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

M. E. Arouri, H. Ben Ameur, N. Jawadi, F. Jawadi & W. Louhichi

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Abstract

Does Islamic finance constitute a promising solution for the current global financial crisis and are Islamic financial innovations enough to reassure investors, stabilize financial systems and provide them with a means of escaping from financial downturns? This article addresses these questions while investigating the dynamics of Islamic and conventional stock prices over the last few years. In particular, we apply Multivariate Vector Autoregressive (VAR) tools to test the interaction between conventional and Islamic financial products, and implement the Granger causality test 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

[1] See Sousa (2010, 2012a) for wealth effects and macroeconomic impacts of these central bank actions and measures.

[2] It is important to note that while the period under consideration enables us to investigate the contribution of investment in Islamic funds before and after the subprime crisis, this cannot apprehend the nature of investment opportunities after the impact of Lehmann's collapse or the EU sovereign debt crisis. Such issues could be the focus of future research work. We would like to thank the anonymous reviewer for this suggestion.

[3] We have not reported the results of the unit root tests to save space, but they are available upon request.

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

[5] 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.

[6] 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.

[7] 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.

[8] We would like to thank the anonymous reviewer for his/her suggestion regarding the derivation of an optimal portfolio.
