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Why a Fund's Piety Is Now Paying Off

Islamic Principles Help Amana Income Avoid Banks, Other Risky Bets

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The little-known mutual fund Amana Income Fund is one of this year's top performers. It can thank Islamic law for that.

The Amana fund is a specialized fund that invests based on Islamic religious principles. That means it must avoid, among other things, investing in banks or other firms that earn money by charging interest. Nor can it invest in companies carrying lots of debt.


Nick Kaiser

This year these restrictions are paying off. The fund, which seeks well-established companies paying dividends, has largely avoided the mortgage-related carnage hitting the markets since the summer. The Amana Income Fund has returned 13% since the start of this year, and is ranked in the top 2% of its category. With shares of many banks and brokerage houses having plunged amid concerns over losses on mortgage-related securities, the average stock income fund is up only 3.6%, according to fund tracker Lipper Inc.

"It's good that you don't have [banks and financial companies] in periods like this year," says Nicholas Kaiser of Saturna Capital Corp., Bellingham, Wash., which manages the Amana funds. "It's great to be out of it."

Indeed, most mutual funds that invest based on Islamic principles have largely weathered the recent credit turmoil. Two Islamic funds offered by Azzad Asset Management, smaller than the Amana and its $333.1 million of assets, also are beating the Standard & Poor's 500-stock index since the start of this year, after trailing the broad market for several years.

Dow Jones Islamic Fund is up 13.3% year to date, which ranks it in the top 4% of its category of large- market-capitalization stocks. The fund, managed by Allied Asset Advisors, tracks the Dow Jones Islamic Market Index, which is a product of **Dow Jones** & Co., publisher of The Wall Street Journal.

A sister Amana fund, Amana Growth Fund, isn't doing quite as well. The fund has $680 million of assets and invests in companies whose earnings are expected to rise faster than the broader market. It has returned 11.5% this year. While that beats the broader market, it still trails its growth-type peers by 1.4 percentage points.

Mr. Kaiser says the fund is basically looking for growth stocks that have such "value" characteristics as "reasonable" share price-to-earnings multiples, but this year the best performers were highflying stocks like **Google** Inc. "So some of our stocks didn't do well this year," he says.

Apart from financial stocks, Islamic funds, like other faith-based funds, also screen out so-called sin stocks, including alcohol, tobacco, gambling and weapons makers. They also must shun companies in pork-processing businesses and companies with a debt level higher or equal to 33%.

These rules eliminate from consideration about half of all the publicly traded stocks in the U.S. Out of the Russell 3000 Index -- which includes the 3,000 largest U.S. companies based on market capitalization and represents about 98% of U.S. stocks -- Amana has about 1,500 companies to choose from. By comparison, KLD Research & Analytics, a social-investing research firm, contains 2,100 stocks in its broad index.

Faith-based or socially conscious mutual funds -- there are numerous varieties -- tend to underperform the broader market. That is often because their blanket prohibition of certain sectors means they automatically rule out some good-performing stocks. At the same time, the added stock-picking research required by their social or religious criteria increases the cost of running such funds.

Amana funds have been a powerful rebuttal to this notion. In the past five years, both are among the top-returning funds in their respective categories, returning about 20% on an annualized basis.

Some of Amana's investment rules -- for instance, low turnover in buying and selling stocks, and aversion to debt -- make investing sense for long-term investors, says David Kathman, an analyst with Morningstar Inc.

Because of the low-debt restriction, Amana has found some good investments. Its growth fund started buying **Washington Group International** Inc., a construction firm, in January 2006 at $55 a share after Mr. Kaiser spotted its zero-debt level. "This looks good for us," he recalls saying. Amana recently sold the stock at $91.50 after the shares rallied on a takeover offer.

- **The News:** One of the top-performing mutual funds this year is Amana Income Fund, a little-known fund that adheres to Islamic principles.
- **Behind the Scenes:** Because Amana must avoid companies that earn money by charging interest or those with large debt loads, it has been largely spared fallout from the credit crunch.
- **Bottom Line, for Now:** Amana's returns belie the tendency of faith-based or socially conscious mutual funds to underperform the broader market.

The Islamic rules have helped Amana dodge some bullets. Enron Corp., which then fit growth-fund criteria, was ruled out from Amana Growth Fund's holdings -- before the scandal was exposed -- because its debt level exceeded the 33% threshold, Mr. Kaiser says.

Saturna Capital uses guidelines set up and endorsed by the Fiqh Council of North America, an organization of religious scholars dealing with issues concerning Muslims in North America.

Islamic law also forbids frequent trading of shares, since that is seen as a form of gambling. As a result, the turnover in the portfolios at Amana funds averages around just 10% each year, compared with 50% or more at a typical mutual fund. Lack of turnover is a contributor to performance, since shareholders are taxed for capital gains when managers sell stocks and make gains, and because of lower trading fees.

The 61-year-old Mr. Kaiser, who isn't Muslim himself, is concerned about the subprime spillover to his funds. As a big part of the U.S. economy "is based on home buying and loans -- that's going to drop off quite a bit," he says, leading people to cut consumption in retails and gasoline. "We have a lot of [those] stocks in our portfolios. If we have a major recession, I don't think we are immune from it just because we are not in those [financial] sectors," he said.

Amana's consistent performance appears to be attracting more non-Muslim investors. In the past 18 months, the two funds have increased from $288 million in assets to more than $1 billion combined. Of course, it is impossible to know for certain the religious persuasion of any given investor in a mutual fund, but by their names "we can pretty much tell they are non-Muslims," Mr. Kaiser says. "They just went for performance."

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