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How factor-based awareness can improve returns in Shari'ah portfolios

Written by: Imtiaz Suliman, Executive Director and Portfolio Manager at Sentio Capital

Shari'ah investing is based on the principles of Islamic or Shari'ah law and involves excluding certain sectors of the investment universe on the basis of their impact on society. For example, Shari'ah restrictions include avoiding interest-charging entities, companies that hold more than 30% of total assets in either debt or cash, and those that engage in what Shari'ah law views as socially harmful activities like gambling, alcohol and weapon manufacture.

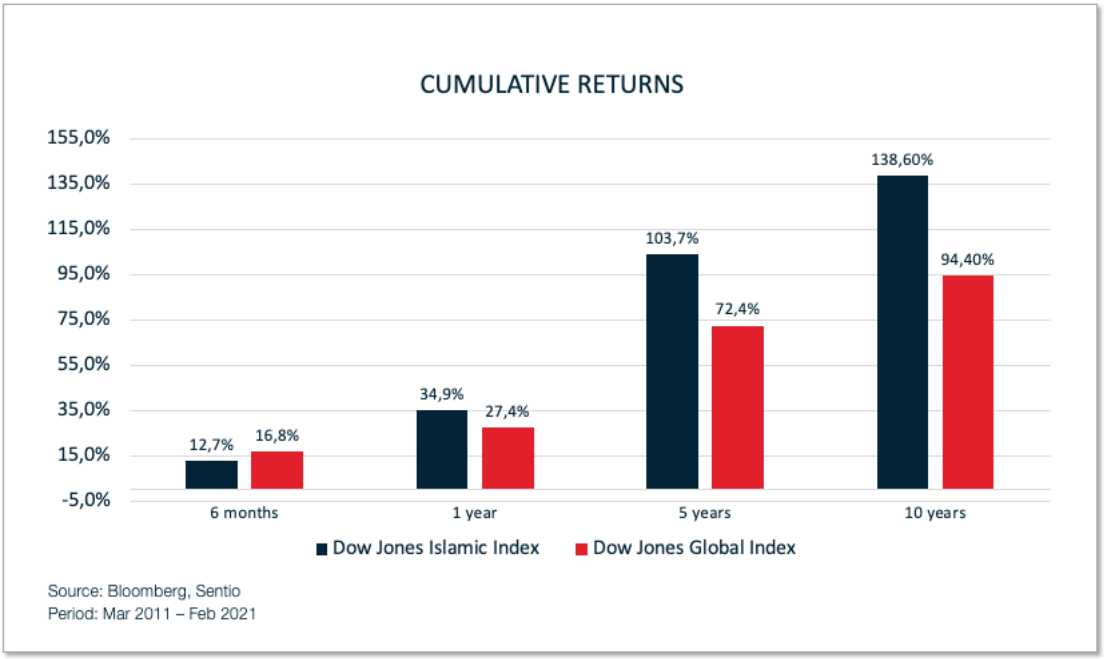
The approach is similar, in essence, to an ESG-focused investment approach. The main difference is that ESG funds can generally invest in financial counters whereas Shari'ah-compliant portfolios can't (either because of debt-related features or because they derive income from interest, which is explicitly forbidden in Shari'ah investing).

Can Shari'ah investing deliver returns as well as positive social impact?

For many investors, the idea that so much of the investment universe is excluded raises the question of whether financial returns are similarly constrained.

The evidence though, shows that in fact, Shari'ah investing has outperformed conventional indices as indicated in the graph below. The Dow Jones Islamic Index has outperformed the Dow Jones Global Index over one, five and 10 years for the period ending February 2021.

Figure 1: Cumulative returns of Shari'ah investing (as measured by Dow Jones Islamic index) versus traditional indices (as measured by Dow Jones Global Index)



A Shari'ah option offers a solution that satisfies the objectives of ESG investing whilst also delivering returns that are in line with, if not better than, a traditional index.

How can Shari'ah returns be achieved with factor-based investing?

Factor-based investing involves targeting specific exposures in the market to generate returns. These factor exposures include value, momentum, growth, quality, or low volatility to name a few.

Today, advancements in quantitative techniques allow investors to measure and access these factors efficiently. A manager can then exploit these factors over time by using machine learning to ascertain which factors are likely to outperform at a point in time as well as making use of a rigorous bottom-up fundamental analysis framework in order to extract these returns in an efficient manner. With the use of artificial intelligence and machine learning, one can better understand factor exposure in the portfolio and allocate risk to the various factors based on the output from these quantitative techniques.

Using a factor-based approach allows a manager to construct portfolios that are diversified whilst giving an investor exposure to a set of factors that are likely to outperform.

As an example, the lack of financial exposure in Shari'ah portfolios can be compensated for with exposure to retailers and property counters that are Shari'ah-compliant. This is achieved as the high cross-correlation between retailers and property gives an investor a similar factor exposure to the financial sector.

Another way to gain financial exposure in a Shari'ah fund is to invest in financial equities that are Shari'ah-compliant. A vast majority of these Shari'ah-compliant financial equities are domiciled in the Middle East or Asia. From a factor perspective this would increase emerging market (EM) exposure in the portfolio.

Knowing the risks that these instruments bring to the portfolio allows the investment manager to balance the exposure of the overall fund by limiting the EM weights in the portfolio or by finding counters that diversify away some of the financial and EM-specific risks that may be brought into the portfolio.

A Shari'ah investor need not be concerned about underperformance given the constrained universe. A skilled manager, who is able to measure factor exposure effectively and who is able to find factor exposures that are lacking domestically should be able to compensate for this somewhat restricted universe by finding counters that exhibit similar factor exposures locally or by accessing specific factor exposures in Shari'ah compliant counters listed offshore. This will allow the manager to build robust diversified portfolios and deliver better risk-adjusted returns over time.

Glacier Research would like to thank Imtiaz Suliman for his contribution to this week's Funds on Friday.

Imtiaz Suliman,
Executive Director and Portfolio Manager
Sentio Capital

Imtiaz is an Executive Director and Portfolio Manager at Sentio with more than 15 years of investment experience. He manages the Sentio Shari'ah Equity and Sentio Shari'ah Balanced Funds and is involved in the asset allocation as well as the stock selection for these funds which make use of fundamental as well as quantitative techniques.

Prior to joining Sentio in 2010, Imtiaz was a senior member of the Alternative Investments team at RMB Asset Management. He has extensive knowledge and experience in derivatives and was responsible for equity selection across a range of funds which consisted of the absolute return product range, structured products and hedge funds.

Imtiaz holds a BSc in Financial Mathematics and is a CFA charter holder.