



**A COMPARATIVE ANALYSIS OF THE  
PERFORMANCE OF ISLAMIC MUTUAL FUND AND  
ETHICAL FUND IN NIGERIA**

**BY**

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## **ABSTRACT**

Islamic financial products in Nigeria is still relatively new, while the Islamic banking aspect is quite popular and doing well, the awareness and acceptance of Non-interest capital market (NICM) products is low. With the intervention of the regulators to increase NICM to 25% of the total market capitalization, Islamic Mutual fund is one of the product introduced few years back to help attract investors who are which to assess the capital market through long term investment that is as well Shari'ah compliant. The Islamic mutual funds industry is quite small in size and scope, hence the need to evaluate its performance and find ways for it improve and increase its participation. This research compares the Islamic mutual funds to ethical funds operating in Nigeria in order to ascertain whether there is a difference in their performance. These two group of mutual funds differs from the other even though they share few similarities. The risk-return performance of two Islamic mutual funds and two ethical funds for the period of 2012- 2016 were using popular performance measures. Findings shows that Islamic mutual funds are more risky than ethical funds and although ethical funds tends to be more responsive to changes in the market, however there is no significant difference in their risk and return.

## خلاصة البحث

لم تزل المنتجات المالية الإسلامية في نيجيريا في حالة البدؤ، عندما كان المصرف الإسلامي في حالة الازدهار، ويتدهور الوعي وقبول المنتجات الإسلامية اللاربوية. ولما تداخل الجهة الرسمية لتنظيم المصارف والأموال التجارية في رفع المنتجات الإسلامية اللاربوية إلى 25% رأس المال، ولجذب قلوب المستثمرين الذين بودهم الاستثمار في الأسواق المالية لمدة طويلة على وفق للنظام الشرعي، أدخل -قبل سنوات- من ضمن المنتجات الجديدة نظام التكافل الإسلامي. كانت شركة التكافل الإسلامي صغير الحجم والنطاق. وبالتالي كانت بحاجة إلى تقييم أداءها لتنمية عملياتها ورفع مستواها من بين أقرانها. قارنت هذه الدراسة بين التكافل الجماعي والاستثمار الاجتماعي، في نيجيريا للتأكد من كونهما متوافقين في الأداء أو لا. وهناك فرق بائن بين المنتجين ولو كان بينهما أوجه التشابه. تعمل عودة الخطر في صندوق الاستثمار الإسلامي وصندوقي الاجتماعي من الفترة 2012- 2016 مقياس الأداء الانتشاري. وقد أشارت النتائج إلى أن صناديق الاستثمار الإسلامية لها أشد خطورة من الأموال الاجتماعية، وبالرغم من أن الأموال الاجتماعية تميل إلى أكثر استجابة للتغيرات في السوق، بيد أن ما بينهما فرق كبير في المخاطر والعائد.

## **APPROVAL PAGE**

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science (Islamic Banking and Finance).

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## DECLARATION

I hereby declare that this research paper is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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All praises id due to Allah who has made the completion of my master degree a success. May the peace and blessings of Allah be upon the noble prophet Mohammad, his household, companions and all those who follow his path in this world and the hereafter.

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# **CHAPTER ONE**

## **INTRODUCTION**

### **1.1 BACKGROUND TO THE STUDY**

The Islamic finance industry in Nigeria is still in a niche in the Nigerian financial system. Institutions offering Islamic financial products and services are categorized under the specialized banks/ financial institutions as non- interest financial institutions. With the growth in the awareness and demand for Islamic financial products, Nigeria is currently identified with the operation of a full-fledged Islamic bank, two Islamic banking windows, Islamic microfinance bank, Islamic funds and Takaful window operators.

The regulatory authorities have made efforts in order to support the implementation and establishment of a successful Islamic finance industry in Nigeria. The apex bank in the country; the Central Bank of Nigeria (CBN) established an Islamic finance working group in 2009 to oversee and address issue relating to the implementation of non- interest banking and finance in the country. Guidelines on the supervision and regulation of institutions offering Islamic financial services were issued and the Financial Regulatory Advisory Council of Experts (FRACE) was inaugurated to deal with all matters regarding Shari'ah compliance and governance.

The Islamic banking sector received more attention in terms of regulation, awareness and participation, many academic literatures have also been written on the potential, prospect and challenges of the system in the country. However, the Islamic capital market segment also known as the Non- Interest Capital Market (NICM) could be said to have been neglected compared to the banking sector as it is known that the banks only serve as short term financial intermediaries whereas the capital market caters for medium and long term financial needs of the people. The development of

the Non- Interest Capital Market (NICM) is quite slow in terms of size, products and market participation. Therefore it appears that NICM's potentials is yet to be explored by the investors who are seeking long term investments that are Shari'ah compliant.

Presently, activities in the NICM include the operation of three (3) Islamic mutual funds which started in 2008. Sukuk (Islamic bond) was also issued by the government of the state of Osun, Nigeria in 2013. Guidelines on both Islamic fund management and issuance of Sukuk were published in 2010 and 2013 respectively by the Securities and Exchange Commission (SEC) which regulates and supervises capital market operations and activities in Nigeria. The SEC have been dedicated in promulgating the Non- interest segment of the Nigerian capital market as a plausible and viable investment alternative.

In an attempt to further enhance market efficiency, transparency and stability that will improve the development of the capital market up to the standard of a developed economy, the securities and exchange commission (SEC) has set up a committee; Capital market committee (CMC) to come up with a 10 years capital market master plan (2015 – 2025).<sup>1</sup> This master plan is aimed at helping to achieve competitiveness of the capital market's four (4) key objectives, each of which has its own strategies and recommendation. These objectives are highlighted below;

- i. To build a strong regulatory foundation for NICM.
- ii. To encourage the development of NICM market stakeholders.
- iii. To encourage the development of NICM products.
- iv. To create a regional NICM hub.

A notable fact from the foregoing is that as far as the Nigeria Islamic capital market is concerned, most activities take place in the Islamic investment fund segment. Islamic investment fund can be described as funds that particularly focus

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<sup>1</sup> [www.sec.gov.ng](http://www.sec.gov.ng).

on investment that are in line/ acceptable according to the Islamic principles (Muhamed, 2009). According to Siddiqi & Hrubí, (2008:16), Islamic investment fund is defined as a special alternative investment, “a joint pool wherein the investors contribute their surplus money for the purpose of its investment to earn permitted profits in strict conformity with the precepts of Islamic Shari’ah”.

An Islamic investment fund is characterized by certain features which distinct it from the traditional investment fund. These characteristics are fundamental for Islamic investments that includes prohibition of transactions which have elements of interest (*riba*), uncertainty (*gharar*), speculations and gambling (*maysir*) (Elfakhani, Hassan & Sidani, 2005). The inclusion of any of these elements in a transaction goes against the principles of the Shari’ah (Islamic law). Islamic investment fund invests in stocks of companies that have been screened and selected accordingly before they are considered Shari’ah compliant. Companies whose core activities involves production and sale of alcohol, pork, tobacco, weapons, gambling, companies operating conventional banking and insurance and companies involved in production of adult entertainment are excluded (Kamso, 2013).

### **1.1.1 An Overview of the Islamic Mutual Funds Industry in Nigeria**

The Islamic mutual fund industry in Nigeria took off with the launch of the Lotus Halal Fund in 2008. The premier fund was launched by Lotus Capital Limited, a halal investment management company which specializes in Shari’ah compliant investments and providing financial advisory services<sup>2</sup>. Its investment portfolio

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<sup>2</sup> <http://www.lotuscapitallimited.com>.

includes listed and unlisted equities, real estate, asset backed investments and cash equivalent. Subsequently in 2012, the company in collaboration with the Nigerian stock exchange launched the NSE LII;<sup>3</sup> an Islamic index which tracks the performance of 15 Shari'ah compliant stocks that are listed on the stock exchange.

Another, Islamic mutual fund; ARM ethical fund was established in 2011 by ARM Company Ltd<sup>4</sup>, a non-bank financial institution primarily involved in all form of asset management. Similar to Lotus fund, its investment portfolio also includes equities, real estate and other investments. Finally, the Stanbic IBTC Imaan fund launched initially in 2011 for private investors but was made public in 2013 when it was registered with the SEC. Except for Lotus Halal fund, the other 2 funds are managed by companies which also operate other mutual funds based on conventional practices.

In 2014, Lotus Capital Limited listed the Lotus exchange traded fund (LHE ETF)<sup>5</sup> on the Nigerian Stock Exchange to track the performance of the NSE LII which consist of 15 Shari'ah compliant stocks as stated earlier. All these funds are open ended with no restrictions in its redemption and mostly long term capital growth investment.<sup>6</sup> Islamic mutual funds in Nigeria is grouped together with the conventional ethical funds because of some similarities which they both share.

Islamic investments funds behave in similar manner with the conventional mutual funds. Diversification leading to lower risk by having many investments within a portfolio, liquidity relates to the ease at which the investment can be redeemed at any time, its affordability especially for retail investors and professionally managed investments are all advantages of both Islamic and conventional funds. In terms of

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<sup>3</sup> Nigerian stock exchange Lotus Islamic index.

<sup>4</sup> Asset and Resource Management.

<sup>5</sup> Lotus halal equity exchange traded fund.

<sup>6</sup> Lotus, ARM & Stanbic Imaan factsheet.

measuring the performance, the Islamic investment funds are said to have outperformed the conventional in a particular period while underperforming in other period. However, findings have shown that most of the time there are no significant difference in the performance of both funds (Ahmad & Razali; Hartono, Soekarno, Damayanti, 2014).

## **1.2 STATEMENT OF THE PROBLEM**

Prior to the occurrence of the global financial crisis that hit the world's capital market in which Nigeria is not an exception, mutual funds operation in Nigeria was not seen as a significant investment alternative. The impact of the crisis led to the loss of confidence in the capital market especially from retail investors who lost their fortune in the unfortunate event (Ugwoke & Onyeonu, 2013; Oduwole, 2015). The emergence of unit/ mutual fund investing was as a result of those investors who came back to participate in the market, however this time were careful in choosing their investment portfolio and options (Olawoyin, 2016).

Mutual funds in Nigeria are generally known to exhibit poor performance due to the fact that majority of the funds failed to offer attractive return to their investors on a constant basis. According to statistics available on the SEC website, majority of these funds report positive NAV, however this could not be said in terms of earnings and the returns on investment. Talking about performance, although some of them have outperformed the market (NSE ASI) at a particular period (Bisi, n.d), however there is no confirmation that one fund performs significantly better than the others (Oduwole, 2015). Considering that the level of awareness and adoption of mutual funds investment in Nigeria is still very low and not totally encouraging not to talk of mutual funds that are based on religious and ethical belief, the impact has not been noteworthy (Ugwoke and Onyeonu, 2013). According to Oduwole (2015), a major

issue is the lack of periodic review of the performance of the participants in the mutual fund industry that could have helped to identify and address some of the issues that may aid in improving their performances.

The performance of Islamic mutual funds in Nigeria is yet to be evaluated amidst the challenges which the mutual funds industry is facing in general. There is a need to further determine whether the restrictions in investment strategies according to the Islamic principles (Shari'ah) affects their performance compared to the conventional mutual funds. For instance, the Lotus Islamic index consist of 15 Shari'ah compliant stocks only out of all that are listed on the stock exchange out of the over 100 listed companies. For a market segment which has been operating for almost 8 years now and with the aim of the SEC to develop the NICM to at a least 25 % of the total market capitalization (Nnorom 2015; Jack, 2015) thereby making it a regional hub for Non- Interest Capital Market Products (NICMPs), it is important to evaluate the risk and return performance of the institutions operating therein to serve as a benchmark to achieve this objective. This study therefore, examines the performance of the Islamic mutual funds vis a vis conventional ethical mutual funds helping to provide an insight on the similarities and differences between the two.

### **1.3 JUSTIFICATION FOR THE STUDY**

Many researches have been carried out on the Islamic finance industry in Nigeria but majority of these studies are focused on the banking industry. Aspects such as prospect, issues and challenges, awareness and perception, regulatory framework etc. of the Islamic banking sector has been thoroughly explored. However, not many literature is written on Islamic capital market otherwise known as Non- interest capital



market (NICM) in Nigeria particularly on products, therefore this research tends to contribute to the body of knowledge on this subject.

This research is partly motivated by the SEC's effort to increase the NICM contribution to at least a quarter of the overall market capitalization as stated in the master plan. The choice of Islamic mutual fund as the product of preference is basically because it is the most active investment product in the NICM. Mutual funds generally are regarded as a perfect means of assessing the capital market especially for investors in order to achieve financial inclusion (Srinivas, 2014). With regards to Islamic mutual funds, in addition to the low risk involved, there are opportunities of diversifying ones investment which are managed by expert fund managers at a relatively low cost of transaction (Schoon, 2011), at the same time investing in Shari'ah compliant stocks.

The trend has shown that investors globally are seeking for alternative avenue to channel their investments. These paved ways for the popularity of Islamic, ethical and other form of investment which involved lower risk and this can be proven by the number of Islamic equity and funds establishment even in non- Muslim countries such as Australia and UK (Reddy and Fu, 2014). Nigerian investors are not exempted, hence the justification of this research which is committed towards the creation of awareness and enlightenment to investors, fund manager and also the regulators on the performance, differences and similarities between Islamic mutual funds and conventional/ ethical funds.

#### **1.4 RESEARCH OBJECTIVES**

The main objective of this research paper is to examine the performance of Islamic mutual fund vis a vis its conventional counterparts as a Shari'ah compliant financial instruments in the Nigerian capital market. The main objective can be further broken down into two specific objectives:

- (i) To measure the performance of both the Islamic and conventional ethical investment funds in Nigeria.
- (ii) To examine whether there is a significant difference between the performance of Islamic investment and conventional ethical funds in Nigeria.

#### **1.5 RESEARCH QUESTIONS**

To achieve the above research objectives, the study addresses the following research questions;

1. Are Islamic ethical funds return significantly different from that of the conventional ethical investment funds in Nigeria?
2. Are Islamic ethical funds significantly riskier than the conventional ethical investment funds in Nigeria?
3. Is there any significant difference in the performance of Islamic and conventional ethical funds?
4. What are the factors that influence the performance of Islamic investment fund in Nigeria?

## **1.6 RESEARCH METHODS**

The main objective of this research is to examine the performance of Islamic mutual funds and ethical funds in Nigeria. In order to achieve this objective, the research adopts a quantitative approach where secondary data obtained from the Securities and Exchange Commission website will be analyzed using classical measures/ techniques commonly used in the evaluation of mutual funds' performance. These are the Sharpe ratio, Treynor ratio and the Jensen alpha. Four mutual funds are examined; 2 Islamic funds and 2 ethical funds to create a 2 portfolios for comparison. Weekly NAVs of each fund is obtained from March 2012 to May 2016. NAVs of the benchmark index (NSE LII) is also obtained from the website of the Nigerian stock exchange.

## **1.7 PLAN OF THE STUDY**

This research is divided into five chapters. The first chapter comprises the introduction and the rationale why the research is being conducted. It gives a general background to the study and highlights the problem and issues. The second chapter is the literature review covering relevant materials on mutual fund and the mutual fund industry in Nigeria, Islamic mutual fund and comparison of the performance of Islamic mutual funds and conventional ethical mutual funds.

The third chapter is the description of the methodology adopted, the research design, data collection techniques and method of analysis. The fourth contains the details of the result and finding from the analysis in the previous chapter. Lastly, chapter five summarizes and concludes the research in relation to the literatures reviewed, implications, recommendations and suggestions.

## **1.8 LIMITATION OF THE STUDY**

A major limitation of this research is the fact that the age and history Islamic mutual fund in Nigeria is relatively short. The earliest fund was established in 2008 and data is not even available from that period thereby shortening the period of observation. Another limitation is that the size of the Islamic mutual fund industry in Nigeria is small which restrict the comparison to ethical funds and not traditional conventional funds as a whole. The question of whether comparison among 4 funds is sufficient to analyze may also lead to criticisms on the possible practical implications of the study.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 MUTUAL FUNDS**

Mutual funds exceptionally became popular in the 1990s even though the industry has been established in the early 19<sup>th</sup> century in Europe. The first mutual fund was established in 1924 (Klapper, Sulla and Vitras, 2004; Fitzpatrick, Hepp and Lott, 2010). It is defined as “a form of financial intermediary that pools saving of investors for collective investment in a diversified portfolio of securities”. Their investments are structured in such manner to comply with certain objectives which is usually stated by the fund management company. Mutual fund asset classes include stocks, bonds, money market instruments and other assets or securities.

The growth in the industry is mainly due to the advantages derived from it by investors. This includes the diversification, low cost, ease in redemption and professional management. According to Klapper, Sulla and Vitras (2004), many factors contributed to the growth in global mutual funds industry. Some of which are the increase in the worldwide movement towards interdependency especially in the area of finance and the improving level of economic development. The establishment of multinational companies and groups in different parts of the world is also a factor. However, the shift in the interest of investors from highly risky investment to investment which are considered to have relatively lower risk as well as provide high return to their investment in the long run is one of the major factors that helped increase the popularity of mutual funds globally.

Mutual funds could either be open ended which implies that investors can exit or liquidate their investment at any time and new shares are issued when new investors enter the fund. Open ended funds are not required to be listed on the

exchange. Closed-ended mutual funds on the other hand implies that new investors are not accepted after the initial offering and also investors cannot exit the fund by simply redeeming their investment from the fund. They usually have fixed redemption period therefore it has to be traded in the stock exchange.

Many investors have chosen mutual funds as a means to save for their retirement and other financial objectives which are usually long term in nature. An investor receives his/ her investment in mutual funds at the net asset value (NAV) as at the time the investment was made. The NAV represent the assets of the mutual funds minus its liabilities and other expense. The more the NAV, the more the value of investment and it is published daily by the fund managers. Changes in the market influence the value of the investment which could be either an increase or decrease. Return on mutual funds could either be in the form of dividend or capital gain which could be received in cash or reinvested as the investor wishes. Statistics as at 2014 shows that there are about 80,000 mutual funds in operation and total asset under management amount to 31.38 trillion USD globally with 44% of the total held in equity funds (International Investment Funds Association, 2015).<sup>7</sup> While most of them are in the US (57%) other countries also have quite a number of mutual funds established, these include Australia, UK, India, Malaysia, South Africa etc.

Since the 1990s in which Islamic investment fund started, it has developed significantly till date (Norman, 2006). The pronouncement of the Fiqh Academy of the Organization of Islamic Countries (OIC) in 1992 which stated that investing in shares and equity is permissible as long as it does not involve the prohibited elements was one of the drives for the development of Islamic funds (Zainudin, Miskan & Sulaiman).

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<sup>7</sup> <http://www.statista.com/topics/1441/mutual-funds>

According to MIFC (2015), as at the 3<sup>rd</sup> quarter of the year 2015, the total of global asset under management (AUM) of Islamic investment fund is estimated at USD 60.2 billion while a total of USD77 billion is expected by 2019. The growth in the Islamic fund industry is largely relative to the increased number of Shari'ah compliant equities. Saudi Arabia and Malaysia remain the major contributor to the industry holding 41% and 24% respectively of the total asset under management (MIFC, 2015). The industry started with equity funds as the premier asset class of investment and is still the leading in the group of asset classes for Islamic investment fund. However, other asset include real estate, mixed income, sukuk, commodity, money market and other structured products have been developed (Ernst& Young, 2008; Kamso, 2013; IFSB, 2015).

The past few decades witnessed the introduction of new forms of mutual funds investing such as Islamic mutual funds and socially responsible investment (SRI) also known as ethical funds. Ethical funds are defined as funds that adopt the exclusion of certain companies stocks when selecting their investment portfolio. Coscarelli, Federico and Notte (2010) defined ethical funds as “ a set of approaches which include social or ethical goals or constraints as well as more conventional financial criteria in decisions over whether to acquire, hold , or dispose of a particular investment”. Ethical funds are mainly concerned with investments which have long term expected risk and return attributes. Series of screening methodology are used to avoid and exclude certain companies from their portfolio.

According to Hussein (2004), the advocates of ethical investment argued that there is an advantage of social and economic contribution through the screening of investments. Corporate social responsibility is one of the main focuses of ethical investing. This is because it deals with issues that are socially related to the

environment in which these companies operate that could lead to damage, increase in cost of production, security cost etc (Hussein, 2004).

Ethical funds exclude companies involved in the production of tobacco, pornography, arms and weapons, animal testing etc. some funds encourage the active involvement of their investors in order to achieve responsible management and also to enhance performance (Forte and Miglietta, 2011). The authors further explained that the main goal of ethical funds is to achieve a more desirable economic system. The main difference between ethical mutual funds and Islamic mutual funds is that in addition to being socially and environmentally oriented, Islamic mutual funds also considers religious values.

### **2.1.1 Characteristics of Mutual Funds**

Irrespective of the type of fund, mutual funds usually exhibit similar characteristics which are mainly the advantages derived and the reason for its popularity. Each of these characteristics depends on what is most important to each investor. Some of these characteristics are explained in details below:

- **Diversification of portfolio:** rather than individual ownership in stocks or other investments assets, mutual funds gives the opportunity for spreading investment across variety of assets in a wide range of companies and sectors. Diversification helps to lower investment risk and reduce the volatility in the price of an asset. It also helps to identify which investment is performing well or otherwise.
- **Professional management:** investment in mutual funds is usually managed by experts who have extensive knowledge of the financial market. With the level of skill required an individual investor might not be able to manage his/her