In focus

The alignment of Shariah and sustainable investing

November 2019

This paper makes the case that investors who embrace Shariah principles should also aspire to adopt the ideas of sustainable investing. Our analysis shows that the two sets of principles have a high degree of overlap. We believe that the providers of Shariah funds should move beyond basic Shariah-based exclusion of industries and companies from their investment universe to an approach which more fully respects the Islamic values of socio-economic justice and overall well-being.

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This is a summary version of a longer paper on the alignment of Shariah and sustainable investing. The full version is available on relevant Schroders' and Maybank websites, or by contacting Schroders or Maybank directly.

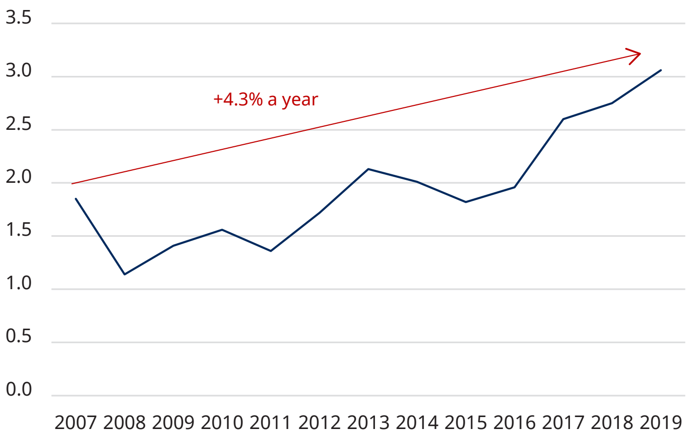
The approximately 1.8 billion Muslims globally represent around a quarter of all people on Earth. However, despite their numbers, Muslims have been underserved by the asset management industry, with limited innovation in product offerings and low growth in assets. As of June 2019, only $3 billion was invested globally in Shariah global equity funds (Figure 1). Furthermore most funds have struggled to achieve scale – in 2017, 69% of funds had assets under management of less than $25 million[1].

This can be contrasted with the rapid growth of assets invested along sustainability lines. There is now over $133 billion invested in funds in this sector (Figure 2 over the page). This is quadruple the amount invested in this way in 2011.

1 Islamic Financial Services Industry Stability Report, 2018.

Figure 1: The Shariah universe is small and growing slowly

Global Shariah equities, $ billion assets under management



Source: Broadridge, as at July 2019.

"Although it has previously received less attention within the Islamic finance fraternity, sustainable investment is, in fact, an embedded principle in Islamic finance. Islam emphasises extensively the sustainable development and protection of the life, which is one of the general purposes of the Shariah (maqasid Shariah). Of course, this notion of sustainable investment should be understood and interpreted within the principles of Shariah. Hence, the alignment of Shariah and sustainable investment as advocated by this report is very timely and highly commendable. I congratulate the team for preparing this important research."

Assoc. Prof. Dr. Aznan Hasan
Chairman of the Shariah Committee, Maybank Islamic Berhad

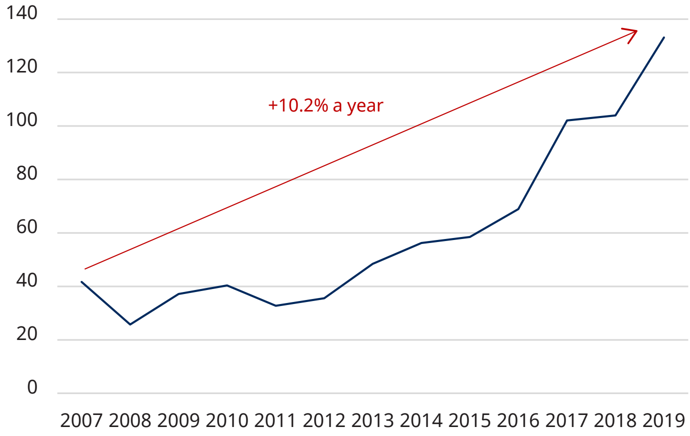
"Historically investors who were interested in investing according to their values were limited to just focusing on what a company produced. Shariah-compliant investments are a prime example. But we all know that how a company conducts its business is equally important, especially when evaluating the impact on the wider world. As sustainable analysis and data grows, Muslim investors now have the opportunity to move beyond mere compliance, to holistically express their values and assess the impacts of their investments. A shift towards a more explicit focus on sustainability is both in keeping with the teachings of Islam and aligned with what investors worldwide are increasingly demanding."

Jessica Ground,
Global Head of Stewardship, Schroders

In collaboration with

Figure 2: The popularity of sustainable investing has grown rapidly

Global equities-responsible investments sector, assets under management, $ billions



Source: Broadridge, as at July 2019.

This illuminates a paradox, as there is significant overlap between Shariah and sustainable investing (see below). Incorporation of sustainability considerations is both complementary in philosophy to Shariah investing and has the potential to improve investment outcomes. The Shariah industry has languished but there is no reason why, if this alignment is embedded and promoted more actively, it cannot grow substantially and better serve the Muslim community. Two important points merit deeper consideration:

1. The consistency between Shariah and sustainable principles
2. The fact that Shariah portfolios score better on sustainability criteria than traditional stock market portfolios...but this is partly fortuitous rather than by design.

Consistency in principles

There are many variants of sustainable investing, each with a specific focus, but a common underlying principle is to incorporate how a company interacts with society and its environment in the investment decision-making process. It can involve excluding companies involved in certain sectors or it can more generally take account of Economic, Social and Governance (ESG) factors when assessing the potential risks and rewards of an investment[2].

Shariah investing has traditionally focussed on excluding companies which do not comply with Shariah principles, such as earning revenues from prohibited activities (e.g. alcohol, gambling, adult entertainment and non-Shariah-compliant finance). The prohibition of interest, or riba, under Shariah law also means that companies which exceed prescribed limits on the portfolio of debt or cash are not permitted. Environmental impact is not normally a consideration.

2 For more information, see A short history of responsible investing, Schroders, November 2016

However, the teachings of Islam have a much broader reach. The objective of Shariah law or what is known as the **Maqasid-al-Shariah**, is to promote the welfare of humankind and prevent harm by preserving religion, life, intellect, the interests of future generation, and wealth[3]. The Islamic view holds that all natural and depletable resources are blessings from Allah (swt) and they are to be managed in trust in order to ensure the rights of this and future generations are preserved. Therefore, Shariah investing widens the focus beyond financial returns to include the overall well-being and welfare of individuals and society at large as well as environmental preservation.

It is immediately apparent that there is a lot of common ground covering Shariah and sustainable approaches. However, although Shariah investing has not fully embraced this alignment, it has gained prominence in other aspects of Islamic finance. For example, the Securities Commission of Malaysia has issued the Social and Responsible Investing Sukuk framework, one of the first guides linking Islamic Finance with sustainable investing[4].

The central bank of Malaysia, Bank Negara Malaysia, is also promoting "value-based intermediation" as a vision of how the Islamic finance industry should operate. Asset management is covered in this vision. It is described as:

> "An intermediation function that aims to deliver the intended outcomes of Shariah through practices, conduct and offerings that generate positive and sustainable impact to the economy, community and environment, consistent with the shareholders' sustainable returns and long-term interests"[5].

Bank Negara Malaysia specifically highlights that "it is essential that greater emphasis should be given to considering the wider impact of the financial activities" and the benefits of shifting "beyond compliance, towards delivering value propositions not only to all financial consumers, but to the wider stakeholders within the society and the economy at large". It also highlights the similarities between values-based intermediation, ESG and sustainability. For example, one consequence of a shift towards values-based intermediation would be that "any activities that would create damage to the community and the environment, for example pollution or deforestation, will be reduced over time."

Similar moves towards greater promotion of sustainability have been occurring elsewhere in Islamic finance. For example, the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions' (AAOIFI) set of norms-based standards for corporate and social responsibility (CSR) specifically set out mandated and recommended actions for Islamic financial institutions to follow with regard to ESG factors.

If approaches such as these were applied to Shariah investing, it would result in almost complete convergence between Shariah and sustainable investing. This would have been impractical in the past due to data limitations. However, the rapidly growing volume of ESG data that is now available makes it possible to assess public companies against these criteria.

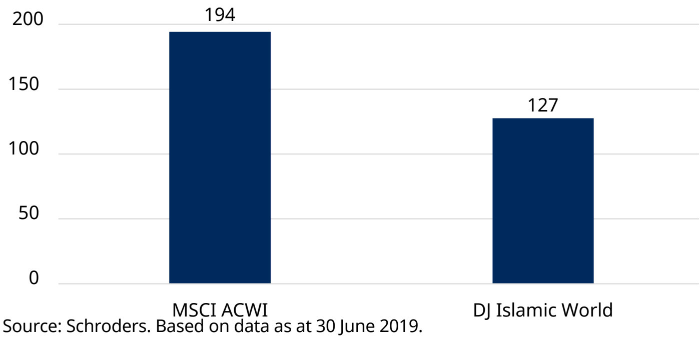
3 Introduction to Islamic Economics, Askari et. al (2015)

4 Islamic Green Finance: Development, Ecosystem and Prospects SC and the World Bank Group (March 2019)

5 Implementation Guide for Value Based Investing, Bank Negara Malaysia, October 2018

Figure 3: Shariah portfolios have lower carbon intensity than traditional portfolios

Carbon intensity (Tonnes of CO2 emissions / $1 million revenues)



Source: Schroders. Based on data as at 30 June 2019.

Shariah portfolios score better on sustainability criteria than the broad market

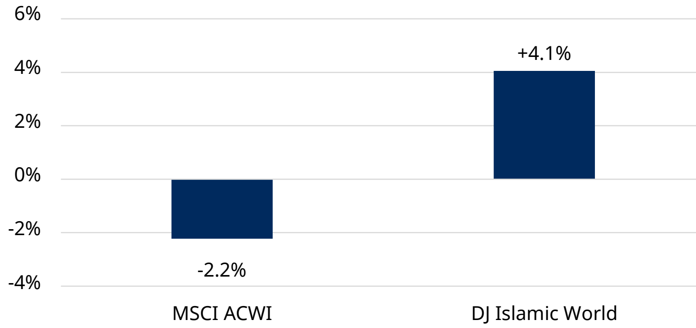
Our research shows that the Dow Jones Islamic Market World Index (DJ Islamic World), one of the most prominent Shariah-compliant equity benchmarks, scores much better than the broad market on a number of sustainability criteria. Despite it not being a focus, the carbon intensity of the DJ Islamic World, measured in tonnes of CO2 emissions per million dollars of revenues, is 34% lower than the MSCI All Country World Index (MSCI ACWI used for comparison purposes rather than the Dow Jones Global index as it is the more widely followed global benchmark). This is a significant reduction (Figure 3). One reason for this is that the DJ Islamic World has minimal exposure to the utilities sector, avoiding heavy-polluting coal-fired power plants in particular. However, this underweighting relative to the broader market occurs, not for environmental reasons, but because these companies tend to have high levels of leverage, which breach the Dow Jones Shariah criteria.

It is also possible to make a broader assessment of the social impact of companies in Shariah portfolios compared with traditional portfolios. Schroders' proprietary SustainEx model allows us to do this. It quantifies the external costs and benefits imposed by a company on society across a wide ranging set of variables[6]. Historically society, the environment and governments have picked up the tab but, from carbon credits to sugar taxes, this is changing. SustainEx assesses the impact on a company's profitability if these costs and benefits were pushed back on to the companies which generate them. The analysis can be aggregated into a single figure, which scales a company's net social cost to its revenues. For example, the social value/sales for the MSCI ACWI is -2.2%. In other words, for every $100 of sales, there is an additional $2.20 of costs imposed on society and profits would be $2.20 lower if these costs were fully recognised. Given that the net profit margin on the MSCI ACWI is currently 8.7% (source: Bloomberg, July 2019), an imposition of an additional cost of $2.20 would reduce that profit margin to 6.5%, cutting profits by 25%. This should not be interpreted as an expectation, rather as an indicator of the risk facing companies.

6 Examples include environmental metrics such as CO2 emissions and water usage. It captures the costs associated with treating and managing problems associated with alcohol, gambling and tobacco. It also compares the effective tax rates paid by companies with the statutory tax rates for the regions where they operate, as a measure of their over- or under-payment, and the value they contribute or detract from society. It additionally recognises the benefits that accrue to society from different activities. These include charitable donations and the social value of employment (compensation levels, employee training etc.). For more information, please see SustainEx, Schroders, April 2019.

Figure 4: Shariah portfolios have a positive social impact whereas standard portfolios have a negative impact

Social value/sales



Source: Schroders. Based on data as at 30 June 2019. Social value/sales is an estimate of the external costs and benefits imposed by a company on society across a wide ranging set of variables, scaled by its sales. For more information, please see footnote 6 and SustainEx, Schroders, April 2019.

The companies in the DJ Islamic World index have, in aggregate, a materially better social impact than the MSCI ACWI. Rather than imposing an unrecognised cost on society, companies in this index have a net positive social value, in aggregate. Schroders' SustainEx analysis estimates their social value/sales at +4.1% (Figure 4).

There are elements of Shariah investing's more favourable scoring for social impact which are very purposeful; for example, the exclusion of alcohol, gambling and tobacco companies, which are clearly very harmful for society. However there are other elements which are accidental, such as the low exposure to utilities noted earlier. If utilities were to reduce their debt levels, then they could form part of Shariah portfolios and this advantage would reduce. The MSCI ACWI Islamic index is a case in point – it uses a different set of rules to assess eligibility which results in it having the same weight in the utilities sector as the MSCI ACWI and it being overweight the energy and materials sectors[7].

The DJ Islamic World also scores well for having a large allocation to the healthcare sector, given the potential benefits to society from medical advances. However, this is a fortuitous side effect of other sectors being excluded rather than because the index has been designed to favour healthcare companies in any way.

Formal integration of sustainability within a Shariah portfolio would make these improvements more purposeful and resilient. It would also formally recognise that sustainability principles are at the core of Islamic beliefs, a fact which has failed to receive the prominence it deserves among traditional Shariah investment products. It would furthermore be a progression from the current practice of excluding what is wrong, to also prioritising what is right – to a more integrated form of Shariah investing.

7 This occurs because of a difference in the way that Dow Jones and MSCI apply accounting-based Shariah tests of cash and leverage – Dow Jones compares cash and leverage to the trailing two year market capitalisation of a company whereas MSCI makes a comparison with the book value of a company. For companies with material intangible value (e.g. intellectual property), book value is likely to understate value relative to market capitalisation. Large technology companies such as Apple, Amazon and Alphabet (Google) are notably affected. They fail the MSCI test so are excluded from the MSCI ACWI Islamic index. One consequence of excluding some of the largest companies in the world is that other companies which are not excluded experience an increase in their weight (to ensure that all weights sum to 100%). This explains why the energy and material sectors end up with a relatively large weight in the MSCI index. In contrast, these large technology companies pass the Dow Jones test and no such distortion occurs in the DJ Islamic World.

Figure 5: Some areas of difference can be bridged relatively easily but others less so

Shariah investing principle	Relationship with sustainable investing
Prohibition of interest	A bias away from highly indebted companies is consistent with sustainable investing; high levels of debt are likely to make a business vulnerable to adverse external developments. By reducing some of the potential downside risks during times of stress, resilience and sustainability of returns could be improved. In this sense, leverage restrictions could be considered an additional source of prudence. Low leverage is also typically one of the main indicators used to assess the "quality" of a company in a factor exposure sense. Shariah portfolios are biased towards the "quality" factor. A company sitting on a high cash balance could be an indication of poor corporate governance. As well as being potentially inefficient – it may be better to return excess cash to shareholders – it also increases the risk of cash being squandered on ill-advised acquisitions.
Exclusion of traditional finance sector	No equivalent restriction. Traditional sustainable investment products are not Shariah-compliant. Where Shariah compliance is essential, Shariah principles must take precedence. Shariah-specific products are required.

Source: Schroders.

What about areas of difference?

The two main areas of difference between Shariah and sustainable approaches to investing concern the prohibition of (receiving or paying) interest and the exclusion of the traditional finance sector. The first of these can be considered consistent with conventional (non-Shariah) views on sustainability, although the latter has no equivalent (Figure 5). Where Shariah compliance is essential, Shariah principles must take precedence. Shariah-specific products are required.

Current offerings force a compromise

Muslim stock market investors are currently faced with a choice between two competing options:

- Invest in a Shariah-compliant fund that pays no formal heed to environmental considerations.
- Invest in a traditional sustainable fund, which is not Shariah-compliant.

Neither is satisfactory. Furthermore, 66% of Asian respondents to the Schroders 2019 Global Investor Study[8] said they would always consider sustainability factors when selecting an investment product, higher than the 57% globally who agreed with this statement (Figure 6). An even higher percentage felt this way in Indonesia (76%), a predominantly Muslim country. The figure for the United Arab Emirates was also above average, at 62% (individual country-level data not available for other predominantly Muslim countries). Furthermore, Middle Eastern and Asian respondents also felt more strongly than their global peers that climate change will impact their investments.

In other words, there is strong demand for investment products which take account of sustainability factors but Muslims are currently forced to forgo their Shariah beliefs in order to source them.

8 A survey which measured the views of more than 25,000 investors across 32 countries. The survey does not break results down by religion.

Figure 6: Sustainability and climate changes are important factors for Asian and Middle-Eastern investors

	Global	Asia	Indonesia	UAE
I always consider sustainability factors (such as climate risk, diversity, corporate governance etc.) when selecting an investment product	57%	66%	76%	62%
Climate change is having, or will have, a significant impact/some impact on my investments?	63%	67%	78%	73%

Source: Schroders 2019 Global Investor Study.

A call to action

The traditional exclusionary focus of the Shariah investment industry is ripe for disruption. It resulted from the industry attempting to replicate what already existed in the traditional investment industry, in a Shariah-compliant way. However, if we were to start with a blank sheet of paper today, using Shariah principles as the anchor for portfolio construction, we would probably end up with something quite different. Sustainability considerations would likely feature strongly.

Muslims should not be forced to compromise between their religious beliefs and their desire to invest in a sustainable manner, especially given that the underlying principles are so closely aligned. The Shariah industry has languished but, if it bridges this divide, it has the potential to grow substantially and better serve the Muslim community.

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