

HEALTH WEALTH CAREER

# SHARIA INVESTING: WHAT YOU NEED TO KNOW

MAY 2019

MAKE TOMORROW, TODAY



Sharia refers to a set of religious principles that are an important part of Islamic tradition for many Muslim investors. Investing in a Sharia-compliant way requires the standard investment process to be adjusted. This paper is aimed at helping investors understand the principles of Sharia-compliant investing, how the opportunity set changes and the implications for clients who are looking to implement Sharia-compliant investment strategies. It also looks at specific considerations for selecting Sharia-compliant managers.

## INTRODUCTION

The opportunities to invest in a Sharia-compliant way are increasing, supported by strong demand from Muslim and non-Muslim investors. The industry remains relatively small — assets under management reached US\$70.8 billion in 2017 (US\$47 billion in 2008) in 1,535 Islamic funds (802 in 2008)<sup>1</sup> — but demand for Sharia-compliant investments is growing.

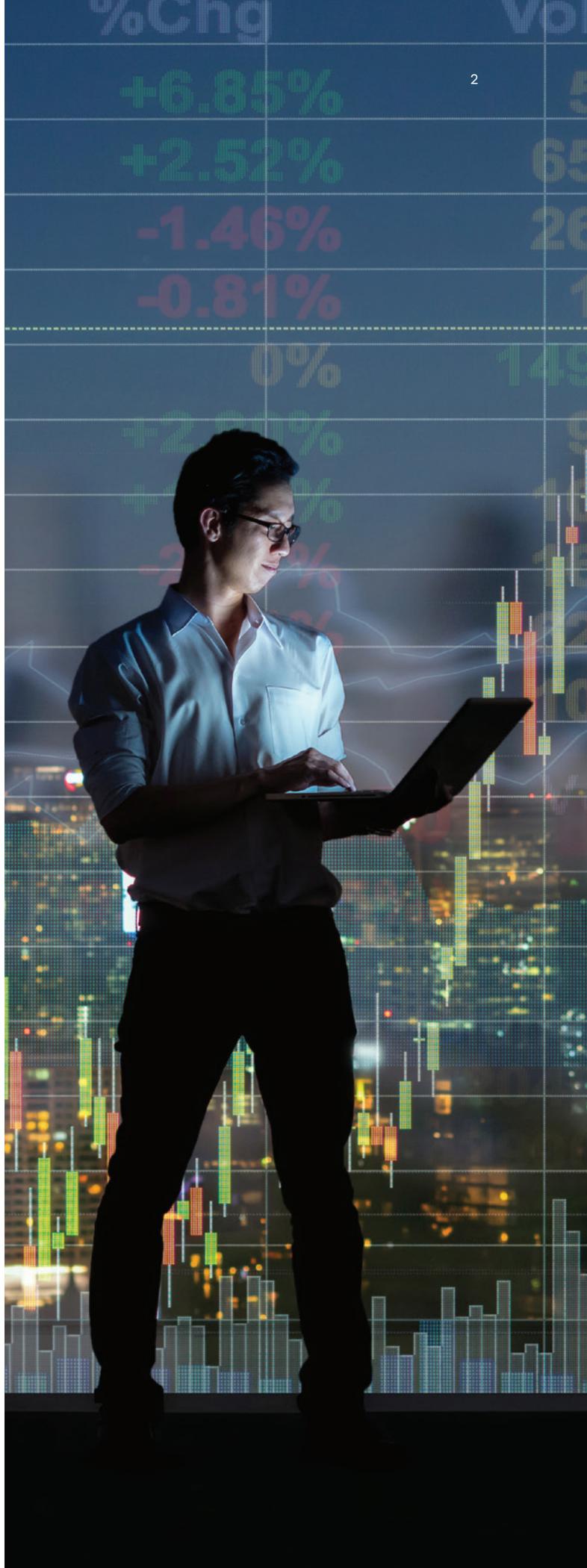
Historically, Islamic funds have been dominated by equity product offerings, but product development has led to the introduction of funds covering other asset classes, such as sukuk (Islamic fixed-income securities<sup>2</sup>), real estate, commodities trading (trade finance) and asset leasing. Areas of product development covering alternative investments, in particular private equity, are experiencing increased interest.

Clearly defined investment beliefs have implications across the investment process — from setting the investment governance framework to deciding on the strategic asset allocation and to implementing this asset allocation through portfolio construction and strategy selection.

Adherence to Sharia investment principles is a core investment belief for some investors. When considering asset allocation and portfolio implementation through the prism of the conventional investment process, it becomes apparent that Sharia-compliant investing impacts both asset allocation and strategy selection as a result of the restrictions it applies to the conventional asset universe.

<sup>1</sup> Malaysia International Islamic Finance Center, *Islamic Funds: Gearing Up*.

<sup>2</sup> Sukuk are fixed income instruments that behave largely like conventional bonds but are Sharia compliant because they are based on approved legal and contractual structures, such as being asset-backed and paying a profit rate versus a conventional interest rate.



## SHARIA-COMPLIANT INVESTMENTS

Sharia-compliant investments are investments that abide by the principles of Islamic finance. All Islamic investment products must be aligned to the principles of Islamic finance. These are summarized below:

- **Riba (interest)** — Interest is strictly prohibited in all transactions. Under Sharia law, money is seen only as a medium of exchange; it is a measure of value and has no real or intrinsic value. Therefore, one cannot charge or be charged interest for the use of it, as charging interest is an advantage to one party at the expense of the other.
- **Gharar (unreasonable uncertainty or speculation)** — Transactions that have uncertainty, or where a lack of information could lead to an undesirable outcome, are prohibited. For example, under a futures contract, an agreement is reached between two parties; a sale is concluded at the outset for delivery on a future date on some underlying asset. However, one is unaware of whether such an asset will be in existence at the future delivery date.
- **Halal (permissible)** — These are the only types of transactions and investments allowed; transactions that involve Haram (impermissible) activities are strictly prohibited. Examples of haram activities include trade in alcoholic beverages, pork meat or gambling.
- **The profit and loss sharing principle** — All parties must share in the risks and rewards with regard to the actual profit or loss realized.
- **The asset-backing principle** — Financial transactions must refer to tangible, identifiable underlying assets.

In practice, these principles restrict the exposure a Sharia-compliant portfolio can have to conventional asset classes. Exhibit 1 sets out the underlying instruments that can be used in a Sharia-compliant portfolio, the equivalent conventional instrument and the relevant Islamic principle applied.

### Examples of business activities deemed impermissible:

- Conventional financial institutions such as insurance companies and conventional banks
- Activities and products associated with alcoholic beverages (and associated products), pork (and pork related) products and non-halal food products
- Gambling and gaming
- Activities associated with entertainment and leisure products related to pornography, music or with adult content

### Exhibit 1: Sharia-Compliant Portfolio Construction (Relative to Peer Group)

ASSET CLASS	CONVENTIONAL	SHARIA COMPLIANT	ISLAMIC PRINCIPLE
Cash	Money market instruments	Sharia-compliant contracts	Ban on uncertainty
		Non-interest-earning deposit accounts	Ban on interest
Fixed Income	Government and corporate debt	Sukuk	Profit and loss sharing principle
			Asset-backing principle
Equity (public and private)	All sectors	Constrained universe	Ban on financing certain economic sectors; restrictions on conventional leverage
Alternatives	Derivatives	n/a	Ban on uncertainty

## PRACTICAL IMPLICATIONS FOR STRATEGIC ASSET ALLOCATION (SAA) AND PORTFOLIO IMPLEMENTATION

### Portfolio implementation and the Sharia compliance continuum

Investing with adherence to Sharia principles requires investors to address the level and mode of adherence to help define the asset-class opportunity set. This impacts the asset allocation and portfolio implementation.

Adherence to Sharia principles can be evaluated on the following aspects:

- **Investment** – The actual portfolio holdings must be Sharia compliant. A Sharia supervisory board or a similar authority is required to verify compliance. A Sharia supervisory board is an independent body that is typically made up of Islamic scholars who are knowledgeable about Islamic finance.
- **Operational** – From the time an investor's capital contributions are received to when these contributions are allocated to the solution, no interest shall be earned and allocated to clients' accounts. Similarly, all disinvestments need to be returned to clients without earning any interest.
- **Legal** – All contracts need to be Sharia compliant. This includes the investment policy and investment management agreements signed with underlying implementation providers.

The levels of adherence to each of these aspects vary from “light” to “strict,” and the choice is based on client preference. A lower level of adherence, for example, places less restriction on the available asset classes and reduces the complexity of portfolio implementation, whereas a higher level of adherence shrinks the asset-class opportunity set and results in more complexity around implementation through the need for

either more sophisticated structuring solutions or more filtering of the underlying investments, or both. One can envision an implementation continuum that ranges from light adherence to strict adherence to Sharia principles, and the implications associated with each type of implementation. Exhibit 2 is an illustrative representation of this continuum.

**Exhibit 2: Adherence to Sharia Principles: The Continuum**



	STRICT	MODERATE	LOW
Prohibited sectors and activities	Excluded	Excluded	Excluded
Income purification applied	To all holdings	To all holdings	On a case-by-case basis
Sharia board certification	Required	Required	Informal certification may be accepted
Use of structuring solutions and Sharia wrappers (creates separation between the investor and conventional leverage, especially for private market asset classes)	Limited or none	Allowed	Allowed
Use of leverage	Conventional leverage limits applied to each holding	Sector screens and leverage screens applied to equities	Conventional leverage allowed at the underlying investment levels, such as in real estate, private equity and infrastructure; only sector screens applied to equities, no leverage limit screens; exclusion of conventional fixed income

## Strategic asset allocation considerations

The principles summarized are exclusionary and, as a result, constrict the conventional investment universe.

In order to determine the SAA for an investor's size, objectives and risk tolerance, assumptions for asset-class returns and volatility in the conventional space can be considered but should be adjusted based on the restrictions placed by Sharia principles.

For the SAA, this has the following implications:

- **The exclusion of all conventional fixed income investments.** Conventional fixed income is excluded from the Sharia-compliant universe due to the prohibition on earning and paying interest and the fact that it gives seniority to bond holders over equity holders. Compared to the conventional bond market, the Sukuk (Islamic fixed income) market is much smaller and less liquid, hence creating practical limitations for their inclusion in institutional portfolios at an allocation weight similar to bonds in a conventional portfolio. This can lead, all else equal, to a lower fixed income allocation for a Sharia-compliant portfolio. If liquidity and lower risk assets are needed in a portfolio, Sharia-compliant cash contracts and accounts can be considered — although the expected investment return will be lower. Additionally, asset-based strategies, such as asset leasing or trade finance, may take on a larger role in the asset allocation as fixed income substitutes.
- **A reduction in the universe of allowable public equity investments.** Sharia-compliant investing applies exclusionary screens to the universe of equity securities, thereby reducing the size of this universe. There are two main categories of Sharia-compliant screens. The first is industry

or sector based, excluding entire industries such as alcohol, tobacco, arms manufacturing, gambling and traditional banking. The second category is a set of financial-statement-focused screens that exclude companies that have excessive leverage, hold excessive cash or derive more than a token of their income from prohibited activities. The smaller equity universe may result in over-representation of certain sectors in a portfolio. Traditional banking is also completely excluded. This results in different characteristics of the Sharia-compliant equity asset class.

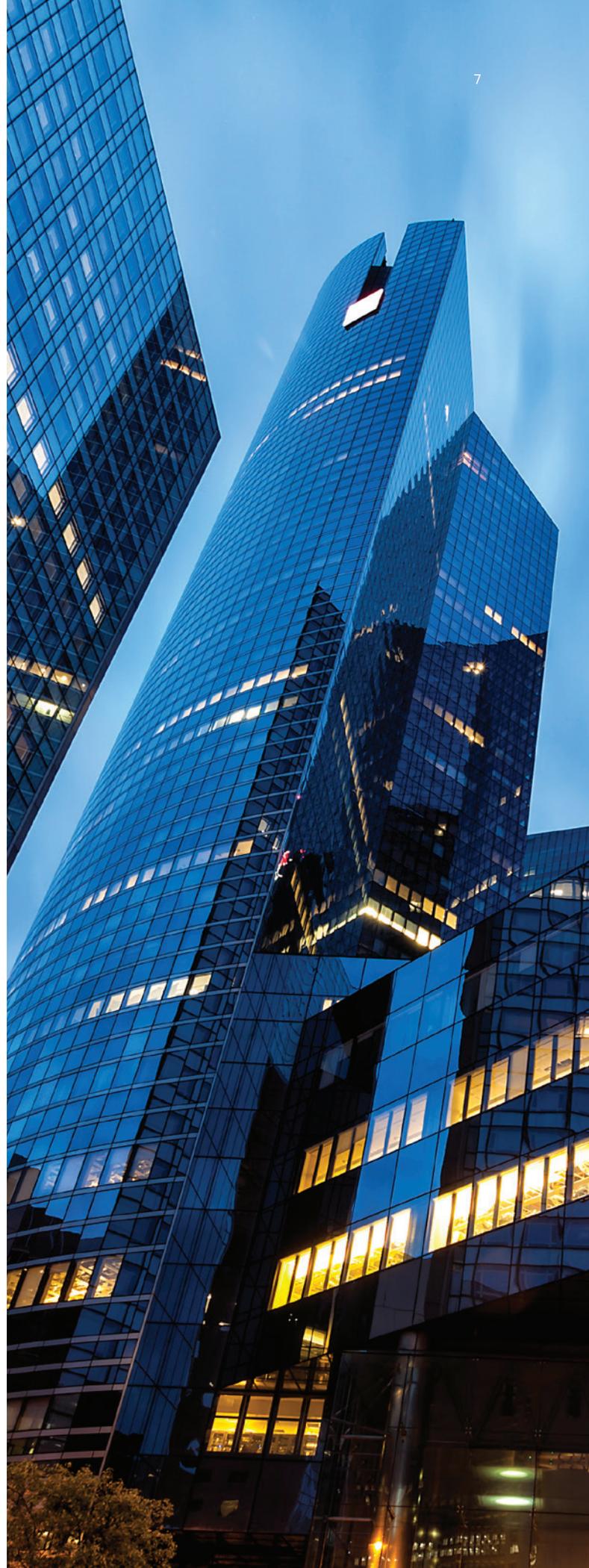
- **Conventional private debt is excluded, whereas private equity, real estate equity and infrastructure equity can be included if they adhere to Sharia guidelines.** These asset classes are private and illiquid versions of the ones discussed already, so they can be included so long as there is adherence to Sharia principles. In private equity, infrastructure and real estate, the restriction is on applying excessive conventional leverage (the definition of “excessive” varies) at the underlying individual investment level; however, nothing inherent in these asset classes makes them noncompliant.

Real estate covers a wide range of assets, including residential properties, office buildings, warehouses, shopping centers, hospitals and various types of infrastructure projects. To ensure compliance, Islamic investors may screen the use of properties by their tenants before any investments take place. Excessive financing of real estate assets through conventional debt is generally deemed to breach Sharia investment guidelines — but using Sharia-compliant financing through Islamic banks, for example, is acceptable.

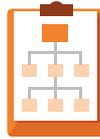
For private equity, the business activities performed by the portfolio company must not be prohibited under Sharia law, and the financial ratios must be met. This is in line with the screens applied under listed equity investments. Where financial ratios are not adhered to at the time of making the investment, it may still be possible to restructure the investment in a Sharia-compliant manner — for example, refinancing conventional debt with Sharia-compliant debt. Given the high levels of leverage employed in private equity buyout, Sharia-compliant investing would typically exclude buyout funds and focus more on venture capital and growth equity investment strategies, which lend themselves more naturally to Sharia investing, due the limited use of leverage in these strategies.

- **Liquid alternatives (hedge funds) are generally excluded because of the prohibition on short selling and speculative activities.** This is a general exclusion based in the first instance on how liquid alternative strategies invest, before considering what they invest in. Hedge funds, strictly speaking, are not an asset class, but a group of strategies that often have complex or nontransparent investment processes that employ derivatives or can be considered speculative. For these reasons, liquid alternatives are typically excluded from the Sharia-compliant universe.

A summary of the asset classes considered is reflected in Exhibit 3.



**Exhibit 3: Asset-Class Characteristics and Considerations From a Sharia View**



PUBLIC AND PRIVATE EQUITY	FIXED INCOME / PRIVATE DEBT	INFRASTRUCTURE	REAL ESTATE	LIQUID ALTERNATIVES
<ul style="list-style-type: none"> <li>• Reduction in size of equity universe</li> <li>• Industry/sector screening</li> <li>• Balance sheet and leverage screens</li> <li>• Income purification</li> <li>• Allowable equity universe tilts toward low-leverage equities in faster-growth sectors</li> <li>• Structuring solutions possible if acceptable to investor</li> </ul>	<ul style="list-style-type: none"> <li>• Exclusion of traditional fixed income and private debt investments</li> <li>• Fixed income represented through Sukuk and asset-backed strategies</li> </ul>	<ul style="list-style-type: none"> <li>• High leverage presents an implementation challenge</li> <li>• Some structuring solutions possible (Sharia wrapper, replacing conventional debt with Sharia equivalent, etc.)</li> <li>• Lower leverage and/or structuring solutions can result in a drag on returns vs. traditional</li> </ul>	<ul style="list-style-type: none"> <li>• High leverage presents an implementation challenge</li> <li>• Some structuring solutions possible (Sharia wrapper, replacing conventional debt with Sharia equivalent, etc.) possible</li> <li>• Implementation costs can reduce return relative to traditional</li> </ul>	<ul style="list-style-type: none"> <li>• Generally excluded due to use of derivatives and speculative strategies</li> <li>• Wrapper structures may allow for implementation if approved by investor</li> </ul>

## CONSIDERATIONS WHEN APPOINTING SHARIA-COMPLIANT MANAGERS

Across the strategies offered by managers globally, some managers offer Sharia-compliant strategies and some others may be willing to offer such strategies based on their existing philosophy and process.

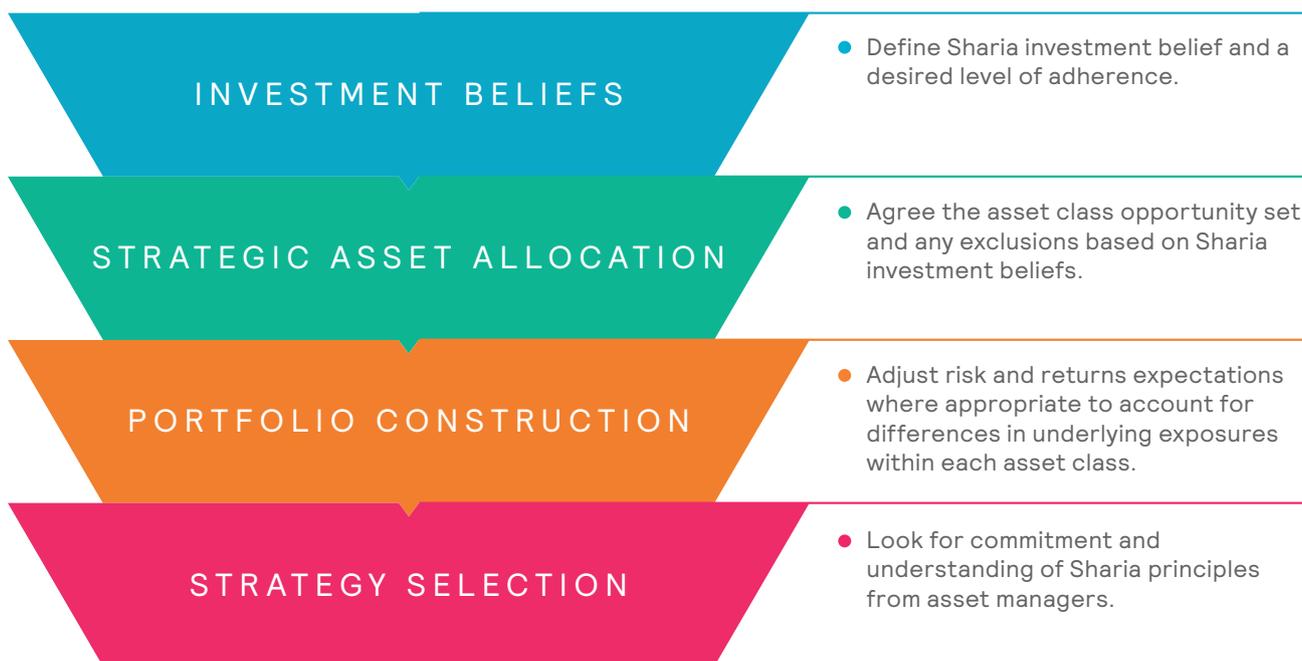
When analyzing Sharia-compliant managers, in addition to other research factors, we look for evidence of a market-leading capability with respect to the manager understanding the opportunity set, setting Sharia-compliant criteria and applying relevant screens. We also look for evidence of the manager adopting a clear process integrating Sharia aspects into active

fund positions, using relevant technology. The manager must demonstrate a good understanding of the technical, financial and Sharia principles as well as Sharia compliance criteria in terms of dealing and operational aspects of implementing investment decisions. In addition to the usual business management assessment, we consider the extent to which the business leaders understand the importance of Sharia investing and the extent to which they are committed to serving this client segment. We also look for the existence of an experienced and highly regarded Sharia advisory board to independently endorse the activities of the portfolio.



## CONCLUSION

Sharia-compliant investing is not without challenges. Investors who have Sharia compliance as a core belief are advised to develop a clear and coherent framework for incorporating this belief into the investment process.



Many of our clients' investment processes have been informed by a variety of ethical and religious beliefs, so our approach is to incorporate these beliefs in a way that meets our clients' requirements while attaining their investment objectives. We also understand how to demonstrate the impact of these beliefs on the investment processes and expected performance, and Sharia compliance is no exception. We look forward to assisting our clients with Sharia requirements on their strategy design and implementation journeys.

## IMPORTANT NOTICES

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.

© 2019 Mercer LLC. All rights reserved.

This contains confidential and proprietary information of Mercer and is intended for the exclusive use of the parties to whom it was provided by Mercer. Its content may not be modified, sold or otherwise provided, in whole or in part, to any other person or entity without Mercer's prior written permission.

For Mercer's conflict of interest disclosures, contact your Mercer representative or see [www.mercer.com/conflictsofinterest](http://www.mercer.com/conflictsofinterest).

This does not constitute an offer to purchase or sell any securities.

The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed.

Investment management and advisory services for U.S. clients are provided by Mercer Investments LLC (Mercer Investments). Mercer Investments is a federally registered investment adviser under the Investment Advisers Act of 1940, as amended. Registration as an investment adviser does not imply a certain level of skill or training.

The oral and written communications of an adviser provide you with information about which you determine to hire or retain an adviser. Mercer Investments' Form ADV Part 2A & 2B can be obtained by written request directed to: Compliance Department, Mercer Investments, 701 Market Street, Suite 1100, St. Louis, MO 63101.

Certain regulated services in Europe are provided by Mercer Global Investments Europe Limited, Mercer (Ireland) Limited and Mercer Limited. Mercer Global Investments Europe Limited and Mercer (Ireland) Limited are regulated by the Central Bank of Ireland.

Mercer Limited is authorized and regulated by the Financial Conduct Authority. Registered in England and Wales No. 984275. Registered Office: 1 Tower Place West, Tower Place, London EC3R 5BU.

6009880-GB