

# ISLAMIC INVESTMENT FUNDS

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**Abstract:** The term “Islamic Investment Fund” in this chapter means a joint pool wherein the investors contribute their surplus money for the purpose of its investment to earn halal profits in strict conformity with the precepts of Islamic Shari’ah. The subscribers of the Fund may receive a document certifying their subscription and entitling them to the pro-rata profits actually earned by the Fund. These documents may be called ‘certificates’, ‘units’, ‘shares’ or may be given any other name, but their validity in terms of Shari’ah, will always be subject to two basic conditions: Firstly, instead of a fixed return tied up with their face value, they must carry a pro-rata profit actually earned by the Islamic Investment Fund. Therefore, neither the principal nor a rate of profit (tied up with the principal) can be guaranteed. The subscribers must enter into the fund with a clear understanding that the return on their subscription is tied up with the actual profit earned or loss suffered by the Fund.

**Keywords:** Islamic investment fund, Murabah, Islamic equity, Ijarah investment funds.

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## I. INTRODUCTION

Investment in Arabic is known as Al-Istithmar. The word Al-Istithmar is derived from the word Tamrah which mean seeking a certain fruit production (Manzûr, 1955). Technically, the terminology " Al-Istithmar " was absent from the classical Fiqh textbooks Sano (2000). Instead, other terms were used interchangeably to express the meaning of Al-Istithmar. For instance, Imam Kassani used the term “استثمار” “Istinm'a while referring to investment (Kasaani, 1986). Similarly, XX used the word “التنمية” Tanmi’ah” while discussing investing in 'Aqad Mudâraaba (al-Dardir, 1989). Further, Imam Shirazi referred to the word “نماء” Nam'a” while elaborating on the legality to invest the money derived from Mokatadah (Shirazi, 1959). Lately, a number of contemporary scholars tried to define Islamic investment. For instance, Taqi Usmani suggested that, Islamic investing is employing the surplus money for the purpose to earn halal profits in strict conformity with the precepts of Islamic Shariah (Usmani, 2007).

The term “Islamic Investment Fund” in this chapter means a joint pool wherein the investors contribute their surplus money for the purpose of its investment to earn halal profits in strict conformity with the precepts of Islamic Shari’ah. The subscribers of the Fund may receive a document certifying their subscription and entitling them to the pro-rata profits actually earned by the Fund. These documents may be called ‘certificates’, ‘units’, ‘shares’ or may be given any other name, but their validity in terms of Shari’ah, will always be subject to two basic conditions: Firstly, instead of a fixed return tied up with their face value, they must carry a pro-rata profit actually earned by the Islamic Investment Fund. Therefore, neither the principal nor a rate of profit (tied up with the principal) can be guaranteed. The subscribers must enter into the fund with a clear understanding that the return on their subscription is tied up with the actual profit earned or loss suffered by the Fund

If the Islamic Investment Fund earns huge profits, the return on their subscription will increase to that proportion. However, in case the Fund suffers loss, they will have to share it also, unless the loss is caused by the negligence or mismanagement, in which case the management, and not the Islamic Investment Fund, will be liable to compensate it. Secondly, the amounts so pooled together must be invested in a business acceptable to Shari’ah. It means that not only the channels of investment, but also the terms agreed upon with them must conform to the Islamic principles. Keeping these basic requisites in view, the Islamic Investment Funds may accommodate a variety of modes of investment which are discussed briefly in the following sections

## **II. INVESTMENT IN SHARES – CRITERIA**

- i). The main business of the company does not violate Shariah. Therefore, it is not permissible to acquire the shares of the companies providing financial services on interest, like conventional banks, insurance companies, or the companies involved in some other business not approved by the Shariah, such as companies manufacturing, selling or offering liquors, pork, haram meat, or involved in gambling, night club activities, pornography etc.
- ii). If the main business of the companies is halal, like automobiles, textile, etc. but they deposit their surplus amounts in an interest-bearing account or borrow money on interest, the shareholder must express his disapproval against such dealings, preferably by raising his voice against such activities in the annual general meeting of the company.
- iii). If some income from interest-bearing accounts is included in the income of the company, the proportion of such income in the dividend paid to the share-holder must be given in charity, and must not be retained by him. For example, if 5% of the whole income of a company has come out of interest-bearing deposits, 5% of the dividend must be given in charity.
- iv). The shares of a company are negotiable only if the company owns some illiquid assets. If all the assets of a company are in liquid form, i.e. in the form of money they cannot be purchased or sold except at par value, because in this case the share represents money only and the money cannot be traded in except at par.

What should be the exact proportion of illiquid assets of a company for warranting the negotiability of its shares? The contemporary scholars have different views about this question. Some scholars are of the view that the ratio of illiquid assets must be 51% in the least. They argue that if such assets are less than 50%, then most of the assets are in liquid form, and therefore, all its assets should be treated as liquid on the basis of the juristic principle: Some other scholars have opined that even if the illiquid asset of a company is 33%, its shares can be treated as negotiable.

The third view is based on the Hanafi jurisprudence. The principal of the Hanafi School is that whenever an asset is a combination of liquid and illiquid assets, it can be negotiable irrespective of the proportion of its liquid part. However, this principle is subject to two conditions:

Firstly, the illiquid part of the combination must not be in ignore-able quantity. It means that it should be in a considerable proportion.

Secondly, the price of the combination should be more than the value of the liquid amount contained therein. For example, if a share of 100 dollars represents 75 dollars, plus some fixed assets, the price of the share must be more than 75 dollars. In this case, if the price of the share is fixed as 105, it will mean that 75 dollars are in exchange of 75 dollars owned by the share and the balance of 30 dollars is in exchange of the fixed assets. Conversely, if the price of that share is fixed as 70 dollars, it will not be allowed, because the 75 dollars owned by the share are in this case against an amount which is less than 75. This kind of exchange falls within the definition of 'riba' and is not allowed. Similarly, if the price of the share, in the above example, is fixed as 75 dollars, it will not be permissible, because if we presume that 75 dollars of the price are against 75 dollars owned by the share, no part of the price can be attributed to the fixed assets owned by the share. Therefore, some part of the price (75 dollars) must be presumed to be in exchange of the fixed assets of the share. In this case, the remaining amount will not be adequate for being the price of 75 dollars. For this reason, the transaction will not be valid. However, in practical terms, this is merely a theoretical possibility, because it is difficult to imagine a situation where the price of a share goes lower than its liquid assets. Subject to these conditions, the purchase and sale of shares is permissible in Shariah.

An Islamic Equity Fund can be established on this basis. The subscribers to the Fund will be treated in Shariah as partners inter se. All the subscription amounts will form a joint pool and will be invested in purchasing the shares of different companies. The profits can accrue either through dividend distributed by the relevant companies or through the appreciation in the prices of the shares. In the first case i.e., where the profits are earned through dividends, a certain proportion of the dividend, which corresponds to the proportion of interest earned by the company, must be given in charity. The contemporary Islamic Funds have termed this process as 'purification'.

The Shariah scholars have different views about whether the 'purification' is necessary where the profits are made through capital gains (i.e., by purchasing the shares at a lower price and selling them at a higher price). Some scholars are of the view that even in the case of capital gains, the process of 'purification' is necessary, because the market price of the share may reflect an element of interest included in the assets of the company. The other view is that no purification is

required if the share is sold, even if it results in a capital gain. The reason is that no specific amount of the price can be allocated for the interest received by the company. It is obvious that if all the above requirements of the halal shares are observed, then most of the assets of the company are halal, and a very small proportion of its assets may have been created by the income of interest. This small proportion is not only unknown, but also ignore-able as compared to bulk of the assets of the company (algharar yasiir). Therefore, the price of the share, in fact, is against bulk of the assets, and not against such a small proportion. The whole price of the share therefore, may be taken as the price of the halal assets only.

Although this second view is not (not what? Needs some clarification) without force, yet the first view is more precautious and far from doubts. Particularly, it is more equitable in an open-ended equity fund, because if the purification is not carried out on the appreciation and a person redeems his unit of the Fund at a time when no dividend is received by it, no amount of purification will be deducted from its price, even though the price of the unit may have increased due to the appreciation in the prices of the shares held by the fund. Conversely, when a person redeems his unit after some dividends have been received in the fund and the amount of purification has been deducted there from, reducing the net asset value per unit, he will get a lesser price as compared to the first person.

On the contrary, if purification is carried out both on dividends and on capital gains, all the unit-holders will be treated at par with regard to the deduction of the amounts of purification. Therefore, it is not only free from doubts but also more equitable for all the unit-holders to carry out purification in the capital gains also. This purification may be carried out on the basis of an average percentage of the interest earned by the companies included in the portfolio. The management of the fund may be carried out in two alternative ways. The managers of the Fund may act as mudaribs for the subscribers. In this case a certain percentage of the annual profit accrued to the Fund may be determined as the reward of the management, meaning thereby that the management will get its share only if the fund has earned some profit. If there is no profit in the fund, the management will deserve nothing. The share of the management will increase with the increase of profits.

The second option for the management is to act as an agent for the subscribers. In this case, the management may be given a pre-agreed fee for its services. This fee may be fixed in lump sum or as a monthly or annual remuneration. According to the contemporary Shariah scholars, the fee can also be based on a percentage of the net asset value of the fund. For example, it may be agreed that the management will get 2% or 3% of the net asset value of the fund at the end of every financial year. Whichever the way, this will act as a booster and a motivator to the management for efficiency as applied to Zakat collectors who are also entitled to a portion of the collected zakat (Qur'an attawbah).

However, it is necessary in Shariah to determine any one of the aforesaid methods before the launch of the fund. The practical way for this would be to disclose in the prospectus of the fund the basis on which the fees of the management will be paid. It is generally presumed that whoever subscribes to the fund agrees with the terms mentioned in the prospectus. Therefore, the manner of paying the management will be taken as agreed upon by all the subscribers.

### **III. RESERVES IN ISLAMIC EQUITY FUNDS**

Reserves are important to the proper management of the fund and the smoothing of redemption payments to the investors. If distribution of profit and redemption of units is done on accrual basis, then reserves are a must for the operation of the fund. Reserves are deducted from the profit generated through the invested funds. This raises two Shariah's questions. Firstly, whether investors are aware of such deduction and they are consenting to their amount. This problem can be solved through clear mention in the prospectus and signed on the agreement with each investor. Secondly, who own such reserves at the winding down of the investment fund? Many investment funds that are managed by Islamic banks opt for donating such amount at the closing of the fund to charity. One should remember, however, that most of these open-end funds have neither specific date nor any future plan for ending the operation of the fund

### **IV. ISLAMIC EQUITY FUNDS**

In an Islamic equity fund the amounts are invested in the shares of joint stock companies. The profits are mainly derived through the capital gains by purchasing the shares and selling them when their prices are increased. Profits are also earned through dividends distributed by the relevant companies. It is obvious that if the main business of a company is not lawful in terms of Shariah, it is not allowed for an Islamic Fund to purchase, hold or sell its shares, because it will entail the direct involvement of the shareholder in that prohibited business.

Similarly, the contemporary Shariah experts are almost unanimous on the point that if all the transactions of a company are not in full conformity with Shariah, which includes that the company borrows money on interest nor keeps its surplus in an interest-bearing account, its shares can be purchased, held and sold without any hindrance from the Shariah side. But evidently, such companies are very rare in the contemporary stock markets. Almost all the companies quoted in the present stock markets are in some way involved in an activity which violates the injunctions of Shariah. Even if the main business of a company is halal, its borrowings are based on interest'. On the other hand, they keep their surplus money in an interest-bearing account or purchase interest-bearing bonds or securities.

The case of such companies has been a matter of debate between the Shariah experts in the present century. A group of the Shariah experts is of the view that it is not allowed for a Muslim to deal in the shares of such a company, even if its main business is halal. Their basic argument is that every share-holder of a company is a sharik (partner) of the company, and every sharik, according to the Islamic jurisprudence, is an agent for the other partners in the matters of the joint business. Therefore, the mere purchase of a share of a company embodies an authorization from the share-holder to the company to carry on its business in whatever manner the management deems fit. If it is known to the share-holder that the company is involved in an un-Islamic transaction, and still he holds the shares of that company, it means that he has authorized the management to proceed with that UN-Islamic transaction. In this case, he will not only be responsible for giving his consent to an UN-Islamic transaction, but that transaction will also be rightfully attributed to himself, because the management of the company is working under his tacit authorization. Moreover, when a company is financed on the basis of interest, its funds employed in the business are impure.

Similarly, when the company receives interest on its deposits an impure element is necessarily included in its income which will be distributed to the share-holders through dividends. However, a large number of the present-day scholars do not endorse this view. They argue that a joint stock company is basically different from a simple partnership. In partnership, all the policy decisions are taken through the consensus of all the partners, and each one of them has a veto power with regard to the policy of the business. Therefore, all the actions of a partnership are rightfully attributed to each partner. Conversely, the policy decisions in a joint stock company are taken by the majority. Being composed of a large number of share-holders, a company cannot give a veto power to each share-holder. The opinions of individual share-holders can be overruled by a majority decision. Therefore, each and every action taken by the company cannot be attributed to every share-holder in his individual capacity. If a share-holder raises an objection against a particular transaction in an Annual General Meeting, but his objection is overruled by the majority, it will not be fair to conclude that he has given his consent to that transaction in his individual capacity, especially when he intends to refrain from the income resulting from that transaction.

Therefore, if a company is engaged in a halal business, but also keeps its surplus money in an interest-bearing account, wherefrom a small incidental income of interest is received, it does not render all the business of the company unlawful. Now, if a person acquires the shares of such a company with clear intention that he will oppose this incidental transaction also, and will not use that proportion of the dividend for his own benefit, how can it be said that he has approved the transaction of interest and how can that transaction be attributed to him?

The other aspect of the dealings of such a company is that it sometimes borrows money from financial institutions. These borrowings are mostly based on interest. Here again the same principle is relevant. If a share-holder is not personally agreeable to such borrowings, but has been overruled by the majority, these borrowing transactions cannot be attributed to him. Moreover, even though according to the principles of Islamic jurisprudence, borrowing on interest is a grave and sinful act, for which the borrower is responsible in the Hereafter; but this sinful act does not render the whole business of the borrower as haram or impermissible. The borrowed amount being recognized as owned by the borrower, anything purchased in exchange for that money is not unlawful. Therefore, the responsibility of committing a sinful act of borrowing on interest rests with the person who wilfully indulged in a transaction of interest, but this fact does render the whole business of a company as unlawful.

## **V. ISLAMIC COMMODITY FUNDS**

Another possible type of Islamic Funds may be a commodity fund. In the fund of this type the subscription amounts are used in purchasing different commodities for the purpose of their resale. The profits generated by the sales are the income of the fund which is distributed pro rata among the subscribers. In order to make this fund acceptable to Shariah, it is necessary that all the rules governing the transactions of sale are fully complied with. For example:

- i). The commodity must be owned by the seller at the time of sale, because short sales in which a person sells a commodity before he owns it are not allowed in Shariah.
- ii). Forward sales are not allowed except in the case of salaam and istisna (For their full details the previous chapter of this book may be consulted).
- iii). The commodities must be halal. Therefore, it is not allowed to deal in wines, pork or other prohibited materials.
- iv). The seller must have physical or constructive possession over the commodity he wants to sell. (Constructive possession includes any act by which the risk of the commodity is passed on to the purchaser).
- v). The price of the commodity must be fixed and known to the parties. Any price which is uncertain or is tied up with an uncertain event renders the sale invalid.

In view of the above and similar other conditions, more fully described in the second chapter of this book, it may easily be understood that the transactions prevalent in the contemporary commodity markets, especially in the futures commodity markets do not comply with these conditions. Therefore, an Islamic Commodity Fund cannot enter into such transactions. However, if there are genuine commodity transactions observing all the requirements of Shariah, including the above conditions, a commodity fund may well be established. The units of such a fund can also be traded in with the condition that the portfolio owns some commodities at all times.

## **VI. IJARA INVESTMENTS FUNDS**

Another type of Islamic Fund may be an ijarah fund. Ijarah means leasing the detailed rules of which have already been discussed in the third chapter of this book. In this fund the subscription amounts are used to purchase assets like real estate, motor vehicles or other equipment for the purpose of leasing them out to their ultimate users. The ownership of these assets remains with the Fund and the rentals are charged from the users. These rentals are the source of income for the fund which is distributed pro rata to the subscribers. Each subscriber is given a certificate to evidence his proportionate ownership in the leased assets and to ensure his entitlement to the pro rata share in the income. These certificates may preferably be called 'sukuk'—a term recognized in the traditional Islamic jurisprudence. Since these sukuk represent the pro rata ownership of their holders in the tangible assets of the fund, and not the liquid amounts or debts, they are fully negotiable and can be sold and purchased in the secondary market. Anyone who purchases these sukuk replaces the sellers in the pro rata ownership of the relevant assets and all the rights and obligations of the original subscriber are passed on to him.

The price of these sukuk will be determined on the basis of market forces, and are normally based on their profitability. However, it should be kept in mind that the contracts of leasing must conform to the principles of Shariah which substantially differ from the terms and conditions used in the agreements of conventional financial leases. The points of difference are explained in detail in the third chapter of this book. However, some basic principles are summarized here:

- i). The leased assets must have some usufruct, and the rental must be charged only from that point of time when the usufruct is handed over to the lessee.
- ii). The leased assets must be of a nature that their halal (permissible) use is possible.
- iii). The lessor must undertake all the responsibilities consequent to the ownership of the assets.
- iv). The rental must be fixed and known to the parties' right at the beginning of the contract.

In this type of the fund the management should act as an agent of the subscribers and should be paid a fee for its services. The management fee may be a fixed amount or a proportion of the rentals received. Most of the Muslim jurists are of the view that such a fund cannot be created on the basis of mudarabah, because mudarabah, according to them, is restricted to the sale of commodities and does not extend to the business of services and leases. However, in the Hanbali School, mudarabah can be affected in services and leases also. This view has been preferred by a number of contemporary scholars.

## **VII. MURABAHAH INVESTMENTS FUNDS**

Murabahah is a specific kind of sale where the commodities are sold on a cost-plus basis. This kind of sale has been adopted by the contemporary Islamic banks and financial institutions as a mode of financing. They purchase the commodity for the benefit of their clients, then sell it to them on the basis of deferred payment at an agreed margin of profit added to the cost. If a fund is created to undertake this kind of sale, it should be a closed-end fund and its units

cannot be negotiable in a secondary market. The reason is that in the case of murabahah, as undertaken by the present financial institutions, the commodities are sold to the clients immediately after their purchase from the original supplier, while the price being on deferred payment basis becomes a debt payable by the client. Therefore, the portfolio of murabahah does not own any tangible assets. It comprises either cash or the receivable debts, therefore, the units of the fund represent either the money or the receivable debts, and both these things are not negotiable, as explained earlier. If they are exchanged for money, it must be at par value.

### **VIII. MIXED ISLAMIC FUNDS**

Another type of Islamic Fund may be of a nature where the subscription amounts are employed in different types of investments, like equities, leasing, commodities etc. This may be called a Mixed Islamic Fund. In this case if the tangible assets of the Fund are more than 51% while the liquidity and debts are less than 50% the units of the fund may be negotiable. However, if the proportion of liquidity and debts exceeds 50%, its units cannot be traded according to the majority of the contemporary scholars. In this case the Fund must be a closed-end Fund.

### **IX. BAI' AL DAIN**

Here comes the question whether or not bai'-al-dain is allowed in Shariah. Dain means 'debt' and bai' means sale. Bai'-al-dain, therefore, connotes the sale of debt. If a person has a debt receivable from a person and he wants to sell it at a discount, as normally happens in the bills of exchange, it is termed in Shariah as Bai'-al-dain. The traditional Muslim jurists (fuqaha) are unanimous on the point that bai'-al-dain with discount is not allowed in Shariah. The overwhelming majority of the contemporary Muslim scholars are of the same view. However, some scholars of Malaysia have allowed this kind of sale. They normally refer to the ruling of Shâfi'ite school wherein it is held that the sale of debt is allowed, but they did not pay attention to the fact that the Shâfi'ite jurists have allowed it only in a case where a debt is sold at its par value.

In fact, the prohibition of bai'-al-dain is a logical consequence of the prohibition of 'riba' or interest. A 'debt' receivable in monetary terms corresponds to money, and every transaction where money is exchanged for the same denomination of money, the price must be at par value. Any increase or decrease from one side is tantamount to 'riba' and can never be allowed in Shariah.

Some scholars argue that the permissibility of bai'-al-dain is restricted to a case where the debt is created through the sale of a commodity. In this case, they say, the debt represents the sold commodity and its sale may be taken as the sale of a commodity. The argument, however, is devoid of force. For, once the commodity is sold, its ownership is passed on to the purchaser and it is no longer owned by the seller. What the seller owns is nothing other than money. Therefore, if he sells the debt, it is no more than the sale of money and it cannot be termed by any stretch of imagination as the sale of the commodity. That is why this view has not been accepted by the overwhelming majority of the contemporary scholars. The Islamic Fiqh Academy of Jeddah, which is the largest representative body of the Shariah scholars and has the representation of all the Muslim countries, including Malaysia, has approved the prohibition of bai'-al-dain unanimously without a single dissent.

### **X. ISLAMIC EQUITY FUNDS**

Islamic Equity Funds are Basically "Ethical Investing" Ethical Investing is not new. It goes back to the 1920's. They became popular, however, in the 1970's and thereafter. In 1971 a group of Methodist clergies in the USA discovered that their church regularly received letters from individuals asking how to invest in company's not manufacturing weaponry. After finding that no organization specializes in this kind of investment, the ministers went to Wall Street firms asking for assistance in setting up a fund for this purpose. Pax World Fund may be the first equity fund to adopt a full set of ethical issues in its screens.

The pioneer fund which excluded companies producing alcohol & tobacco from its portfolio holding was available to investors in 1928. Then the environmental movement and the equal employment opportunities programs in the 1970's produced a number of equity funds tailored to the preferences of investors who are concerned about these issues, and want their money to help influence the business sector into more compliance. Dreyfus third century fund was pioneering in this regard. Such funds do exist now in USA & Europe. Islamic Equity Funds are, therefore, part of a larger group of ethical investment programs. They address the needs of a class of investors, who are concerned about public issues and social justice. However, the main concern of Islamic "ethical" investor is the sources of his income. He is obliged religiously to make sure his earnings always come from "clean" sources.

### *Three Shifts in Islamic Banking*

Islamic equity funds came amid fundamental shifts that were taking place in the development of Islamic banking in the 1990's. These changes gave rise to these Islamic equity funds and other investment and financial innovations, and will sustain a phenomenal rate of growth for them in the near future. They are:

#### *A. Defensive to positive Islamic banking*

In the 1970's & 1980's the major concern of the clients of Islamic banking is just the avoidance of interest. Islamic banks, at that time, were "brimming" with free-money in current account deposits. The major worry of these deposit holders was to make sure that their funds are distant from usurious transactions. The 1990's witnessed an important shift. More and more Muslims, who want to stay away from interest, also want their money to earn a return. This created opportunities for innovations to bring to the market investment programs that, while abiding by the Shariah's prohibition of interest they are capable of providing reasonable return on investment.

#### *B. Non-Islamic to Islamic*

Islamic religious revivalism is now disseminated into segments of the Muslim societies which are wealthy, more influential and educated. These groups of people are not new to business and investment but their religious solace included a movement from conventional to interest-free banking. It is because of this private banking departments catering primarily to HNW individuals are the most active in the provision of Islamic banking service in many conventional banks. Islamic equity funds are responding to the needs of this group of investors.

#### *C. Local to international*

Banking and financial services are being globalized. Islamic banking and investment are no exception. More and more Muslims now are looking outward, searching for investment opportunities beyond the boundaries of their home countries. They no longer identify Islamic banking with Muslims or Muslim countries. An increasing-number of investors are adopting selection criteria based on examination of the transactions and investment offers to ascertain Shari'ah compatibility, rather than relying on the vendor's name. This created opportunities for major financial institutions in the west to cater to the needs of these investors. Equity funds play a major role in this regard.

## **XI. ISLAMIC EQUITY FUNDS ARE RECENT PHENOMENON**

The oldest Islamic Equity Fund offered the public goes back to only 2 years ago when the National Commercial Bank in Saudi Arabia decided, with the help of the Wellington Management Company of Boston, Massachusetts, to launch a global equity fund that follows the Shari'ah restrictions on investing in shares. NMCC, a consultant of NCB, worked very hard to articulate the relevant Shari'ah principles into workable screens that can be used by the manager in the selection of the portfolio holdings, and the daily operation of the fund. Through the joint effort of the three institutions, the first ever Islamic equity fund was launched in January 1995. It was not too long when other funds were to follow. In less than 2 years, already five equity funds are in the market, based on the same basic model.

## **XII. THE RELIGIOUS FOUNDATION OF THE ISLAMIC EQUITY FUND DESIGN**

Like any legal system, Shari'ah is a set of do's and don'ts. The difference, however, is that Shari'ah is not just worldly, but a part of a system of beliefs that relates life to the hereafter. Therefore, a believer is supposed to internalize in his method of judgment and "cost-benefit" analysis this aspect of heaven & hell. This means that, through Shari'ah, the now and the hereafter are united into one spectrum. Because of this, believers are keen to make sure that their investment decisions are in tune with religious requirements by abiding by Shari'ah rules. As a result, Shari'ah approval of structure & operation is the most important element of the working of equity funds.

## **XIII. SHARI'AH ASPECTS OF ISLAMIC EQUITY FUNDS**

Investment funds are created when investors pool their money for a shared investment goal. Collective power affords an opportunity to participate in a well-diversified, professionally managed investment portfolio. To be acceptable from Shari'ah point of view, it is essential to examine certain aspects of investment funds. In particular, we will evaluate the contractual relationships between the parties involved in the working of a fund, choice of portfolio holdings as well as some operational elements of such funds.

#### **XIV. CONTRACTUAL RELATIONSHIPS IN FUND MANAGEMENT**

The most visible is the relationship between investors and the manager of the fund. Fund management may be based on Mudarabah, where the manager, individual or institution, the Mudarib and the investors are rab-ul-mal (providers of funds). In such a case, manager will only share in the profits generated. Sharing of profit must be in accordance with the ratio spelled-out in the prospectus which constitutes, from Shari'ah point of view, a contractual relationship. His income will be based on the difference between the initial NAV and the NAV at the pricing date which represents profit in such arrangement. Pricing date represents the accounting liquidation of the Mudarabah.

Many managers would not like their compensation to be tied to profit, but rather prefer to get a fixed remuneration. In such case, the relationship can be based on the Ijarah contract. The manager is, then entitled to an income linked to his managerial effort. Most investment funds management is based on such arrangement. In this case, the manager charges a percentage of the NAV at the pricing date. Ijarah is a permissible contract. However, compensation in the Ijarah contract, like any exchange contract in Shari'ah, must be known at the beginning of the period (time of contracting) not the end (time of liquidation), otherwise gharar will be present which may void the contract unless it is very little (algharar yaseer) as accepted by scholars. Such compensation will not be known exactly at the time of contracting (since it is based on end-of-the-term NAV), but only known in approximate amount, which reduces such gharar, though by no means eliminate it. Although the writer is of the view that such Ijarah is permissible, there are some contemporary scholars who think otherwise. Making compensation for the next period depend on last period's NAV is a straightforward solution.

#### **XV. EQUITY FUNDS - GUARANTEE OF CAPITAL OF THE FUND BY THE MANAGER**

To attract investors, many conventional fund managers guarantee to the investors the nominal value of their investment. This is not acceptable from Shari'ah point of view. Many advanced to a manager that guarantees it return at the end of the period (or at any time in the future) makes it, from contractual point of view, a lender-borrower relationship. Profit on such money will then be a form of usury (riba), even of such profit is variable. In an Islamically managed fund no such guarantee should be made.

#### **XVI. GEARING IN INVESTMENT FUNDS**

Gearing is one of the most important advantages of investment funds in conventional setting, i.e., the possibility of pledging the assets in the fund for borrowing and reinvesting to enhance the earning in the fund. This is clearly not acceptable from Shari'ah point of view since these borrowings are interest based. The rationale behind this approach, is to have some resources in the fund that receive fixed return. Because the fund can generate higher earnings than that fixed return, then participants will have their return on investment improved. It is not wholly unlikely that an Islamically acceptable design to the same effect. For example, the fund can purchase some assets on Murabahah basis using the rest of assets in the fund as collateral.

#### **XVII. PURIFICATION IN ISLAMIC EQUITY FUND**

In the case of equity investment, this refers primarily to interest earning and incidental income from other non-permissible sources such as sale of liquors or pork. While the idea looks simply, in fact it is not. A company is a going concern. It is a living entity with far reaching activities and widely stretched concerns. It is also very complex from accounting and financial point of view. Things are not as simple as they may look. Therefore, estimating such income is a formidable task. One that require an excellent knowledge of accounting and corporate finance and exceptional ability to handle Shari'ah issues, a combination that is not always within reach

#### **XVIII. SHARI'AH BASIS FOR PURIFICATION**

Although the Islamic equity investment program gains more and more acceptance every day from an increasing number of Shari'ah scholars and the public at large, it remains that some still believe that its Shari'ah basis are doubtful. It is not the same for the concept of purification. Purification finds clear Shari'ah basis exemplified in the classical annals of fish and statements of major learned scholars of the early centuries based on their understanding of the texts (Qur'an and Sunnah).

However, articulating those Shari'ah principles into a formal procedure for purification is quite a heroic task and one with a number of unsettled issues. For example: what is exactly to be purified? Is it dividend and therefore if the company doesn't distribute dividend no purification is required, or capital gain, although capital gain is a market earning that



derives no direct income from the company, or both? Do we treat interest earning as net or gross variable? For the first, we will then assign no expenses on such earnings for the second, interest earned will be netted by deducting operating expenses.

### **XIX. METHODS OF PURIFICATION**

We have deducted several methods of purification which will be present below. Each method is based on assumptions the purpose of which is to embody Shari'ah requirements in a formula that lends itself easily to implementation by fund managers. All the methods presented here are already in practice, and are used by fund managers. However, these; I am sure, are not the only methods. Nevertheless, I am quite confident they are the most common. In each methodology we are trying to find factor P, by which we can estimate interest income.

#### *A. First method*

Let us assume that we have a portfolio of company shares. On January 1 (t1) we have an investee company (c) each earning interest equal chance let us assume that the net operating income for any company is y hence the total net operating income for the portfolio. Let us assume that the net asset value of the fund on Jan 1 equal NAVt1. Then calculate Z which equals NAVt2 – NAVt1 purification factor P will then equal  $ZH = P$  Hence for every dollar invested, the investor must multiply by P and donate this amount to charity. If  $P = .007$  and the investor's  $Z = \$ 2000$  then he must dispose of \$ 14.00

#### *B. Second method*

Assume we have n companies in the portfolio: C1, C2....Cn Dividend yield = market value dividend = d then annual portfolio dividend yield =  $dc1 + dc2 + \dots + dcn$

Calculate interest income ratio =  $\frac{lc}{c}$  net operating income interest income for the portfolio =  $c c cn lc + lc + \dots + lc$   
2 purification =  $(d) (lc) = P$  Hence for every dollar invested the amount of \$ P must be donated annually to charity

### **XX. INVESTMENT IN LAND & BUILDING: TABUNG HAJI**

Over the years it has actively participated in long-term investments involving the property market, by building premises for the offices as well as for rental purposes. In fact, it has become one of the biggest property owners in Malaysia with more than 100 buildings all over the country while also having a sizable land bank to be developed.

### **XXI. INVESTMENT PRINCIPLES: TABUNG HAJI**

In carrying out its function as an investment institution, Tabung Haji has always adopted a prudent approach in analyzing the investment proposals submitted to the board. The investment philosophy of these encompasses a medium to long term perspective that emphasizes on growth sectors that benefit from changes and improvement in the industrial structure and economy. They focus on those companies with good track records that will lead the economic growth of each industry and on those companies who will be able to sustain high earnings growth. In view of this, investments are mostly for the long term with emphasis on high dividend rates.

With a cautious investment approach, emphasis is placed on the fundamentals of a company, its superior management efficiency and high growth potential sectors with synergies in the industry so as to safeguard and ensure success of these investments. Diversifying into various sectors provides widespread hedging opportunities, which ensure security in investment and offer good returns. The main investment objective is to produce steady incremental returns. The decision-making process is in line with these investment choices that are consistent with its overall philosophy of long-term growth, risk minimization and steady investment returns. Key investment decisions are taken by the board of those whose members are appointed by the minister in the prime minister's department.

Further, these are recognized as an approved investment institution under the Malaysian government's national development policy. As such, it is invited by companies to participate in their restructuring exercises to reflect Bumiputera and local equity participation. This is also an advisor to the *Mallis Penasihat Economy Negara* or Malaysian Economic Advisory Council that is responsible in devising Malaysia's policy with regard to its financial system for the next 10 years. Participation in this council enables them to contribute to the efficient and effective running of Malaysia's financial system, especially that of the Islamic financial system. It also ensures that the investment policies are in line with national policies.

## **XXII. INVESTMENT IN EQUITIES: TABUNG HAJI**

This type of investment is equivalent to the uqud al-ishtirak. Most of this investment is in quoted companies as they are easily marketable. In cases where the holding is more than 10% of the company's equity, Tabung Haji seeks board representation. The board members and/or senior officials sit on the board of the company to represent it and thus look after the interest of Tabung Haji, also the officers make regular visits to the factories and offices to keep in touch with the progress to be informed of the future plans of the company. Furthermore, officers make constant reviews on the companies' performance.

Presently, it has incorporated and own 14 subsidiary companies. These subsidiaries can be grouped into three main sectors, i.e., plantation, project management and services. The plantation sector is the most profitable group of companies and they contribute a reasonably high number of dividends to them. It has also invested in palm oil plantation in Indonesia as well as in the Philippines. The project management sector includes property development. This sector was also affected with the economic crisis of 1997 to 1999 when prices of properties and demand for project management remain very low. Nonetheless, these are picking up mainly due to the government's efforts of providing numerous incentives to encourage property purchases in Malaysia. The services sector is a stable sector where the demand is rather predictable. The services provided also complement these operations such as travel management, food catering and its infrastructure. These synergies are mutually beneficial for them, the subsidiaries and more importantly, the depositors

## **XXIII. DISTRIBUTION OF PROFIT: TABUNG HAJI**

Like any investors, the depositors of Tabung Haji expect a satisfactory return from their deposits. It is the policy of whenever possible to pay very competitive bonus rates to its depositors. As mentioned earlier, returns in terms of bonus paid to depositors after deducting the zakat of 2.5% has varied between 8.0% to 9.5% since 1991 and over the years it has continued to maintain a steady growth in its deposits and investments in terms of size and returns.

## **XXIV. CHALLENGES TO ISLAMIC INVESTMENT FUNDS**

If Islamic investment funds, operating as separate entities from their fund managers and sponsors with their large stakes, are to play their roles to promote cross-border investment, and thus help the investors (fund holders) create wealth based on Islamic principles, one issue warranting attention is how these funds can gain the confidence of the investors who want to earn licit profit by making an investment based on Islamic principles. Another is that these investors do not want their capital to be exposed to unwanted excessive risk. Lack of investor confidence can lead to the withdrawal of the invested capital by the investors, as in the financial crisis of 1997 and 1998, which saw a reduction in cross-border investment. A concern about investor confidence was reflected in government-led reforms, such as in Malaysia after the regional financial crisis of 1998.

Given that investments are made in a number of international geographical areas with which local investors are not familiar, these investors may be unwilling to place their capital in Islamic investment funds that operate under this purpose. They may prefer to invest in funds that only include local equity and other securities, to which they are more exposed. These challenges thus must be dealt with by the funds. Gaining the investors' confidence is needed to encourage their involvement in these diversified forms of funds, thus expanding these fund's activities. The reluctance of investors to participate in cross-border investment can be overcome if Islamic investment funds (through the sponsor or fund managers) play their roles effectively, and this can be done for example through precise compliance with Islamic principles and reducing the information asymmetry between the investors and the funds.

Islamic investment funds as the fiduciaries accordingly must reflect their obligations towards their investors and thus must invest based on Islamic rules. These include the four main prohibitions on riba (interest), gharar (uncertainty), maysir (gambling), and in companies that produce certain haram goods, such as alcohol and pork. Building on these prohibitions, the roles of these funds must be strengthened in ensuring their investment portfolios comply with Islamic teachings. In this case, evaluation of the financial securities included in the investment portfolio must be made continuously to ensure that their investment does not violate the Islamic precepts. The roles to comply with the Islamic principles here are considered as accountability of funds towards their investors.

There are several ways by which the information asymmetry from Islamic investment funds to the investors can be further reduced to enhance investor confidence, notably improving the transparency and disclosure of Islamic investment funds' information. In this context, Islamic investment funds as institutional investors must be open in their investment processes

and thus show the investors actual and accurate information, so that they know how the funds are managed, and the potential and actual financial performance of their investment capital.

There is standard information provided by funds to the public or their investors related to investment objectives (depending on the type of funds), asset allocation, potential risk, financial performance, etc. However, the information supplied to the investors could be enhanced by including other elements such as the potential risk of investment in the different regional capital markets, and the mechanisms for dealing with those risks. Rather than just giving the information of the benefits of investment in different capital markets, information on current market situations, in which they made their transaction, should also be provided. In this case, providing extensive information to the investors can reduce insecurity among the investors, and provide them with an understanding of the types of investment in which they are involving themselves. Muslims cannot be disinterested investors, and on moral and religious grounds need to familiarize themselves with the types of investments they are undertaking. This requirement puts commensurate obligations on those operating the investment funds to increase the flow of information that is provided to the investors.

## **XXV. CONCLUSION**

Islamic investment funds need to be responsible and accountable fiduciaries towards their fund holders, and be transparent in their investment process. The disclosure of information, financial performance and market conditions in the capital markets in which they focus their investment can enhance investors' confidence in these investment funds. In this case, the investors with insufficient information on different capital market situations can readily assess the information from their prospectus and fund management companies' websites without necessarily searching for the information themselves. The fulfilment of their fiduciary duties towards fund holders in preserving their fund holders' investment objectives and disclosing sufficient information can promote and encourage the involvement of investors in these types of funds, while enabling the participants to meet their religious duties as involved Islamic investors.

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