International Journal of Engineering & Technology, 7 (3.35) (2018) 110-113

International Journal of Engineering & Technology

Website: www.sciencepubco.com/index.php/IJET

Research paper

Does Shari'ah screening methodology matter?

First Author[1]*, Second Author[2], Third Author[3]

[1]*Affiliation of the first author*
[2]*Affiliation of the second author*
[3]*Affiliation of the third author*
**Corresponding author E-mail:*

Abstract

The identification of Shari'ah compliant stocks is known as Shari'ah screening, which is announced to the public twice a year. The previous methodology is employed in 1995 to May 2013 and the revised methodology is employed in November 2013 until now, which provides certainty and clarity on the status of stocks listed on the stock exchange. There is a lack of research conducted to study the effect of classifying stocks as Shari'ah compliant and non-Shari'ah compliant on stock returns, by employing both previous and revised methodologies at a time. Hence, this study aims to investigate the effects of announcement of inclusion (removal) of stocks in (from) the Shari'ah Compliant List on stock returns, using the previous and revised Shari'ah screening methodology. Employing the event study methodology in years 2007 – 2015, this study found that inclusion of stocks in Shari'ah Compliant List leads to the increment of stock returns, whilst the removal of stocks from the list leads to the decreasing of stock returns regardless of using the previous or revised screening methodology.

Keywords: *Shari'ah Compliance; Shari'ah Screening Methodology; Inclusion; Removal.*

1. Introduction

Islamic capital market (ICM) is a part of the main capital market in Malaysia. Activities and transactions in the ICM are based on Islamic laws and principles. Consequently, the establishment of a Shari'ah index plays an important role to enhance Muslim investors' confidence and assist Muslims to identify Shari'ah compliant investment. In Malaysia, the process of identification of Shari'ah compliant stocks is known as Shari'ah screening. It is conducted twice a year by Shari'ah Advisory Council (SAC) of Securities Commission (SC). The Shari'ah screening process is grounded on the inputs and support received from the SC. To classify security as either Shari'ah compliant or not, SAC will analyze the data gathered by SC from various sources, including companies' annual reports and enquiries made to the companies. SAC continuously reviews the Shari'ah status of these listed companies based on their latest annual audited financial statements. In this light, the SAC had established this Shari'ah screening methodology in 1995 and it has been used until May 2013. Meanwhile, a revised screening method was adopted for the first time to compile Shari'ah Compliant List announced in November 2013 (Securities Commission, 2016).

The previous screening methodology comprises of two forms of assessments: quantitative assessment and qualitative assessment. For the quantitative assessment, the SAC measures the level of mixed contributions from both permissible and non-permissible activities to a company's turnover and before tax profits. In this regard, the calculated contributions from non-permissible activities should not exceed four benchmarks: 5%, 10%, 20% and 25%. Meanwhile, for qualitative assessment, the SAC considers two additional criteria for companies with mixed activities, which are the companies' image and the maslahah (Wee, 2012). Since November 2013, SC has practiced a two-tier quantitative approach to identify Shari'ah compliance stocks. The first tier measures the contribution of non-Shari'ah permissible activities to the companies' the turnover and profit before tax. The 5% benchmarks is used for activities clearly prohibited by Shari'ah such as gambling, riba based activities and business dealing with liquor and pork. Meanwhile, the 20% contribution condition is adopted for mixed activities that are generally permissible but there are evident of vague elements, such as hotels and resorts operations and stock trading. The second-tier measures two financial ratios, Cash-to-Total Assets and Debt-to-Total Assets, where the company's riba and riba based element in both ratios, should be less than 33%. In addition to the above two-tier quantitative criteria, the SAC also takes into account qualitative aspects, which involves public perception or image of the company's activities from the perspective of Shari'ah.

In the context of Malaysian capital market, the Shari'ah Compliant List is a very important document for the reference of investors and fund managers in managing their investments. There are many researches that have been conducted to compare the performance between conventional and Shari'ah compliant stocks, for instance Habib and Islam (2014) and Kr and Fu (2014). However, there is still a lack of study that investigates the effect of classifying stocks as Shari'ah compliant or non-compliant. In addition, Yazi, Morni and Saw (2015) have conducted a research to test the effect of inclusion and removal of stocks from Shari'ah Compliant List once SAC applied the revised screening methodology in November 2013. At the best of our knowledge, there is no study has been done to compare such effect by employing the previous and revised Shari'ah screening methodology at a time. Hence, the present study aims to investigate the effects of announcement of inclusion (removal) of stocks in (from) the Shari'ah Compliant List on stock returns, using the previous and revised Shari'ah screening methodology.

The remainder of this paper proceeds as follows. Literature review section explains the theoretical foundation employed in this study as well as the reviews on the previous studies which are related to the present study. Methodology section describes on data anad the method employed. Results and discussion are presented in the next section and this paper is ended with the conclusion section.

2. Literature review

Efficient Market Hypothesis. The Efficient Market Hypothesis (EMH) or popularly known as the Random Walk Theory, is the proposition that the current stock prices fully reflects the available information about the value of the firm, and there is no way to earn excess profits, by using this information (Muhammad & Rahman, 2010). Hence, a market that is efficient prevents investors with no special information from making abnormal profit. Consequently, new information that becomes available is quickly reflected in a stock price. It is an idea where all subsequent price changes represent random departures from previous prices. The logic of this hypothesis is that if the flow of information is unimpeded and information is immediately reflected in stock prices, then, tomorrow's price change will reflect only tomorrow's news and will be independent of the price changes today (Malkiel, 2003). Therefore, stocks will always be traded at their fair value on stock exchanges, making it impossible for investors to purchase undervalued stocks or sell stocks for inflated prices, and it should be impossible to outperform the overall market through expert stock selection or market timing, and the only way an investor can possibly obtain higher returns is by purchasing riskier investments.

2.1. Stock returns

Shari'ah indices were firstly introduced in Malaysia in 1999. The Bursa Malaysia Shari'ah index is a weighted-average index and its component was initially made up of 276 Main Board companies which have been designated as Shari'ah approved securities. At the first place, a study conducted by Sadeghi (2008) examined the performance and liquidity of included stocks. An event study methodology was used to estimate the mean cumulative abnormal returns in the days surrounding the event. The result shows that there are significant negative abnormal returns from 15 days prior to the event to 15 days after the event and there is a significant percentage decrease in the bid-ask spread over the same time interval. However, over longer periods, the cumulative average abnormal returns (CAAR) become positive and increase over time. Moreover, the change in the bid-ask spread also becomes positive and increases over longer periods. It is concluded that the market reaction to the introduction of Shari'ah indices has been generally positive due to the increases in the bid-ask spread in the longer period after the event.

A study conducted by Yazi et al., (2015) investigated the effects of the changes imposed by the SAC of Securities Commission Malaysia, to its Shari'ah screening method. The research shows that the CAAR had increased after the inclusion of stocks in the Shari'ah Compliant List while elimination of a stock from had decreased its value. The study revealed that being listed as a Shari'ah compliant stock influences the value of a stock. This indirectly shows that investors in Malaysia are very concerned on the halal and haram status of the business activities. This is consistent with observation done by Mcgowan & Muhammad (2010,) that a few counters have tried to be listed as Shari'ah compliant after has been removed from the list. They assumed that being included or removed from the Shari'ah Compliant List will impact a company's image. Moreover, it is concluded that stock returns reaction is simply the effect of people's behavior or perception and belief in their daily business trading and this is not related to the obedience to the teaching of Islam.

In conclusion, there is limited number of literatures on the impact of Shari'ah Compliant List announcement. In addition, the samples selected in the literature are only based on one Shari'ah compliance announcement in April 1999 and November 2013. In this regard, this study contributes to the literature by filling the current gap in the field by employing samples from the introduction of FTSE Bursa Malaysia Emas Shari'ah Index in May 2007 until November 2015.

3. Methodology

Data for this study are obtained from DataStream International. FTSE Bursa Malaysia EMAS Shari'ah Index is used to calculate the market return for each sample and as the index has been introduced in 2007, the sample frame for this study comprised of the stocks which has been included (removed) in (from) the Shari'ah Compliant List for the period of study 2007 to 2015. The study employs event study methodology where event date is identified as the day when the Shari'ah Advisory Council (SAC) released the Shari'ah Compliant List as shown in Table 1 below.

Table 1: Shari'ah Compliant List Released Dates

Shari'ah Compliance Announcement		Event Date
Year	Period	
2007	1st	25-05-2007
	2nd	30-11-2007
2008	1st	30-05-2008
	2nd	28-11-2008
2009	1st	29-05-2009
	2nd	30-11-2009
2010	1st	31-05-2010
	2nd	26-11-2010
2011	1st	27-05-2011
	2nd	25-11-2011
2012	1st	25-05-2012
	2nd	30-11-2012
2013	1st	31-05-2013
	2nd	29-11-2013
2014	1st	30-05-2014
	2nd	28-11-2014
2015	1st	29-05-2015
	2nd	27-11-2015

Under previous Shari'ah screening methodology, the number of stocks that have been included and removed are 200 and 65 stocks respectively, whilst under revised Shari'ah screening methodology, the number of stocks that have been included and removed are 128 and 259 stocks respectively. New stocks that are traded as Initial Public Offering are excluded from the sample due to the unavailability of stock price for 120 days (estimation window) before the announcement date. As such, for the inclusion of stocks in the Shari'ah Compliant List, 79 stocks from 200 (39.5%) final samples are selected using the previous Shari'ah screening methodology, while 98 stocks from 128 (76.6%) final samples are selected using the revised Shari'ah screening methodology. For the removal of stocks from the Shari'ah Compliant List, 55 stocks from 65 (84.6%) final samples was selected using the previous Shari'ah screening methodology, while 130 stocks from 259 (50.2%) final samples was selected using the revised Shari'ah screening methodology.

The timing sequence of this event study analysis follow the time line employed by MacKinley (1997) as illustrated in Figure 1 below. The estimation window for this study is around 100 days, which spanned from 120 days to 21 days before the Shari'ah Compliant List is released to the public. Meanwhile, the event period ranges from 20 days before to 20 days after the announcement (41 days in total).

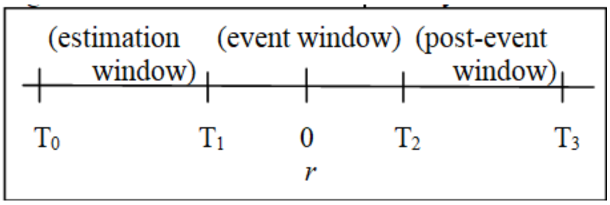

Fig. 1: Time Line for the Event Study.

This study applied market model to estimate the expected return. The market model was selected as it assumes that there is a stable linear relationship between stock returns and the market return (MacKinley, 1997). For this study, the event study analysis is run using a special software called 'Event Study Metric' version 1.06. Alternative hypotheses that are being tested are the inclusion (removal) of stocks in (from) the Shari'ah Compliant List give a significant effect on the stock Cumulative Average Abnormal Return (CAAR). The test statistics for the abnormal return is based on the standardized cross-sectional t-test as proposed by Boehmer, Masumeci and Poulsen (1991). The same method is also employed by Sadeghi (2008), who studied the performance of Shari'ah compliant investment in Malaysian market.

4. Results and discussion

The effect of the announcement on stocks inclusion. The results exhibit that this study failed to reject the null hypotheses except for the during announcement event in -1 day to +1 day subperiod where the inclusion of stocks in the Shari'ah Compliant List gives a significant positive effect on the stock returns for both screening methodologies used by the SAC. The results are shown in Table 2.
The inclusion of stocks in the Shari'ah Compliant List has no significant impact towards stock price performance, except during the event announcement in -1 day to +1 day sub periods, which both show positive CAAR at 10% significant level for the previous Shari'ah screening methodology and 5% significant level for the revised Shari'ah screening methodology. This shows that inclusion of stocks in Shari'ah compliant list has increased affected companies' stock price 1 day within the announcement. This is contrast with the findings of Yazi et al. (2015) who found no significant impact to the stock performance during the announcement.

Table 2: The Effect of the Stocks Inclusion Announcement on Stock Returns

Subperiod	Previous Shari'ah screening methodology		Revised Shari'ah screening methodology	
	CAAR	t-stat	CAAR	t-stat
Pre-announcement				
(-10,0)	-0.019	-1.522	-0.018	-0.692
(-20,0)	-0.003	-0.073	-0.014	-0.504
During announcement				
(-1,+1)	0.006	1.801*	0.008	2.225**
(-3,+3)	-0.012	-1.501	-0.006	-0.549
(-10,+10)	-0.014	-1.059	-0.008	-0.358
(-20,+20)	-0.005	-0.812	-0.015	-0.938
Post announcement				
(0,10)	0.006	0.802	0.017	1.510
(0,20)	-0.002	-0.417	0.005	0.095

**indicates statistical significance at 5% level of confidence
*indicates statistical significance at 10% level of confidence

Other than that, post announcement shows positive CAAR for sub period of 0 to 10 day using the previous screening methodology, 0 day to 10 day and 0 day to 20 day using revised screening methodology. These findings support results found by Yazi et al. (2015) and Mcgowan and Muhammad (2010) which reported the positive impact on stock price when the stocks are included in the Shari'ah Compliant List. It is expected that the Shari'ah compliant investors will start to buy the Shari'ah compliant stocks and the stock price will start to rise, which leads to a positive CAARs. However, the t-statistics results was insignificant at any level.

Meanwhile, for the pre-announcement period, the CAARs was found to be negative and the t-statistic results was insignificant at any level. Therefore, the inclusion of stocks in the Shari'ah Compliant List does not have any significant effect before the announcement is made.
The effect of the announcement on stocks removal. The results show that the null hypotheses are rejected except for the pre-announcement in -20 day to 0 day subperiod using revised screening methodology; and the post announcement in 0 day to 10 day and in 0 day to 20 day using previous screening methodology. Therefore, the removal of stocks gives a significant negative effect on the stock returns for both screening methodologies used by the SAC during announcement subperiods and pre-announcement subperiods except for -20 day to 0 day using revised screening methodology. Meanwhile, the same effect is also found in the post announcement subperiods using revised screening methodology. The results are shown in Table 3.
The removal of stocks from the Shari'ah Compliant List has a negative effect on the stock returns. This is consistent with results found by Yazi et al. (2015), Sadeghi (2008) and Mcgowan and Muhammad (2010) who found that prices of the stocks that are removed from the Shari'ah Compliant List decreased. The results are significant at 10%, 5% and 1% significance levels for all subperiods, except for the pre-announcement using revised screening methodology (-20,0); and both subperiods for the post announcement using previous screening methodology.
For pre-announcement period, it is found that the t-statistics within -10 day to 0 day and -20 day to 0 day are significant at 10% and 5% levels respectively using previous screening methodology, while -10 day to 0 day using revised screening methodology is significant at 5% significance level. During the announcement period, all subperiods using previous and revised screening methodology show a significant negative effect on stock returns. This consequently reflects investors selling of the stocks which have been removed from the Shari'ah Compliant List. For the post announcement period, previous screening methodology shows insignificant result towards stock returns, while when revised screening methodology is used, the negative CAAR shows a significant effect at 1% significance level. This negative return suggests that investors selling their stocks, especially investors who select only Shari'ah compliant stocks.

Table 3: The Effect of the Stocks Removal Announcement on Stock Returns

Sub period	Previous Shari'ah screening methodology		Revised Shari'ah screening methodology	
	CAAR	t-stat	CAAR	t-stat
Pre-announcement				
(-10,0)	-0.027	-1.690*	-0.025	-2.169**
(-20,0)	-0.043	-2.453**	-0.014	-0.361
During announcement				
(-1,+1)	-0.013	-2.020**	-0.013	-2.513**
(-3,+3)	-0.019	-2.963***	-0.024	-3.656***
(-10,+10)	-0.026	-1.818*	-0.042	-3.169***
(-20,+20)	-0.058	-2.414**	-0.057	-2.986***
Post announcement				
(0,10)	-0.010	-1.253	-0.022	-3.189***
(0,20)	-0.025	-1.508	-0.048	-5.040***

***indicates statistical significance at 1% level of confidence
**indicates statistical significance at 5% level of confidence
*indicates statistical significance at 10% level of confidence

Even though Tuyon and Ahmad (2016) and Chin (2008) classified Malaysian market to have an adaptive weak market efficiency considering that the stock price is determined only by its historical prices, the findings of the present study do not support their conclusions as the results show that Shari'ah compliance announcement has a valuable information content which influence investors' actions. It is highlighted that Shari'ah compliance announcements are made for Muslim to assist them avoiding haram investment activities. Therefore, Muslim investors are expected to give reaction to the announcements being made. Thus, Shari'ah compliance announcements influence stock price that lead to the increase or decrease of stock returns, which in turn affecting the market.

5. Conclusion

There are not so much different regarding the effect on stock returns due to the inclusion (removal) in (from) the Shari'ah Compliant List regardless of using previous or revised Shari'ah screening methodology. However, the announcements of Shariah Compliant List do carry informational value and have significant effect on the stock returns in Malaysian capital market. In other words, the investors react to the announcements that lead to the changes of the stock returns. Even though Malaysian market has been classified as a weak efficient market which suggests that the stock price is determined only by its historical prices, it has not been supported when it relates to the Shari'ah compliance announcement. This is proven through a declined of stock returns when the stocks is removed from the list and an increased of stock returns on the day new stocks has been classified as Shari'ah compliant. This suggests that the Shari'ah Compliant List, which has been announced for almost twenty years, influence investors' decisions that lead to the increased or decreased on stock returns. Therefore, Shari'ah compliance announcements are important to the Malaysian market players as it gives significant abnormal returns to the stock price. Shari'ah compliance announcement is significant especially to the Muslim investors to assist them avoiding prohibited investment activities. As such, Muslim investors are expected to react to the announcements made which in turn affecting the stock returns.

References

[1] Boehmer, E., Masumeci, J., & Poulsen, A. B. (1991). Event-study methodology under conditions of event-induced variance. Journal of Financial Economics, 30 (2), 253–272.

[2] Chin, W. C. (2008). A sectoral efficiency analysis of Malaysian stock exchange under structural break. American Journal of Applied Sciences, 5 (10), 1291–1295.

[3] Habib, M., & Islam, K. (2014). Performance of Shariah Compliant Index: A comparative study of India and Malaysia. International Journal of Interdisciplinary Studies, 1 (6), 231–240.

[4] Kr, K. R., & Fu, M. (2014). Does Shariah compliant stocks perform better than the conventional stocks? A comparative study stocks listed on the Australian Stock Exchange. Asian Journal of Finance & Accounting, 6 (2), 155-170.

[5] MacKinley, C. (1997). Event studies in Economics and Finance. Journal of Economic Literature, XXXV (1), 13–39.

[6] Malkiel, B. G. (2003). The Efficient Market Hypothesis and its critics. Journal of Economic Perspectives, 17 (1), 59–82.

[7] Mcgowan, C. B., & Muhammad, J. (2010). The theoretical impact of the listing of Syariah-approved stocks on stock price and trading volume. International Journal of Business and Economics Research Journal, 9 (3), 11–20.

[8] Muhammad, N. M. N., & Rahman, N. M. N. A. (2010). Efficient Market Hypothesis and Market Anomaly: Evidence from day-of-the week effect of Malaysian exchange. International Journal of Economics & Finance, 2 (2), 35–42.

[9] Sadeghi, M. (2008). Financial performance of Shariah-compliant investment : Evidence from Malaysian stock market. International Research Journal of Finance and Economics, (20), 15-26.

[10] Securities Commission (2016), List of Shariah-compliant securities by SC's Shariah Advisory Council. Retrieved 5 December 2016, from https://www.sc.com.my/data-statistics/list-of-shariah-compliant-securities-by-scs-shariah-advisory-council/

[11] Tuyon, J., & Ahmad, Z. (2016). Behavioural finance perspectives on Malaysian stock market efficiency. Borsa Istanbul Review, 16 (1), 43–61.

[12] Wee, C. P. (2012). Analysis of Syariah quantitative screening norms among Malaysia Syariah-compliant stocks. Investment Management and Financial Innovation, 9 (2), 69–80.

[13] Yazi, E., Morni, F., & Saw, I. S. (2015). The effects of Shariah compliance announcement towards stock price changes in Malaysia. Journal of Economics, Business and Management, 3 (11), 1019–1023.