New Generation of Shariah Stock Screening

By Zaineb Sefiani

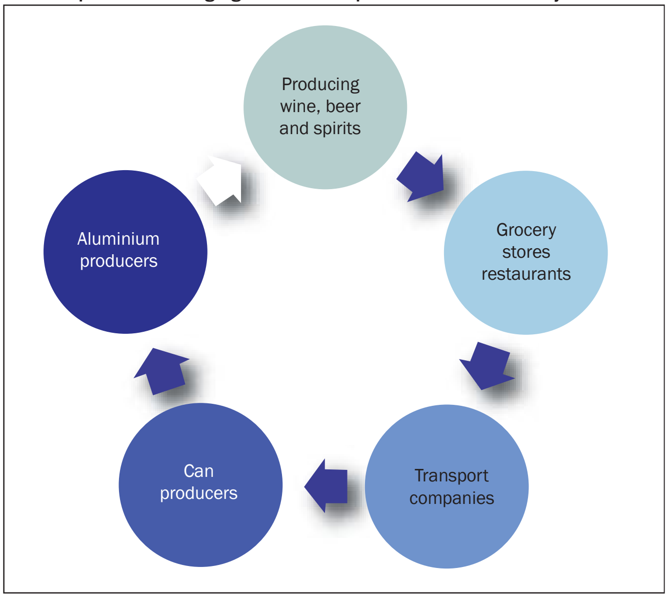
The definition of a Shariah compliant stock is ambiguous. At best, it suggests that a stock is Shariah compliant if it fulfils both sectoral and financial screening filters. Shariah investment management is concerned with investments in assets that are in compliance with Islamic law. An Islamic investor is not allowed to invest in companies that derive most of their revenue from non-Shariah business activities, or that use interest in operating or financing their business. In the context of investing in equities, screening for Shariah compliance is ensured using two main screens: business activities and financial ratios.

The first level is business activity screening (or sectoral screening) in which those stocks, which derive more than a certain percentage (usually 5%) of their business activities from one of the sectors forbidden by Islamic law are filtered out from the investable universe. The outright forbidden trading sectors include pork related, non-halal meat, alcohol, gambling, interest-based banking and finance, tobacco, and adult entertainment.

The process of implementing de facto haram is not straightforward, as we need to look at all the business activities involved in the value chain. In the case of the industry sector, this would mean from the production of a raw material to the delivery of the final product.

It would be interesting to take one non-Shariah business activity and analyze the entire value chain. If we take the example of alcoholic beverages, a company whose core activity includes producing wine, spirits and beer, such as Diageo, would naturally be screened out of any Shariah investment universe. Large pub-owning companies such as Scottish and Newcastle will also automatically be classified as haram because they are involved in the selling of alcoholic beverages. At the logistics stage, there is a strict Shariah requirement to exclude companies that deliver barrels to pubs and bars.

An example of screening against alcohol production and ancillary services



In general, Shariah rules against any business activity which is directly or indirectly involved in the haram business. The 5% threshold is applied at any stage of the value chain. If, for example, there is sufficient information to believe that a company produces aluminium cans solely for beer canning, this company should be screened out. The same rule applies to aluminium producers themselves.

The screening process for companies operating in weaponry, advertising and media industries, and certain sectors within the healthcare industry, on the other hand, are less straightforward. While not overtly forbidden under Shariah law, these sectors are in effect filtered out on a moral and ethical basis.

Investment in weaponry is permissible in Shariah law if the underlying motive is defensive in nature, and as long as there is no potential collateral damage. However, due to the subjectivity of differentiating what constitutes legitimate defence, contemporary Shariah opinion have opted to exclude this sector all together. More recently, debates have arisen around the Shariah compliancy of company stocks operating in certain sectors of the specialised healthcare industry. Companies operating in the laser hair removal, plastic surgery and abortion sectors attract differing opinions, but most of them lean more towards prohibition.

More recently, a European top ethical fund manager, in collaboration with BMB Islamic, a London-based Shariah advisory and structuring firm, has worked on a new investment approach that genuinely integrates ethical and faith-based investment strategies.

This is an interesting example that adds a new layer to the traditional sectoral screening process. In addition to the traditional filters, there is a positive screening process where companies are selected if they make a positive contribution to society and encourage good management practice of sustainable issues. It is easy to see that this approach makes the stock selection process much more complex.

In terms of negative screening, companies that have a high involvement in animal exploitation, nuclear power generation, poor relations with employees' and/or customers and/or suppliers are at the top of the Shariah screen list. The positive screening seeks out investment in companies that are involved in providing basic necessities, offering customers ethical and environmentally friendly product choices, actively addressing climate change, promoting the protection of human rights, having a positive impact on local communities, with effective anti-corruption control, and transparent communication, among others.

This list is not comprehensive but illustrates how the universe of investment stocks might be considerably reduced once all these filters are applied. This revolutionized investment approach has been endorsed by some of the most prominent scholars in the Islamic finance industry, four of whom sit on the board of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

To accommodate the demand by Islamic fund managers, index providers were the first to introduce Shariah indices as early as

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1998. FTSE, DJIM, MSCI and S&P offer a selection of Shariah indices that allow the end users, such as fund managers, to pick stocks for their investment portfolio. This is the reason why many funds have composite portfolios that rely on one or several index providers.

These Shariah indices, however, may give the investment fund manager a fairly limited choice in terms of investable universe. In addition, some of these indices do not delve deep enough into a company's financials so as to determine the exact percentage of revenue which is generated from the prohibited activities. This has serious implications on other services related to Shariah compliance such as dividend purification, where fund managers are required to purify dividends earned by companies in their investment portfolio, that derive a percentage of their revenue from non-Shariah business activity.

In short, the indices' sectoral screening is purely based on the primary business activity of the company. What this entails is that Shariah indices perform an automated industry screening using classification codes that define only the companies whose core business activities are not Shariah compliant. Those businesses whose primary activity are Shariah compliant, but derive a portion of their revenue from haram activities, are hence not excluded. The real challenge in Shariah stock screening application is to specifically "capture" the latter companies, that still generate more than 5% percent of their revenues from prohibited activities.

For example, a company such as Sainsbury's is categorized under the "food and drug retailer" sector, but it sells pork and alcohol and might be generating more than the 5% revenue threshold from these business activities. Another example is Louis Vuitton Moet Hennessy, categorized as "clothing and accessories", but it still earns revenues from the sale of wines and spirits.

In order to determine the exact percentage of revenue from non-Shariah activities within companies operating in multiple business segments and that pass the generic industry filters, Islamic fund managers need to conduct a thorough analysis of the firms' accounts and reports, which may not be readily available. A company like Sainsbury's might not be segregating between its sources of revenues (from pork sales versus non-prohibited products).

A new generation of Shariah stock screening process has now emerged, creating a sophisticated but viable stock screening system which identifies the exact portion of prohibited activity within a company. A US-based provider of Shariah fund management solutions offers its clients a global equity screening service which is considered a powerful filtering engine, composed of 40,000 stocks globally in 95 different countries.

The service features daily market data feeds provided by the top three market data providers — Thomson Financial, Reuters, and Interactive Data Corporation. Once received, all data feeds are subsequently screened using proprietary software and manual researchers to accurately classify the company's activities. Finally, the filtered data is securely delivered using state-of-the-art web technology that allows for in-depth research, analysis and purification tasks to effectively screen for Shariah funds.

The service provider lists the investments that need purification, and also has the capability to calculate dividend purification. The screening system does not yet have a fatwa from the scholars, but it can be programmed to accommodate any financial ratio at the discretion of the Shariah scholars of a fund management company.

In terms of sectoral screening, the system has the ability to remove companies that are indirectly involved in haram businesses, such as a software company that produces software for casinos. However, when the data information is not available such as in the case of Sainsbury's — which does not provide a breakdown of its revenues — this company is considered Shariah, unless there is sufficient evidence to prove otherwise.

However, a UK-based hedge fund manager, that has spent two years developing one of the most sophisticated and rigorous Shariah screening systems, considers such companies as non-Shariah. This screening system looks at 38,000 stocks representing more than 95% of the stocks worldwide. Another interesting feature is that it has both a web-based interface where clients can search the Stock Exchange Daily Official List (SEDOL) and various tickers, as well as sectors like geography and industry.

In addition, the Shariah screening system has an Excel add-on so that a client can screen a complete portfolio from within the Excel software that takes daily downloads from global financial information providers.

The filtering system is achieved in two steps. The first step consists of removing companies whose core activity is prohibited. The second stage involves a manual in-depth research on the financial and business activities of those companies that pass the first step. In addition, this Shariah screening system provides daily updates on the compliance status of a company. For example, the system takes into account daily corporate actions, which means that a fund manager holding a position on a stock that becomes non-Shariah, will be notified on the same day and, in theory, can take immediate action.

The number of Shariah equity funds now exceeds 400, of which a large number are focused on the Middle East and North Africa (MENA) region, or targeting individual countries within that region. There is a rising demand from fund managers seeking to outsource these labour-intensive tasks to an external specialist.

Moreover, conventional fund managers looking to launch Shariah equity funds will find off-the-shelf Shariah stock screening systems a simple and practical solution. The move from the traditional approach of using in-house resources for stock screening to a new generation of screening and monitoring tools can be achieved by using specialist Shariah advisory and structuring firms.

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