (Mohamed & Rubi, 2008; Beik & Arsyianti, 2015) this study reveals that the performance of Shariah-compliant stocks is better than conventional stocks during the select period. Similar to the findings of (Spence Laschinger, Wong, & Grau, 2012; Ibrahim & Mirakhor, 2014; Kenourgios, Naifar, & Dimitriou, 2016) this study also observed that return of Shariah-compliant securities is less volatile than the conventional security which indicates that the investment in Shariah-compliant stocks for long-term is good decision. As suggested by (Abdul Rahman et al., 2010; Loo, 2010; Ariff, 1988) this study also submits that as the speculation is prohibited in Shariah securities, return of Shariah-compliant stocks is better than conventional stocks; hence this study is a proof of confidence for the prospective investors in Shariah-compliant shares.

## Conclusion

The study examined the comparative performance of Shariah-compliant shares and conventional shares listed in BSE in India and submitted that the select Shariah compliant shares are outperforming the select conventional shares. However, the researchers do accept the limitations of this exercise in determining performance based on the limit number of stocks and optimization periods could have been enlarged to envelop a greater degree of information. It suggests for the further research with maximized samples and duration.

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