THE ROLE OF ISLAMIC ASSET CLASSES IN THE DIVERSIFIED PORTFOLIOS

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Asset allocation is a central issue for the entire asset management industry in order to achieve the best possible risk-return profile. As the current trend shifts from intra-asset allocation to inter-asset allocation, the variety of asset classes becomes a key driver in determining the overall performance of a diversified portfolio. The rationale is that each asset class conceals its unique dimensions of risk, where a mixture of multiple asset classes may expand an investment opportunity set. This leads global investors to adopt a niche approach in order to achieve positive-sum games. The increasing importance of asset classes has substantially driven innovation in the financial industry from traditional assets (i.e. equity and fixed income) into a broader range of traditional alternative assets (private equity, real estate, commodities, currency) and modern alternative assets (hedge fund and managed futures).

This article is based on the findings from an academic research paper "The role of Islamic asset classes in the diversified portfolios: Mean variance spanning test", published in Emerging Markets Review (2017). The first objective is to address the conventional investors' problem as to whether any asset class from the Islamic investment universe may deliver value added to a well-diversified conventional portfolio, even in the presence of tail risk. The unique risk-return profile may be explained intuitively by the Shariah (Islamic) rules imposed on each Islamic asset class. Meanwhile, the second objective of the study focuses on addressing the Islamic investors' problem as to whether any conventional asset class may deliver value added to a well-diversified Islamic portfolio, accounting for the presence of tail risk. This is attributable to the nature of the investable Islamic asset classes, which mainly consist of Islamic equity, sukuk, and commodity. While only a few number of Islamic REITs exist predominantly in Malaysia, the number of established private equity funds is negligible. Moreover, the presence of Islamic hedge fund and managed futures remains controversial due to the prohibition of short-selling and derivatives. In other words, the study identifies whether Islamic inter-asset allocation is a disadvantage.

The research sample covers the U.S. and Malaysian portfolios, as well as a specific asset class in a few regions such as the GCC bond, Malaysian bond, Malaysian REITs, Malaysian equity, and emerging markets' equity. This study uses the recent mean-variance spanning test. The overall analyses focus on the expanding opportunity set in the presence of tail, and identify the source of value added either from tangency portfolio or from global minimum variance.

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The study provides some policy implications for the global Islamic financial industry. First, the industry should come up with Islamic asset classes which portray the risk-return profile of TIPS and high-yield bonds. It is justified by the fact that most of the sukuks are structured using ijara contract can be structured by periodically resetting the rental payment. Hence, the substantial increase of their issuances may enhance the opportunity set of Islamic portfolio. For the high-yield bonds, there is a large number of high-risk sukuks which are unrated by the global rating agencies. Due to an increasing appetite for risk among global investors in the recovery period, the role of the global rating agencies is very essential to improve the credibility of these sukuks. Moreover, the industry also need to create a high-yield sukuk index, as a proper benchmark for the global Islamic investors, in order to strengthen its high-yield market. The confidence in high-yield sukuks can significantly increase the number of Islamic private equities since it may create the Shariah-compliant mezzanine bridge financing. As for REITs, the substantial number of Shariah-compliant REITs in the global market is indispensable. There are only very few Islamic REITs available mostly in Malaysia. As the Islamic financial markets are well-developed mainly in Muslim countries, the Islamic financial industry can benefit from a considerable growth in their real estate market. For example, the concept of Islamic Tower REITs can boost the number of Islamic REITs from Middle East.

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On the fixed-income market, the global sukuk industry should reduce its heavy reliance on Middle East market due to its high sensitivity to the global oil market. In that case, the other Muslim countries need to develop their sukuk markets. The objective is to boost the number of global sukuk issuances with different risk profiles. The issuances from non-Muslim countries can expand the frontier albeit they may take longer time to solve some specific issues, i.e. taxes, ownership of underlying assets, etc. It is also encouraged that the industry in each country to structure their sukuks according to a single international standard, i.e. AAOIFI, in order to avoid any segmentation within the global sukuk market. Again, the role of global rating agencies is very critical in enhancing the attractiveness of corporate sukuks since some countries still rely heavily on the large issuances of their sovereign sukuks. The policy makers also should increase the sukuk issuances from some major firms that play as a backbone of the economy, i.e. the GCC sukuks financial services, and so on.

For modern asset class, the findings show no value added of hedge funds if we are aware of tail risk. Since the Shariah principle of investing is to mitigate extreme losses as best as possible, the Islamic financial industry can forgo the efforts in creating Islamic hedge funds using helah or legal tricks, i.e. a minority view in accepting the sale of a stock on the basis of future delivery (Salam) to replicate a short selling activity, the use of bay-al-urbun to replicate the economic effect of a conventional short sale, the use of bay-al-istijrar to replicate the Asian and barrier options, allowing both short selling and derivatives along with a substantial leverage using murabaha or ijara, and so on.

Although the Islamic fund managers of a specific asset class can benefit from some certain types of conventional assets in particular regimes, the findings show that the U.S. Islamic institutional investors are not at disadvantage when they invest in all Islamic asset classes, except for TIPS, high-yield bonds, and REITs. Even the long-term Malaysian Islamic institutional investors can forgo any conventional asset classes. Therefore, it is encouraged that Islamic institutional investors to be fully Shariah-compliant in their asset allocation decision, justified by the available opportunity set. The Islamic investors cannot blame any limitation in Islamic markets as the source of their underperformance since the opportunity set should be clearly distinguished from the investment skills.

Finally, although the conventional fund managers of a specific asset class can benefit from Islamic assets in particular regimes, the findings show that the conventional institutional investors cannot benefit from the combination of all Islamic asset classes. This encourages both policy makers and practitioners in the Islamic financial industry to structure Islamic assets purely according to the Shariah rules rather than merely mimicking conventional assets via helah (legal tricks). The structure of a variation of sukuks (ijara, mudaraba, musharaka, etc.) and its implementation in the industry should fully comply with the Shariah rules. In that case, the generated revenue and ownership risk of sukuks will completely represent their underlying assets. It is also encouraged that more innovations in the sukuks' structure with irregular streams of revenues rather than being dictated by a fixed-income nature in the conventional industry, i.e. muzara'a sukuk, RORE-linked sukuks (rate of return of the economy), and so on. The risk-return profile produced by any unique Islamic asset class will be rewarded, instead of being penalized, by institutional investors since it satisfies their main objective of expanding their opportunity set. The global rating agencies, again, have to come up with a new rating methodology for the new type of sukuks in order to enhance their credibility.

For the equity asset class, the Islamic financial industry should improve the process of Shariah screening beyond the criteria related to halal activities and interest or riba (interest income, interest-based debt, cash-equivalent assets). Many Shariah principles have not been incorporated in the screening process, especially related to business activities, i.e. Islamic marketing, Islamic human resources management, maqasid Shariah for firms' activities, and so on. As to the capital structure, the practice of bay-ad-dayn should be strictly prohibited so that it discourages Islamic firms in using any debt-generated instrument since it cannot be traded in the market. The prohibition of bay-al-wafa is very critical to ensure that the Islamic firm raises financing only for new assets, thereby automatically creating the upper limit of leverage for productive businesses. The underlying assets also should be completely kept out of the firm's balance sheet. Without the implementation of binding wa'd or purchase undertaking, the capital structure of Islamic firm will be driven primarily by operational leverage, which further reduce the firms' beta as the firm is completely financed by equity. As a result, the combination of the improved screening criteria and capital structure will produce such a unique risk-return profile of Islamic equity.

***Notes:**

Dewandaru , G., Bacha, O., Masih, R., & Masih , M. (2017). The Role of Islamic Asset Classes in the Diversified Portfolios: Mean Variance Spanning Test. Emerging Markets Review , Vol 30, 66-95.