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The Risk and Performance of Ethically Compliant Investment

[1*]Norhidayah Abu Bakar, [2]Juliana Arifin, [3]Norizan Remli

[1,2,3]Faculty of Business and Management, Universiti Sultan Zainal Abidin, 21300 Kuala Nerus, Terengganu, Malaysia

*Corresponding Author Email: hidayahabubakar@unisza.edu.my

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Abstract

This paper presents a discussion of prior literature on the risk and performance of ethically compliant equity. This review of literature provides an organised evaluation of the available studies in ethical investment. In particular, this paper presents surveys of literature concerning *shariah*-compliant equity and socially responsible investments. The discussion of the literature synthesises the information in the respective studies into a summary. Each subsection provides an analysis of the information gathered by first providing an overview of the current empirical studies and, second, identifying gaps and showing the limitation of theoretical views in the existing studies. Discussion in previous literature emphases only one type of ethical investment, however, this paper, on the other hand, covers both the religious and social perspectives of ethics, which provide a more comprehensive view of ethics. The paper finds out that studies on the risk and performance of ethically compliant investment report mixed results. This is due to the disparities in the research methodological approach. However, it is almost unanimous that ethical funds demonstrate higher stability (lower risk) during the financial crisis and tend to outperform the conventional funds during this state of financial uncertainty. Future studies can conduct more firm-level analysis and integrates both screening criteria (*shariah* and socially responsible screening) to reconcile the results.

Keywords*:* Risk, Performance, Shariah Compliant, Ethically Compliant, Socially Responsible Investment

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INTRODUCTION

Shariah-compliant stock is a well-recognised ethical investment prospect in the financial industry. Following its increased acceptance in the market, prior literature has conducted numerous empirical studies to examine the performance of *shariah*-compliant equities compared to their conventional counterparts. A majority of the analysis is conducted at the index or portfolio level, and only a limited number of studies test at the firm level. The social norms perspective of ethical conduct essentially focuses on the societal influence on individual behaviour. Complementary to this view, ethically compliant firms are a representation of ethical behaviour at the firm level. These perspectives are interrelated and form a comprehensive understanding of the relationship between ethics and corporate performance.

In addition to *shariah*-compliant equity, the conventional type of ethical investment is called socially responsible investment (SRI). SRI capitalises on firms in ethical industries and engages in social welfare, environmental sustainability, and alternative energy production. These companies also implement sound governance policies to protect their shareholders and external investors. The two main objectives of SRI are to promote a positive social impact and financial gain for ethical investors. To achieve this, ethical-based investors have adopted various innovative strategies, including 'best-in-class' investing, active ownership, and ESG integration (Trinks & Scholtens, 2017). A common SRI investing strategy is to exclude stocks of companies involved in harmful and controversial activities, and this is termed negative screening.

In the era that promotes sustainable development, ethical investment has gained more attention not just by the religious investors but, also from a broad-spectrum of investors. As of 2011 alone, there are more than fifty academic empirical studies provide evidence on the risk and performance of ethical investment funds. This prospect of investment indicates rapid expansion with a growing asset size year by year. This paper intended to uncover the risk and performance of the two main types of ethical investment; first is ethical from the religious perspective, and the second is ethical from the universal social perspective. Discussion in prior literature mostly focuses only on one definition of ethical investment, this paper, on the other hand, covers a more comprehensive view of ethics. From this outlook, the papers able to compares the attributes of both types of investment and further identifies a more solid gap for prospective research.

In sum, empirical studies report a mixed result. The ethical investment funds in some analysis show similar performance to their conventional counterparts, and in other research reports, a higher or more stable performance compared to other assets. Despite this, from a comprehensive point of view, ethical funds demonstrate one primary advantage. Ethical funds appear to be more stable during financial uncertainties and indicate a higher tendency to outperform conventional funds during the financial turmoil. This sequel is majorly due to the screening criteria in the *shariah*-compliant and SRI. The ethically compliant companies are involved in less risky business activities and stable capital structure and better governance. This finding reconciles the debates on the inferiority of ethical funds, hence, consistent with the fundamental investment theory of risk and return.

This paper begins the discussion by providing the essence of risk and returns from the *Islamic* view, followed by the connection between ethical investment and the objectives of *Islamic* law in section three. The main discussion about the risk and return of ethical investments is in section four. Finally, section five summarises and concludes the overall discussion.

THE CONCEPT OF TRADING IN ISLAM AND RISK AND RETURN

Islam encourages trading as the main source of economic activity, provided that the business and the transactions involved are in accordance with Shariah principles. For instance, businesses involving alcohol, pork, and pornography are clearly condemned and should be totally avoided. In addition to this, the transactions within the business need to avoid the elements of *riba*, *gharar* and *maysir*.

"Allah hath permitted trade and forbidden riba…" (Al-Quran, 2:275). This Quranic verse undoubtedly condemns *riba* and provides trade as an alternative to earn a profit. In a transaction involving *riba*, the profit is positive, fixed and guaranteed regardless of the outcome or the proposed of the transaction (Iqbal & Mirakhor, 2011). Unlike *riba*, profits generated from trade are not risk-free but are a form of economic activity that involves risk-taking and risk-sharing. The concept of risk-taking and risk-sharing are a manifestation of Islamic ethical principles such as *'adl* (justice), *taqwa* (fear and abstinence), *ta'awun* (cooperation) and *ukhuwah* (brotherhood) (Rosly, 2005). Thus, Islam recognises trade as legitimate because it assumes risk-taking as opposed to *riba* that rejects the idea of risk-taking. Therefore, it is clear that trading is encouraged in Islam and that in Islam, combining risk with capital is a condition of earning a profit which is different from the concept of usury/interest.

The risk and return relationship are fundamental to the concept of trading in Islam (Obaidullah & Wilson, 2005). The Islamic legal maxims *(Qawaid Fiqiah)* explicitly state that *"Benefits (return) comes with liabilities (risk)" (Al-kharaj bi al-daman)* (Obaidullah & Wilson, 2005); *"Loss is burdened on those who have acquire profit"* (*al-ghurmu bil ghunmi*) (Rosly, 2005). The maxims indicate that one cannot expect to earn a profit without assuming loss or risk in their undertakings (Rosly, 2005). A logical deliberation of these maxims are observed in the prohibition of positive returns on zero-risk assets or riba (Obaidullah & Wilson, 2005). Islam condemns all forms of exploitation; specifically, the injustices continued in the form of a guaranteed positive return without assuming a share of risk (Iqbal & Mirakhor, 2011).

The *shariah* (Islamic law) recognises the risk in dealing with the outcomes of investment and business decisions, but, at the same time, prohibits the element of excessive uncertainty (*al-gharar*) in contractual obligations (Rosly, 2005). *Gharar* in business terms refers to an action to undertake a venture blindly without sufficient knowledge or to undertake an excessively risky transaction (Lewis & Algaoud, 2001). Furthermore, an element of maysir (gambling or speculation) arises as a consequence of the presence of *gharar* (Lewis & Algaoud, 2001). *Maysir* is an ethical dealing resulting from unjustified enrichment through games of pure chance (Lewis & Algaoud, 2001) in which one party will fully bear the burden of any loss. Islamic law explicitly forbids any transaction that contains elements of *maysir (Al-Quran 5: 90-91).* However, risk can never be totally avoided in any business activities; as such, only conditions of excessive risk have to be avoided (Visser, 2009). The prohibition of *gharar* and *maysir* stand for transparency and fairness. The ban on *gharar* is to prevent people from taking advantage of their counterparties due to asymmetric information (Visser, 2009).

The above principles of trading in *shariah* provide the grounds for the current basic screening criteria. Basic *shariah* screening generally involves two main steps: firstly, excluding companies with business activities that are contradictory to the *shariah*; and secondly, screening the company's financial aspect based on the identified financial ratios. The second step of the screening corresponds to the prohibition of *riba, gharar*, and the trading of money (*maysir*), as explained above. In addition to the main principles of *shariah*, business activities should also take into account public interest (*masalih*) and the protection of wealth as one of the objectives of the *shariah* (*maqasid al-shariah*) (Smolo & Mirakhor, 2010). The *maqasid al-shariah* justifies the need for a screening framework that fulfils the intrinsic value of Islam, which will be discussed in the next subsection.

THE OBJECTIVE OF ISLAMIC LAW AND THE ESSENTIAL OF ETHICAL INVESTMENT

The fundamental part of Islamic finance is to provide alternative financial products and instruments that sustain religious principles and incorporate ethical and moral values (Nasr, Lux, Ajmi, & Gupta, 2016). These principles are explicit in the *maqasid* of the *shariah*. In essence, the *maqasid al-shariah* aims to protect the benefits of individuals and the community and facilitate the improvement and fulfillment of human life (Kamali, 1999).

Kamali (2008) explains that the *maqasid* are embedded in the primary source of the *shariah* which views the general philosophy and objective of the textual injunction in the *Quran* and the *Sunnah*. The *Quran* describes the *maqasid* in chapter 10, verse 57:

> *"O mankind, a direction has come to you from your Lord; it is a healing for the (spiritual) ailments in your hearts and it is guidance and mercy for the believers."*

The message in this verse is that there should be no barriers to mercy and beneficence that God has intended for all human beings. Therefore, the objective of the *shariah* is exclusively about justice, mercy and wisdom, which aim at safeguarding the interests of the people in this world.

One important component to achieve justice is 'considerations of public interest' (*maslahah*). Within this component, Al-Ghazali classifies the *maqasid* into five main pillars: safeguarding the faith, self, intellect, posterity, and wealth. Kamali (2008, p.34) provides examples of this classification of *maqasid*. (1) Protection of faith covers direct compliance with the main religious law such as the propagation of heresy. (2) Protection of the self includes safeguarding the means to facilitate an honourable life such as the freedom of work, speech and travel. (3) Protection of the intellect requires the encouragement of learning and taking precautions against events that could threaten individual and societal development. (4) Preserving the purity of lineage necessitates the protection of the family and creating a positive social environment for the next generation. (5) Finally, the protection of wealth involves promoting the right of ownership, assisting the development of fair trade and lawful business transactions in the community.

Understanding the *maqasid* is a prerequisite for *ijtihad*[1] as the *maqasid* provides a meaningful understanding of the general outlines of the objectives of the Shariah (Kamali, 2008). The objective of Islamic commercial law is to protect and enhance the maqasid (Ahmed, 2011). The elements of the *maqasid al-shariah* are also parallel to conventional ethical, moral and social values. Hence, the current screening criteria fulfil the essentials of commercial law, which represent the first pillar of the *maqasid*: the protection of faith. Figure 1 shows the details on the connection between ethical investments with the *maqasid al-shariah.*

environmental degradation, health and safety, and human rights. As such, future study can incorporate additional criteria which covered in SRI into the basic screening in view of the *maqasid al-shariah* and reconcile the gap in current screening practices.

THE RISK AND PERFORMANCE

Shariah Compliant Equity

Al-Khazali *et al.* (2017) present evidence that the performance of the ethical stock market is connected to the norms of the local investors. In an analysis involving 15 Islamic countries for ten years, the findings reveal that the volatility of stock returns significantly decreases during the month of *Ramadan* as compared to the volatility observed in the other eleven months of the Islamic calendar. The results are robust in most Muslim countries and after controlling for the global financial crisis and the Arab spring. As the majority of Muslim countries promote *shariah*-compliant investments, the findings suggest a connection between social norms, faith-based investor attitudes, and the performance of *shariah*-compliant investments. The faith-based investor invests only in *shariah*-compliant equities and excludes conventional equities in their portfolio. The conventional investor, on the other hand, invests in both Islamic and conventional equities. Also, the comovement of newly added stocks with the existing Islamic index constituents increases during periods of high trading movement and during the fasting month of *Ramadan* (Mazouz, Mohamed, & Saadouni, 2016). The markets show positive reaction around the announcement for stocks that are added to the Islamic index and negatively to stocks that are removed from the index

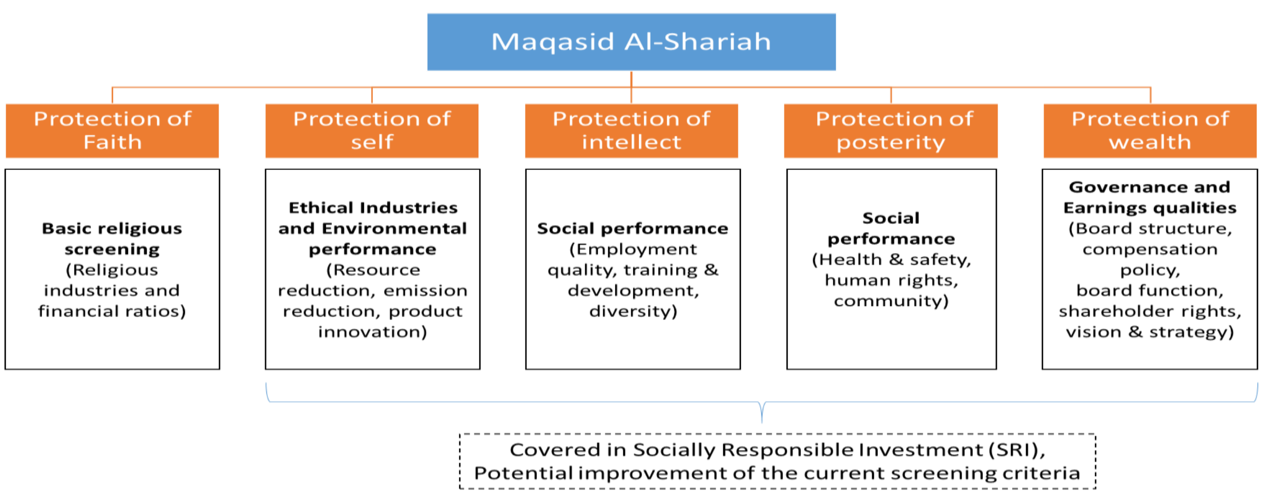

Figure 1: Mapping the Ethical Investment Screening with the Maqasid Al-Shariah

However, from the figure, it is clear that the current screening criteria is still lacking in fulfilling the intrinsic *shariah* values of equity, justice and fairness (Naughton & Naughton 2000; Abdelsalam et al. 2014). *Shariah* compliant equity includes business activities that might be contradict with the general principles of *shariah* such as, companies involved in

(Mazouz, Mohamed, & Saadouni, 2019). The finding suggests that investors perceive firms' commitment to ethics as good news which is likely to be a source of value creation rather than a diversification constraint. In short, this strand of research supports the influence of religion on asset prices.

[1] Ijtihad means striving or exertion by the one who carry out ijtihad (mujtahid) in deriving the rules of the *shariah* on a particular issue from the sources (Kamali 2008, p.25).

[2] The 12 indices comprise of the Dow Jones Islamic Market (DJIM), Morgan Stanley Capital International Islamic Index Series (MSCI), Standard & Poor Islamic (S&P), Russell Jadwa Islamic (RJI), Financial Times Islamic Series (FTSE), Royal Bank of Scotland Islamic (RBSI), Directional Movement (DMI) 150 Index, Bombay Stocks Exchange (BSE) TASIS Shariah 50, Jakarta Islamic (JII), Kuala Lumpur Shariah (KLSI), Hong Kong Islamic (HKII), and Societe Generale Islamic (SGI).

Following the above framework, Umar (2017) analysed the performance of the *shariah* versus the conventional index. The sample comprised of the Dow Jones conventional and Islamic indices for the world, developed countries, emerging markets, and the United States. The findings show that Islamic equities exhibit both short-term and long-term performance on a standalone basis. However, the inclusion of conventional equities in the portfolio reduces the desirability of Islamic equities in the short-term. Similarly, Al-Awadhi and Dempsey (2017) report that conventional equities in the GCC countries indicate higher returns and lower liquidity but face higher liquidity risk because of faith-based investors' preference compared to Islamic equities. Thus, this suggests the inferior performance of Islamic indices and some opportunity costs for faith-based investors due to the exclusion of conventional equities from the portfolio. This result might reduce the competitive advantage of Islamic equities in the global market.

Despite the inferior performance, *shariah*-compliant equities demonstrate higher performance during the financial crisis. An analysis comparing 12 major indices[2] in the world indicates that Islamic indices outperformed the conventional indices during crisis periods; however, the results are inconclusive for non-crisis periods (Ho, Abd Rahman, Muhamad Yusuf, Yusuf, & Zamzamin, 2014). This finding is comparable in the regional analysis involving Europe, the USA and the World. Conventional equities show higher returns during a stable period, but Islamic indices indicate a better performance starting from the emergence of the subprime mortgage crisis in 2008 and in turbulent times (Jawadi, Jawadi, & Louhichi, 2014). Islamic equity funds show lower performance compared to conventional funds by an average of 40 basis points per month but show higher performance during the financial crisis (Nainggolan, How, & Verhoeven, 2016). Alam (2010) demonstrated evidence that the outperformance of Islamic equities during the period of economic downfall has overcome its underperformance during an economic boom. The shariah-compliant equities performed better than the rest of the European market and exhibited less risk (Alam, 2010). *Shariah*-compliant equities carry less risk than conventional equities as a result of capital structure composition. Accordingly, during the global financial crisis, *shariah* compliant equities demonstrated lower values of systematic risk in the case of 'Low Debt' portfolios as compared to 'High Debt' portfolios (Alaoui, Bacha, Masih, & Asutay, 2016).[3] Thus, this suggests that Islamic funds are a safer investment with the return trade-off of being more ethical.

Prior studies thus far demonstrate that *shariah* compliant equities outperform their conventional counterparts during the period of the financial crisis and high volatility. This outcome is primarily due to the filtering criteria associated with *shariah* equities. Companies categorised as *shariah* compliant are involved in less risky business activities and have a stable capital structure. These companies are largely industrial companies with lower leverage and hold more tangible assets. Empirical evidence demonstrates that *shariah* compliant equities are generally less risky than conventional compliant equities (Ashraf, Felixson, Khawaja, & Mujahid, 2017; Ashraf & Khawaja, 2016). The results suggest a positive investment prospect for investors, especially during episodes of financial difficulties, and it also suggests the significance of research concerning *shariah*-compliant investment.

However, some studies report contradictory findings. Nasr *et al.* (2016) analysed the statistical properties of the Dow Jones Islamic Index (DJSI) and found that the volatility dynamic of DJSI was comparable to all formalised facts of traditional asset classes, and the forecast performance also aligned with predominant findings in the literature. Based on these results, Nasr *et al.* (2016) questioned the advantage of the Islamic index during extreme market fluctuations. Islamic indices exhibit higher performance in the long term and suggest some risky attributes compared to their conventional counterparts (Charles, Darné, & Pop, 2015). This study shows that the majority of Islamic indices have a higher level of risk than conventional indices in both periods of low and high volatility. In spite of this, the findings of these two studies might not represent overall *shariah*-compliant investment because the sample is limited to the Dow Jones indices. Different indices use different screening methodology, and the performance of Islamic equities is significantly affected by the screening methodology applied, which is either book-value based or market-value based. The book-value based approach normally suggests better nominal and risk-adjusted returns compared to the market-value based approach (Ashraf et al., 2017; Ashraf & Khawaja, 2016).

Analysis concerning the performance of *shariah*-compliant investment at the firm level reveals more detailed results. US firms added to the Dow Jones Islamic Market World Index witness a permanent positive price, liquidity effects, and lower costs of equity, whereas excluded firms sustain a negative price, liquidity effects and show no significant changes in the cost of equity (Chen & Ngo, 2017). The findings suggest a positive market reaction for companies categorised as *shariah*-compliant. Nevertheless, the ethical aspects of *shariah*-compliant firms are concentrated only on the core religious rules (the business and financial component screening). The prior literature argues that the current standards do not fully represent the intrinsic value of religion and are not a true representation of ethical investment. Consequently, the next subsection discusses the empirical assessment of the performance of socially responsible investment (SRI) and whether SRIs present a promising investment prospect for ethical investors.

Socially Responsible Investment

Prior literature provides evidence that the financial performance of SRIs is related to the criteria of the screening process. Trinks and Scholtens (2017) report that the controversial stocks or the 'sin stocks' indicate additional risk-adjusted returns in a portfolio and excluding them may reduce financial performance. Higher screening intensity also reduces the financial performance of SRI mutual funds (Capelle-Blancard & Mojon, 2014). However, the study finds that the result is only significant for negative screening (excluding sin stocks). In a global analysis, SRI funds in the

[3]Alaoui et al. (2016) constructed proxy portfolios for Shariah funds based only on the debt filtering criteria. The 'Low Debt' portfolio represent the proxy for Shariah compliant funds while the 'High Debt the proxy for Shariah compliant funds portfolios are the conventional funds.

US, the UK, and in many continental European and Asia-Pacific countries indicate lower performance compared to their domestic benchmarks by -2.2% to -6.5% (Renneboog, Ter, & Zhang, 2008). However, in some countries such as France, Japan and Sweden, the performance of SRI funds measured by risk-adjusted returns is comparable to conventional funds. Corporate governance and social screens are the two main contributing factors that lead to the inferior performance of SRI funds. However, Lee *et al.* (2010) report a significant reduction in alpha by 70 basis points per screening criteria using the Carhart performance model. Despite the lower performance reported in Trinks and Scholtens (2017), Capelle-Blancard and Mojon (2014) and Renneboog *et al.* (2008), the findings in Lee *et al.* (2010) suggest that an increase in screening intensity leads to lower systematic risk, which is consistent with the risk and returns hypothesis. These findings suggest a significant relationship between the screening criteria and SRI financial performance. In addition, ethical-based investors need to bear opportunity costs as a result of negative screening and limited portfolio choice but at the same time, enjoy a low-risk investment portfolio.

In the Australian market, Humphrey and Lee (2011) report no significant difference between the returns of SRI and conventional funds. Negative screening excludes firms that are involved in unethical business practices (i.e. tobacco, alcohol). Positive screening, on the other hand, includes companies with high ESG performance in their funds. The study found little evidence that the screening process, either positive or negative screening, influenced total return, and it reported weak evidence that funds with higher screen intensity provided better risk-adjusted-performance. Hence, this suggests that positive screening significantly reduces a fund's risk, whereas negative screening significantly increases risk and results in a less diversified portfolio. Abdelsalam *et al.* (2014) explore the impact of screening criteria, particularly portfolio restrictions, expenses and value-added criteria, on the performance of ethical investments such as SRIs and Islamic mutual funds. To overcome the limitation of analysis based on an average basis, this research uses a quantile regression that captures fund performance at different stages. The findings report that the variation in the performance of SRIs and Islamic funds is only significant for some of the quantiles of the conditional distribution of fund performance. Despite the differences in the screening criteria of SRIs and Islamic mutual funds, both of the funds present a comparable performance. Overall, prior research on the performance of SRIs demonstrates inconsistent results. SRIs either show lower or comparable performance compared to their conventional counterparts.

In correspondence to the inconsistent performance of SRIs and the lack of ethical features in *shariah*-compliant investment, researchers try to examine ethical investments using a more comprehensive approach. Erragragui and Revelli (2016) demonstrate that the integration of social performance measures in Islamic portfolios leads to higher performance. The findings apply for portfolios with good records in governance, products, diversity, and environmental issues. In contrast, excluding community and human rights controversies in the *shariah* compliance portfolio resulted in negative performance. The results are robust after controlling for market sensitivity, investment style, the momentum factor, and sector exposure. The pioneering work of Erragragui and Revelli (2016) supports a positive investment prospect for ethical investment and the need for more comprehensive screening requirements to develop good quality, ethical investment portfolio.

SUMMARY AND CONCLUSION

In summary, prior literature provides compelling evidence of the significant influence of religious and ethical screening on the risk and performance of investment funds. Previous studies, however, suffer from several limitations such as their measurements, limited sample coverage, and narrow research perspective. Prior studies are mostly conducted at the index or portfolio level, and only a limited number of studies conduct analysis at the firm level. In addition, the current *shariah* criteria only focus on the basic religious criteria (industry and financial screening) and ignore the intrinsic value of religion (the ethical values). Previous research also unable to derive conclusive evidence on the performance of SRIs. SRI funds indicate either lower performance or are insignificant compared to conventional funds.

Nevertheless, the common findings demonstrate higher stability and greater performance for ethical funds as compared to their conventional counterparts during the period of financial uncertainties. This is primally a result of the screening criteria for both *shariah*-compliant and SRI. Companies categorised under both funds involved in less risky business activities and show a stable capital structure and governance policies. This major finding reconciles the debates and also consistent with the fundamental investment theory of risk and return. Based on the findings and the gaps in the prior literature, a future study can incorporate the ethical performance criteria (ESG and earnings quality) in the current *shariah* screening framework to derive a comprehensive identification of ethical investment. Additionally, more analysis at the firm level could further resolve the mixed in the empirical findings.

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