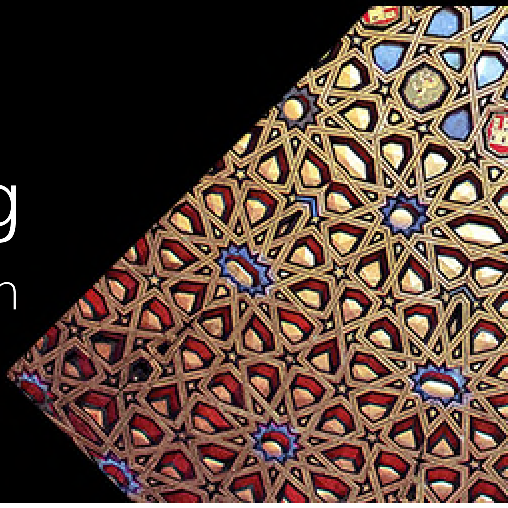
HSBC Asset Management



Shariah Compliant Investing

Sustainable Investing's Not-So-Distant Cousin

For Professional Clients only

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Summary

- There is considerable overlap between Islamic and sustainable investment strategies
- Understand the screening methodologies used to create Shariah-compliant portfolios
- Explore the role of a Shariah board in the development and oversite of our products
- A broad choice of equity, fixed income, and multi-asset options mean numerous risk-return profiles can be created using a moderate number of Shariah-compliant asset classes
- Islamic faith-based investments are growing in popularity. On the face of it they seem distinctly niche, but there is far more philosophical and practical overlap with sustainable investments than most investors realise
- In this article we explore the screening methodologies employed, the nature of equivalent fixed income products, known as Sukuk, and how Shariah compliant investment portfolios can target a number of risk-return profiles using just a moderate number of Shariah compliant asset class.

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Shariah Philosophy

Shariah compliant investments are assets that have been screened according to a set of principles commonly associated with Shariah law. Examples of such principles include risk sharing between parties to a financial transaction, the limiting of unnecessary uncertainty in business or financial contracts, a prohibition on interest (Riba) and hoarding of capital with no productive intention, whilst at the same time there is a strong emphasis on property rights and fair treatment of employers, employees, customers, and other stakeholders.

Very often when screening companies for Shariah compliance, the nature of the screening has two dimensions:

1. Business activity: Ensuring the company has no significant exposure to non-permissible revenue sources such as selling goods or services related to gambling, weapons, alcohol, tobacco, pork products, adult entertainment, and other prohibited offerings.
2. Financial screening: This addresses the tolerance limits for prohibited (haram) interest-based investments, interest-based debts, liquidity, and other forms of prohibited income.

Typically speaking, companies or other entities which pass these two screening methodologies are deemed to be Shariah compliant.

When managing Shariah compliant investment products of any kind, governance and oversite by a reputable Shariah board is crucial. At HSBC we are proud to have a well-known and respected Shariah board that is intricately involved in the development and oversite of our Shariah compliant investment. Whether it is monitoring the portfolio management practices and operational set-up of our funds and platform, ensuring legal documentation is correctly reflective of investment features, or applying the correct methodology for calculating impure income; our Shariah board ensure our products are created and managed in an entirely Shariah compliant way and meet AAOIFI standards.

Shariah compliant investments should have a dividend purification system in place where the proportion of total revenue for applicable companies that comes from non-permissible sources is used as a guide to ring fence some of the dividend income which investors are then required to donate to charity. At HSBC Asset Management we carry out this process on behalf of investors, under the watch and guidance of our Shariah board, to ensure our products remain Shariah compliant.

What are 'Sukuk' bonds and how do they differ from conventional fixed income?

Sukuk are Shariah compliant equivalents to conventional fixed income securities. These securities are typically issued by governments, corporates, supranationals and other entities to raise capital, but despite their differences to conventional fixed income securities, the Sukuk market displays similar dynamics to conventional fixed income markets and emerging market bonds in particular.

Sukuk bonds have a high correlation to their conventional counterparts and have low average credit spreads. These measures are a good gauge of investor perception of interest rate and credit risk for Sukuk versus conventional bonds. Although periods of volatility (such as the pandemic in 2020 and the broad market sell off in 2022) briefly impacted spreads, spread differentials have continued to tighten over the years.

But there are other distinct features of the asset class too including:

- A fixed maturity period and coupon as with conventional fixed income
- Typically, Sukuk are asset backed which has culminated in a low default rate
- They are assessed and rated by international rating agencies which investors use as a guideline to assess risk/return parameters of the security
- Sukuk are tradable in the secondary market, depending on the structure, and they are becoming increasingly liquid instruments given the impressive growth of the market in recent years

Conventional bonds are instruments where the issuer has an obligation to pay bondholders cash flows in the form of interest and principal on certain specified dates. In contrast, Sukuk are based on the ownership of a share of an asset, as well as the associated cash flows and risks. In practice, investors are considered as part owners rather than creditors given the transfer of ownership of certain assets. Every Sukuk bond is generally tied to a tangible asset or project.

Additionally, conventional bonds pay interest – this is not permitted by Shariah law, so the periodic payments of Sukuk instruments are structured from the profits from the underlying assets. Sukuk issuers ensure that funds that are raised are invested in areas that do not contradict Shariah law. Like any other credit instrument, investors do face default risk, although as mentioned these numbers are quite low. As of end H1 24, less than 0.25% of all issued Sukuk had defaulted.

Overall, Sukuk can be considered as Shariah compliant versions of conventional bonds, although there are differences in the way they are structured.

Pension investors have been selecting Shariah compliant equity strategies for many years. However, following requests from scheme members for broader choice, several providers now offer a full suite of equity, fixed income, and multi-asset options. Rather than a traditional 60/40 equity/bond portfolio, the scope for a much broader Shariah multi-asset approach now exists, for example:

- Sukuk Bonds (18.28%)
- Global Equity (18.04%)
- All Country World Equity (17.60%)
- Supranational Sukuk Bonds (12.68%)
- US Equity (11.41%)
- Commodities (10.71%)
- Global Emerging Markets Equity (5.05%)
- Europe Equity (2.13%)
- Liquidity (1.60%)
- Property (1.41%)
- Japan Equity (1.09%)

What is the overlap with sustainable investment products?

Sustainable investment products aim to create long-term value for investors by integrating environment, social and governance factors into investment analysis and portfolio construction. Islamic investment products on the other hand are aimed at ensuring products are compliant with Shariah law. The screening process used by Shariah-compliant investment products and sustainable investment products share many similarities, though they are guided by different principles.

Both aim to align investments with a set of moral or ethical standards, whether derived from religious beliefs or broader societal values, and as such, there is considerable overlap in their approaches.

Both types of screening processes exclude companies operating in industries considered harmful or morally questionable. These exclusions reflect a shared commitment to promoting investments that minimize harm to society and uphold ethical conduct.

In addition, both Shariah-compliant and ethical investments tend to focus on stability and risk reduction, with both approaches aiming to minimize exposure to speculative, high-risk ventures, preferring companies with stable financial foundations. For instance, investments in highly leveraged companies or speculative financial instruments are typically avoided under both frameworks.

However, it is important to note that, unlike sustainable products, Shariah compliant investment products do not have sustainability goals (carbon emission reductions, ESG uplift, etc.). They are better viewed as complementary rather than substitutes.

Our range of Shariah compliant investment options enables Investors to create richer, more diverse portfolios.

Source: HSBC Asset Management, January 2025.

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