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# Are Islamic finance innovations enough for investors to escape from a financial downturn? Further evidence from portfolio simulations

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Pages 3412-3420 | Published online: 09 Aug 2012

🗨️ Cite this article 🔗 <https://doi.org/10.1080/00036846.2012.707776>

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to specify the dependence orientation of feedback between Islamic and conventional stock prices. Our article differs from previous work on the topic in that it develops portfolio simulations to determine whether Islamic finance can supplant conventional finance by generating investment and diversification opportunities during periods of crisis. In addition, we develop optimal portfolio strategies and investment proportions for conventional and Islamic funds to ensure the best resource allocation. Our main findings are: (i) the impact of the current crisis on the Islamic finance industry is less marked than on conventional finance, (ii) investment in Islamic products generates high returns, (iii) portfolios that include Islamic products reduce systemic risk and generate significant diversification benefits, (iv) the US crisis has led to significant changes in resource allocation through changes in investment choices.

Keywords:

- Islamic finance
- portfolio simulations
- financial crisis

JEL Classification::

- G01
- G11
- C32

## Notes

- <sup>1</sup> See So et al. (2014) for a review of these central bank policies.
- <sup>2</sup> It is important to note that the investment strategies of Islamic funds are subject to Shariah constraints, which may impact on their performance. The focus of this paper is on the diversification benefits suggested by the simulation results.
- <sup>3</sup> We have used the data available in the Islamic Finance Index (IFI) and the conventional stock index (CSI).



<sup>4</sup> We do not report the results of Granger test for the sub-periods to save space. They are however available upon request.

<sup>5</sup> Such specifications seem to be unchanged for both of the samples considered, suggesting stable lead-lag effects between conventional and Islamic industries. This may be due to the fact that the period under consideration is relatively short, whereas significant changes to the relationship between these two financial industries probably require much more time.

<sup>6</sup> Jawadi et al. ([2011](#)) also investigate the performance of Islamic funds with regard to conventional funds before and after the crisis and show how Islamic products supplanted conventional assets to some extent after the US crisis.

<sup>7</sup> For more details about changes in investor's preference, see Sousa ([2012b](#)), who explores the nature of preferences of the representative investor to emphasize the role of wealth shocks in explaining time-variation in portfolio composition. Also, Sousa ([2012c](#), d, e) recently investigated the linkages between asset wealth, labour income, stock returns and government bond yields, and provides evidence of changes in investor's choices and preference.

<sup>8</sup> We would like to thank the anonymous reviewer for his/her suggestion regarding the derivation of the following results.



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