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Challenged by Commodities

Shariah Investing: Still beating the Credit Crunch?

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Introduction

Since our last paper “Shariah Investing: Beating the Credit Crunch”¹, the markets have proven challenging for Shariah Investing. The third quarter of 2008 (“Q3”) saw dramatic falls in commodity and energy prices whilst strangely financials rallied. Islamic Finance’s dependence on these asset classes proved to be the Achilles heel. Whilst Shariah Investing continues to outperform the conventional through this credit crisis, it weathered a severe storm in Q3.

Through the recent turbulence there has been much debate on the future of the conventional financial system and the increasing role of Islamic finance as the system “evolves” out of this current crisis. There are principles and approaches in the Islamic Finance system that could be leveraged, however Shariah finance can not purely replace conventional. They are inherently two different systems that co-exist.

No immunity but some shelter

Shariah Investing can not be immune to the problems of the Credit Crisis however Islamic Indices remain sheltered from the most extreme ups-and-downs. Islamic indices have avoided the mass of the Credit Crunch panic although, as markets around the world have been rattled by rapid market swings and volatility has reached new heights, over the last quarter Islamic stocks have felt the impacts and knock-on effects.

The exclusion of the financial sector and an aversion to debt continues to hold Islamic stocks in good position to avoid the Credit Squeeze. These attributes have created a resistance to the current crisis, though they can not insulate completely. The avoidance of financials remain key to Islamic Indices performance but heavy weightings to Materials and Energy, which have seen price drops in the last quarter, have dampened the gap of out performance over the conventional Index. The Dow Jones Islamic Developed World Index (DJIWI)’s lead over the MSCI World Index in Q3 narrowed over the quarter although it still continues to outperform over the last seven Sub Prime challenged quarters (see Figure 1 “Dow Jones Developed World Index versus MSCI World Index”)

¹ Shariah Investing: Beating the Credit Crunch, SEI, July 2008

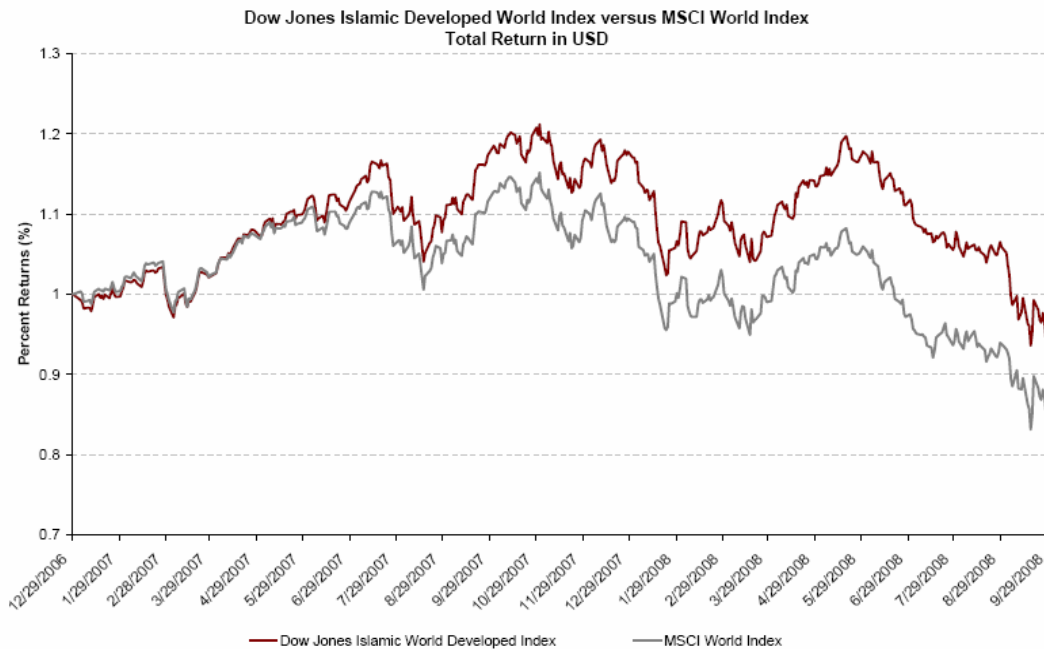


Figure 1: Source - Factset, Dow Jones Islamic Indexes

Sectoral shifts and a difficult quarter; but still pulling through year-to-date

Since the beginning of 2008, the Dow Jones Islamic Index (DJII) has outperformed the broader markets given its underweight to the significantly underperforming financial sector. The shift in sector leadership however saw the Dow Jones Islamic Indices reverse this trend and under perform the MSCI (see Figure 2 “Difference Return between DJII and MSCI”) in the last quarter. Surprisingly, despite the demise of some of the biggest names in the sector, Q3 saw financials pick-up and although it remains the worst performing sector year to date in absolute returns, it outperformed the overall market by more than 5% (as measured by the MSCI World).

It was not only financials that were part of the shift in sector leadership that detracted from Islamic Indices in the last quarter. Energy and materials, two sectors favoured by the DJII, reversed course sharply in the same period and lagged well behind the rest of the market following a big sell-off. Falling commodity prices weighed on the Material and Energy sectors and the worst commodity period in decades also impacted Islamic Indices unfavourably.

However, on the positive side, against a backdrop of sharply falling crude oil prices, traditionally defensive areas such as Consumer Staples and Health Care sharply outperformed the broader market faring well for Islamic Indices which tend to overweight these sectors.

The period of 31 December 2006 to 30 September 2008 shows that Shariah Indices still appear to have benefited from the characteristically favoured sectors that have proved resilient over this longer period. Relative returns show that the DJIWI has held strong across several sectors, such as Telecommunications and Consumer Staples, outperforming the MSCI World (see Figure 3 “Sector relative Returns”). In a year-to-date comparison, with the exception of Pacific Basin Equities, respective regional Dow Jones Islamic Indices have recorded a positive out performance compared against their MSCI Conventional equivalent (see Figure x “Difference Return between DJII and MSCI”) suggesting that Shariah Investing could be a viable alternative approach across global markets.

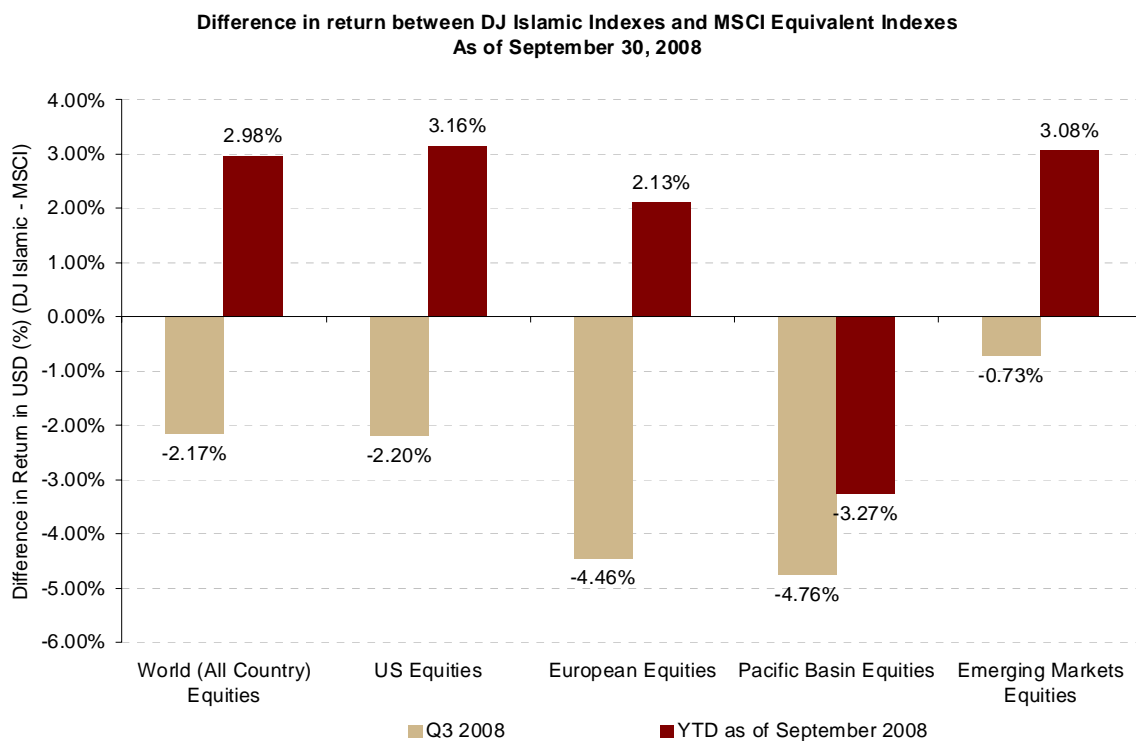


Figure 2: Source - SEI, Morgan Stanley Capital International Dow Jones Islamic Index.

The behaviour of the Dow Jones Pacific Basin Index exemplifies the challenge of overweighting the cyclical sectors. The allocations of this Index lean heavily towards the cyclical sectors and it is the only Index of the Islamic family to differ so strongly in its allocations in this regard. Any benefit of being underweight in financials has been strongly offset by the overweighting to those sectors which struggled given the risk aversion and flight to safety by investors.

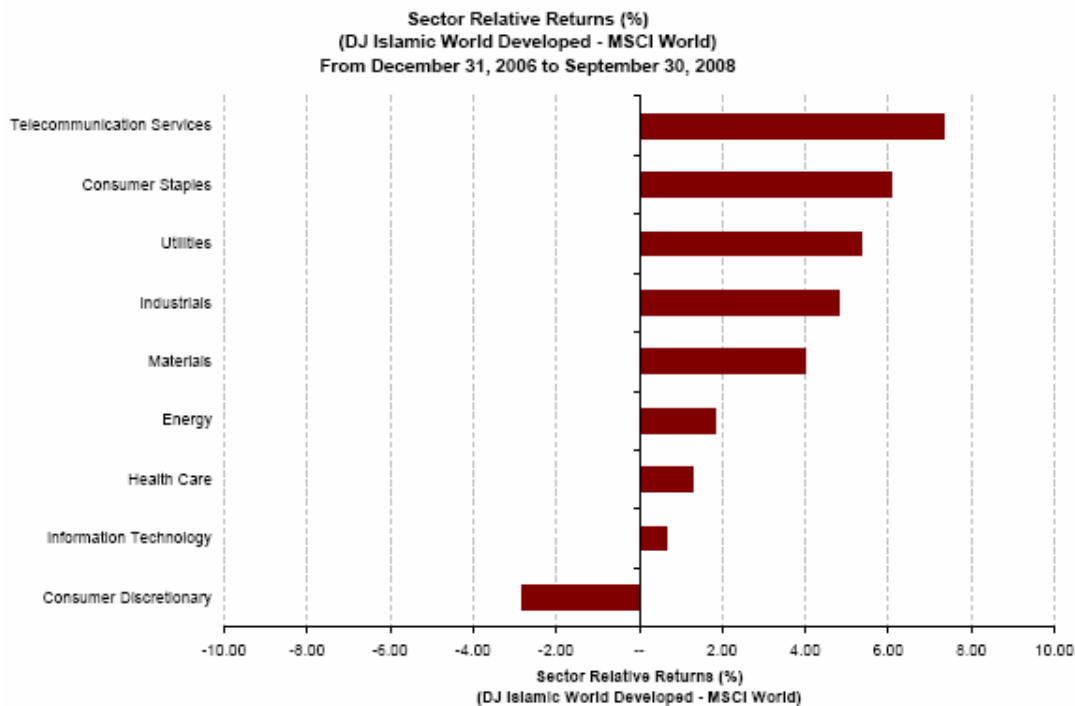


Figure 3: Source - Factset, Dow Jones Islamic Indexes: USD

The challenge is in the commodities

Q3 saw Shariah Indices struggle with cyclical downturns and overweight exposure to cyclically sensitive areas, these primarily being the Industrial, Material and Energy sectors. Traditionally defensive sectors, and those favored by Shariah Indices; Utilities, Consumer Staples and Healthcare, have outperformed amid the turmoil, but they are trading at price-to-earnings multiples that are potentially unsustainable.

Shariah Indices will not be immune to global recessionary impacts. However long-term beliefs in global economic recovery should fuel resurging demand for commodities despite short-term concerns and Shariah Indices should yield the positive results of this. Should Commodities, Materials and Energy pick up over the next quarter and beyond, we would expect to see Shariah Indices recover from the Q3 slow down.

What could prove to be the real concern for the Islamic Banking Industry is that other favoured asset-based investments (in particular real estate) and limited portfolio diversification might still impact negatively. However, the exclusion of leveraged and indebted companies should continue to contribute to the strength of Shariah Indices as the credit squeeze rolls on and high debt-to equity ratio stocks struggle with their liquidity issues. Stock-selection will still remain vital for Shariah Fund managers as for their conventional counterparts.

Summary

It still holds that Shariah Investing does have benefits through difficult market periods and the features and criteria of Shariah stock selection should not be discounted over one difficult quarter.

All though Q3 saw a surprising financial sector pick-up, financials remains the worst performing sector year to date in absolute returns and the exclusion of this sector aversion to debt should continue to hold Islamic Indices in a strong position.

Over this Credit Crisis episode, characteristically Shariah compliant portfolios that exclude options, avoid derivatives, deny short-selling and ignore hedge funds, will have fared better than conventional portfolios with these exposures. It is important to note that making drastic changes to an investment program in the midst of a market crisis rarely results in positive outcomes and Shariah's more committed buy-and-hold approach has helped its Indices avoid some of the Credit Crisis panic.

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SEI currently manages four Shariah Compliant funds under the SEI Islamic Investment Funds range. This range includes SEI Islamic US Equity Fund, SEI Islamic Pacific Basin Equity, SEI Islamic European Equity and SEI Islamic Emerging Market Equity Fund.

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