Ethical Investment vs Islamic Investment: Will the Two Ever Converge in the Globalized World?

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Abstract

Faith and moral have not been the only factors that influenced people to invest ethically, but also their conscience too. People has long shun away from unethical forms of business activity. Therefore, many view that ethical investment overlaps Islamic investment. Though there are many similarities between them such as the prohibition of investment in business activities that are harmful to human being, and that both forms of investment required screening processes in order to determine the ethically acceptable form of investment. Nevertheless, there are some distinct differences. This is because Islamic investment is much more than merely investing activities as it is deeply rooted in the teaching of the Qur’an. Hence, principally the two types of investment are different. With the intense process of globalisation, there is a belief that they will converge. This study tries to show that while the types of investment possess similarities, however they differ in many aspects.

This paper was presented May 22, 2008, at the 18th International Conference of the International Trade and Finance Association, meeting at Universidade Nova de Lisboa, Lisbon, Portugal.

Key Words: Islamic investment, Ethical Investment, Converge
1. INTRODUCTION

There is a renewed interest in ethical matters. Morality and ethics have always been the Achilles’ heel of the market economy (Warde, 2000). According to him, ethics is now a fixture of business school curricula. Investment is an act whereby certain sum of fund is set aside for the benefits to be realized in the future or stream of income earned over a period of time. Investment, irrespective of whether it is direct investment into a business venture, or an indirect investment through a pooled unit trust, has been widely accepted as the principal driver stimulating economic growth and prosperity. But what makes an investment ethical? The origin of large scale ethical investments dates back to 1960s (Schlegemilch, 1997), and the concept of investment is very much related to Islamic Finance, since a Muslim is always encouraged to invest instead of hoarding.

The ethical investment is also known as “socially responsible”, “screened” “social” or “sustainable” investment is a pool of investment that is to be acquired, retained or realized by reference to non-financial factors such as a company’s compliance with environmental standards, the company’s employment policies, or the company is involved in the manufacture or sales of alcohol, tobacco or armaments. Hence, an ethical investment essentially promotes corporate social and environmental responsibility, tobacco, gambling, uranium mining, rainforest logging or armaments manufacturing corporations as inappropriate for ethical investment.

The Islamic investment is a joint pool of investment wherein the investors contribute their surplus funds for the purpose of investment in conformity with the Islamic injunction. Essentially an Islamic investment fund is a portfolio of shares of companies, selected on the basis of certain Islamic principles, and managed with a consideration of pre-set Shari’a parameters. Shari’a refers to the Islamic injunction based on the Qur’an. Hence, it can be said that an Islamic investment is basically “ethical investment”. The Islamic investments are, therefore, part of a larger group of ethical investments which are designed to cater to the needs of a group of investors, who are concerned about public issues, social justice or certain individual preferences.

Therefore, it can be seen that there are similarities between socially responsible investment and Islamic investment. Nevertheless, there are major differences between the two. However, there are views among them such as Dar (2006) that the intensity of process of globalization will led to the convergent of
the two forms of investment. Dar believed that there seem to be a convergence of Islamic system and conventional system taking place, even though they are very distinctive but with a great deal of commonality. This will eventually lead to a convergence in the two forms of the ethical investment.

Globalization is the advancing and accelerating of global interconnectedness in all aspects of contemporary social life, and those also incorporate ethical system (Richter and Butteny, 2002). This is evident in the integration in Global Markets, whereby many multinational banks are now offering Islamic products, many investment companies offering Islamic investment and major stock exchanges provide Islamic indices.

Hence, the motivation of the study is to determine if they will converge. The paper is structured as follows; section 2 reviews the literatures available on ethical and Islamic investment. Section 3 discusses theoretical framework in the selection of investment portfolios, while section 4 examines if the two investments will ever converge. Finally section 5 concludes the paper.

2. LITERATURES ON ETHICAL INVESTMENT

The literatures available on performance of ethical and Islamic investments are not as voluminous as studies on performance of firms. Nevertheless, a considerable number of studies have been undertaken in ethical investment and recently in Islamic investment.

1.1. Definition

Schwartz (2003) defined ethical as an act which is in accordance with a set of substantive normal standards. He defined social or ethical investment as a set of approaches which include social or ethical goods or constraints as well as more conventional financial criteria in decision over whether to acquire, hold or dispose of a particular investment. According to him, general factors may have contributed to the growth of social or ethical investment including (i) growing investment concerns over issues such as the environment, labor, product safety and tobacco; (ii) growth of the business ethics and corporate social responsibility.

Ethics refers to a set of rules that define right and wrong conduct that help individuals distinguishes between facts and belief, decide how issues are defined, and decide what moral principles people apply to the situation. The edifice of the entire Islamic way of life rests on absolute ethical values whereby the Islamic ethical values are a complement on the universal ethical values. This is because
many of the ethical values laid down in Islam are not unique to Islamic society only (Hasanuzzaman, 2003).

However, Wilson maintained that the word ethical in term of banking is used as a label, and equated with Islam and no attempt to link between what is ethical and the specific methods of conducting financial transactions. Nevertheless, with respect to investment there are clear guidelines as to what are permissible and what are not as well as the process of investment. An Islamic Investment such as equity, venture capital, or trust-type funds is structured in such a way so that the owners entrusts the investment manager to act in their behalf. In the Islamic investment funds the returns on investments depend on the actual profit or loss generated by the fund.

There are fundamental differences between ethical practices derived from religious teaching and those designed to appeal to popular secularist morality. Ethics in Islamic finance are based on holy revelation, whereas ethics derived from social values are inevitably more transitory (Wilson, 2000).

The consideration of ethical issues in investments according to McLachlan and Gardner (2004) is pertinent in selection of investment portfolios. These ethical issues will be the focus of the comparison of socially responsible and Islamic investment will include the environment, racism/sexism, trade with oppressive regimes, arms-export, inaccurate advertising, alcohol, gambling, and use of pesticides, pornography, nuclear-weapons, and tobacco.

1.2 Ethical Investment in Practice

According to Bal (2008), the growth rate of 15% and more in the recent years, the Islamic banking and investment industry ranks as one of the faster growing segments of the world’s financial services industry. The total value of assets managed according to Shari’a-compliant principles is estimated to be as high as $750 billion. Even though, the Islamic funds market has developed at a slower pace, but its potential is clearly huge. There are now more than 400 Islamic funds – four times the number at the turn of the century. On the whole, the performance of Equity funds has been positive. Studies have shown that excluding financials, defense, tobacco, alcohol, leisure and entertainment stocks is no big disadvantage.

A study by Elfakhani et al. (2005), found that there is no statistically significant evidence of risk-adjusted abnormal reward nor penalty associated with investing in Shari’a compliant mutual funds. Another study undertaken by
Elfakhani and Hassan (2005) has shown that the behavior of Islamic mutual funds does not differ from that of other conventional funds and that there was not statistically significant risk-adjusted abnormal reward or penalty associated with investing not only in Shari’a compliant funds but also with following one’s belief in financial investment.

On the same note, Bauer et al. (2002), found that there is corroborative evidence for the results that ethical funds do not under-performance relative to conventional funds. A study undertaken by Girard and Hassan showed that there is no difference between Islamic and non-Islamic indices. Overall, similar reward to risk and diversification benefits exist for both indices. The Islamic indices are found to be somewhat correlated with MSCI AC world. Islamic indices are less diversified as compared to their peers, that is, the cost of diversification is above MSCI Index. The behavior of Dow Jones Islamic Market Indices do not differ from that of their conventional counterparts, with some indices over-performing their counterparts and others under-performing them. Overall, similar reward to risk and diversification benefits exit for both indices.

3. THEORETICAL FRAMEWORK IN SELECTION OF INVESTMENT PORTFOLIOS

Any investment venture can be considered as ethical if it adheres to the universal ethical norms of good behaviors. On that ground, Islamic investment is basically an ethical investment. However, there is more than meet the eyes for Islamic investment, since it has also to take into considerations the injunction of the holy Qur’an pertaining what is permissible and what is not. There is even a stricter adherence on the part of the Islamic investment company to see that their investors are protected from unscrupulous investment managers. Nevertheless, the ultimate aim of any investment venture is the financial returns that one is going to get. However, there are also concerns with the sources of the income that is going to be earned. This is because it is the obligation of every Muslim to ensure that his earnings would always be from “pure” sources.

The theoretical framework outlined in attaining these financial rewards for investors are the common guidelines which must be adhere by the respective investment fund managers. There is nothing as distinctive in the world financial markets as Islamic financing, the nearest secular parallel would be the socially responsible investment. For the sake of comparison and analysis of ethical investment, the non-Islamic ethical investment takes into consideration socially
responsible investment. This is because both forms of investment have to undergo certain procedures in order for the investor to attain the financial rewards.

Hence in terms of selection of ethical investment portfolios, the comparisons will be made between a socially responsible investment and an Islamic investment. Figure 1 shows the framework that each type of investment has to go through and the prospect of convergent if there is such a thing will occur in the future as some believed there would be.

Basically there are two criteria to be considered when considering ethical investment, namely: from the theoretical perspective and from the practical perspectives. In trying to understand the type of investments, one needs to know the similarities and the differences between them in order to understand if there is going to be convergent between the two in the future. This can be achieved by analyzing the criteria in selection of investment portfolios.

Ethical investment should promote environmental sustainability, favoring renewable and clean energy, best practice in waste minimization, recycling and energy efficiency for instance. It should favor good occupational health & safety practice, industrial relations, gender equity and family-friendly conditions including maternity leave.

**Figure 1: Framework of an Ethical Investment**

![Diagram of Ethical Investment Framework](image-url)
3.1 Theoretical Perspectives

There are two principles that guide ethical investment decisions, namely; the religious principle and the social principle. The extent of the influence may however differ in degree among individual investors, with respect to Muslim and non-Muslim.

3.1.1 Religious Principle

The differences may also be the influence by the teaching of each of the respective religion that the investors profess. Islam nevertheless, laid out specific clear rules relating to permissible activities that Muslim can invest, which each and every Muslim must adhere to. For the non-Muslim, they may also be influenced by their respective religious belief.

3.1.2 Moral Principle

Moral principle in general refer to the impartial general rules of behavior that are of great importance to a society and along with the values they represent, are fundamental to ethics (Richter and Buttery, 2002). In Islam, morality refers to doing good and avoiding bad doing. Therefore, when man strives hard to free itself from impurities by way abstaining from firms that has been prohibited by God, by way of submitting itself to God’s commandment, it will again experience the happiness it used to enjoy in the primordial stage of life. In this way, cleansing of the self is achievable when he struggles through life, enjoining the good and avoiding the bad. A moral duty exists and it is related to sustainable development. The moral duty according to Cummings (2000), is not only to maximize shareholder wealth but also shareholder welfare in particular or society in general.

To introduce morals, religion and conscience into investments is a challenging task and a difficult problem to overcome. Business ethics scholars are unable to precisely define social investing, and attempts to identify what falls within the ambit of social investing can lead to different answers (Dunfee, 2003). Furthermore, when speaking of socially responsible, moral, and faith-based funds, are we dealing with the same class of investments or are we grouping investment styles without overlap and with characteristics that are mutually inconsistent?

3.2 Practical Perspectives

From the practical perspectives, investors have to take into consideration certain process before selection of investment portfolios, this is the screening process. Once these investment screens are applied, they would provide a choice
of companies that investment can be based on. In the world of interdependence, it is rarely to find that a company depends entirely to the equity capital subscribed by its shareholders. In almost all cases, a company is leveraged; hence a portion of the capital structure of the company is not acceptable as interest-based transactions are prohibited under the Shari’a law. Hence it has to be purified and cleansed before it can be given to investors (Elgari, 2002). Thus, Islamic investment has to undergo a purification process. While this may not be necessary for social responsible investors, it is compulsory for the Islamic investor to adhere.

Both these processes may differ between socially responsible and Islamic investment. While a more stringent measure is taken to ensure that the Islamic investment comply with the religious injunction such as the Shari’a law, no such measure is required of the socially responsible investment.

3.2.1 Screening Process

Screening process is a procedure for evaluating companies as part of the ethical investment requirement. The screening process evaluates the companies' activities, products and services and the effects that may have on society at large. Ethical investment avoids companies whose business or production activities can harm people, animals or the environment. All companies violating this set of conditions are eliminated from the ethical Investment portfolio.

In selecting portfolios, the screening process ensures that investment comply with the ethical norms of the investors whether it is from the Islamic perspectives or the socially responsible investment point of view. However, the Islamic investment criteria have a more stringent condition to be fulfilled. According to Rosly (2005), the screening process will ensure that the Islamic investment comply with the Shari’a ruling. This screening process comprises basically of two aspects, namely; (i) legal aspect which deals with the nature of contractual agreement taking place between the issuing company and the investors, while (ii) the business or production aspect in which it looks at the nature of production and financial activities observed by the issuing party.

Such choices cannot be made on the basis of software, or by simply applying the published criteria of another fund, or index. So, when an Islamic equity fund is licensed to such an index, it may at least rest assured that the stocks it invests in will accord with the guidelines for prudent Islamic investing.
The funds are commonly constructed using a screening process. There are two forms of screens namely; (i) positive screens which seek out investment with good community and environmental practices, and (ii) negative screens which avoid unethical investment. Positive screens are used to identify desirable investment for inclusive in a portfolio whereby they pick specific stocks out of the investment universe such as low pollution emission, equal employment opportunities and good workplace condition. While negative screens are used to reject investment based on undesirable characteristics, they delete specific stock such as production of alcohol, tobacco, nuclear power and arms (Ali, Gold, 2002).

In aspect the Islamic criteria include more than what the socially responsible investment entails. For the socially responsible investment, business activities such as those involving the sale of pork and production of pork related product are not prohibited. However, for the Islamic investment such activities are prohibited. This is in line with the prohibition of Muslim to not only to consume pork but to rear and to sell it.

According to Elgari (2002), in Islam, the most important screen is the debt-to-equity ratio. Nevertheless, there are basically five categories of screening that can be as a guideline, namely; (i) the nature of business of the company, (ii) total outstanding debt does not exceed 33 per cent, (iii) cash and interest-bearing securities do not exceed 33 percent, (iv) Receivables and cash are less than 50 percent and (v) prohibitions of financial instruments such as futures, options, preference shares and short sales.

3.2.2 Purification Process

Purification refers to the process of deducting from one’s investment those earning in which the source of income is not acceptable from ethical point of view. Therefore, in the case of equity investment, this refers to interest earning and incidental income from other non-permissible sources of income such as sale of alcoholic beverages and estimating earning from sale of alcoholic beverages and so forth.

Furthermore, they attracts strict Muslim investors (who would be keen to dispose off this amount every quarter), and the not so strict and non-Muslims to invest in the fund. On the other hand, some Shari’a scholars think an equity fund will not be truly Islamic unless all returns to investors are “pure”. Hence the manager must himself deduct such amount and dispose off to charity.
In Islam, a stringent from purification would have to adhere; there are basically two factors in the purification of Investment according to Rosly (2005), namely; (i) legal factor and (ii) ethical factor. The legal factor lay out rules why there is need to spell out the real nature of contract of stock trading.

Basically portfolio purification comes in two forms or types, namely; financial and moral. Purification is the cleansing of an investment portfolio of impure elements. If one earns an impermissible income, he will be cleared if he disposed of the same from other sources. In the final analysis, those who subscribed to the fund with the intention of earning pure and clean return will purify.

For socially responsible investment portfolio, any or all traded firms, company or enterprise, regardless of the activity they are engaged with qualifies for investor’s ownership of stocks. The sole criteria to purchase the stock are the company’s ability to prosper and produce high dividends and opportunity to increase in capital-gain share value and the taking of interest is considered the cost of doing business.

Islamic investment however, prohibits the share acquisition of any companies whose income is derived from gambling, alcoholic beverages, financial lending for interest, either with or without risk, derivatives, selling short or any other method in conflict with Shari’a Islamic Law, and borrowing at interest (leverage) is impermissible. The principal of Shari’a does not allow ‘interest’ to be considered as a part of the cost of a product or service as it does not add to the end value and plays no part in the commercial system.

Hence the purification process for socially responsible investment and Islamic investment might have to go through a different benchmark. The Islamic criteria are more stringent and hence, there are many factors that Islam has to take into consideration, while a socially responsible investment does not need to. Table 1 summarizes the basic criteria in selection of ethical investment.
Table 1: Basic Criteria in Selection of Ethical Investment

<table>
<thead>
<tr>
<th>Theoretical Perspectives</th>
<th>Practical Perspectives</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. Religious principle</td>
<td>i. Screening Process</td>
</tr>
<tr>
<td>- Ethical behavior derives from the religious belief and injunctions.</td>
<td>- Screening process is a procedure for evaluating companies as part of the ethical investment requirement.</td>
</tr>
<tr>
<td>- Religious rulings dictate what can be invested and what cannot.</td>
<td>- The screening process evaluates the companies' activities, products and services and the effects that may have on society at large.</td>
</tr>
<tr>
<td>ii. Moral principle</td>
<td>ii. Purification Process</td>
</tr>
<tr>
<td>- Ethical behavior derives from practice good behavior and avoiding bad behavior.</td>
<td>- Cleansing of returns will be undertaken after the screening process, on any interest element remaining in the income received from the investment.</td>
</tr>
<tr>
<td>- Moral values dictate what is good and what is not.</td>
<td>- The income has to be cleansed and distributed to charities.</td>
</tr>
</tbody>
</table>

3.3 The Importance of Financial Return from Investment

Financial returns or rewards are important to investors as no one would want to invest and get nothing in return. No matter how pious and staunch follower a person is to certain belief, the reward is still the ultimate aim of an investment activity. This is supported by McLachlan and Gradner (2004) who contended that while many investors view social responsibility and ethics admirably, money remains their primary concern. They would need to be ensured that their financial return is socially acceptable returns in order to clear their conscience.

However, McLachlan and Gradner found that there is no significant different between the socially responsible investments and the conventional investors in term of the importance of financial returns. They predicted that return on investment would be more important consideration for conventional investors then it would for socially responsible investors, however, this was not supported in their study. Cummings (2000) further stated that an ethical investment pursues a joint financial and social utilitarian perspective, whereby both financial and social goals are achieved through long-term commitment to social behavior, which minimizes externalities to the firm.
4. ANALYSIS IF THE TWO INVESTMENTS WILL EVER CONVERGE

Islamic investors, as Wilson (1997) points out, may be interested in different screening criteria but the idea of excluding companies according to a set of ethical constraints is of mutual interest. For Islamic investment, the areas of economic activity involving companies dealing in impermissible products or services, for example, alcohol, pork, gambling, interest based financial institutions are excluded from the portfolio. It is also unlikely that there is a move towards a universal global system of ethics. Western values are unique to the west but not universally applicable like wise the Islamic values is unique to the Muslim.

The probability of convergence of Islamic investment and socially responsible investment is high as far they seek to increase accountability, responsibility and transparency. This would mean that the future investors’ protection and also the reduction in agency costs may be consistent for both socially responsible investing with that of Islamic investment. However convergence, which includes transaction practices, may not be consistent with Shari’a primarily because all the social investment, despite their ethical role in the financial markets, may not be able to pass the test of permissibility under Shari’a (Ali Adnan, 2006). This is because rulings based Shari’a is more stringent in comparison to the rulings based on morality.

5. CONCLUSION

In view of theoretical framework of ethical investment, it can be concluded that in term of what is going on in reality might led to a convergence in the financial returns of ethical investment irrespective of socially responsible investment or Islamic investment. This is supported by the study undertaken by Cummings (2000) found that there is no significant evidence to show that the ethical screening of portfolios helps or hinders portfolio performance. Thus in term of the fund performance in term of financial returns, it can be said that the market will converge. This is very true as the market demand and supply dictates the final outcome, in this case the return to portfolio investment will be ultimately be determined by the market mechanism. As more investors going for the ethical funds be it socially responsible funds or Islamic fund, their performance will rise.

However, in term of selection and criteria for purification, the socially responsible investment and the Islamic investment funds show different characteristics, such as the screening process and purification process that are unique only to Islamic investment portfolio. Therefore, when comparing them,
these are distinctive features which distinguish one from another. Hence, Islamic investments are managed in accordance with specific clearly defined values and some of these values do not converge with the values emphasized by a socially responsible investment such as the emphasis that they place on human rights and environmental protection.

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