

## Do well by doing good

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**Environmental, Social, Governance (“ESG”) and Shariah compliant investing are often viewed as distinctly separate investment approaches. In truth, they share similar principles; both promote stewardship, social responsibility, and value creation. In fact, adopting an ESG screening process with a Shariah overlay can offer attractive sustainable returns over time.**

Shariah investing seeks to promote responsible behaviour by being good stewards of the society and environment. Shariah or Sharia is the religious law of Islam and the key principles of Shariah investing are a) the prohibition of interest bearing instruments, security lending and short selling and b) the use of negative screening to exclude high leverage companies, prohibited goods or services defined by rules of Shariah such as (industries involved in tobacco, alcohol, weapons and non-halal products).

ESG investing too seeks to promote responsible behaviour by integrating environment, social and governance factors to achieve sustainable outcomes. The ESG approach looks at more intricate issues to mitigate risks and enhance long-term returns and

screening is one of the most widely used tools<sup>1</sup>. For example, a screen might be used to exclude the highest emitters of greenhouse gases from a portfolio (negative screening) or to target only the lowest emitters (positive screening).

The process of screening can be traced to faith-based approaches to avoiding, or divesting from, companies which were involved in activities seen as incompatible with a set of beliefs or values.

### **MALAYSIA'S GROWING ESG LANDSCAPE**

Demand to invest in funds which focus on ESG factors accelerated in 2020, driving assets under management up 29% in the fourth quarter of 2020 to nearly USD1.7 trillion according to industry tracker Morningstar. Inflows into sustainable funds also hit a record high during the fourth quarter, up 88% to USD152.3 billion, with Europe-domiciled funds accounting for almost 80% of the total inflows. In Malaysia, there are currently a total 22 ESG funds with 12 Islamic funds focused on ESG<sup>2</sup>. As at December 2020, Islamic ESG funds make up about RM2.1 billion or 1% of the total Shariah assets under management of RM216.8 billion in Malaysia<sup>3</sup>.

<sup>1</sup><https://www.unpri.org/an-introduction-to-responsible-investment/an-introduction-to-responsible-investment-screening/5834.article> <sup>2</sup>ESG Fund Landscape in Malaysia, data collected from Lipper 29 March 2021. <sup>3</sup><https://www.sc.com.my/api/documentms/download.ashx?id=edb8a38a-0a75-4c74-89c8-37768611f2c1>

Going forward, the demand for Islamic ESG funds is expected to increase from both retail and institutional investors. Institutional investors such as the Employee Provident Fund have announced their commitment towards ESG best practices. The pension fund became a United Nations Principles for Responsible Investment ("UN PRI") signatory in 2019<sup>4</sup>.

### SHOULD INVESTORS ADOPT A SHARIAH OR ESG VIEWPOINT?

A study on ESG and Shariah investing covering 6,500 publicly listed companies found a direct correlation between Shariah compliance and higher ESG scores. Shariah-compliant companies had ESG scores that were on average 6% higher than those excluded by the Shariah screening process. For non-financial companies, the difference rose to 10%<sup>5</sup>. Nevertheless, the often-asked question is whether an ESG or Shariah investing approach would compromise outcomes given a smaller investable

universe which could result in more risk taking and lower returns.

Another study that constructed portfolios based on the global equities' universe of 2,500 stocks with both ESG and Shariah screens found that by applying the ESG screen, the ESG compliant universe decreased to 850 stocks, of which 50 -70 stocks were chosen to be in the ESG portfolio. Meanwhile the Shariah plus ESG screen portfolio had 30-50 stocks filtered from a smaller universe of 350 stocks. The outcome from this study found that both portfolios had broadly correlated performance over a 5-year period<sup>6</sup>.

Meanwhile ESG Shariah indices have outperformed the conventional ESG indices due to the better financial management and the lower leverage nature of the companies. See Fig 4. This is evident in the post Covid-19 equity market recovery from March 2020 whereby the Shariah-compliant equity index (S&P Global 1200 ESG Shariah Index) experienced

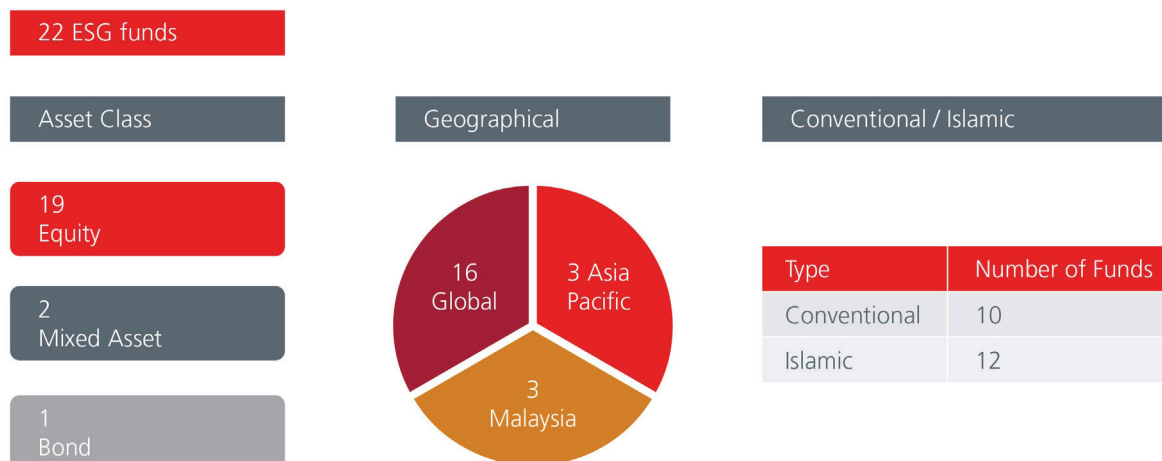
**Fig 1: Comparison between ESG and Shariah investing**

	ESG	Shariah
Screening	Client / Fund Specific Policies based on negative / positive screens	100% based on Shariah screening criteria
Company engagement on environment and social issues	High level	Low level
Interest / Riba*	No restriction	Restricted
Security Lending	No restriction	Restricted
Voting	High level	Low level
Dividends	No restriction	100% based on Dividend Purification process
High Leverage / Gearing	No restriction	Apply Shariah Screening Ratio
Short Selling	No restriction	Restricted

Source: UN PRI, CFA Institute 2019. <https://www.unpri.org/download?ac=9578> \*Riba is a concept in Islamic banking that refers to charged interest. It has also been referred to as usury, or the charging of unreasonably high-interest rates.

<sup>4</sup><https://www.kwsp.gov.my/-/epf-adopts-un-supported-principles-for-responsible-investment> <sup>5</sup>Refinitiv and RFI Foundation, "Islamic Finance ESG Outlook 2019: Shared Values." [http://www.refinitiv.com/content/dam/marketing/en\\_us/documents/reports/islamic-finance-esg-outlook-2019-report.pdf](http://www.refinitiv.com/content/dam/marketing/en_us/documents/reports/islamic-finance-esg-outlook-2019-report.pdf) <sup>6</sup>Thomson Reuters RFI Responsible Finance Report 2016, The Emerging Convergence of SRI, ESG and Islamic Finance. <https://ceif.iba.edu.pk/pdf/ThomsonReuters-ResponsibleFinanceReport2016TheEmergingConvergenceofSRIESGandIslamicFinance.pdf>

**Fig 2: ESG funds in Malaysia**



Source: Lipper Investments 29 March 2021.

identical volatility-induced declines to conventional stock index (S&P Global 1200 ESG Index), but the ESG Shariah index staged a better recovery.

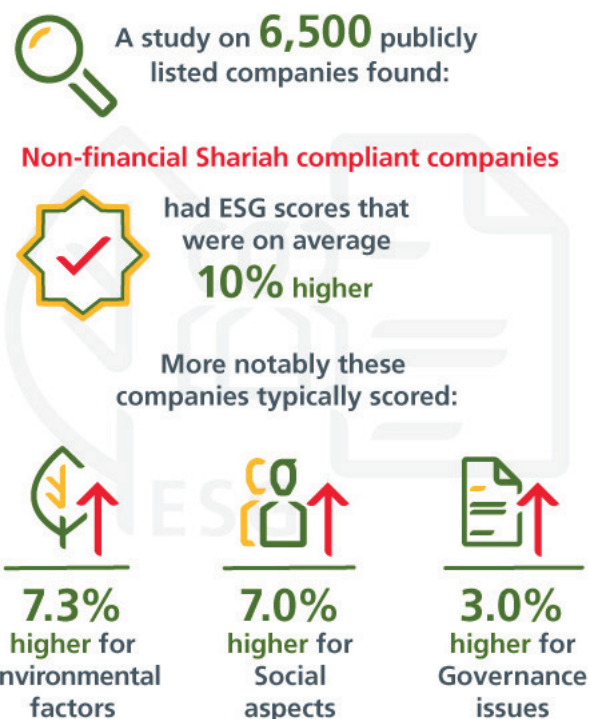
Separately, Malaysia's first ESG index also known as FTSE4Good Bursa Malaysia index<sup>7</sup> has outperformed both the FTSE Bursa Malaysia EMAS index and FTSE Bursa Malaysia KLCI index but came in second to the FTSE Bursa Malaysia EMAS Shariah index. See Fig 5. This suggests that the combination of both ESG screening plus a Shariah overlay can offer attractive sustainable returns over time.

#### A COMBINED APPROACH OFFERS MORE BENEFITS

The Malaysian government, as part of its overall initiative to develop an Islamic banking and finance industry in the country, established a Shariah Advisory Council (SAC) in 1996. SAC's primary task is to advise the Securities Commission on all matters related to the development of the Islamic capital market and function as a reference body for issues related to the Shariah.

Given the growing importance of Islamic and ESG policy, further cooperation and education

**Fig 3: Shariah-compliant companies had higher ESG scores**



Source: Refinitiv and RFI Foundation, "Islamic Finance ESG Outlook 2019: Shared Values."

<sup>7</sup><https://research.ftserussell.com/Analytics/FactSheets/temp/2e261d2f-f66e-48fe-bab3-2e05bd64cdfc.pdf>

between regulators and investment professionals is to be expected, leading to policies and initiatives such as promoting transparency and disclosure from investors, fund managers and companies on integrating ESG issues. Fiscal incentives to improve the practice plus adoption of sustainable standards for corporations and integrating Islamic principles into ESG policies would facilitate greater adoption. Both Shariah and ESG investing are becoming

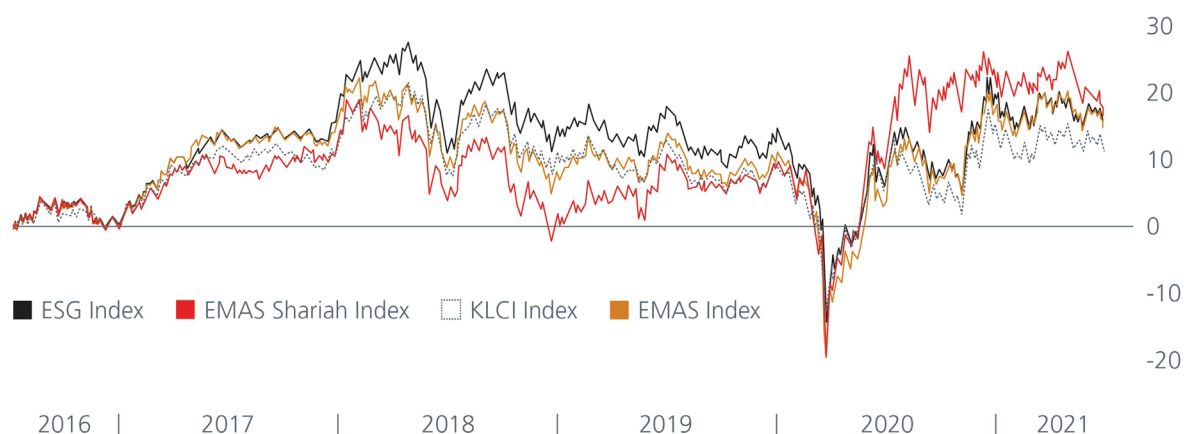
popular. Both Muslim and non-Muslim investors are placing increasing emphasis on the impact of climate change on their portfolios and allocating their portfolios accordingly. Potential investors should consider the fact that Islamic principles combined with ESG investing offers competitive risk-adjusted returns across multiple time periods. This supports the belief that it is possible to do well while doing good.

**Fig 4: ESG Shariah index staged a better recovery than ESG index**



Source: Bloomberg, S&P Global 1200 ESG Index and S&P Global 1200 ESG Shariah Index for the period 30 June 2016 – 25 June 2021.

**Fig 5: The Shariah and ESG indices outperformed the broader indices**



Source: Bloomberg, FTSE4Good Bursa Malaysia Index (ESG Index), FTSE Bursa Malaysia EMAS Shariah Index (EMAS Shariah index), FTSE Bursa Malaysia Kuala Lumpur Composite Index (KLCI Index), FTSE Bursa Malaysia EMAS Index (EMAS Index) for the period 30 June 2016 – 25 June 2021.

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