Rosie Bullard
Partner and Portfolio Manager

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Applying Shariah principles to investment portfolios

Increasingly we find that investors want to incorporate ethical considerations within their portfolios. Ramadan, which drew to a close this week, reminded us of our growing number of clients who have an awareness of Shariah law when investing their capital.

With an increasing amount of wealth being invested outside of the Middle East and by individuals with a religious stance on investing, we are seeing more and more financial products and services being developed that are compliant with Muslim law or Shariah law.

However, there remain challenges to building portfolios that are strictly compliant and effective – for reasons that will become clear. Many Muslims recognise this and take a pragmatic approach, adopting the Shariah principles that matter most to them. These principles turn out to be popular with many non-Muslims too.

Primary considerations

Equities form the core part of our portfolios, and because we build portfolios with a large proportion of direct equities, we can easily shape them to help meet the primary ethical requirements of clients wanting to invest with Shariah compliance in mind.

Equity investments that accord strictly with Shariah law must have prudent debt levels (no more than 30% of total assets). In addition, the following industries are haram (or forbidden):

- Conventional banking and insurance
- Pork-related products or non-Shariah-compliant food
- production
- Alcohol
- Tobacco
- Gambling
- Adult entertainment
- Weapons and defence manufacturing

We are able to exclude heavily indebted and haram businesses from portfolios, but grey areas will always exist. For instance, in respect of pork-related and tobacco products, we use our ethical screening software and establish blocks on companies whose business is specific to the manufacture and distribution of those products. But where does this then leave supermarkets, for which such products make up only a fraction of their profits?

It is vital that we maintain open dialogue with faith-driven investors to establish their tolerances where matters of interpretation like this arise.

One of the biggest challenges we face is that strict adherents of the faith require investments that do not attract riba (or interest), which is considered as usury.

It is widely acknowledged that in international businesses a small amount of interest or non-Shariah-compliant income cannot always be avoided – investors who want their assets invested with Shariah law in mind will put a limit on how much of this is acceptable (for example, 5%). They may donate to charity dividends or realised profits that are attributable to such non-compliant income (as an act of purification).

At the moment, we have little corporate debt within portfolios. However, this may change in the future, and we will discuss case by case with clients how they may feel about the size of their exposure to this asset class.

Religious blessing

The UK has no specific regulatory body for Islamic finance (all UK banks and financial institutions being regulated by the Financial Conduct Authority. As a result, many Muslims, uncertain of whether their financial decisions are in accordance with their faith, feel compelled to turn to their religious leaders for guidance.

This can lead to confusion and create poor financial outcomes. Under the terms of their agreed relationship, a client's financial planner or investment manager is considered their mudarib (or expert adviser). The mudarib in such a relationship does not possess religious expertise, but equally the client's religious teachers would not claim intricate knowledge of stock markets and companies' balance sheets. The complexity of the issue may explain why many Muslims adopt a simple, pragmatic approach, targeting companies with strong environmental, social and corporate governance (ESG) principles and avoiding so-called sin stocks.

We believe we can deliver this service and are constantly looking for ways to enhance our offering. One final way we can help is in transparent reporting. Ramadan is a time when many Muslims offer zakat, a form of charitable giving based on a calculation of 1/40th of overall wealth and income, for wealthier individuals who meet the nisab (or minimum level of wealth). A clear picture of one's financial circumstances is therefore paramount, and we stand ready to meet such changing needs by running appropriately liquid portfolios for these clients so they can fulfil their obligations.

Shariah for all?

Investing in a way that adheres to Shariah principles suits a lot of investors and is fairly closely aligned to how we run client money anyway. At present, we do not invest in tobacco, for example, and we are wary of many financial stocks. We also do not like high levels of debt within companies. We are moving towards incorporating ESG principles into all portfolios too, and we agree that investors and entrepreneurs should share risk.

We always remind clients that restricting their investment universe excessively can reduce returns. We are however very happy to discuss incorporating any religious and ethical values into portfolio management with existing and prospective clients.