Islamic finance and ethical investment

Rodney Wilson
Department of Economics, University of Durham, Durham, UK

The amount of finance designated as being ethically invested in the UK currently exceeds £1 billion, of which over £414 million is in the Friends Provident Stewardship Fund. In the USA over 20 times this amount is invested ethically, including finance which is invested in environmentally friendly projects and companies which are screened using moral criteria. Companies which are engaged in tobacco production or distribution or are involved in armaments are typically excluded by US ethical fund managers.

Islamic investors may be concerned with a very different set of ethical criteria from Western "green" or ethical investors, but the issues of stock selection and screening technique are of mutual interest. There is arguably much that both parties can learn from one another, especially with respect to investment techniques, even though the underlying moral value systems are very different, and there is no question of importing or exporting cultural norms or religious beliefs.

Western ethical fund management issues are addressed first in this paper, which should shed some light on the dilemmas facing Islamic investors. Criteria for *haram* and *halal* investment are then considered, as well as whether prime business activity should be a defining characteristic of stock selection. The implications of company capital gearing or leverage for *riba* is discussed, as well as investment specific issues such as the treatment of capital gains in Islam and the evaluation of the conduct market participants. Muslims view deception or *gharar* as illegal under the *shariah* Islamic law, which means transparency is required in investment dealings. Finally emerging markets in the Islamic world are surveyed, as these are of obvious interest to Muslim investors wishing to broaden their portfolios.

The design of and demand for ethical investment products

The development of specifically ethical investment products is a phenomenon that emerged during the 1970s in response to the demands of particular types of customers. Some see the concept as a mere fad, a pandering to political correctness, while others see it as a cynical attempt by some financial institutions to exploit their clients' potential benevolence, perhaps paradoxically in an unethical way. An investment company or unit trust may claim it is not investing in armaments companies or in ventures which cause environmental damage, and explain that as a result it is having to pay a lower return. There may be an economic argument for this, as excluding some potentially profitable activities may reduce the return on any portfolio in relation to the risks involved.

International Journal of Social Economics, Vol. 24 No. 11, 1997, pp. 1325-1342. © MCB University Press, 0306-8293

If, however, the return is much lower than that offered by non-ethical investments, and the criteria for exclusion are narrowly defined, then the poor rewards to the investor may simply disguise incompetent management or the fact that the institution is siphoning off profits to its executives or other insiders.

Ethical banking and investment may be simply viewed as a marketing ploy to appeal to the environmentally concerned, pacifists or leftists who view all private financial institutions with suspicion[1]. It is related to the politics of direct action which was invigorated by the anti-Vietnam war protests of the late 1960s and the green and ecology movements of the 1970s and 1980s. It is an attempt to appeal to the beliefs and values of individuals who have taken part in or been influenced by these movements. The aim is to get potential clients to translate their political preferences into their financial practices, by convincing the investor that the institution concerned shares his or her point of view. From a marketing perspective this is a way of winning client trust and encouraging loyalty, while persuading the investor that more is being offered than a mere financial term, and that the institution is adding value in a qualitative sense. The aim is produce a "feel good" factor for the investor, so that he or she can have a good conscience about the returns on their assets.

Cowton (1994, pp. 213-32) defines ethical investment as the use of ethical and social criteria in the selection and management of investment portfolios, generally consisting of company shares. Ethical investors are not only concerned about the financial returns on their portfolios and the risks involved, but also with the characteristics of the companies in which the funds are placed. This involves the nature of the company's goods or services, the location of its business and the manner in which it conducts its affairs. The strategy for ethical investment can either be positive or negative, the former being supportive of companies which are particularly approved of in terms of their products, activities or business methods. The latter aims to avoid investing in companies which are involved in unacceptable products or countries, or whose business methods are regarded as unethical. Negative criteria are more usual than positive criteria, with investors starting with a complete listing of quoted companies, and then excluding the unethical minority.

Cowton discusses product design issues, as although it is possible to have a customized professionally managed ethical portfolio, in practice most ethical investment is placed in standardized offerings (1994, pp. 222-27). For individuals and institutions with more than £100,000 to invest, a personalized ethical stockbroking service can be provided, firms such as Holden Meehan being specialists in this for the UK market[2]. It is only worth constructing tailor made portfolios to meet the clients income or capital growth and ethical objectives if substantial amounts are involved, as fund monitoring costs are relatively high for a stockbroker offering a conscientious service, and a large portfolio is necessary to ensure adequate diversification to reduce risk. The standardized products can be purchased through a stockbroker or directly from the investment institution managing the ethical fund, with investments of as little as £1,000 accepted, or savings of £50 a month for regular investment plans.

The earliest established and largest ethical fund in the UK is, as already mentioned, the Friends Provident Stewardship Fund which started operating in June 1984. Friends Provident is one of Britain's oldest mutual insurance companies, established by the Society of Friends, better know as the Quakers, because of their fear of God, in the mid-nineteenth century. Although Friends Provident has long catered for the wider public regardless of religious affiliation or belief, and its employees can be of any or no religion, it still tries to conduct business in accordance with the ethical beliefs of its founders. It offers a full range of investment services, and most of its funds are not employed on a specifically ethical basis, but the provision of ethical investment seemed a natural extension of its activities following the start of similar funds in the USA.

Positive ethical criteria used by the managers of the Stewardship Fund when examining companies for possible investment include a good record for quality products, safety, staff management and customer relations. Companies involved in environment improvement and pollution control are favoured as well as those with interests in sustainable woodland management and energy conservation. Negative criteria means the exclusion of companies which promote gambling or pornography, or are engaged in tobacco or alcohol production or distribution. Military suppliers are also excluded, as well as companies involved in the exploitation of animals for cosmetics or the fur trade, or in factory farming for the meat trade. The rulings of the Health and Safety Executive, the National Rivers Authority and the Advertising Standards Authority are studied, as companies which are subject to prosecutions or complaints from these authorities are excluded.

Friends Provident do not take a proactive approach to ethical investment, their policy being to simply not invest in, or withdraw from involvement with companies which do not meet their guidelines. In contrast Britain's second largest ethical fund, the Merlin Jupiter Ecology Fund, "pushes" companies to respond beyond the letter of the law to issues raised by their sustainable development agenda. The Merlin Resources Unit is engaged in a continuous dialogue with the companies they fund, and their research unit produces a bi-annual newsletter. Investors are invited to fill in regular questionnaires so that their views on the Fund's policies can be ascertained, the emphasis being on constructive and open exchange of views. Although only founded in March 1988, by 1994 the Merlin Jupiter Ecology Fund had £62 million under management which was invested internationally[2], including in worthwhile projects in developing countries.

Table I shows the major ethical funds in the UK, which had assets worth over £766.5 million under management in 1994.

The Friends Provident Stewardship Fund was by far the largest player accounting for over 54 per cent of the market, with some of the other funds being very small. Holden Meehan ranks the funds according to the resources applied to screening which is obviously important for ethical management. Friends Provident scores well, as does the Jupiter Merlin Ecology Fund, but it is evident that some of the major insurance companies which are very new to

	Assets £million	Market spread[a]	Launch date	Screen[b]
Friends Provident Stewardship Fund	414.0	UK+	6/84	5
Credit Suisse Fellowship Trust	5.2	UK	7/86	4
Framlington Health Fund	11.8	Int	4/87	4
Abbey Life Ethical Trust	22.1	UK+	9/87	5
NIM Conscience Fund	12.3	UK+	9/87	4
Allchurches Amity Fund	19.0	UK	2/88	4
Jupiter Merlin Ecology Fund	62.0	Int	3/88	5
City Financial Acorn Ethical Unit Trust	3.6	Int	3/88	2
Scottish Equitable Ethical Unit Trust	25.5	UK	4/89	5
Sovereign Ethical Fund	9.1	UK	5/89	2
Eagle Star Environmental Opportunities Fund	13.5	UK+	6/89	1
TSB Environmental Investor Fund	23.3	UK+	6/89	2
Homeowners Friendly Society Green Chip Fund	13.5	UK+	11/89	3
Commercial Union Environment Exempt Pension Fund	33.0	Int	12/89	2
Clerical Medical Evergreen Fund	15.9	Int	2/90	5
CIS Environmental Trust	26.9	Int	5/90	3
NPI Global Care Fund	6.7	Int	8/91	5
Abtrust Ethical Fund	1.3	Int	9/92	2
Sun Life Global Management Ecological Fund	4.0	Int	12/92	2
Mercury Provident Personal Pension Plan	15.5	Int	1/94	5
Co-operative Bank Ethical Unit Trust	12.8	UK	9/93	3
Equitable Ethical Trust	15.5	Int	1/94	3

Notes:
[a] "UK+" is mostly domestic with limited international exposure, "int" is worldwide
[b] Resources applied to screening – an assessment by Holden Meehan of the time, care and expertise applied to selecting shares. A higher number indicates a more comprehensive screening process

Table I.
British ethical funds

ethical investment and have relatively small amounts of funds deployed in this way are not devoting sufficient attention to the screening. One question is whether Eagle Star, the Commercial Union and Sun Life would attract more funds if they treated ethical investment more seriously, or if the lack of company support reflects a perception that their ethical funds have not been a success, and therefore it is not commercially viable to channel resources in this direction. Cynics might suggest that they were merely jumping on an ethical bandwagon, and using ecology and the environment as marketing ploys.

The performance of ethical funds

Although some investors may be more than willing to sacrifice returns for the sake of funding an especially good cause, the performance of ethical funds is of as much concern as that of any other fund, as the ethical investment industry does not want to see its backers loose out in relation to those with holdings in purely commercial funds; otherwise they will have relatively less to invest in the future. Ethical investors themselves still hope for above average performance, usually defined in terms of capital gains in relation to benchmark indices such as the FTSE 100 or FTSE All Share in the case of the UK or the Dow Jones index in the case of Wall Street. It can be argued that placing restrictions on share selection on ethical grounds results in a smaller universe from which to select potential purchases, which must adversely affect returns. Ethical fund managers argue, however, that the overall stock market is large, with a capitalization of £800 billion in the UK alone. They suggest that stock worth over £320 billion, representing 40 per cent of the total, is eligible for ethical investment. Given this large pool available for ethical investment, performance is unlikely to be any different from that of unrestricted investments.

There is a bias in ethical investment towards medium-sized and smaller companies in both the UK and the USA, with 80 per cent of the companies listed in the FTSE 100 not eligible for ethical funding for one reason or another[3]. As the medium-sized companies in the FTSE mid 250 index and the FTSE smaller companies index typically outperform those in the FTSE 100, reflecting the greater risks involved, ethical investment in medium and smaller companies might be expected to perform better than that in larger companies. Over the 1988 to 1993 period in the UK the average ethical pension fund grew by an average of 14.2 per cent per year, compared with 13.4 per cent for the average conventional pension fund[4]. However, over the 1995-1997 period larger companies have performed better than those comprising the FTSE 250 index.

Performance within the ethical investment sector varies widely however, although these differences are similar to what is found within other sectors. The Allchurches Amity Fund rose by 21.1 per cent over the year to 9 February 1996, 1.3 per cent more that the *Financial Times* All Share Index, while the Abbey Life Ethical Trust rose by 16.3 per cent over the same period, 3.5 per cent below the *FT* All Share Index[5]. The Scottish Equity Ethical Unit Trust recorded a 27.5 per cent rise over the 12-month period to September 1996, while the Friends Provident Stewardship Fund recorded the largest rise of the major ethical funds of 27.6 per cent[6]. The so-called "high low" chart illustrates the price trends and annual price variations of the Friends Provident Stewardship Fund since its instigation in 1985. Quarterly data were used, the top of the bar for each year showing the highest price attained at the end of a quarter and the bottom the lowest quarterly price. So-called opening and closing prices are also shown. As the bars refer to years rather than days the line to the left of each bar shows the price for the end of the first quarter of each year, usually 31 March unless this falls on a weekend or the Easter holiday. The line to right shows the price for the end of the final quarter, typically 30 December, as the 31st is not a trading day (see Figure 1)[7].

As with any equity-based investment, with ethical funds the size of capital gains or losses depends crucially on the timing of purchases and sales. The problem is to anticipate the price peaks and troughs in any particular time period when the investor has funds to deploy. One way round the difficulties in timing purchasing decisions for small investors is to subscribe to a monthly

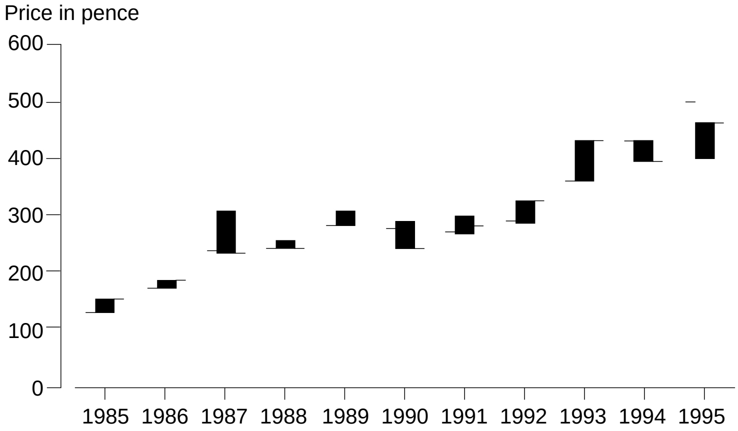


Figure 1.
Friends Provident Stewardship Fund

Source: *Datastream International*, February 1996

savings plan, which irons out the peaks and troughs[8]. This facility is offered by most ethical funds, the minimum subscription being £50 per month. The larger ethical funds also offer personal equity plans which can improve returns, as under these UK government provisions investors can realize capital gains of up to £6,000 per year without paying tax. Tax advantages can also be realized by linking investment in ethical funds to pension plans, which increases benefits in relation to monthly contributions.

Most of the ethical funds are set up on a unit trust basis, with the prices of the units related to a weighted average of the prices of the underlying shares held. Ethical investment companies represent a slightly more risky investment, as these companies can borrow from banks for share purchases, unlike unit trusts. This added gearing gives the fund managers more flexibility over the timing of investment acquisitions and sales, which do not have to be adjusted immediately to withdrawals as in the case of unit trusts. Substantial capital losses with borrowed funds can be disastrous for any investment company, including those run on ethical lines.

In the USA ethical investment has been part of the financial scene for over two decades. There are two measures of the performance of US ethical funds compared with conventional funds. The first by the Lipper Corporation shows ethical mutual funds, the US equivalent of unit trusts, rising by over 95 per cent over the five-year period up to December 1992, compared with an 80 per cent price rise for conventional funds. The second, the Domini Social Index, comprises 250 ethically screened companies from the Standard and Poors 400 largest American companies, plus 150 socially acceptable smaller companies. When this index is tracked against the S and P 500 largest companies, it reveals a 10 per cent advantage over the July 1990 to December 1993 period[9].

In the UK the Church Commissioners who look after the financial assets of the Anglican church do not use ethical screening, although in the 1970s and 1980s they avoided investments in South Africa. The Church Commissioner's policy on investment in the late 1980s caused much controversy, not so much on ethical as on financial grounds, as they lost a considerable amount of money in ill-judged property investments, by buying at the peak of the price cycle, and then experiencing a drop in the value of their assets, and a fall in rental income as tenancy contracts came up for renewal. Rather than attempting to manage their finances "in-house", other churches, including the Methodists and the Presbyterians, have used professionally managed ethical funds, the Allchurches Life Amity Fund, as its name implies, being particularly tailored to this market, as is Clerical and Medical, which has handled pensions for the clergy.

Islamic investments as ethical investments

Islamic investors have a range of choices when constructing a financial portfolio. These include *riba* free bank deposits, investments in Islamic unit trusts and investment companies, private placements in Muslim businesses and investments in conventional institutions and businesses which undertake to deploy funding from Islamic investors on an *halal* basis. Options regarded as *haram* include conventional bank savings and investment deposits, the purchase of interest yielding bonds, and the acquisition of shares in companies involved in alcohol production or distribution or in pork products.

Participatory finance through *musharakah* was one of the earliest forms of Islamic finance involving a partnership between the provider of the capital and the user or entrepreneur. Such financing was used widely and successfully in the Muslim world, usually for the funding of small businesses. Short-term trade finance was available through *murabahah* arrangements[10], but longer-term capital projects were funded through *musharakah*. There was usually a formal contract between the parties specifying the amount of the funding, the proportion of the profit shares, what happened in the event of losses, and the terms of divestment. Usually the *mudarab* would have to be consulted if the provider of the capital sold his stake in the business to another party. Divestment was the usual ultimate outcome, but this could not simply be carried out unilaterally as happens with the sale of equity in a traded stock.

Traditional *musharakah* can be looked on as a type of venture capital financing, with relatively high risks involved for the provider of the funding. The risks are greater today given the much more competitive international conditions than they were in the isolated and to a large degree sheltered markets of Muslim countries historically. In this modern context the number of individuals who are in a position to provide *musharakah* financing is limited, although modern *musharakah* funding through equity market participation may have much smaller risks because of the ease of divestment.

Perhaps the best method of *musharakah* financing in a modern financial context is through Islamic banks. Because the banks have the resources to build up diversified *musharakah* portfolios, they are able to engage in such financing at much lower risks to themselves. Yet Islamic banks appear to concentrate excessively on short-term murabahah financing, and have neglected to a considerable extent the possibility of *musharakah*. In so far as they undertake longer-term finance it is through *ijara* or leasing. Although useful for many Muslim businesses, this cannot be regarded as a substitute for *musharakah*, which involves risk sharing through partnership. *Musharakah* is regarded by many *shariah* scholars as the mode of financing which comes closest to the Islamic ideal, and there have been many who urge its use more widely. Given such opinions, why have Islamic banks not undertaken such financing to a greater extent, and what can be done to encourage its development?

Criteria for *halal* and *haram* investment

What selection criteria should be used when determining which companies are acceptable from the point of view of Islamic investors? How should the companies be ethically monitored? Can such monitoring be carried out in a cost-effective fashion given the large amount of published information available in most company accounts? How much attention should be paid to company mission statements? How seriously should press reports be treated? Does the rejection of companies on ethical grounds imply that an Islamically acceptable portfolio will yield lower dividends and smaller capital gains than one not subject to non-financial constraints?

There are a multitude of issues that confront any Islamic investors wanting to place funds in equity markets. Purists could of course argue that all investment in western markets and those of most Muslim countries is unacceptable, as quoted companies inevitably deal with *riba*-based banks. Many deal in products which are not acceptable to Muslims, even if their main business is *halal*. Food retailers, hotel chains and airlines, for example, often derive a proportion of their revenue from alcohol sales, but does this mean that such businesses are to be classified with breweries and excluded from any Islamic investment portfolio?

Traditional arrangements involving *musharakah* represented a type of high risk Islamic venture finance, with the financier often unable to liquidate his or her assets as the company was unquoted, and as a buyer could not easily be found. Such financing may be appropriate for specialist venture capital companies, but private individuals and conventional investment companies usually want more liquid assets. If finance is to revolve and deployment to work efficiently, marketability is essential. Asserting that all Islamic equity finance should be in small unquoted and highly risky companies is to deny Muslim investors the opportunity of participating in global capital markets. For a diversified portfolio involvement in western markets is essential, with perhaps some exposure in Istanbul and Kuala Lumpur, although again this may not be seen as *halal* to some purists, given the involvement of the leading companies in these markets with *riba*-based banks.

In an imperfect world, where most financial markets do not function according to the *shariah* law, pragmatism may be considered the most appropriate way of serving Muslim interests. The government of the Islamic Republic of Iran allows its companies and banks to deal normally in western financial markets, even though the internal financial system is Islamized. It has little choice but accept this second best solution if it is to continue trading internationally.

For equity investment it can be argued that investing in companies involved with *riba*-based banks can be dealt with in a similar fashion. Furthermore what matters is the company's main business activity, and it is inappropriate to boycott a otherwise acceptable trading company such as a supermarket chain simply because a small proportion of its activities are *haram.* Adopting a 5 or 10 per cent rule for unacceptable activities is possible, although such criteria are, of course, arbitrary.

For the ethical investor who wishes to deploy his or her funds according to personal religious values, the ultimate test must be the investor's own conscience. *Shariah* advisers can help, but all human agents inevitably disagree. While respecting the advice given by eminent *shariah* scholars, the devout Muslim can nevertheless read the Koran himself or herself, and seek guidance through prayer. The investor will want to ensure that not merely personal financial interests, but the those of his or her family are safeguarded, indeed the interests of all those whose welfare the investor is responsible for. These responsibilities are also a matter of conscience which have to be balanced with the quest for financial purity. Financial management concerns the stewardship of resources which for the devout Muslim are ultimately provided by the almighty. The ordinary investor can only do his or her best to carry out financial responsibilities in an honest fashion.

Investment would be easier from an Islamic point of view if company accounts could be dissected, and *halal* separated from *haram* activities, so that Muslim funds could be concentrated on the former. This presents major difficulties however, not least because it can be argued that any *haram* activities will poison the whole company. It is in any case impossible to separate out the share ownership of a quoted company as there is no split for ethical and non-ethical capital. The choice is either to purchase or refrain from purchasing. It would also be time consuming to attempt to dissect company activities. The more time which is spent on investment appraisal, the less there is for other activities, including family and Muslim community obligations. It is easiest for a recluse or a hermit to be absolutely thorough over financial activities than for someone leading a more balanced life.

In Islamic finance it is important to separate the activities of speculators and legitimate investors. Investment is the rational use of knowledge, and the rewards come from having and knowing how to use information. Speculative gains in contrast simply come from seeking out risk (Keon, 1989). With *mudarabah* finance there are rewards for risk sharing, but this activity of taking on the risk of others is different in nature from deliberately seeking risk. Speculators can actually increase risk for all market participants by churning stock, or by engaging in destabilizing buying and selling. Yet it is impossible to prevent speculative investment in equity and bond markets through regulation (Yusoff, 1992). Taxing purchases or short-term sales may damage market liquidity and legitimate investment. It is only the intent of the speculator, which becomes manifest latter on, that distinguishes speculation from genuine investment. Hence conscience is the ultimate check, which, as already stressed, implies each investor must constantly examine his or her motives and objectives.

Investment in emerging markets in the Islamic world

The stock markets of the Muslim World would seem to be appropriate destination for Islamic ethical investment, as they could be viewed as promoting business activities which help other Muslims. Some markets in the Islamic World are categorized as "emerging", and attracting the attention of western fund management groups. One alternative to constructing Islamic investment products which screen out quoted companies in London or other western exchanges, is to invest in quoted companies in Muslim countries with active stock markets.

Such a pragmatic strategy may appeal to many Muslim investors, and there is certainly scope for fund management groups to establish Islamic World funds, set up either as investment or unit trusts with their major focus on markets such as Kuala Lumpur, Jakarta, Dacca, Karachi, Istanbul, Casablanca, Amman and possibly Cairo. The companies quoted on these markets are subject to the constraints of the Islamic environments in which they operate, and are primarily involved in *halal* activities. Some critics express ethical concerns about the speculative of much of the buying and selling in such markets. One possibility would be to have a parallel Islamic market which was run on more ethical grounds, but from a financial, and perhaps conceptual standpoint, this is by no means straightforward. There has been some debate over the merits of having specifically Islamic stock exchange, mainly in Malaysia in the context of securing greater access to the financial markets for the *Bumiputra* (Harran, 1995). Kuala Lumpur has by far the largest stock market in the Islamic world, but much of the trading is dominated by Chinese brokers dealing largely in the shares of companies with only a minority statutory *Bumiputra* stake.

Pragmatic fund managers have to deal with what opportunities currently exist, rather than those that might arise in the future. The issue for Muslim investors at present is whether to invest in the equities currently on offer or abstain. Viewed from this perspective, the possibilities offered by emerging markets looks attractive, although for many this will sensibly be viewed as an addition to their investment portfolios which also includes exposure to major western markets. Nevertheless diversification into such markets can widen any portfolio and overcome some of the systematic risk in Western markets where stock prices often move up and down together. Taking on emerging market risk introduces the possibility of higher gains or losses, but the Islamic World is sufficiently diverse to create portfolios which are hedged to a considerable degree.

The advantages of diversification are evident from examining the performance of individual stock exchanges in the Islamic World. Kuala Lumpur, despite the size of the market, exhibits considerable volume and price volatility. Malaysian share prices performed extremely well in the early 1990s with substantial capital gains, but the trend for the last two years has been slightly downward as the chart shows, although there have been significant gains in recent months. Regional diversification into other Muslim countries in South East Asia is not an adequate way of reducing risk. As Figure 2, showing the performance of the Indonesian stock over the last two years, demonstrates, trends in Jakarta have tended to mirror those in Kuala Lumpur, and more detailed technical analysis can illustrate this correlation. In these circumstances it is better to look to markets in other parts of the Islamic World, and not be lured by the "tiger economy" image into having excessive exposure in South East Asia. A review of the fundamentals of each Islamic emerging market is appropriate, including an analysis of political risk factors.

The other stock exchanges in the Islamic world which are classified as emerging markets include the exchanges in Istanbul, Casablanca and Amman. Istanbul is the second most active exchange after Kuala Lumpur, and the ambitious Turkish privatization programme is expected to give it a considerable boost (Brown, 1994, p. 12). Turkey is attracting the attention of Western fund managers as a market with good potential but only moderate risk. Markets in the Middle East and North Africa which are distant from countries directly involved in the peace process appear to have performed better than those in Egypt or Jordan, even though they have similar political risks. In Turkey there has been a terrorist campaign by illegal Kurdish groups, and to complicate matters even further, the instability of the coalition of political parties in government and indecisive elections. Yet in spite of these factors the stock market in Istanbul has fared comparatively well, encouraging western portfolio investment. The outlook for the future is positive, as the domestic market is growing for manufactured goods, Turkish goods enjoy virtual tariff-free access to the European Union, and there is good potential for Turkish business in the markets of Central Asia (see Figure 3).

Casablanca is worth considering for inclusion in any Islamic World fund. Framlington, one of the largest western fund management groups, launched a Magreb fund in September 1994 that initially placed $30 million in Morocco and Tunisia (Brown, 1994, p. 8). The virtual civil war in neighbouring Algeria does not seem to have affected the fund's performance. The stock exchange index for Morocco's 25 top quoted companies has risen strongly over the last two years, with relatively modest volatility in comparison to many other emerging markets.

Amman attracts funds both from local investors and Jordanians and Palestinians living overseas. If the Middle East peace process moves forward it could be given a considerable boost, as it is the logical place for companies serving the Palestinian market to be based, at least for a lengthy interim period. The stock exchange in Amman has not surprisingly been volatile to political developments in recent years, however, and potential investors should weigh up the political risk factors (Nicholson and Whittington, 1994). Jordan's private sector benefited throughout the 1970s and 1980s from Iraqi business, as its main regional trade was with Baghdad, but the continuing sanctions against the regime of Saddam Hussain, and the uncertain political future for Iraq also

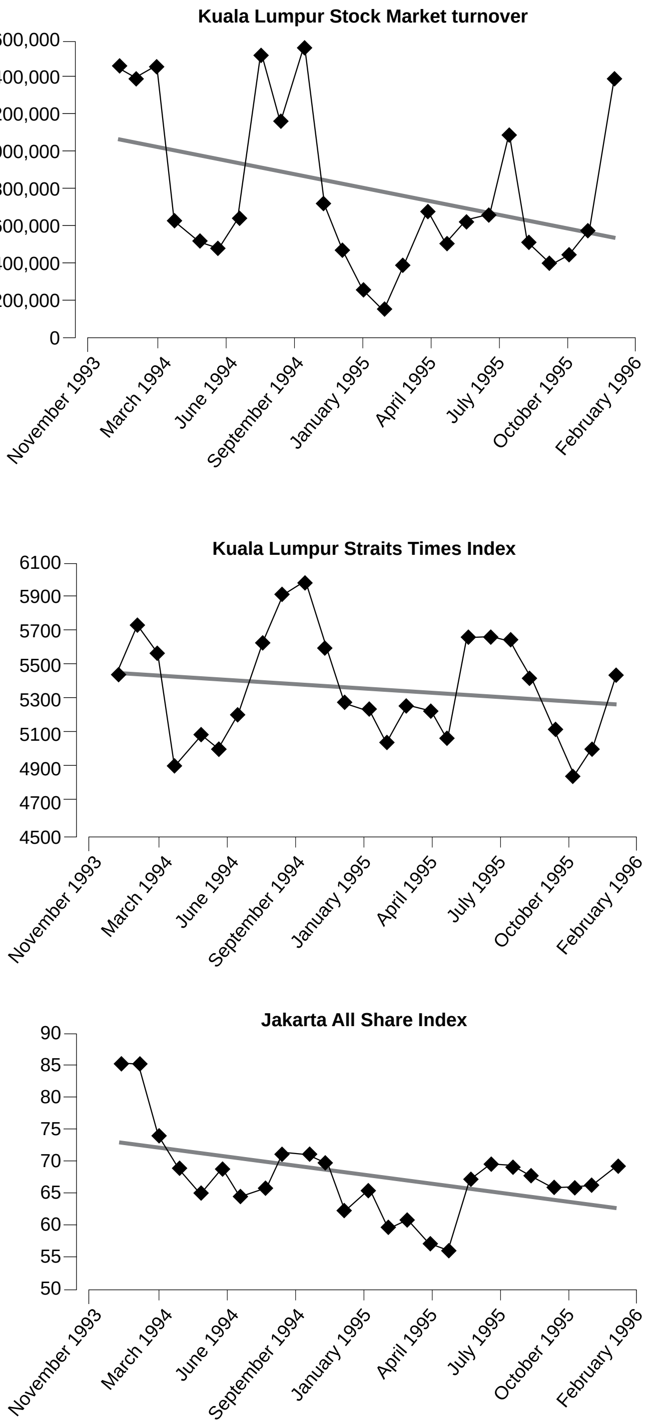
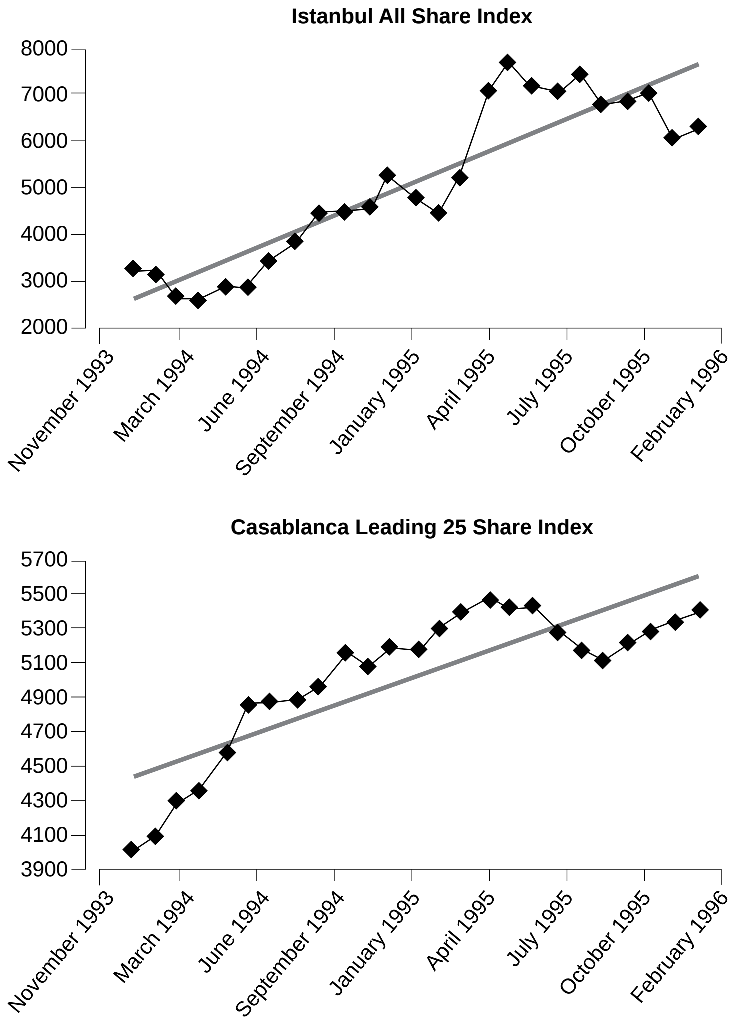


Figure 2.
Performance of Indonesian stocks, November 1993 to February 1996

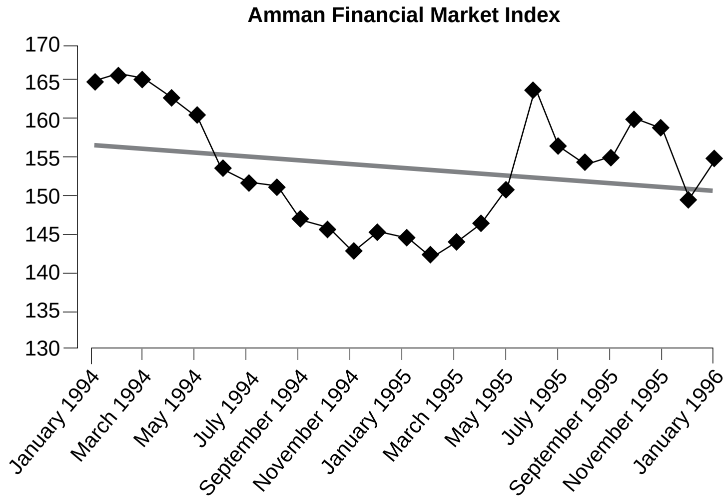


Source: (both indices) *Datastream International*, February 1996

Figure 3. Performance of Turkish stocks

affects investors' attitudes towards Jordan. The attempt by the Jordanian government to distance itself from Iraq may have impressed political commentators, but financial analysts are more cautious.

The peace with Israel has not helped the prices of shares on the Amman market, and as the chart shows the trend throughout 1994 and 1995 was downward despite the attempts by governments to give an optimistic picture regarding the economic outlook for Jordan. As the market in Amman fell by 23 per cent in 1993, a better performance in the following two years might have been expected. Western fund managers placed less than $6 million in shares in



Source: *Datastream International*, February 1996

Figure 4.
Amman Financial Market Index

Amman, a minute proportion of the $280 million which the Jordanian authorities had hoped to attract (Whittington, 1995a) (Figure 4).

The market in the Middle East with perhaps the greatest long-term potential is Cairo, especially given Egypt's population of 60 million, the relatively high level of education, and the considerable industrial experience. Egypt has the oldest stock market in the Islamic World, the history of the Alexandria exchange dating from 1883 (Qassem, 1994). A separate exchange was established in Cairo, and by the 1920s this was flourishing; indeed for a while it was the fifth busiest securities market in the world, with business channelled into a number of quoted holding companies. It was Bank Misr, founded by Tal'aat Harb, that owned a stake in each of these companies, Bank Misr itself being a quoted company. Although the cross holding structures can be criticized as serving the interests of a narrow business clique, the successful growth of the textile industry in Egypt was entirely privately financed in the 1920s and 1930s, with modern plant and equipment installed, yet no calls on government funding (Deeb, 1976). Indeed much of the machinery was still working when the industry was nationalized by Nasser, along with Bank Misr, and it was arguably the lack of subsequent investment that resulted in the industry stagnating, and becoming totally dependent on a heavily protected domestic market.

Although there has been some revival in the Cairo stock market in the 1990s, with share dealings worth around $30-40 million a month by 1995, this is a very small amount for an economy of Egypt's size (estimated figures from Central Bank of Egypt, 1994/95). Most transactions are in local currency, but around 10 per cent of the total are in US dollars which functions as a type of parallel currency in Egypt, although its role is being reduced. Dealings on the

Alexandria exchange are less than 10 per cent of the value of those in Cairo, with few dollar transactions. Most dealing is through floor trading in both exchanges, although there is a small over-the-counter market through Egyptian banks. The volume of transactions is minuscule in Cairo in comparison to most emerging markets, seldom exceeding 5,000 deals per month (see Table II).

The majority of companies listed on the Cairo exchange are closed, which precludes the issue of new shares. Most interest, however, has recently been centred on the joint stock companies, as the Capital Market Act of 1994, which has improved regularity procedures, is encouraging existing companies to raise fresh equity capital and new companies to seek market quotations. Before the act there were only 12 stockbrokers, but by 1995 there were over 40, and settlement procedures have been speeded up (Whittington, 1995). Four mutual funds with an initial capital of $150 million have been established by the state-owned National Bank of Egypt, Bank of Alexandria, Bank Misr and the part private Egyptian American Bank. Privatization would of course result in a substantial boost to stock market activity, but although there are 314 companies on the government's privatization list, so far only limited tranches have been offered on the stock market for a handful, the most notable being the 10 per cent stake in the Paints and Chemical Industries Company (Whittington, 1995b).

There is little Western involvement in the Cairo stock market, not more than 2 per cent of the $70 million in assets which are actively traded being held by European or US fund managers. Foreign and Colonial, Merrill Lynch, Robert Fleming and Framlington all have regional funds which include Egypt, but the extent of their future involvement will clearly depend on market conditions. The incentives are already in place, and the 2 per cent capital gains tax is unlikely to deter western funds, but much depends on share price performance. Share price to earnings ratios average 17 for the 20 most traded companies on the Cairo stock market, which is lower than in many emerging markets. Share prices rose by 24 per cent in 1994, but marked time in 1995 with a stagnant performance over the year as a whole. Unfortunately share price information on the Cairo exchanges is not yet available online through financial information services such as Datastream, and as a consequence outsiders have more difficulty in monitoring market developments than is the case with the Istanbul and Casablanca and Amman exchanges.

Type of company	Joint stock	Closed company
Number of companies	154	526
Number of shares	291,900	153,100
Capital LE million	1,372	2,995
Capital US$ million	390	631

Source: Central Bank of Egypt (1994/95, p. 123)

Table II.
Companies listed on the Cairo Stock Market

Western fund managers interested in the Indian sub-continent tend to focus on India itself, partly because of the recent opening up of the economy and the rapid development of the Bombay market. Yet it is important not to neglect the Muslim states of the sub-continent, Pakistan and Bangladesh, which have considerable potential. In Pakistan political uncertainties have inhibited the development of the Karachi Stock Exchange, but the country has a substantial internal market, and good possibilities of developing further trade with neighbouring Iran, the Arabian peninsula states and China. There is a high level of financial sophistication, and the accounting and legal traditions inherited from Britain can potentially facilitate involvement by western fund managers. The leading 100 stock index has fallen over the last two years, but the time may be right for a revival of market confidence. Shares represent good value at present prices, and although analysis of the fundamentals reveals many continuing uncertainties, conditions are improving (see Figure 5).

Bangladesh faces daunting economic problems, but its stock market has confounded all the sceptics, and performed extremely well over the last two years. The government has managed to create effective development institutions, and there is strong community cohesion at the local level which institutions such as the Gameen Bank have been able to harness. Prospects for economic diversification which can be at least in part privately funded remain encouraging, especially as the country is likely to continue to receive concessionary finance from development assistance agencies which subsidize infrastructure renewal. Private finance is then free to concentrate on the more commercially viable projects. Given the country's geographical position it is well placed to trade with the rapidly growing economies of South East Asia, including Malaysia and Indonesia (see Figure 6).

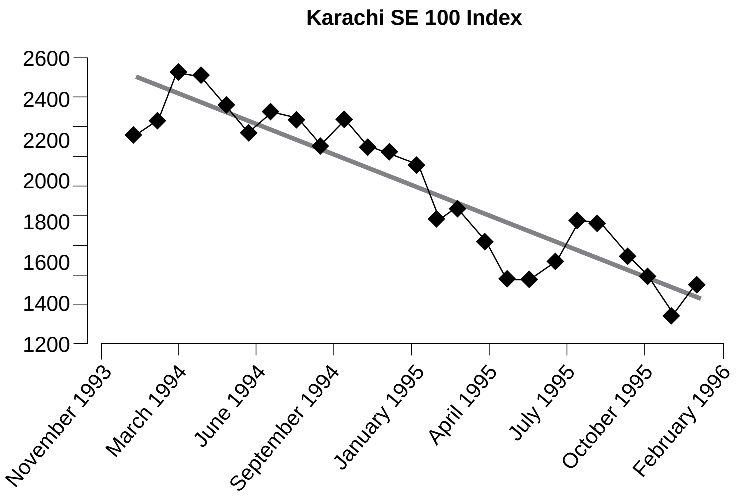
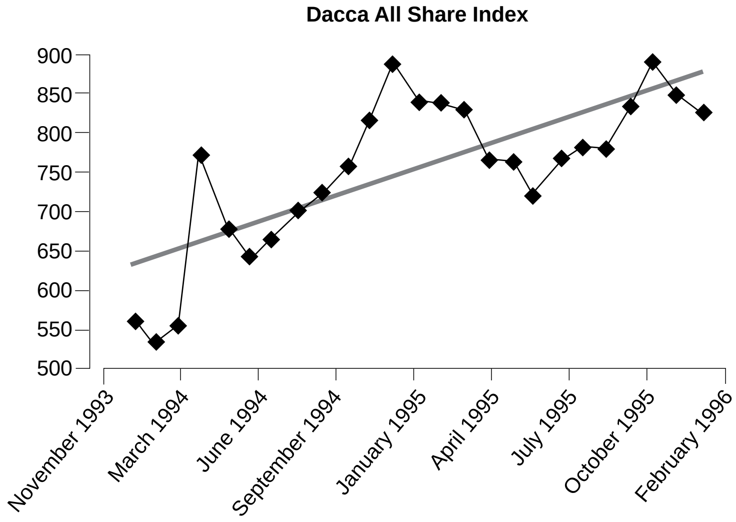


Figure 5.
Karachi SE 100 Index

Source: *Datastream International*, February 1996



Source: *Datastream International*, February 1996

Figure 6. Dacca All Share Index

Overall the emerging markets of the Islamic World would appear to offer worthwhile investment opportunities for Muslim investors. Islamic investment is often criticized as being too focused on short-term instruments such as *murabahah*. Longer-term participatory finance with at least some of the characteristics of *mudarabah* and *musharakah* arrangements can be best developed through investing in quoted stock. This may involve both investment in companies in Western markets which have been screened using Islamic ethical criteria, and portfolio investment in Muslim countries which can contribute to their economic development, while bringing potentially attractive returns to the investors themselves.

Notes

1. A survey of attitudes towards ethical investment has been undertaken for the UK. See Lewis, A. and Webley, P. (1994), "Social and ethical investing: beliefs, preferences and the willingness to sacrifice financial return", in Lewis, A. and Wärneryd, K.-E. (Eds), *Ethics and Economic Affairs,* Routledge, London, pp. 171-82. The authors also discuss the characteristics of ethical investors in their sample of 100 professional people living in properties worth at least £100,000 in 1990.
2. Holden Meehan provide a range of information on ethical investment on the World Wide Web of the Internet which is frequently updated. The address is http:/www.bath.ac.uk/centres/ethical/Holden Meehan.
3. Figures from Holden Meehan (see Note 2).
4. According to Holden Meehan (see Note 2).
5. According to Holden Meehan (see Note 2).
6. Figures from Datastream, London, February 1996.
7. Figures from Datastream, London, February 1996.
8. Holden Meehan provides a list and details of the ethical funds offering this facility.

9. Information quoted by Holden Meehan (see Note 2).
10. Mark-up trade financing. The good is purchased by the bank for cash on the client's behalf, and sold at a later date to the client on pre-agreed terms. Contractually it is different from *Bay al Muajjal*, sale on deferred payments, but in Pakistan *murabahah* works in practice in the same way. See Chapra, M.U. (1985), *Towards a Just Monetary System*, Islamic Foundation, Leicester, pp. 261-2.

References

Al-Harran, S. (1995), "An Islamic stock exchange", in Al-Harran, S. (Ed.), *Leading Issues in Islamic Banking and Finance,* Pelanduk Publications, Kuala Lumpur, pp. 143-52.

Brown, J.M. (1994), "Istanbul bounces to the top", *Financial Times Survey of Emerging Markets,* 7 February.

Central Bank of Egypt (1994-95), *Economic Review,* Vol. 35 No. 1, pp. 24-5.

Cowton, C.J. (1994), "The development of ethical investment products", in Prindl, A.R. and Prodhan, B. (Eds), *Ethical Conflicts in Finance,* Blackwell, Oxford.

Deeb, M. (1976), "Bank Misr and the emergence of the local bourgeoisie in Egypt," in Kedourie, E. (Ed.), *The Middle Eastern Economy: Studies in Economics and Economic History,* Frank Cass, London, pp. 69-86.

Keon, N.S. (1989), *Stock Market Investment,* Berita Publishing, Kuala Lumpur, pp. 138-9.

Nicholson, M. and Whittington, J. (1994), "Middle East: magic carpet not ready for take-off", *Financial Times Survey of Emerging Markets,* 7 February, p. 13.

Qassem, M. (1994), "Developments in the Stock Market in Egypt", *Newsletter of the Economic Research Forum for the Arab Countries, Iran and Turkey*, Vol. 1 No. 3, pp. 8-9.

Whittington, J. (1995a), "Equity souk opens for foreign business", *Financial Times Survey of Emerging Markets,* 20 February, pp. 7-8.

Whittington, J. (1995b), "Cairo Stock Exchange: the market wakes up", *Financial Times Survey of Egypt,* 15 May, p. 2.

Yusoff, N.Z. (1992), *An Islamic Perspective of the Stock Market,* Dian Darulnaim, Kuala Lumpur, 1992, pp. 89-93.