

# IFN ISLAMIC SUSTAINABLE INVESTING THOUGHT LEADERSHIP REPORT



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# Combining ESG and Islamic finance principles in an index framework

Authored by

## S&P Dow Jones Indices

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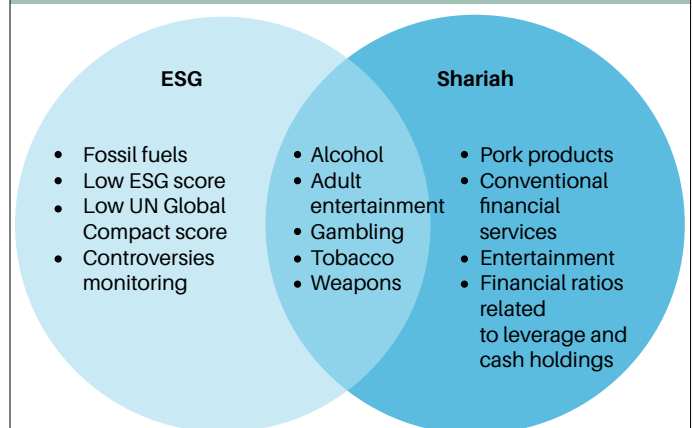
Islamic finance and environmental, social, and governance (ESG) investing are complementary in many ways and hold a number of shared principles. Though broader in nature, ESG strategies often exclude companies involved in such businesses as alcohol, tobacco and gambling that are considered Haram in the Muslim world. However, there are also fundamental Shariah compliance exclusions, such as conventional financial services and pork, that are not considered problematic in general ESG strategies.

This article will explore the similarities and differences of broad-based ESG and Islamic indexing through a real-world example of an innovative index that combines both frameworks — the **S&P Global 1200 ESG Shariah Index**. This index also allows us to examine the impact of applying ESG and Shariah screens on the general investment characteristics of the S&P Global 1200 — a conventional global equity benchmark.

### Understanding ESG and Shariah screening criteria

Because Islamic and ESG investors seek to avoid companies involved in certain activities, it is necessary to apply various quantitative screens

**Figure 1: Representative ESG and Shariah exclusions**

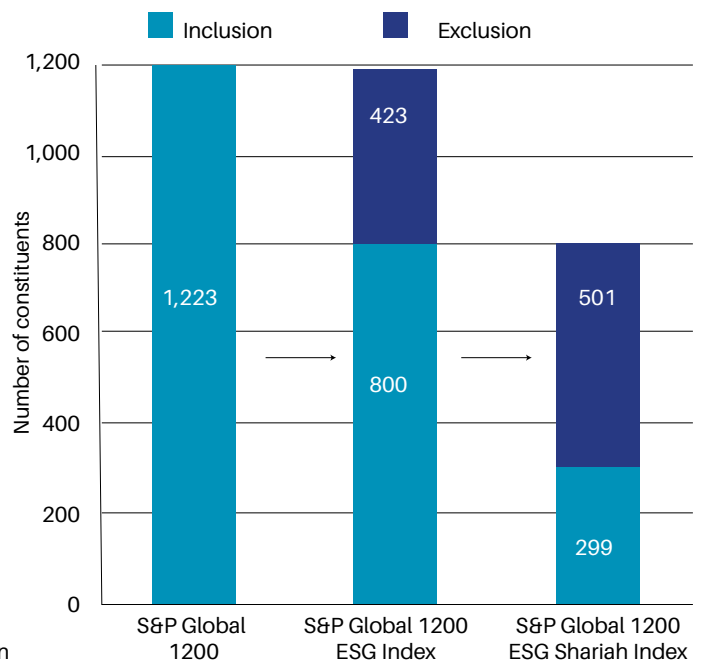


Source: S&P Dow Jones Indices. Chart is provided for illustrative purposes. Screens shown are commonly used in ESG and Islamic index methodologies and do not reflect a specific methodology employed by S&P DJI.

to identify and exclude companies violating specific ESG or Shariah compliance criteria. While these involve a number of overlapping themes, there are also some distinct areas that only fall in the Islamic or ESG space. Figure 1 provides a general overview of typical screens relevant for ESG and Islamic indices.

**Figure 2: S&P Global 1200 ESG Shariah Index construction**

- Step 1:**  
Exclude companies involved in thermal coal, tobacco, controversial weapons or with a low UN Global Compact Score.
- Step 2:**  
Exclude companies with S&P DJI ESG Scores in the bottom 25% of their GICS Industry group globally.
- Step 3:**  
Rank companies by the S&P DJI ESG Score within each GICS Industry group.
- Step 4:**  
Starting with the company with the highest S&P DJI ESG Score, select companies for inclusion from the top down, targeting 75% of the industry group by market cap.
- Step 5:**  
Exclude companies with > 5% of revenue in non-Shariah compliant business activities\*
- Step 6:**  
Exclude companies failing Shariah compliance financial ratios
- Step 7:**  
Weight remaining companies by float-adjusted market capitalization



Source: S&P Dow Jones Indices. Data as of the 30<sup>th</sup> September 2021. Chart is provided for illustrative purposes. \*Non-compliant business activities per S&P Shariah Indices include alcohol, adult entertainment, advertising of non-Shariah compliant products/activities, conventional financial services, gambling, media and entertainment, pork products, tobacco and trading of gold/silver as cash on a deferred basis. For further details, see the S&P Global 1200 Shariah Index Methodology.

It is important to note that while many ESG indices apply all of the aforementioned criteria — including several published by S&P Dow Jones Indices — the S&P Global 1200 ESG Index takes a more inclusive approach, as it is designed to serve as a broad alternative to conventional global benchmarks. Given this, it does not exclude companies with involvement in alcohol, gambling or adult entertainment (these areas are often chosen for exclusion by investors for ethical reasons). Likewise, while an alternative framework provided under the Dow Jones Islamic Market Indices excludes companies that produce weapons, the S&P Shariah Indices do not exclude all companies involved in weapons production. The combined approach allows the exclusions to meet the needs of both ESG and Shariah requirements in a comprehensive way.

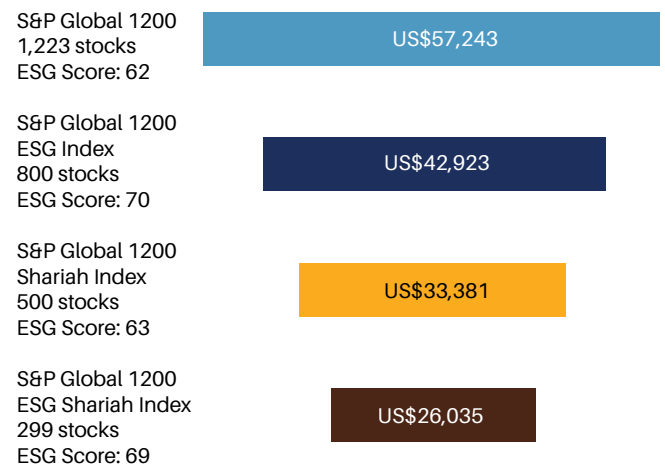
**The S&P Global 1200 ESG Shariah Index — an overview**

Introduced in August 2019, the S&P Global 1200 ESG Shariah Index is designed to be a measure of large-cap global equities meeting both ESG and Shariah standards. From a technical standpoint, the index is constructed by including members of the S&P Global 1200 ESG Index that pass rules-based screens for Shariah compliance as defined by the S&P Shariah Index Series. Figure 2 describes the index construction process.

**Compositional impact of S&P DJI ESG and Shariah screens**

As illustrated in Figure 3, the application of ESG and Shariah screens results in a narrowing of the index universe, but also an increase in

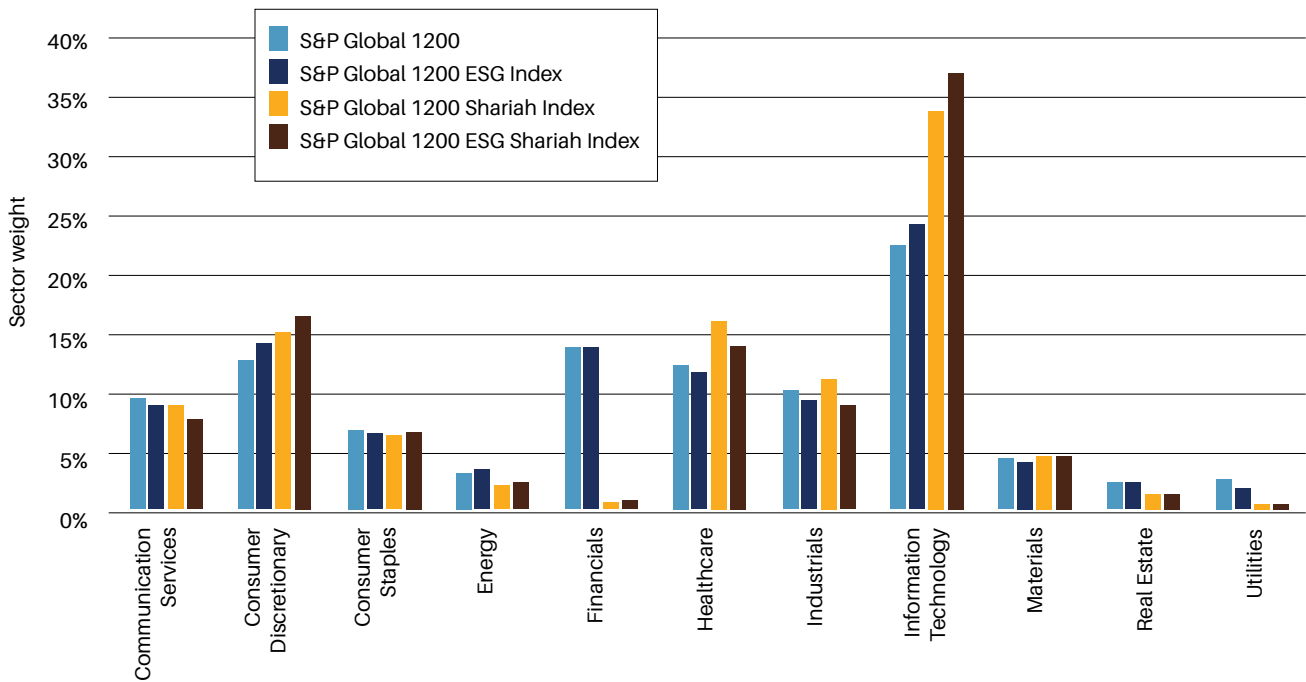
**Figure 3: Impact of ESG and Shariah exclusions (float-adjusted market cap in US\$ billions)**



Source: S&P Dow Jones Indices. Data as of the 30<sup>th</sup> September 2021. The ESG score is calculated as a weighted average of each index constituent's S&P DJI ESG Score. Chart is provided for illustrative purposes.

ESG performance. As of the 30th September 2021, the S&P Global 1200 ESG Shariah Index included 299 companies, representing about 45% of the market cap of the benchmark S&P Global 1200. It is noteworthy that the Shariah screening resulted in a significantly greater portion of the exclusions by market cap and stock count than that caused by the ESG methodology.

Figure 4: Comparative sector weights



Source: S&P Dow Jones Indices. Data as of the 30<sup>th</sup> September 2021. Chart is provided for illustrative purposes.

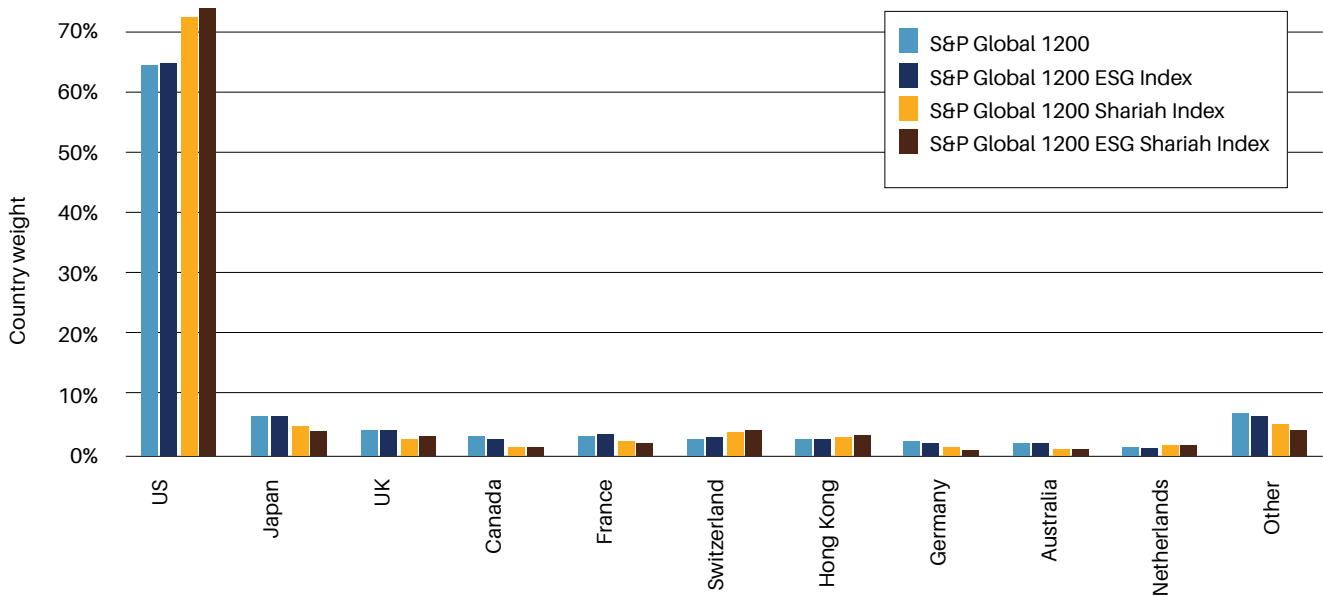
As depicted in Figures 4 and 5, the S&P Global 1200 ESG Index has similar sector and country weights as the benchmark S&P Global 1200. However, the introduction of the Shariah screening results in a near elimination of the financials sector and significant overweighting to information technology in the S&P Global 1200 ESG Shariah Index. Because the information technology sector is overweight in the US market and the financials sector is relatively underweight, the S&P

Global 1200 ESG Shariah Index also has meaningfully higher exposure to the US compared with the conventional S&P Global 1200.

**Performance analysis**

By design, the S&P Global 1200 ESG Index maintains similar risk/return characteristics compared with the benchmark S&P Global 1200. However, because the Shariah screening introduces differences in sector and

Figure 5: Comparative country weights



Source: S&P Dow Jones Indices. Data as of the 30<sup>th</sup> September 2021. Chart is provided for illustrative purposes.

Figure 6: Risk/return characteristics

Period	S&P Global 1200	S&P Global 1200 ESG Index	S&P Global 1200 Shariah Index	S&P Global 1200 ESG Shariah Index
<b>Annualized returns (%)</b>				
1 year	28.46	27.81	24.42	23.8
3 years	13.23	13.96	17.09	17.87
5 years	14.12	14.6	17.04	17.32
10 years	13.11	13.23	14.84	14.71
<b>Risk (standard deviation) (%)</b>				
3 years	17.99	17.81	17.48	17.21
5 years	14.46	14.34	14.16	13.96
10 years	13.21	13.19	12.79	12.63
<b>Risk-adjusted return</b>				
3 years	0.74	0.78	0.98	1.04
5 years	0.98	1.02	1.2	1.24
10 years	0.99	1	1.16	1.16

Source: S&P Dow Jones Indices. Data as of the 30<sup>th</sup> September 2021. Past performance is no guarantee of future results. Index performance based on total return in the US dollar. Table is provided for illustrative purposes and reflects hypothetical historical performance.

country exposures relative to the benchmark, the returns of the S&P Global 1200 ESG Shariah Index have been more differentiated. Over the past year, the S&P Global 1200 ESG Shariah Index underperformed primarily due to its underweight to financials. However, over longer time periods, the index outperformed due to its relatively high exposure to outperforming sectors such as information technology and healthcare. An overweight to the US also contributed to outperformance.

## Conclusion

As the Islamic investment community increasingly seeks to integrate ESG considerations into the investment process, the need for indices

that merge Shariah and broad-based ESG has developed. The S&P Global 1200 ESG Shariah Index aims to meet this need while serving as a unique dataset to examine the interconnections between Islamic finance and ESG.

For more information about S&P Dow Jones Indices ESG and Shariah index solutions, please visit: [www.spglobal.com/spdji/](http://www.spglobal.com/spdji/). 

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## Disclaimer

The S&P Global 1200 ESG Shariah Index was launched August 28, 2019. The S&P Global 1200 Shariah was launched March 19, 2014. The S&P Global 1200 ESG Index was launched May 6, 2019. All information presented prior to an index's Launch Date is hypothetical (back-tested), not actual performance.

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