

“O you who believe! If you help (in the cause of) ALLAH, He will help you, and make your foothold firm” (Qur’an, *Muhammad: 7*).



الجامعة الإسلامية العالمية ماليزيا
INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA
بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

THE MALAYSIAN ISLAMIC STOCK MARKET:
A STUDY ON PERFORMANCE AND THE
CONDITIONAL CAPITAL ASSET PRICING MODEL

BY

MOHD MAHYUDI BIN MOHD YUSOP

A dissertation submitted in partial fulfilment of
the requirements for the degree of
Doctor of Philosophy in Economics

Kulliyyah of Economics and Management Sciences
International Islamic University
Malaysia

JULY 2008

ABSTRACT

The progress in the Malaysian Islamic capital market (ICM) is the envy of the international community since Malaysia is now regarded as one of the leading centers for Islamic finance. To maintain this position, research on the present market is imperative. Hence, this two-part study is undertaken to fill that role. The first part evaluates the performance of Kuala Lumpur Shariah Index (KLSI) and RHB Islamic Index (RHBII) against the market benchmark, Kuala Lumpur Composite Index. To that end, the method employed involves the measurement of performance; and measurement of risk, selectivity and timing. The second part tackles the issue of beta relevancy in describing returns. The capital asset pricing model (CAPM) in the traditional and conditional forms are examined in addressing this issue. Our research also seeks to discover the characteristics of beta for *shari'ah*-compatible securities. For this, the ordinary least squares and generalized method of moments estimation techniques are utilized. To achieve these goals, the phase from April 1999 until June 2005 is treated as the sample period. The findings show that the Islamic betas are positive and less than one. More importantly, the results reveal that KLSI is of poorer quality than RHBII and both Islamic indices are not market competitive. Furthermore, there is evidence for the significance of beta from the results of not only the traditional CAPM, but also the conditional CAPM. Thus, we conclude by confirming the relevance of beta for the exploits of the practitioners and by critically arguing that FTSE Bursa Malaysia EMAS Shariah Index and FTSE Bursa Malaysia Hijrah Shariah Index might not be good enough in alleviating our concern on KLSI. Therefore, the Islamic version of the FTSE Bursa Malaysia 100 Index is proposed to stimulate more encouraging developments for the Malaysian ICM.

ملخص البحث

ان التقدم في سوق رأس المال الاسلامي الماليزي قد جعل ماليزيا محط انظار المجتمع الدولي كاحد المراكز الرائدة لسوق المال الاسلامي. وللمحافظة علي هذا الموقع المميز فان القيام ببحث حول السوق الحالية أصبح ضرورة، ولهذا فان هذه الدراسة ذات الجزئين تتكفل بالقيام بهذا الدور. يتم في الجزء الاول تقييم أداء كل من مؤشر شريعة كوالا لامبور (KLSI) و مؤشر (RHB) الاسلامي (RHBII) مقارنة بمعيار السوق وهو مؤشر كوالا لامبور المركب. الطرق المستخدمة هي قياس الاداء و قياس المخاطر و الانتقائية والتوقيت . أما في الجزء الثاني فيتم معالجة قضية ارتباط البيتا بوصف العائد عن طريق دراسة نموذج تسعير أصل رأس المال بشكليته التقليدي والشرطي. يحاول هذا البحث ايضا ان يكتشف خصائص البيتا للاوراق المالية المتساوية لمؤشر شريعة وذلك باستخدام طريقة اقل المربعات التقليدي و الطريقة العامة لقياس اللحظات من أجل تحقيق هذه الاهداف وذلك باختيار المرحلة بين شهر ابريل 1999 حتي يونيو 2005 كعينة. قد أوضحت النتائج ان البيتا الاسلامية اجابية و اقل من واحد، واهم من ذلك فان النتائج قد أظهرت أن مؤشر شريعة كوالا لامبور (KLSI) أقل جودة من مؤشر (RHBII) وأن كلا المؤشرين الاسلاميين لا يمتلكان القدرة التنافسية في السوق و فضلا علي ذلك هنالك دليل علي أهمية البيتا اوضحته نتائج دراسة نموذج تسعير أصل رأس المال بشكليته التقليدي والشرطي. وبهذا نختتم البحث بتأكيد إرطبات البيتا باستثمارات أصحاب المهن، وبالجدل نقداً بان كل من (FTSE) بورصة ماليزيا (EMAS) مؤشر شريعة، ومؤش بورصة شريعة هجرة ماليزيا (FTSE) غير جيدين بما يكفي لتخفيف التخوف حول مؤشر شريعة كوالا لامبور، ولهذا نقترح تبني النسخة الاسلامية لمؤشربورصة ماليزيا المؤي (FTSE Bursa Malaysia 100 Index) من أجل تحفيز تطور أكثر تشجيعاً في سوق رأس المال الماليزية.

APPROVAL PAGE

The dissertation of Mohd Mahyudi bin Mohd Yusop has been approved by the following:

Mohd Azmi Omar
Supervisor

Mohammed Yusoff
Supervisor

Rosylin Mohd. Yusof
Supervisor

Jarita Duasa
Internal Examiner

Abdul Ghafar Ismail
External Examiner

Nasr Eldin Ibrahim Ahmed
Chairman

DECLARATION

I hereby declare that this dissertation 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.

Mohd Mahyudi bin Mohd Yusop

Signature

Date

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

**DECLARATION OF COPYRIGHT AND AFFIRMATION
OF FAIR USE OF UNPUBLISHED RESEARCH**

Copyright © 2008 by Mohd Mahyudi bin Mohd Yusop. All rights reserved.

**THE MALAYSIAN ISLAMIC STOCK MARKET: A STUDY ON
PERFORMANCE AND THE CONDITIONAL CAPITAL ASSET PRICING
MODEL**

No part of this unpublished research may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise without prior written permission of the copyright holder except as provided below.

1. Any material contained in or derived from this unpublished research may only be used by others in their writing with due acknowledgement.
2. IIUM or its library will have the right to make and transmit copies (print or electronic) for institutional and academic purposes.
3. The IIUM library will have the right to make, store in a retrieval system and supply copies of this unpublished research if requested by other universities and research libraries.

Affirmed by Mohd Mahyudi bin Mohd Yusop.

.....
Signature

.....
Date

To these special people whose endless love and support I can never repay: my parents;
mother-in-law; wife; Enizahura, and kids; Muhammad Mukhlis, Sayyidah Nafisah,
and Muhammad Muhsin.

ACKNOWLEDGEMENTS

First and foremost, all praises are to Allah for it is due to His mercy that I have managed to complete this research work. This is just one of His countless bounties that He has bestowed upon me. To put it in the right perspective, it is simply my duty as His servant to always appreciate His blessings; even the smallest of them. Therefore, this dissertation should serve as another reminder for me to continuously fulfill my responsibilities to Him.

My deepest sense of appreciation is to my three supervisors; namely, Professor Dato' Dr. Mohd Azmi Omar, Professor Dr. Mohammed Yusoff, and Dr. Rosylin Mohd Yusof. Believe me that I have benefitted so much from all of you; especially Prof. Azmi given that we have come into contact the most since you are both, my main supervisor and post-viva supervisor. That is why I dare to say that the things that I have gained under your supervision are much more than what has appeared in this dissertation. Indeed, it is a great desire of mine to use those valuable lessons, advice and guidance to be not only a researcher of high quality, but also a better person to all whose lives cross path with mine.

I would also like to express my many thanks to these practitioners: Mr. Zainol Ali, Senior Associate, Islamic Capital Market Department of Securities Commission; Mr. Kamarulzaman Hassan, Senior Research Analyst, Avenue Securities Sendirian Berhad; Mr. Mohammad Hanis, Assistant Vice President, Treasury and Markets of Hwang-DBS Investment Bank Berhad; Mr. Yunos Surano, Al-Mudarabah Margin Financing Application Officer, BIMB Securities Sendirian Berhad; Dr. Mohd Daud Bakar, President, International Institute of Islamic Finance, Malaysia; and Mr. Amran Zaki, Senior Executive, RHB Securities Sendirian Berhad. Your inputs are a huge and invaluable contribution to this dissertation and for that, I pray that Allah will reward each one of you and your family with the best of rewards. Accordingly, this gratitude is also extended to the respective organizations that the above-mentioned individuals attached to.

In addition, my sincere appreciation goes to my fellow colleagues with whom I have shared this journey. This special group of people includes Aminul Islam, Nasir, Chan, Anuar, Fauziah Hanim, Norasibah, Shivee and Aisha; to name a few. The high and low moments that we have gone through together are the elements that would bind us to be good friends forever.

Last but not least, I must also acknowledge the support that I have been getting from my sponsors; which are Universiti Sains Malaysia and Ministry of Higher Education. Without the financial assistance, I might have not been able to start this research in the first place.

TABLE OF CONTENTS

Abstract	ii
Abstract in Arabic	iii
Approval Page	iv
Declaration Page	v
Copyright Page	vi
Dedication	vii
Acknowledgements	viii
List of Tables	xi
List of Abbreviations	xiii
CHAPTER 1: INTRODUCTION.....	1
1.1 Background of the Study	1
1.2 Problem Statement	6
1.3 Objectives of the Study	13
1.4 Scope and Limitations of the Study	15
1.5 Contributions of the Study	18
1.6 Organization of the Study	21
CHAPTER 2: THE ISLAMIC STOCK MARKET.....	22
2.1 Introduction.....	22
2.2 Legitimacy of Share Ownership	23
2.3 Selected <i>Shari'ah</i> Issues Relating to a Stock Exchange.....	25
2.3.1 Speculation	25
2.3.2 Margin Trading	29
2.4 Criteria for Constituent Stocks of Islamic Indices	36
2.4.1 Non- <i>Shari'ah</i> Elements	38
2.4.2 <i>Shari'ah</i> Elements	41
2.5 Empirical Works on the Islamic Stock Market.....	47
2.5.1 Studies on the US Market.....	48
2.5.2 Studies on the Malaysian Market.....	50
2.6 Conclusion	55
CHAPTER 3: CAPM: THEORY AND EVIDENCE	57
3.1 Introduction.....	57
3.2 Derivation and Theory of CAPM.....	58
3.3 Justification for Conditional CAPM	63
3.4 Empirical Tests on Conditional CAPM.....	69
3.4.1 International Evidence.....	69
3.4.2 Malaysian Evidence	85
3.5 Islamic Perspective on Risk-Return Relationship.....	87
3.6 Conclusion	90

CHAPTER 4: RESEARCH METHODOLOGY	92
4.1 Introduction.....	92
4.2 Methodological Procedures	93
4.2.1 Relative Performance of Indices.....	93
4.2.2 Relative Performance of Models	99
4.2.3 Auxiliary Tests Procedures.....	111
4.3 GMM Estimation	113
4.3.1 Instrumental Variables Selection	118
4.4 Data and Variables	122
4.5 Conclusion	129
CHAPTER 5: RESULTS AND DISCUSSIONS	130
5.1 Introduction.....	130
5.2 Results on Relative Performance of Indices	131
5.2.1 Descriptive Statistics for Return Series.....	131
5.2.2 Risk-Adjusted Return Measures of Indices.....	135
5.2.3 Risk Features of Indices	138
5.2.4 Findings from Treynor and Mazuy Model.....	142
5.3 Results on Relative Performance of Models.....	143
5.4 Auxiliary Tests Results.....	154
5.5 Conclusion	158
CHAPTER 6: CONCLUSION	160
6.1 Introduction.....	160
6.2 Summary of Main Findings	161
6.3 Implications of Research Findings.....	163
6.4 Recommendations for Future Research.....	166
6.5 Concluding Remark.....	168
BIBLIOGRAPHY	170
APPENDIX I: List of <i>Shari'ah</i>-Compliant Securities	184
APPENDIX II: FTSE BM EMAS Shariah Index Design.....	204
APPENDIX III: FTSE BM Hijrah Shariah Index Design	205
APPENDIX IV: Constituents of FTSE BM EMAS Shariah Index.....	206

LIST OF TABLES

<u>Table No.</u>		<u>Page No.</u>
1.1	<i>Shari'ah</i> -approved securities on the Malaysian stock exchange	4
1.2	<i>Shari'ah</i> -based unit trust funds	7
2.1	Prohibited industry screening	42
4.1	Test outcome for instrumental variable status	121
4.2	Results on Chow breakpoint test	124
5.1	Descriptive statistics for return series	132
5.2	Risk-adjusted return measures of indices	136
5.3	Autocorrelation test outcome on OLS alpha estimation	137
5.4	Heteroskedasticity test outcome on OLS alpha estimation	138
5.5	Risk features of indices	139
5.6	Results on Treynor and Mazuy model	143
5.7	Results for unconditional CAPM	144
5.8	Diagnostic tests results for unconditional CAPM	145
5.9	Results for conditional CAPM	146
5.10	Diagnostic tests results for conditional CAPM	149
5.11	Results for conditional CAPM with beta-square	150
5.12	Correlation matrix for conditional CAPM with beta-square	152
5.13	Diagnostic tests results for conditional CAPM with beta-square	153
5.14	Results on relative size of betas	155
5.15	Test outcome on alpha and market risk premium	155

Table No.

Page No.

5.16 Hansen's J -statistic test

157

LIST OF ABBREVIATIONS

ADF	Augmented Dickey Fuller
APT	Arbitrage Pricing Theory
ARCH	Autoregressive Conditional Heteroskedasticity
ASEAN	Association of South East Asian Nations
BE/ME	Book-to-Market Equity Ratio
BIMB	Bank Islam Malaysia Berhad
BM	Bursa Malaysia Securities Berhad
BSETI	Bangkok Stock Exchange Trade Index
CAPM	Capital Asset Pricing Model
CCAPM	Conditional Capital Asset Pricing Model
CIFA	Council of Islamic Fiqh Academy
CML	Capital Market Line
CoV	Coefficient of Variation
CRSP	Center for Research and Security Prices
DAFOX	Deutscher Aktienforschungsindex
DJIAS	Dow Jones Index-Americas
DJII	Dow Jones Industrial Index
DJIMI	Dow Jones Islamic Market Index
DJSWI	Dow Jones Sustainability World Index
DJWI	Dow Jones World Index
DRIMI	Dow Jones RHB Islamic Malaysia Index
E/P	Earnings/Price Ratio
EBA	Extreme Bounds Analysis
EGARCH	Exponential Autoregressive Conditional Heteroskedasticity
EMAS	Exchange Main Board All Share Index
EIV	Error in Variable
<i>et al.,</i>	<i>et alia</i> (and others)
EWI	Equally Weighted Index
FBI	FTSE Bursa Malaysia 100 Index
FEFB	Foreign Exchange Fund Bill
FESI	FTSE Bursa Malaysia EMAS Shariah Index
FHSI	FTSE Bursa Malaysia Hijrah Shariah Index
FTSEGI	FTSE Global Islamic Index
GARCH	Generalized Autoregressive Conditional Heteroskedasticity
GMM	Generalized Method of Moments
HAC	Heteroskedasticity and Autocorrelation Consistent
ICM	Islamic Capital Market
i.e.,	that is
<i>iid</i>	independent and identically distributed
IRF	Impulse Response Function
JII	Jakarta Islamic Index
JSX-CI	Jakarta Stock Exchange Composite Index
KLCI	Kuala Lumpur Composite Index
KLIBOR	Kuala Lumpur Interbank Offered Rate

KLSE	Kuala Lumpur Stock Exchange
KLSE	KLSE Syariah Index
LIBOR	London Interbank Offered Rate
LRT	Likelihood Ratio Test
MSCI	Morgan Stanley Capital International
n.d.	no date
NAV	Net Assets Value
NYSE	New York Stock Exchange
OLS	Ordinary Least Squares
PP	Phillips-Perron
PSEI	Philippines Stock Exchange Index
QS	Quadratic Spectral
RHB	Rashid Hussain Bank Group Berhad
RHBII	RHB Islamic Index
RHBS	RHB Securities Sendirian Berhad
RM	Ringgit Malaysia
SAC	Shariah Advisory Council
SAEI	Singapore All Equities Index
SC	Securities Commission
SGX	Singapore Exchange
SML	Security Market Line
UK	United Kingdom
US	United States of America
USD	United States Dollar
VDA	Variance Decomposition Analysis
VECM	Vector Error Correction Model
VWI	Value Weighted Index
W5000	Wilshire 5000 Index
WLS	Weighted Least Squares

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

There is no other area in Islamic economics that has experienced stimulating developments as rapid as Islamic finance, be it in Muslim countries or in Western countries like the United Kingdom (UK) and the United States of America (US). Undeniably, one of those countries that are spearheading this economic agenda is Malaysia. The primary reason for this fact is crystal clear; such progress in Islamic finance has the full support from the present Malaysian government. The special economic advisor to the fourth Prime Minister (i.e., Dr. Mahathir Mohamad), Nor Mohamed Yakcop (2003: B2-B3) explained,

The development of Islamic finance that began with a period of discovery (1983-1992), and was followed by acceptance and pervasiveness (1993-2002), is now to be used as a strategic and developmental tool to our nation's and the ummah's advantage.

As a result of the undivided commitment from the government, Malaysia has gained the utmost respect and recognition as the pioneer in the area of Islamic capital market (ICM) from the international community. In March 1996, the Securities Commission (SC) of Malaysia held its inaugural International Islamic Capital Market Conference in Kuala Lumpur. The most important objective of that historic event was to bring together views on how to develop a functional ICM. The topics discussed include Islamic financial instruments, intermediaries and investors, institutional framework and the Malaysian experience so far. Since then, there have been countless conferences, seminars and events organized by the authority and private parties at both, local and international levels; for example, the SC's Islamic Capital

Market Week that were held in March 2002. Collectively, those significant happenings represent the various endeavours undertaken to establish a proper and feasible ICM framework in Malaysia. Consequently, such hard work is part of the reason why Malaysia is now regarded as one of the leading centers for Islamic finance (SC, 2006a).

The SC, as the single regulator of the Malaysian capital market, has been playing a pivotal role in making the equity and bond markets to be more conducive for investors who subscribe to the Islamic tenets and principles. To that end the SC has, among others, put in place the necessary elements and infrastructures that ensure the existence of an operational ICM.¹ With regard to its organizational structure, an ICM unit was formed in the SC to oversee the implementation of the intended progress. Recently, the status of this unit has been upgraded to a department. This reflects the increasing importance of ICM to the future direction of Malaysia's capital market development as charted in the Capital Market Masterplan, which was officially unveiled in February 2001.² On another front, in 1994, the SC established an informal group called the Islamic Instrument Study Group consisting of *shari'ah* (Islamic law) scholars and corporate figures to chart and guide the expansion of ICM. That set up was formalized on 16 May 1996 upon the approval from the Minister of Finance to become what is now referred to as the SC's Shariah Advisory Council (SAC), whose primary function is to advise on *shari'ah* issues relating to the stock and bond markets. It also scrutinizes the specific operations and activities of companies listed on the Kuala Lumpur Stock Exchange (KLSE), presently known as Bursa Malaysia Securities Berhad (BM), twice a year in order to establish the *shari'ah* status of all

¹ The SC (n.d.a: 1) defines ICM as "the market where the activities are carried out in ways that do not conflict with the conscience of Muslims and the religion of Islam."

² In fact, to establish Malaysia as an internationally acknowledged centre for ICM is one of the objectives of the Capital Market Masterplan (Abdul Halim, 2000).

publicly traded counters. With such ongoing initiatives by the SAC, which is the highest ruling body on *shari'ah* matters pertaining to the capital market, concerned Muslims may now be involved in the stock market activities by investing in those approved shares and at the same time, uphold their religious obligations.

Table 1.1 below summarizes the product of the SAC's stock screening activity, which is correctly viewed by Mohamad Nabil (2005) as one of the main catalysts for the development of ICM in this country. The table shows that the screening activity was initiated in 1997 and seven lists of *shari'ah*-approved securities were issued up until September 1999. Since April 2000, SAC has been carrying out *shari'ah*-compliant review of BM's Main Board, Second Board and MESDAQ Market listed corporations on a semi-annual basis. Consequently, the updated list of *shari'ah*-approved counters had been announced on every last Friday for the month of April and October each year. In March 2007, this announcement exercise was changed to every last Friday in May and November (SC, 2007c). It is interesting to note that based on the outcome from the latest *shari'ah* screening process, across the 12 sectors classified on BM, 853 securities carry the *shari'ah*-compliant status effective from 30 November 2007.³ This means that about 86% of the total unscreened stock universe can be part of a Muslim's stock portfolio.⁴ In comparison, there were only 371 securities, which accounted for approximately 57% of the entire listed shares, were considered to be tradable under the purview of Islamic commercial law at the end of June 1997. Evidently, there is a 29% increase in the size of Islamic equity investment universe over the ten-year period.⁵

³ Only the hotels and closed-end funds sectors do not have any representative in the *shari'ah*-approved securities list.

⁴ Appendix I provides the latest full list of *shari'ah*-approved securities.

⁵ At the end of 2006, the market capitalization of *shari'ah*-approved equities stood at Ringgit Malaysia (RM) 548.4 billion, which was equivalent to 64.6% of total market capitalization (SC, 2006).

Table 1.1
Shari'ah-Approved Securities on the Malaysian Stock Exchange

Effective date	Number of approved securities	Total number of listed securities	Percentage of approved securities ^a
18 June 1997	371	651	57
23 December 1997	476	680	70
4 May 1998	531	728	73
9 September 1998	542	730	74
4 January 1999	543	736	74
12 May 1999	541	739	73
22 September 1999	545	746	73
28 April 2000	566	762	74
27 October 2000	606	791	77
27 April 2001	630	807	78
26 October 2001	642	811	79
26 April 2002	652	828	79
25 October 2002	684	860	80
25 April 2003	704	874	81
31 October 2003	722	889	81
30 April 2004	743	924	80
29 October 2004	787	947	83
29 April 2005	826	985	84
28 October 2005	857	1011	85
28 April 2006	871	1024	85
27 October 2006	886	1029	86
25 May 2007	875	1023	86
1 December 2007	853	991	86

Note. Data extracted from various SC press releases (1997-2007).

^a The percentage is for each number of approved securities over its corresponding total listed securities on the stock exchange.

Table 1.1 highlights two important points regarding the Malaysian Islamic stock market. Firstly, the mentioned basic statistics proves that there are ample avenues for anyone who wishes to proscribe to the Islamic way of investing, to minimize his or her diversifiable risk. Therefore, the negative perception that the

mere existence of the SAC's stringent screening procedure might lead to the investable stock universe becoming overly restricted does not seem to have any solid support. Secondly, more and more companies are willing to comply with the *shari'ah* guidelines imposed by the SAC in order to attain the *shari'ah*-compatible status. By doing so, they are actually making their stocks to be more marketable than those counters that are not approved by the SAC. This is because when a public listed company is identified as a *shari'ah*-approved counter, it does not in any way hinder the non-Muslims from owning the company's shares and at the same time, it opens up the possibility for that company's shares to be part of a Muslim's investment portfolio. Reasonably, these points on diversification and marketability issues are among the factors that contribute to the existence of a genuine interest in *shari'ah*-approved stocks among the investing community.

In fact, the interest in *shari'ah*-compatible counters has been very promising to the extent that an official benchmark, whose dominant role is comparable to BM's Kuala Lumpur Composite Index (KLCI), became necessary for investors to track their Islamic equity investments.⁶ KLSE Syariah Index (KLSI) was introduced on 17 April 1999 to serve this purpose (SC, n.d.b). The construction of KLSI was exactly similar to that of BM's Exchange Main Board All Share Index (EMAS) whereby only Main Board companies were to be its constituents and it was weighted based on market capitalization. As at its base date of 31 December 1998, KLSI had 272 component stocks. Beginning from 1 December 2007, there are 513 Main Board securities belonging to 10 distinct sectors, have been approved by the SAC to be *shari'ah*-

⁶ Interestingly, Singapore is also following Malaysia's footsteps. It was announced in January 2006 that the Singapore Exchange (SGX) in collaboration with London's FTSE Group and Yasaar LLC, a British-based *shari'ah* consultancy firm, would be launching not one, but a series of Islamic indices as early as February 2006. The first index of the series is the FTSE-SGX Asia Syariah 100 Index.

compliant. This represents an 88.6% rise from the base date figures. Without a doubt, KLSI had become much broader since its commencement.

Actually, there was another barometer for the Malaysian Islamic stock market that was published in-house by the Rashid Hussain Bank Group Berhad (RHB) and was formally called RHB Islamic Index (RHBII). The index made its announcement debut at an earlier date than KLSI (i.e., 10 May 1996), making it to be the world's first index that tracks *shari'ah*-compliant equities (Zaha Rina, 2005). RHBII had 176 component stocks upon inception. RHB Securities Sendirian Berhad (RHBS), RHB Share Indices Steering Committee and RHB Equity Indices Committee jointly managed this index with the advice and guidance from the *shari'ah* council of RHB Capital (Muchamad Imam, 2006). The local and international investing public had significantly benefited from RHBII until it came to an end on 22 June 2005 to make way for the Dow Jones RHB Islamic Malaysia Index (DRIMI).

1.2 PROBLEM STATEMENT

An offshoot from the progress made in ICM that has a direct impact on the equity market is the Islamic unit trusts industry. The SC (n.d.b: 3) defines Islamic unit trust schemes as “collective investment funds which offer investors the opportunity to invest in a diversified portfolio of Syariah-approved [*sic*] securities that are managed by professional managers in accordance with the Syariah [*sic*].” Table 1.2 provides some key statistics depicting the breadth and depth of the Islamic unit trusts market for the past six years. At the end of 2006, there were 100 *shari'ah*-based unit trusts funds as compared to only 32, 44, 55, 71 and 83 funds in 2001, 2002, 2003, 2004 and 2005, respectively. Consequently, total approved fund size has also shown incremental changes with the latest amount being 64.3 billion units. As for units in

circulation, it has experienced a rising trend and reached a maximum of 18.62 billion units in 2005. The year after, it fell slightly to 18.54 billion units. In terms of net assets value (NAV), the total figure has steadily grown over the years from the lowest value of RM 2.42 billion in 2001 to as high as RM 9.17 billion, which was registered for 2006.

Table 1.2
Shari'ah-Based Unit Trust Funds

	2001	2002	2003	2004	2005	2006
Number of approved funds	32	44	55	71	83	100
Total approved fund size (in billion units)	10.2	17	24.9	38	50.5	64.3
Units in circulation (in billion units)	4.26	5.76	8.59	13.16	18.62	18.54
NAV of approved funds:						
Total (in RM billion)	2.42	3.21	4.75	6.76	8.49	9.17
% from total industry	5.1	6.0	6.8	7.7	8.6	7.5

Note. Data are compiled from various SC Annual Reports (2002-2006). %=Percentage.

Referring to the number of approved funds in 2006, 50 were equity funds, 18 were sukuk funds, 19 were balanced funds and the remainder were money market funds, structured products, feeder funds and fixed income funds. Those 100 funds amount to 24% of 416 total approved funds (SC, 2006). Moreover, “The NAV of Shariah-based [*sic*] unit trust funds grew at a compounded annual growth rate of 33.8% from 1997 to 2006; outstripping the industry growth rate of 15.4%” (SC, 2006: 6-45). Taken together, the cited figures are indeed an impressive portrayal of the huge appetite for Islamic oriented investment products amongst not only the Muslims of this country, but also the non-Muslims.

A critical factor for Malaysia to maintain its commanding position in Islamic finance is the continuous offering of innovative products. These financial products should be able to cater a wide variety of clientele who bear unique risk profiles. On this vital matter, Datuk Dr. Gan Khuan Poh, who is the President of the Malaysian Economic Association, cautioned the domestic financial institutions that, “If we do not develop new Islamic products fast, these countries will take over (as leaders in the Islamic financial industry),” because he was alarmed by the burgeoning interest in *sharīah*-compatible financial products and services among European countries including Switzerland (New Straits Times, 2004: B4). Therefore, from the Malaysian ICM perspective, the significant progress highlighted above underlines the point that new Islamic financial offerings are always welcomed in order to safeguard Malaysia’s competitive edge in the global financial marketplace.

Meanwhile, the developments in the area of portfolio management are moving towards some exciting directions. Hakim and Rashidian (2002) share about the two trends that are taking shape in investment selection. First, there is a greater interest in ‘socially responsible’ investment avenues. Second, more funds are tied up to index funds as a translation of the higher preference on ‘passive’ over ‘active’ money management style.⁷ Hence, such accommodating change in the investors’ taste worldwide should not go unnoticed in any effort to come up with fresh Islamic financial products.

In the context of the Malaysian unit trusts market, up until December 2006, there are only two *sharīah* index funds available in the local scene (Zainol Ali,

⁷ Recent studies on the Malaysian unit trusts industry also suggest that there should be a higher preference for passively managed funds. See Soo-Wah (2005), Fikriyah, Shamser and Taufiq (2005) and Wee-Yeap (2005).

personal communication, March 22, 2007).⁸ The first fund is called MAAKL Syariah Index Fund, which was launched on 23 January 2002 to track the KLSI with an approved fund size of 300 million units. Unlike MAAKL Syariah Index Fund, the second fund, which was launched on 11 May 2006, is designed to track the newly introduced DRIMI. Accordingly, it is named Dow Jones-RHB Islamic Malaysia Index Fund and has an approved fund size of 500 million units. In short, there is only a single *sharī'ah* tracker fund that mimics KLSI. This particular situation is amidst the existence of 100 *sharī'ah*-based funds. Therefore, based on our knowledge that there are only a meager 11 tracker funds out of 416 funds in the industry, the index fund, as an asset class itself, may be considered as a fairly new financial offering.

To summarize, it is easy to appreciate the notion that a *sharī'ah* index fund addresses the vital points on innovation raised by Datuk Dr. Gan Khuan Poh, and Hakim and Rashidian (2002). Given the inherent nature of the *sharī'ah* stock screening process, it is perfectly agreeable that the shares included in any Islamic indices can easily fit the description of 'socially responsible' investments option. Simultaneously, when offered as a unit trust fund that moves perfectly in tandem with an equity investment benchmark such as the KLSI or any other Islamic index for that matter, the particular fund automatically becomes a fund that is passively managed. Finally, looking at the local capital market scene, a *sharī'ah* index fund is still a relatively new type of product. These observations combined indicate that a *sharī'ah* tracker fund has massive potentials to be a successful offering.

On the basis of the above observations alone, one may be enthusiastic enough to suggest that a *sharī'ah* index fund is truly an attractive financial product. Coupled

⁸ The author would like to express his gratitude to Mr. Zainol Ali, a Senior Associate at the Islamic Capital Market Department of SC, for providing the most up to date details regarding the Malaysian unit trust industry.