Ethical Investing

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Abstract - ESG is a strategy for evaluating investment decisions based on Environment, Social or Governance criteria. Only stock of such companies are chosen which cause the least harm to the environment, those that safeguard human and social rights and those which promote good governance standards. Finding ethical companies is difficult as it is not mandatory for companies to reveal their ethical conducts. Therefore, ethical funds are the solution to ethical investing. An Ethical Fund is one which does not solely rely on financial criteria in security selection, but uses ethical non-financial criteria when choosing securities. As the investor is limiting himself from making investments in listed companies that are not regarded as ethical, it would increase the risk of the portfolio or decrease the return of it relative to a well-diversified portfolio. Thus should an investor accept lower return or higher risk for being ethical? This paper seeks to investigate if ethical investors are in fact paying a price for making ethical investments.

Mutual funds have introduced Shariah Compliant Funds or Shariah Funds, which are ethical funds and is slowly gaining momentum in India. These funds seek capital appreciation based on the Islamic Shariah principles which forbids investment in businesses that involve gambling, alcohol, financial services, pornography, tobacco, certain categories of media and advertising, pork, and pawn broking. The objectives of the study are to measure the return performance of select Ethical/Shariah Funds and to examine if ethically conscious investor must accept a lower return for investing in ethical funds relative to market returns in the short term

The paper concludes that Shariah Compliant Stocks are a good investment choice for ethical minded investors. These funds are earning returns on par with traditional portfolios but at much lower level of risk. Thus the assumption that Shariah Compliant Funds may have higher risk levels due to limited diversification opportunities does not hold good and in spite of restrictions on choice of stocks for a portfolio the Shariah Compliant Funds have performed better than the market. It suggests that Shariah Funds are not only a good choice for followers of Islam but also ethical minded investors who give importance to non-financial measures also while making investment choices.

Key Words: Socially Responsible Investing; Ethical Investing; ESG; Shariah.

I. INTRODUCTION

Socially Responsible Investing as an investment strategy has been gaining popularity the world over. A strategy evaluating investment decisions based on ethical criteria otherwise known as ESG wherein businesses are evaluated on the basis of Environment, Social or Governance criteria. Only stock of such companies are chosen which cause the least harm to the environment, those that safeguard human and social rights and those which promote good governance standards.

Finding ethical companies is difficult as it is not mandatory for companies to reveal their ethical conducts. Therefore, ethical funds are the solution to ethical investing. Kreander (2001) defines an ethical fund as "a fund which does not solely rely on financial criteria in security selection, but uses ethical non-financial criteria when choosing securities". Ethical funds carefully choose companies and use ethical criteria to screen them which is defined by the fund. Some funds use the services of firms which specialize in ethical investment screening.. An ethical fund is marketed to investors who may have moral objections to certain investment companies. For example, an individual may have a moral objection to smoking and may therefore buy units in a mutual fund that refrains from investing in tobacco companies. Ethical funds may have positive or negative guidelines; that is, a fund's ethics may inform where it makes investments and where it does not.

An ethical investor who is concerned about common good, confines himself to investing in ethical stock only and refrains from investing in majority of the listed companies. This limits diversification, which increases the risk of the

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portfolio and reduces return according to financial theory. In fact one of the most discussed topics in finance in recent years is whether the cost of ethical investing is higher risk and lower return. The objective of this paper is to examine the cost of ethical investing in term of lower returns to ethical investors.

Shariah Compliant Funds or Shariah Funds are slowly gaining momentum in India. These funds which are based on Shariah Principles, avoid investing in businesses whose main activities are financial services, gambling, pornography, alcohol, tobacco, pork, and pawn broking.

Shariah-Compliant Investment: are those which invest as per Islamic Principles. There are three principal rules to be followed to be Shariah Compliant.

➢ The first is the absence of interest (riba). Islam prohibits both receiving and taking interest (riba). But a return on capital can be shared with the provider if he is willing to share the risk

➢ The second is benchmarks clarifying what are not acceptable as an investment under Shariah. • Alcohol . • Banking Institutions involved in interest generating activities including insurance companies • Gambling •Firms involved in pornographic activity. • Manufacturers of tobacco and tobacco related products. • Or any other activities which the Shariah Board feels are against Islam.

➢ The final area relates to the nature of the contract between the parties involved. Any contract which fails to clearly specify its key components (e.g. price, subject matter, delivery date etc) which may cause a dispute between the contracting parties is guilty of containing "gharar" (Unacceptable Uncertainty) and is null and void in the eyes of Shariah. Example Derivative contracts

Sharia funds can be managed as mutual funds, exchange-traded or hedge funds. Shariah screening institutions formulate their own Shariah screening norms under the guidance of their respective Shariah Boards. AAOIFI, Dow Jones, MSCI, S&P and TASIS are some of the well known global Shariah advisory institutions which have formulated globally accepted Shariah screening norms. TASIS Pvt. Ltd (Taqwaa Advisory and Shariah Investment Solutions) is the leading Shariah advisory institution in India which has formulated widely acknowledged and accepted Shariah screening norms in India.

II. SHARIAH SCREENING PROCESS

(i)Business Screening

First all companies which are primarily into the following activities are screened out at the business screening stage.

- Companies offering financial services like banking, insurance, investment services, stock broking etc.
- Companies engaged in the production, sale and marketing of non-Halal consumption products like Pork, Alcohol, Tobaccco
- Vulgar entertainment,.
- Hotels and restaurants providing non-Halal products.
- Gambling, Narcotic drugs, etc.

(ii) Financial Screening:

Companies passing the business screening stage next go through the financial screening stage where it is ensured that income earned are within the limits specified by the Shariah scholars.

✓ Interest based-debt should be less than or equal to 25% of Total Assets.

✓ Interest income plus returns (currently considered @8%) from interest-based investments should be less than or equal to 3% of the total income.

✓ Receivables plus cash and bank balances should be less than or equal to 90% of Total Assets.

Indian mutual fund industry is currently offering three Shariah compliant funds, one of that is a passively managed fund, while the other two are actively managed. Taurus Mutual Fund was the first to launch actively managed Shariah compliant fund in February 2009 named as Taurus Ethical Fund. The stocks which comply with the principles of Shariah are selected from the universe of the S&P CNX 500 Shariah Index. After Taurus Ethical Fund, the 15 year old. Tata Select Equity Fund was renamed as Tata Ethical Fund in September 2011. Benchmark Mutual Fund (recently acquired by Goldman Sachs group) was the first to launch a Shariah based ETF called the Shariah BeES in February 2009 and now renamed as GS S&P Shariah BeES. On the other side, actively managed Taurus Ethical Fund has seen its AUM grow to Rs 35.39 crore, when compared with an AUM of Rs 2.48 crore in April 2009. Tata Ethical Fund's AUM has grown to 498 crores as against an AUM of Rs 103.61 crore in September 2011. Taurus Ethical Fund and Tata Ethical Fund have high exposure to sectors such as Pharmacy, Consumer Non-Durables, Software, Industrial Capital Goods and Oil & Gas among others. Normally equity diversified funds have high exposure to banking sector, with an average of about 10% to 15% of the portfolio.

III. LITERATURE REVIEW

Forte, Gianfranco and Miglietta, Federica, (2007) studied the underlying principles of SRI and Islamic funds as investment classes, and tried to determine whether Islamic mutual funds, as faith-based investments, exhibit distinguishing characteristics that indicate that they would be more fittingly grouped in a separate investment family or

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can be included into the category of socially responsible mutual funds.

Lobe, Sebastian and Walkshäusl, Christian, (2011) Employed a multi-factor performance measurement framework and recent boot-strap procedures for robust performance testing. They f0und no compelling evidence in the data that ethical and unethical screens lead to a significant difference in their financial performance.

Dewi and Ferdian (2010) measure the performance of Islamic mutual funds in Indonesia and Malaysia By using 5 measurement tools, namely Sharpe, Treynor and Jensen Indices, as well as Snail Trail Methodology and Market Timing. The study found that Malaysian Islamic stocks seem to outperform the Indonesian Islamic mutual funds, even in the period of global economic crises. They also discovered that risk-return relationship of debt Islamic mutual funds is relatively stable as compared with asset allocation and equity Islamic mutual funds. Lastly concluded that market timing ability of investment managers of Islamic mutual funds in the two countries cannot increase the funds' returns as a whole.

Karim (2010) compared the risk and returns of the Islamic based portfolio and conventional portfolio during the period 1989 to 2008 in Malaysia. The study uses the KL Composite Index (KLCI) and the FTSE Bursa Malaysia Shariah Index (FBMSHA) and Malaysian 3-month Treasury bills (T-bills) rates as proxy for risk free rate investment instrument to compare the performance between both portfolios. The study found that there is no different between returns of the both portfolios during the study period but risk is more on conventional portfolio than Islamic based portfolio.

Kraeussl, Roman and Hayat, Raphie(2011) concluded that Muslim investors might improve their performance by investing in index tracking funds or ETFs rather than to invest in individual IEFs.

Natarajan P., Dharani M. (2012) examined the risk and return behavior of the selected Shariah Compliant Stocks and benchmark indices. The study reveals that the average returns of the Shariah Compliant Stocks, Shariah index and benchmark indices were almost similar and thus the equity based Shariah Compliant investment is a viable and ethical investment avenue.

Mansour, Walid and Jlassi, Mouna (2014) analyzed the effect of religious beliefs on investors' preferences, risk perception, ethical values, and psychological behavior and discussed how religious beliefs can conflict with financial theory involving making financial and investing decisions

Mohsina Habib and Khalid ul islam (2014) undertook a study to assess and compare the performance of MSCI India Islamic index and MSCI Malaysia Islamic index with their respective conventional Indices for eleven years . Also the behavior of Islamic Indices is studied during recent financial crises. To assess their performance risk adjusted monthly returns were calculated. Beta and standard deviation was used to assess risk. The study found that in India Islamic Indices has underperformed while as in case of Malaysia, it has outperformed the respective conventional Index. But in crisis period both Islamic Index has outperformed its counterpart index

Mohamed Sherif (2016) This study examined the relative importance of the Shariah-Compliant Dow Jones market indexes to capture the dynamic behavior of stock returns at economy and industry levels. The analysis indicated that ethical investment has only an insignificant influence on the performance of stock market returns for both the economy and industry levels. Further, alternative measures of investment performance including the Carhart and Habit Formation models had been used to examine the behavior of the Shariah-Compliant Dow Jones market indexes. The findings revealed that while Islamic indexes are growth focused, conventional indexes are value focused. This was due to less diversification of Islamic Indices.

Risalvato, Giuseppe (2017) found that after the financial crisis of 2008 ethical or sustainable indices have generally performed better than traditional indices.

Objectives

- To measure the return performance of select Ethical/Shariah Funds
- To examine if ethically conscious investor must accept a lower return for investing in ethical funds relative to market returns in the short term

IV. DATA AND METHODOLOGY

All studies so far have examined the risk return performance of ethical funds in the long run. The present study evaluates performance of these funds in the short run. It is a well established fact that though equity gives good results in the long run there are investors who prefer a short term investment horizon and the returns in the short period are taken as indicators for long term returns.

Two popular Shariah Funds in India, Tata Ethical Fund and Taurus Ethical Fund and one Traditional Portfolio Nifty50 have been chosen for evaluation.

Tata Ethical Fund: Tata Ethical Fund an open ended equity fund invests in Shariah compliant stock. The objective of the scheme is to provide medium to long-term capital gains by investing in Shariah compliant equity and equity-related instruments of value and growth companies. The fund avoids investments in companies involved in activities which are against Islamic principles.

Taurus Ethical Fund: is India's First Actively Managed Equity Oriented Shariah Compliant Diversified Fund. Its objective is to provide capital appreciation and income

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distribution to unit holders through Sharia based investments It is based on the fundamental Shariah principles of justice, transparency, common interest and public need.

Nifty 50: The index comprises of 50 stocks of blue chip companies in India. it is considered as an efficient portfolio as it covers all major sectors of the Indian economy.. It is the flagship index of the National Stock Exchange

A period of 252 trading days (1/6/2017 to 1/5/2018) was chosen for the study.

Daily NAVs of the two schemes and the daily adjusted closing prices of the index for the corresponding 1 year period were collected. The data was sourced from the respective websites of the organizations.

The yield on 10 year Government of India Bond has been taken as the proxy for the risk free rate of return.

The following procedure was used to measure the performance of the selected portfolios.

Returns: $(P_t-P_{t-1})/P_{t-1}$ was used to calculate the daily returns and converted into percentages.

Standard Deviation: which is an accepted measure of the total risk is calculated as the square root of variance by determining the variation between each data point relative to the mean

Coefficient of Variation: It is a measure of relative risk i.e., risk per unit of return. Coefficient of variation allows us to determine how much risk we are assuming in comparison to the amount of return we are expecting from our investment.

Beta: The volatility or systematic risk of a security or a portfolio in comparison to the market as a whole is measured by Beta. If Beta is greater than 1 indicates aggressive portfolio.

All the above measures were calculated with the help of MS Excel Application

Risk Adjusted Performance measures:

1. *Shape Ratio:* It is also termed as reward to variability ratio and is calculated as the excess return per unit of total risk. Sharpe Ratio can be calculated as:

$$\text{Sharpe Ratio} = Rp - Rf / \sigma p$$

Where, Rp = average return on portfolio

Rf = risk free rate of return

σ p = standard deviation of the portfolio return.

2. *Treynor Ratio*: It is also called reward to volatility ratio and is calculated as the excess return per unit of systematic risk. Systematic risk is indicated beta (β).

$$\text{Treynor Ratio} = Rp - Rf / \beta$$

Where, Rp = average return on portfolio

Rf = risk free rate of return

β = Beta coefficient of portfolio

3. *Jensen's Alpha*: It is the excess of actual return over CAPM return and is also termed as abnormal return.

Jensen's Alpha $\alpha = Rp - \overline{Rp}$

Where, $\overline{Rp}$ = average return on portfolio

$\overline{Rp} = Rf + \beta(Rm-Rf)$

Rf = risk free rate of interest

β = a measure of systematic risk

Rm = average market return

V. RESULTS AND FINDINGS

The results of the study have been tabulated below. The study analyzed daily returns of two ethical portfolios and one traditional portfolio for a one year period. The mean return of Taurus Ethical Fund is higher than Tata Ethical Fund and Nifty 50 by 22.49% and 9.5% respectively (table:1)

Table 1: Risk Return Profile of Ethical and Traditional Portfolios.

	Ethical Funds		Traditional Fund
Measure	**Taurus**	**Tata**	**Nifty 50**
Ave. Returns	0.0612	0.0474	0.0554
Std. Dev.	2.0185	2.0765	2.0255
Beta	0.387	0.382	1.00
Annualized Return	25.02%	18.88%	22.40%

Source: Authors compilation

The standard deviations which measures the risk indicates a marginal difference .Taurus Ethical fund seems to be less volatile than the market

Table 2: Correlation Matrix

Portfolios	**Taurus Ethical**	**Tata Ethical**	**Nifty 50**
Taurus Ethical	1		
Tata Ethical	0.902045		
Nifty 50	0.388445	0.373596	1

Source: Authors compilation

The correlation matrix (table: 2) indicates strong positive linear relationship exists between the two ethical funds. This is because of portfolio composition being more or less similar. The correlation between the ethical fund and the market is positive but weak indicating portfolio returns may not be exactly replicating the market returns .This is justifiable as the market portfolio comprises of stock from best performing sectors of the economy which may have been excluded in the ethical portfolios.

Table 3: t-test results for returns of portfolios

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Portfolios	Mean Difference	t.stat	P value
Taurus &Tata	0.0001381	0.237081	0.4083
Taurus & Nifty	0.000058	0.101636	0.4595
Tata & Nifty	-0.000506	-0.13649	0.4457

Source: Authors compilation

The t-test (table: 3) results throw light on how significantly different are the mean returns of the three portfolios. The p values indicate that the returns of the two ethical portfolios are not significantly different from the market portfolio. Thus ethical funds have performed on par with the well diversifies equity market portfolio. Hence restricted choice has not affected the return of the portfolios.

Risk-Adjusted Performance

Table 4: Risk Adjusted Performance Measures of Traditional and Ethical Portfolios.

	Ethical Funds		Traditional Fund
Measure	**Taurus**	**Tata**	**Nifty 50**
Sharpe Ratio	0.562	0.359	0.478
Treynors Ratio	46.37	30.84	15.33
Jensens alpha	12.01	5.94	…..

Source: Authors compilation

The NIFTY 50 has been taken as the benchmark index and annual yield on 10 year Government of India Bond has been taken as the proxy for the risk free rate. The results have been presented in the table 4 above. According to Sharpe and Treynors ratio Taurus Ethical fund has outperformed the market index and as per Treynors ratio Tata Ethical Fund provided more risk adjusted returns than NIFTY 50. Jensen’s alpha indicates that both the ethical funds have given returns over and above normal market returns. Thus their risk is lower than the conventional portfolios.

VI. Conclusion

The study concludes that there is no significant difference between the average returns of Taurus Ethical Fund, Tata Ethical Fund and NIFTY 50. This means their returns are on par with traditional market portfolios. However the risk of Shariah Compliant Portfolios is much lesser than the conventional portfolio.

It is thus concluded that Shariah Compliant Stock are a good investment choice for ethical minded investors even in the short run. These funds are earning returns on par with traditional portfolios but at much lower level of risk. Thus the assumption that Shariah Compliant Funds may have higher risk levels due to limited diversification opportunities does not hold good and in spite of restrictions on choice of stocks for a portfolio the Shariah Compliant Funds have performed better than the market. It suggests that Shariah Funds are not only a good choice for followers of Islam but also ethical minded investors who give importance non-financial measures also while making investment choices. The mutual fund industry in India should open up to this opportunity and come up with more such ethical schemes not only for investors in India but all over the world.

VII. Scope for Further Study

The study has been limited to the Indian Context and has covered a short period only. It may be extended to include Ethical or Shariah Funds in other countries of the region. Further the returns of Ethical Funds can be compared with returns of other investment avenues apart from equities.

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