



MACROECONOMIC DETERMINANTS OF NET  
ASSET VALUE OF ISLAMIC EQUITY UNIT  
TRUSTFUNDS: A CASE OF MALAYSIA

BY

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## ABSTRACT

The purpose of this study is to examine the relationship between the NAV of the Islamic equity unit trust funds and macroeconomic variables, namely consumer price index, Industrial production index, three-month treasury bill rate, money supply (M3) and crude oil price as well as the recent global financial crisis in Malaysian financial industry. The analysis based on monthly closing price for a sample of 68 equity unit trust funds over a period of 6 years, from January 2004 to December 2009, where the years from 2007 to 2009 are considered as crisis period. Multiple regression and analysis model has been adopted for analyzing the relationship. The study also compares the performance of Islamic and conventional equity unit trust funds for Malaysian capital market. The major findings of the study show that, CPI, IPI, M3, and crude oil price have significant relationship with the NAV of the Islamic equity unit trust funds in Malaysian capital market. In addition, the current global financial crisis records the highest positive relationship with the NAV of the Islamic unit trust funds. However, the three-month treasury bill rate has no statistically significant relationship with the NAV of the Islamic equity unit trust funds. The results also reveal that Islamic equity unit trust funds achieve higher capital appreciation than the conventional equity unit trust funds. This study facilitates the investors in taking effective investment decisions by estimating the future direction of NAV of the Islamic equity unit trust funds using the expected trend in the macroeconomic variables such as CPI, IPI and Oil Price as well as the effect of the recent global financial crisis. Therefore, the study suggests that macroeconomic policy should be designed keeping in view the response of the Islamic unit trust industry as the efficient market respond to the new information. In addition, the empirical result of this study also will present the investors with new prospective of selecting the type of funds as the part of their portfolio selection, whether Islamic equity fund or conventional equity fund.

## خلاصة البحث

إن الغرض الأساسي لهذه الدراسة هو دراسة العلاقة بين صافي قيمة الأصول (السعر) لأسهم الصناديق الاستثمارية الائتمانية الإسلامية والعوامل المتغيرة للاقتصاد الكلي، وهما مؤشر أسعار المستهلكين، مؤشر الإنتاج الصناعي، معدل الفائدة على سندات الخزانة (فترة ثلاثة أشهر)، وعرض النقود (M3) والسعر العالمي للنفط الخام فضلاً عن أثر الأزمة المالية العالمية الحالية في القطاع المالي الماليزي. تمت عملية التحليل على أساس سعر الإغلاق الشهري لعينة تحتوي على 68 وحدة من الصناديق الائتمانية الاستثمارية خلال فترة زمنية 6 سنوات تبدأ من يناير 2004 وتنتهي في ديسمبر 2009، حيث إن الأعوام من 2007 إلى 2009 تمثل فترة الأزمة المالية العالمية. اعتمدت هذه الدراسة في عملية التحليل على نموذج الانحدار المتعدد في تحليل وشرح هذه العلاقة. إن الهدف الثاني لهذه الدراسة هو مقارنة أداء صناديق الأسهم الاستثمارية الائتمانية الإسلامية وصناديق الأسهم الاستثمارية الائتمانية التقليدية في السوق المالي الماليزي. النتائج الرئيسية لهذه الدراسة تشير إلى أن مؤشر أسعار المستهلكين، ومؤشر الإنتاج الصناعي، وعرض النقود (M3)، وأسعار النفط الخام لها علاقات إحصائية ومهمة في تحديد صافي قيمة الأصول (السعر) لأسهم الصناديق الاستثمارية الائتمانية الإسلامية في السوق الرأسمالي الماليزي، وبالإضافة إلى ذلك فإن نتائج هذه الدراسة تشير إلى أن الأزمة المالية العالمية الحالية لها علاقة إيجابية ومهمة في تحديد صافي قيمة الأصول لأسهم الصناديق الاستثمارية الائتمانية الإسلامية. على العكس من ذلك، فإن معدل الفائدة على سندات الخزانة (فترة ثلاثة أشهر) لا يوجد لها علاقة ذات دلالة إحصائية مهمة في تحديد صافي قيمة الأصول (السعر) لأسهم الصناديق الاستثمارية الائتمانية الإسلامية. وتكشف نتائج مقارنة أداء أسهم الصناديق الاستثمارية الائتمانية الإسلامية وأداء أسهم الصناديق الاستثمارية التقليدية إلى أن أسهم الصناديق الاستثمارية الإسلامية تحقق مستوى أعلى من الأرباح الرأسمالية مقارنة بأسهم الصناديق الاستثمارية الائتمانية التقليدية. لذلك فإن نتائج هذه الدراسة سوف تساعد المستثمرين في اتخاذ القرارات الاستثمار الفعالة عن طريق تقدير الاتجاه المستقبلي لقيمة الأصول الصافية (السعر) لأسهم الصناديق الاستثمارية الائتمانية الإسلامية من خلال معرفة الاتجاه المتوقع في متغيرات الاقتصاد الكلي مثل مؤشر أسعار المستهلكين، مؤشر الإنتاج الصناعي والسعر العالمي للنفط الخام بالإضافة إلى التأثير الكبير والإيجابي للأزمة المالية العالمية الحالية على الاستثمارات الإسلامية. ولذلك، تقترح الدراسة بضرورة تصميم سياسة الاقتصاد الكلي أخذ بعين الاعتبار استجابة أسواق الأسهم للصناديق الاستثمارية الائتمانية الإسلامية حيث إن نظرية الأسواق الرأسمالية الكفوءة تستجيب لأي معلومات جديدة. النتائج التجريبية لهذه الدراسة أيضاً سوف تمكن المستثمرين من اختيار أنواع الأسهم في حقائبهم الاستثمارية من وجهة نظر مختلفة سواء كانت في الصناديق الائتمانية الإسلامية أو في الصناديق الائتمانية التقليدية.

## 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 qualify, as a dissertation for degree of Master of Science (Finance).

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## DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise is stated. Other sources are acknowledged by giving explicit references and a bibliography is appended.

Anwar Hasan Abdullah Othman

Signature.....

Date.....

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*This research is dedicated to my beloved parents, Mr. Hasan Abdullah Othman and Ms. Raslah Ahmed Mohammed for their sacrifice, endeavor and encouragement me for continue post-graduate studying. In addition, this work is also dedicated to Dr. Mohamed Mutahhar and my fiancé Thorayah and to the Muslim Ummah as my contribution to the development of the Islamic finance industry.*

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# CHAPTER ONE

## INTRODUCTION

### 1.0 BACKGROUND OF THE STUDY

The Islamic unit trust industry is one of the rapidly growing segments of the Islamic banking and the finance industry. According to the *Ernst and Young Islamic Fund and Investment Report 2010*, the total assets of the Islamic funds stood at USD52.3 billion in 2009 with a potential growth of 20 percents per annum. The Islamic unit trusts represent 88 percents of the global Islamic fund and 54 percents of the total asset of Islamic fund are represented by the Islamic equity funds (Bursa Malaysia's Report, 2009). The industry is expected to maintain the growth momentum due to a strong demand from the Muslim investors who are searching for the *Shariah*-compliant investment products. In addition, the willingness of the investors to diversify in both the conventional unit trusts as well as the Islamic unit trust funds also contributes to the high demand of the Islamic unit trust investment. In this regard, the Islamic unit trusts provide a good avenue for the investors to diversify in low-risk and modest return investments.

By definition, the Islamic unit trust is an investment establishment that pools money from the unit-holders in order to invest in a group of assets with particular conditions that are in line with the *Shariah*. The funds collected are invested in shares, *sukuk* and other securities which are *Shariah*-compliant. The concept of the Islamic equity unit trust fund is based on the *Musharakah* principle whereby, the fund managers buy the shares from different companies to become the partner in the capital

of the companies thereby sharing the profit or loss with the investors. The investors can realize the profit (or loss) from the fluctuations of the fund's net asset value (NAV).

While the Islamic unit trust is similar to the conventional unit trust investment in many ways, there is a specific requirement that the Islamic unit trust must conform to the *Shariah* investment principles. According to the Securities Commission (SC), Malaysia, there are three screening criteria being adopted in determining the *Shariah* compliancy of a company, namely, the core activity of the business, the mixed activities of the business, and the benchmarks of tolerance. The core activity criterion means the company's major activity should not be *Shariah* incompatible. In particular, the core activities of a company must be excluded from the financial services that are based on interest (*riba*), gambling, manufacture or sale of non-*halal* products or related products, such as, the conventional insurance, and the entertainment activities that are non-permissible. A mixed activity criterion applies to companies that are commercially active both in the permissible and the non-permissible elements. The *Shariah* Advisory Council (SAC) of the SC considers two additional criteria which are the public perception or the image of the company which must be good as well as the core activities of the company are important and considered *maslahah* (public interest) to the Muslim nation and the country, while the non-permissible element is basically very small and involves matters, such as, *umumbalwa* (common plight and difficult to avoid), *uruf* (custom) and the rights of the non-Muslim community which are accepted by Islam.

The last screening criterion is a benchmark of tolerance which is applicable in the case of mixed activities. If the contributions in turnover or profit before tax from the non-permissible activities of a company exceed the benchmark, the securities of

the company are classified as *Shariah* non-approved. There are four categories of the benchmarks: First, 5 percents benchmark is used to assess the level of mixed contributions from the activities that are clearly prohibited, such as, *riba* (interest-based), gambling, liquor and pork. Second, 10 percents benchmark is applied to assess the level of mixed contributions from the activities that involve the element of “*umumbalwa*” which is a prohibited element affecting most people and difficult to avoid for example, the interest income from fixed deposits in conventional banks. Third, 20 percents benchmark is used to assess the level of contribution from the mixed rental payment from the *Shariah* non-compliant activities, such as, rental payment from premises that involve in gambling. Fourth, 25 percent benchmark is applied to assess the level of mixed contributions from the activities that are generally permissible according to the *Shariah* and have an element of *maslahah*, but there are other elements that may affect the *Shariah* status of these activities, such as, hotel and resort operations. In addition, the screening investment criteria take into account the proportion of the debts and receivables which means that, the debt to the total assets ratio of eligible companies may not exceed 33 percents and the amount of receivables may not exceed 45 percents of the total assets.

In summary, the selections of the *Shariah*-compliant companies are based on the screening process using two approaches, namely, the qualitative and the quantitative parameters. The qualitative parameter involves the screening of the business that are prohibited by the *Shariah*, such as, the conventional financial services which are based on *riba* (interest), gambling, manufacture or sale of non *halal* products, conventional insurance, entertainment activities that are non-permissible according to the *Shariah* law and any other activities which are deemed as non-permissible according to the *Shariah* principle. On the other hand, quantitative

parameter is used to measure the level of mixed contributions of the permissible and the non-permissible activities towards the revenue and the profit of the company. This method also requires that the contribution of a non-permissible activity must not exceed a permissible benchmark. However, if it exceeds the benchmark, the company will be considered as non-*Shariah* compliant. Furthermore, there are many multinational companies which receive very small proportions of their revenue from the forbidden activities. However, *Shariah* scholars tend to allow investment in stocks with acceptable proportions of the revenue from the prohibited activities under the condition of *haram* (forbidden) purifications. This condition requires that, investors must donate the equivalent proportion of their distributions from such companies to charities in order to purify their earnings from the non-*halal* activities (Hoepneret *al.*, 2009).

## **1.1 GENERAL OVERVIEW OF UNIT TRUST INVESTMENTS**

The idea of the unit trust fund is to pool the capital of several investors and subsequently employ the experiences of the fund managers to trade the securities. As such, the unit trust fund is a collective investment scheme that pools money from different investors and invests it in various investment instruments, such as, stocks, bonds, money market investments and other securities.

The unit trust investment comprises three main parties, namely, the trustee who holds the assets of the trust for the unit holders, the management company which is the promoter of the scheme and provides administrative expertise, and the unit-holders who provide the funds. There are many advantages that investors can benefit from their investments in the unit trust fund. First, the unit trust investments provide a diversification of involvement in various commercial activities which spread risks

over extensive portfolio of stock and bond in different companies, sectors, regions and countries. Second, the unit trust provides a high fund liquidity which means that the investors can convert their investments into cash during the business transaction and the fund manager has the obligation to purchase the units trust fund. Therefore, due to this advantage of liquidity, the unit trust is also called the “open-ended fund”. Third the unit trust fund facilitates investors with a compounding advantage which means the investors can reinvest their distribution of their contributions in the same fund. Fourth, the unit trust has a convenient administration, where the unit trust funds offer tailor-made solutions which are very convenient to investors, like, systematic investment plans and systematic withdrawal. Furthermore, investors do not have to worry about investment decisions because the unit-holder does not have to deal with the brokerage or the depository for buying or selling of securities (Gupatet *al.*, 2010). The unit trust funds also offer specialized schemes, such as, retirement plans, children’s plans and industry-specific schemes. Fifth, the unit trust funds have a good possession of a transparent form, whereby the unit trust funds offer daily the NAVs of schemes which help investors to monitor their investments on a regular basis. Sixth, the unit trust funds have proven to be cost effective which means that a small time investor can save much transaction cost as the unit trust funds get concessions from the brokerages. The investor also gets the service of a financial professional for a very small fee (Gupatet *al.*, 2010). Thus, the unit trust provides affordability whereby the funds allow small investors to invest small sums.

Despite the advantages that the investors can gain from investing in the unit trust industry as mentioned above, there are several potential risks faced by the fund managers. The risks include market risk, which involves buying and selling of the fund, whereby the unit trust can be considered as a basket of various stocks and bonds.

The price of stocks may fluctuate in response to the activities of the individual companies, and the general market or the global economic circumstantial situations which can be enumerated as such fluctuations in the values of stocks and shares would cause the NAV of the unit trust fund to fall as well as rise and investors stand to lose money when the stock market price falls. Second, interest rate risk which is the result of the bond (fund) price that moves in the opposite direction of the interest rate. Any rise in interest rate will cause the bond price to fall due to which it will consequently decrease the value of the investment. Third, the credit risk, which occurs in a situation where the unit trust fund loses if the issuer or guarantor of the fixed income securities is unable or unwilling to make a timely principal or interest payment. Forth, the country risk, where the price of securities is affected by the political and economic conditions of the country. Such risks include changes in the country's economic fundamentals, social and political stability, and foreign investment policies. Fifth, currency risk or foreign exchange risks where this type of risk is associated with investments that are denominated in the foreign currencies. When the foreign currencies fluctuate unfavorably against the local currency, the investments may face currency losses. Sixth, *Shariah* non-compliance risk, where it may occur when the *Shariah*-approved securities invested by the fund may be reclassified by the *Shariah* advisory board as *Shariah* non-compliant securities. The fund performance may be affected as the fund has then to be disposed of and all the investments have to be reclassified.

In terms of investment technique, the fund management companies of the unit trust normally adopt a combination of two approaches, which are the top-down approach and the bottom-up approach. The top-down approach generally looks at the top-level first, where the fundamental analysis starts on a global macroeconomic level,

moving to consecutively narrower economic levels to reach at the individual business itself. In particular, the analyst will observe whether the economics of the country are reasonably well or not and moving to the specific industry to see whether it is doing well in the given economic condition. The analyst continues to evaluate the company's performance whether it is performing well in the related industry or not. Consequently, the investors make the decision to buy or sell the shares of this company. In other words, the top-down approach believes that both the economy and industry significantly affect the stock, regardless of the qualities of a firm. Therefore, the top-down approach takes into account the macroeconomic factors, such as, inflation, consumer price index, industrial production index, money supply (M3), three months treasury bill discount rate and the global oil price. In addition, the economic theory suggests that stock prices should reflect the expectations of the future corporate performance and corporate profits which generally reflect the level of economic activities. If the stock prices accurately reflect the underlying economic fundamentals, then the stock prices should be employed as the leading indicators of the future economic activities and not the other way round. In this regard, the causal relations and dynamic interactions among the macroeconomic variables and stock prices are important in the formulation of the country's macroeconomic policy (Maysamiet *al.*, 2000). As for the effect of the macroeconomic variables on the stock prices, the efficient market hypothesis suggests that a competition among the profit-maximizing investors in an efficient market will ensure that all the relevant information currently known on the changes in the macroeconomic variables are fully reflected in the current stock prices (Mohammed *et al.*, 2009). Therefore, the macroeconomic factors serve as important predictors of the economic performance, particularly, in the emerging market, such as, Malaysia (Roselee and Fung, 2009).

In contrast, the bottom-up approach argues that it is possible to find stocks that provide superior returns regardless of the economy and the industry outlook (Ozbay, 2009). The bottom-up approach is exactly the opposite of the top-down approach and the analysts using this approach generally pick a company and then check how that company is performing without having any particular concern of the state of the economy. This approach takes into consideration the microeconomic factors, such as, the company management, size, credibility, financial track record, and the market share. This style is more suited for the more aggressive investors.

## **1.2 UNIT TRUST INDUSTRY IN MALAYSIA**

In Malaysia, the unit trust industry has staged an encouraging performance since it was first introduced about fifty years ago. The first unit trust was established by the Malayan Unit Trust Limited Company in 1959. The development of the unit trust industry in Malaysia can be divided into four periods. The first period which started from 1959 to 1979, witnessed a slow growth in the sales of units and a lack of public interest in the new investment product. During this period, there was also the emergence of the state government sponsored unit trust funds, in response to the Federal Government's call to mobilize the domestic household savings (Federation of Investment Managers Malaysia). The second period which was started from 1980 to 1990, marked the role of the government in the unit trust industry regulation and the configuration of a committee to regulate the unit trust industry. In addition, this period witnessed the emergence of more unit trust management companies, which were subsidiaries of the financial institutions. The third period which spanned from 1991 to 1999 witnessed the fastest growth of the Malaysian unit trust industry in terms of the number of new management companies established and funds under management. In

particular, the total NAV of funds under management rose from RM15.72 billion at the end of 1992 to reach RM59.95 billion at the end of 1996. However, the Asian financial crisis in 1997-1998 has given a negative impact on the unit trust industry, nevertheless, the industry has maintained its high level at RM43.3 billion at the end of 1999. The period had also observed a greater product innovation and deregulation of the industry. The rapid growth of the industry in this period has led to the establishment of the Securities Commission (SC), Malaysia on 1 March 1993 under the Securities Commission Act 1993. Lastly, the fourth period (from 2000 until recently), witnessed a steady growth of the industry in which the NAV of the unit trust grew from RM43 billion at end-December 2000 to RM169.626 billion as at end-December 2009.

While the conventional unit trust industry in Malaysia has a long history since 1959, the Islamic unit trust industry has a relatively recent history. The first Islamic equity unit trust fund was established on 12 January 1993 under the name of the Arab Malaysian TabungIttikal by the Arab-Malaysian Unit Trust Berhad, with an approved 300 million units and an estimated NAV of RM97 million (AMMB, 2006). Similar to the conventional counterpart, the Islamic unit trust funds have experienced significant growth over the last decade. This is well reflected by the number of funds offered and the size of capital managed by the unit trust management companies. According to the SC of Malaysia, the number of Islamic unit trust funds launched in Malaysia as at December 2004 was 65 funds with RM13.155 billion of units in circulation. By December 2009, the number of funds grew up to 144 funds with 56.848 billion of the units in circulation. During the same period, the NAV of the Islamic unit trust surged from RM9.761 billion at December 2004 to RM22.080 billion at December 2009. This is equivalent to a growth of 126.20 percents during the period 2004-2009 or

approximately 25.24 percents per annum. This extraordinary growth has encouraged the banking sectors to offer value-added niche services that well-correspond with the *Shariah*, as well as to attract investors to shift their investments from the conventional investments to the Islamic investments.

According to the Federation of Malaysian Unit Trust Manager (FMUTM), there are five categories of unit trust funds in Malaysia. The first category is the equity funds (or growth funds) in which investors invest mainly in stock/share with the objective of a long-term investment through capital appreciation and income distribution. This category of fund has a higher volatility and high risk-return as well as it is appropriate for the aggressive-risk investors. The second category is the bond fund which is also called fixed income fund. For this type of fund, the investors invest primarily in the corporate or government funds, whereby, this investment is appropriate for the conservative-risk investors as it provides a constant income. The third category is the balanced fund in which investors invest in both stock and bond. This type of fund is suitable for moderate-risk investors and it provides the income and capital appreciation with excessive risk. In other words, it provides the investors with single unit trust fund that combines both the growth and the income objectives. The fourth category is money market fund which is a short-term investment instrument that is highly liquid and appropriate for the financial institutions to store money that is not currently invested. The risks and returns for the money market funds are low. In addition, the biggest risk involved in the money market investment is the inflation that will affect the return and the purchasing power of the investor's money. The fifth category of the unit trust fund in Malaysia is a capital guaranteed fund, whereby, the initial capital investment is guaranteed from any loss and this investment requires the investors to put their investment for long-term periods with a minimum of three to five

years due to its fixed income nature. Also, the investors cannot redeem the investment before maturity.

### **1.3 PROBLEM STATEMENT**

The unit trust has been a viable avenue of investment for the low and high income people. The sustainability of this vital part of the Islamic finance is important for inculcating the investment culture among the low income people, which can also be a source of diversification for investors. Moreover, in view of the fact that conventional unit trust funds are also available for the low income investors in the Malaysian unit trust industry, this sort of trust fund begins to proliferate in the money market that is risk free and interest-based which is prohibited by the *Shariah* investment principle. However, it is difficult for the Muslim investors representing more than 60 percent of the total population to participate freely in the Malaysian capital market. In particular, Muslims investors are not allowed to participate in the conventional unit trust funds since their faith prohibits them to invest in certain deviant equities, such as, conventional banks, conventional insurance companies or companies that deal in alcohol, pork products, tobacco products, gambling and entertainment (cinema, casinos and TV channels). Based on different strategies of both counter-parties, the conventional funds are subjected to the capital market laws, while the Islamic funds are subjected not only to the capital market laws but also to the *Shariah* law. Therefore, it is important for the investors to have a vividly clear understanding of the performances of these two diverse unit trust funds in the Malaysian capital market. Furthermore, the increasing demand for the alternative investment vehicles which conform to the *Shariah* principle, has prompted the banking sectors and financial industry as a whole to offer new Islamic financial products, including unit trust funds