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Original Articles

Islamic mutual funds' financial performance and international investment style: evidence from 20 countries

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Abstract

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are consistent over time and robust to time varying market exposures and capital market restrictions.

Keywords: fund manager learning home bias Islamic finance Islamic mutual funds responsible investment three-level Carhart model

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Our paper substantially benefited from suggestions by Iqbal Asaria, Shahid Ebrahim, John Wilson and two anonymous referees. We would also like to thank Mohsen Derregia, Dewi Fitriasari, Phil Molyneux and seminar participants at Nottingham, St Andrews and the Emerging Scholars in Banking and Finance conference at Cass Business School for their comments. Finally, we are very grateful to Andrew Gibson Miller of Eurekahedge and Robert Schwob of Style Research Limited for provision of data. All remaining errors are our sole responsibility. The views expressed in this paper are not necessarily shared by the Principles for Responsible Investment.

Notes

The estimated growth is partly related to an extended estimation coverage. Nevertheless, Islamic financial services' market value was only about $150bn in the mid-199 annual growth r

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The liter Most notably, Derigs a es to deliver a lower s of Forte and Migl ents, as they do not o s socially responsible or conventional counterpart. Girard and Hassan (2008), however, do not find international FTSE Islamic indices to trail their conventional peers. These three papers are recommended as gateway into this literature.

We follow Bollen (2007) and Renneboog, Ter Horst, and Zhang (2008) by defining equity mutual funds as investing at least 75% in stocks. As Eurekahedge does not provide asset allocation data for Islamic funds, our sample comprises all funds classified by Eurekahedge as equity as well as all of Eurekahedge's balanced funds, whose benchmark consist to at least 75% of an equity index.

It is common practice to analyse portfolios of assets with religious or ethical characteristics based on equal-weighted rather than value-weighted portfolios. This practice ensures a focus on the assets' religious or ethical characteristics and substantially reduces the risk of bias due to idiosyncratic return characteristics of a specific asset (Hong and Kacperczyk 2009; Renneboog, Ter Horst, and Zhang 2008). In the case of Islamic mutual funds, the available data furthermore do not allow for a precise computation of value-weighted portfolios. Eurekahedge, for instance, provides only static fund size data, which are very generously rounded and somewhat incomplete.

In the case of two countries (Liechtenstein, Qatar), our data set comprises more than 20 but less than 30 observations. Thirty observations are commonly considered to be the minimum threshold to assume an approximately normal distribution of ordinary least squares (OLS) regression residuals based on the central limit theorem. Since we cannot assume a normal distribution of regression residuals for these two countries, we
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As Style Research does not offer the construction of the size and book to market factor precisely according to Fama and French (1993), we follow the slightly amended procedure of Renneboog, Ter Horst, and Zhang (2008). Renneboog, Ter Horst, and Zhang (2008, 307) found that their 'factors are virtually identical' to the ones of Fama and French (1993).

Matching Islamic equity mutual funds against conventional equity mutual funds as common in the socially responsible investment literature (e.g. Kreander et al. 2005) is not possible for large parts of our sample, as the usual databases cover an insufficient number of conventional mutual funds from many nations in Asia or Africa.

As we do not have sufficient data on any benchmark asset for Liechtenstein, we employ Germany's benchmark assets for it. For Luxembourg, we employ the equity market benchmark and the investment style benchmarks of the Benelux countries due to the same reason.

For instance, in case the global factor and the national factor were perfectly correlated, whereby the absolute returns of the global factor would always be half of the national factor's returns, subtracting the global from the national factor would lead to a corrected national factor, which is identical to the global factor. Hence, multicollinearity problems would be certain in this case.

As our baseline model is a national four-factor Carhart model, we expect the coefficients of the orthogonalized regional and global factors in our three-level Carhart model to be more variable than their national equivalents.

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The mean zero value transformation of Cortez, Silva, and Areal (2009) addresses some but not all multicollinearity in our sample. Hence, we also pursue a three-step orthogonalization procedure. First, we orthogonalize the product involving the treasury bill from its terms spread equivalent. Second, we orthogonalize the product including the dividend yield from its cleaned treasury bill and its term spread equivalent. Third, we orthogonalize the product based on the default spread from its cleaned dividend yield, cleaned treasury bill and term spread equivalent. Eventually, we use the product involving the cleaned default spread, the cleaned dividend yield, the cleaned treasury bill and the term spread.

The results of the further robustness tests are available upon request.

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