

How Indexing Affects Shariah-Compliant Investing

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Executive Summary

Shariah-compliant investing has grown considerably in recent decades, as the Islamic investment community has demanded increasingly sophisticated investment solutions that adhere to the tenets of Islamic law. As a result, the need for high-quality, transparent, Shariah-compliant benchmarks has developed. Today, Islamic indices serve a critical role in Islamic finance; these unique indices identify the universe of securities available for investment and define the way Islamic investors measure the markets.

Introducing Islamic Indices

Islamic indices are subsets of conventional benchmarks that include only companies that pass rules-based screens for Shariah compliance. The resulting Shariah indices tend to be highly correlated to their conventional non-Shariah counterparts and provide Islamic investors with Shariah-compliant versions of a wide variety of popular benchmarks. For example, the [S&P 500® Shariah](#) is a subset of the widely recognized [S&P 500](#), and it includes only Shariah-compliant constituents of the S&P 500.

As with all Islamic financial products, a supervisory board of Islamic scholars oversees the rules governing Shariah-compliant indices. The board is responsible for defining and maintaining the rules governing the Shariah screening process. However, S&P Dow Jones Indices retains oversight on all other index methodology issues, including rules for company selection in the benchmark index, weighting and index maintenance.

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The Ins and Outs of the Shariah Screening Process

Shariah screening is performed at two primary levels: business activity and financial ratios. First, the business activities of each company are evaluated. Companies with significant involvement in certain business activities prohibited by Shariah law are deemed noncompliant. Activities that are generally considered noncompliant include conventional financial services, alcohol, tobacco, gaming, pork, pornography and most conventional media organizations. After removing companies with noncompliant business activities, the remaining companies are examined for compliance with board-approved financial ratios. Areas of focus include the degree of financial leverage and holdings of cash, receivables or interest-earning securities.

Exhibit 1 provides a comparison of the screening methodologies employed by the S&P Shariah Indices and Dow Jones Islamic Market™ Indices. While the criteria evaluated are largely similar, there are some differences, as Shariah scholars have not reached a complete consensus on all aspects of Islamic finance. For example, the Dow Jones Islamic Market Indices exclude defense companies, while these firms are allowed in the S&P Shariah Indices. The calculations of accounting ratios also differ to some extent across the two index series.

Exhibit 1: Comparing the S&P Shariah Indices' and Dow Jones Islamic Market Indices' Screening Methodologies

Selection Criteria	S&P Shariah Indices	Dow Jones Islamic Market Indices
Common Sector Exclusions		
Alcohol	X	X
Cannabis	X	X
Cinema and Television	X	X
Hedging of Gold and Silver	X	
Music	X	X
Non-Islamic Financial Services including Banking and Insurance	X	X
Online Dating	X	X
Pork-related products	X	X
Pornography	X	X
Tobacco and Electronic Cigarettes	X	X
Weapons/Arms/Defense Manufacturing		X
Non-Permissible Income Threshold		
Total Income from Non-Permissible Sources Not to Exceed	5%	5%
Accounting Ratio Inclusion Threshold		
Total Debt	33%	33%
Total Cash + Investments	33%	33%
Total Receivables*	33%	-
Denominator	Three-Year Average Market Cap	Two-Year Average Market Cap
Dividend Purification		
Formula Used for Constituent-Level Purification Purposes	$\frac{\text{Non - Permissible Revenue Including Interest}}{\text{Total Revenue}}$	
Screening Basis		
Frequency Compliance Screening Applied	Monthly	Quarterly

*The Total Receivables threshold is no longer applicable for Dow Jones Islamic Market Indices starting in March 2023 and is reflected in the exhibit accordingly. Source: S&P Dow Jones Indices LLC. Data as of March 2023. Table is provided for illustrative purposes.

Maintaining the Index

The rebalancing frequency is another important factor to consider when evaluating Islamic indices, and it is an area that also serves as a distinguishing feature between S&P DJI's two index series. The S&P Shariah Indices are reviewed on a monthly basis, and companies that fail the review are removed each month. On the other hand, the Dow Jones Islamic Market Indices are reviewed quarterly. More frequent rebalancing presents the advantage of ensuring that noncompliant companies are removed and newly compliant companies are added as quickly as possible. As a result, the frequent screening approach has resulted in higher turnover over some historical periods.

Putting Islamic Indices to Use

As discussed earlier, the need for Islamic indices has developed with the growing demand for Shariah-compliant investment solutions. Today, Shariah-compliant indices are widely used by Islamic and conventional banks, asset managers and other financial institutions. The indices are used for several purposes, including serving as:

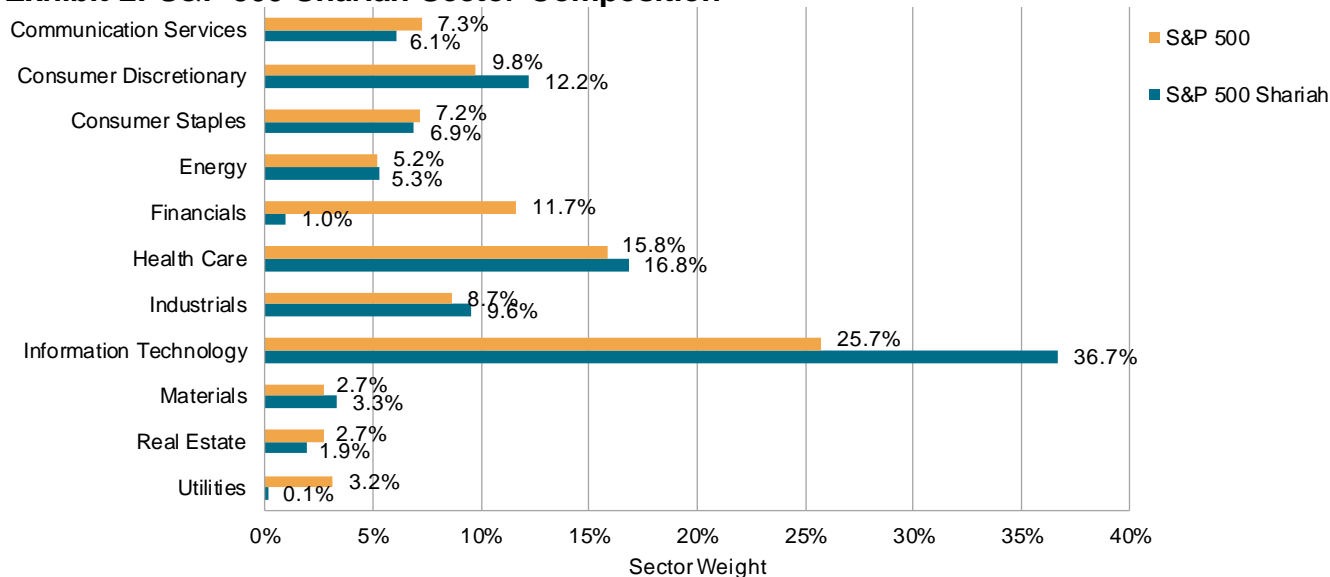
- Performance benchmarks for Shariah-compliant portfolios;
- The basis for index-linked investment products such as exchange-traded funds, mutual funds and structured products; and
- Selection pools for actively managed portfolios.

Key Investment Characteristics of Islamic Indices

1. Sector Composition and Market Coverage

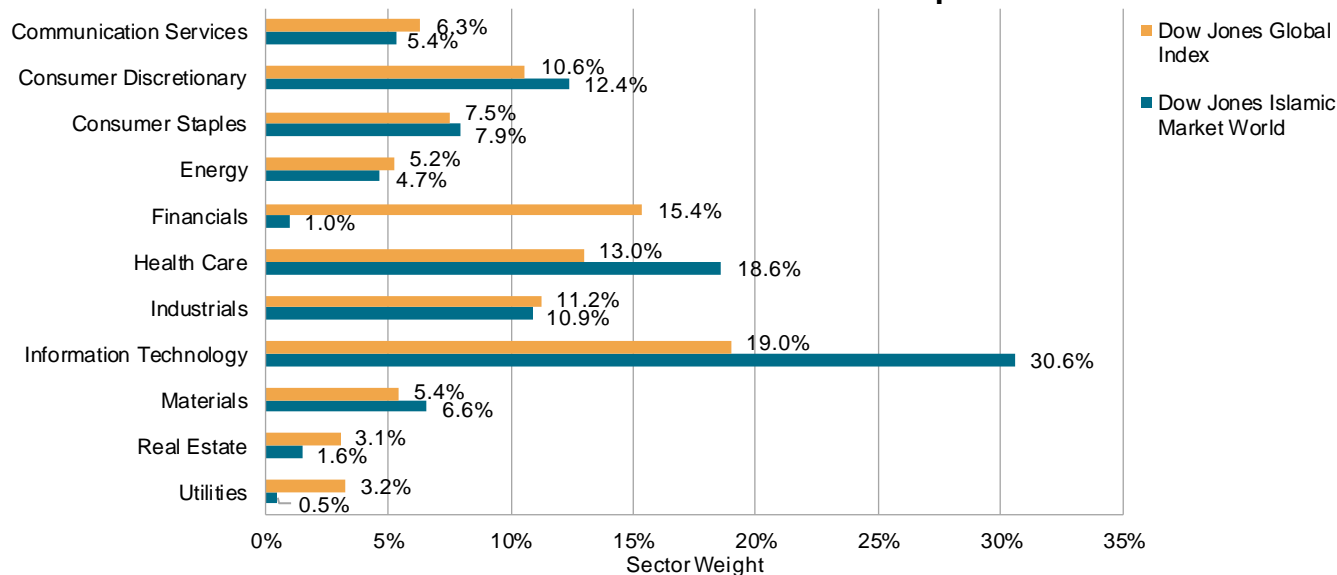
Despite having significant deviations from conventional indices in certain sector weights, Islamic and conventional indices tend to have similar long-term performance characteristics and are typically highly correlated. Exhibits 2 and 3 depict sector weights for the S&P 500 Shariah compared with the S&P 500 and for the [Dow Jones Islamic Market World Index](#) compared with the [Dow Jones Global Index](#), respectively. Because nearly all firms involved in conventional financial services are not Shariah compliant, the Financials sector is the primary area of sector deviation. To a lesser extent, consumer-related sectors tend to be underrepresented as well, due to the exclusion of media and gaming firms, along with companies involved in the production or sale of alcohol, tobacco and pork products. Likewise, Utilities tend to have limited representation, since these firms typically have relatively high leverage ratios. However, these sectors have relatively small weights in major U.S. and global equity benchmarks, therefore limiting their effect on historical returns.

Exhibit 2: S&P 500 Shariah Sector Composition



Source: S&P Dow Jones Indices LLC. Data as of Dec. 30, 2022. Chart is provided for illustrative purposes.

Exhibit 3: Dow Jones Islamic Market World Index Sector Composition



Source: S&P Dow Jones Indices LLC. Data as of Dec. 30, 2022. Chart is provided for illustrative purposes.

After the removal of noncompliant companies, Islamic indices typically represent about one-half of the total float-adjusted market capitalization of their conventional benchmark indices. Exhibit 4 illustrates the coverage of the S&P 500 Shariah and Dow Jones Islamic Market World Index by sector. As expected, it varies considerably, with the highest representation typically found in Information Technology, Health Care, Industrials and Energy, and with the lowest in Financials, Utilities and Communication services.

Exhibit 4: Sector Coverage of Shariah-Compliant Indices (Float-Adjusted Market Cap)

Sector	S&P 500 Shariah (%)	Dow Jones Islamic Market World Index (%)
Communication Services	54.6	47.6
Consumer Discretionary	81.1	65.5
Consumer Staples	62.5	59.3
Energy	65.5	50.3
Financials	5.5	3.5
Health Care	69.0	80.7
Industrials	71.7	54.7
Information Technology	92.5	90.5
Materials	79.5	68.3
Real Estate	46.1	28.0
Utilities	2.8	8.6
Total	64.9	56.2

Source: S&P Dow Jones Indices LLC. Data as of Dec. 30, 2022. Table is provided for illustrative purposes.

2. Performance Characteristics

Over the long term, Islamic indices tended to perform similarly to conventional benchmarks. For the 15-year period ending Dec. 30, 2022, the S&P 500 Shariah posted an annualized total return of 9.6%, while the S&P 500 gained 8.8%. Over the same period, the Dow Jones Islamic Market World Index and Dow Jones Global Index gained 6.4% and 5.2%, respectively.

Exhibit 5: Comparative Performance Characteristics

Period	S&P 500 Shariah	S&P 500	Dow Jones Islamic Market World Index	Dow Jones Global Index
Returns (%)				
1-Year	-22.5	-18.1	-24.2	-18.2
3-Year	8.6	7.7	5.1	4.0
5-Year	10.8	9.4	7.2	5.1
10-Year	13.1	12.6	9.3	8.2
15-Year	9.6	8.8	6.4	5.2
Risk (Standard Deviation, %)				
1-Year	24.2	23.0	22.7	21.0
3-Year	21.9	21.2	20.4	20.3
5-Year	19.2	18.7	18.1	17.8
10-Year	15.2	14.8	14.4	14.4
15-Year	16.0	16.3	16.6	17.1

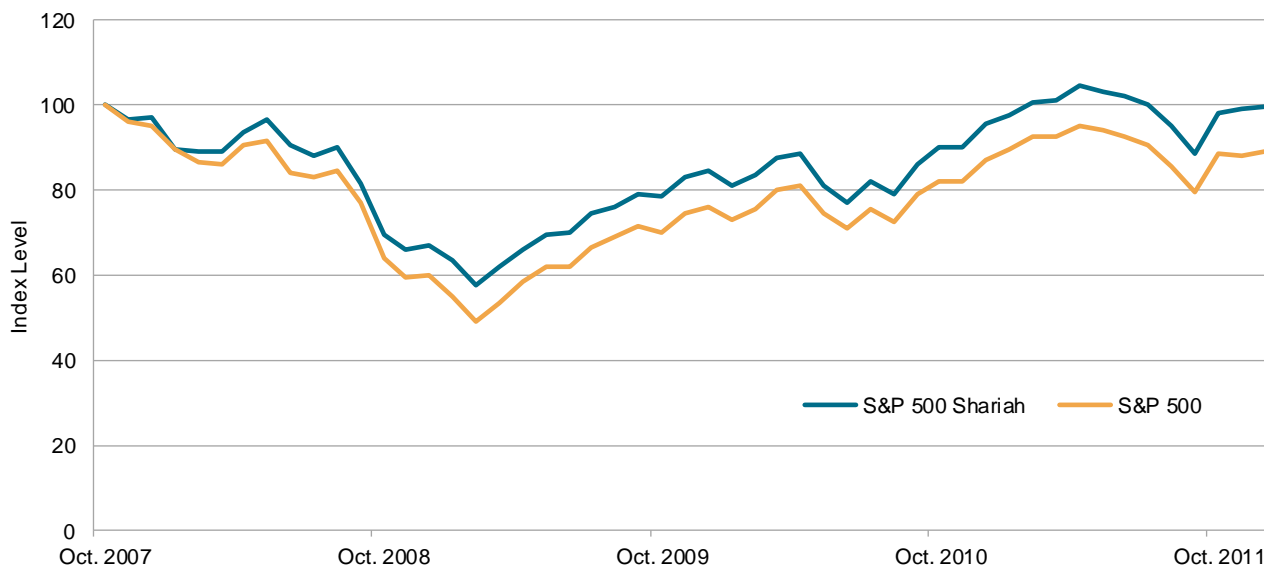
Source: S&P Dow Jones Indices LLC. Dec. 30, 2022. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

However, differences in performance can occur in periods when there is significant underperformance or outperformance in sectors that have large allocation differences between Islamic and conventional benchmarks. For example, as shown in Exhibit 6, the S&P 500 Shariah outperformed the S&P 500 in the period following the onset of the 2008 financial crisis, as Financials significantly underperformed overall, and Information Technology and Health Care outperformed the broader market.

In fact, in the period between Oct. 31, 2007 (the monthly peak of the S&P 500), and Dec. 30, 2011, the S&P 500 Financials sector declined nearly 58% on a total return basis, while the S&P 500 Information Technology sector declined merely 3%, and S&P 500 Health Care made a gain of 5% over the same period. Due in part to the significant divergence in the performance of these key sectors, the overall outperformance of the S&P 500 Shariah was meaningful over this period, as the annualized total returns of the S&P 500 Shariah and S&P 500 were -0.1% and -2.7%, respectively.

Notably, these performance levels can be reversed, as illustrated in 2016, when the Financials sector of the S&P 500 returned nearly 23%, and the Health Care and Information Technology sectors returned -3% and 14%, respectively. Due in part to the relative outperformance of the Financials sector, the S&P 500 Shariah underperformed the S&P 500 by approximately 3.5% in 2016.

Exhibit 6: Comparative Performance of the S&P 500 Shariah and the S&P 500 from Oct. 31, 2007, to Dec. 30, 2011

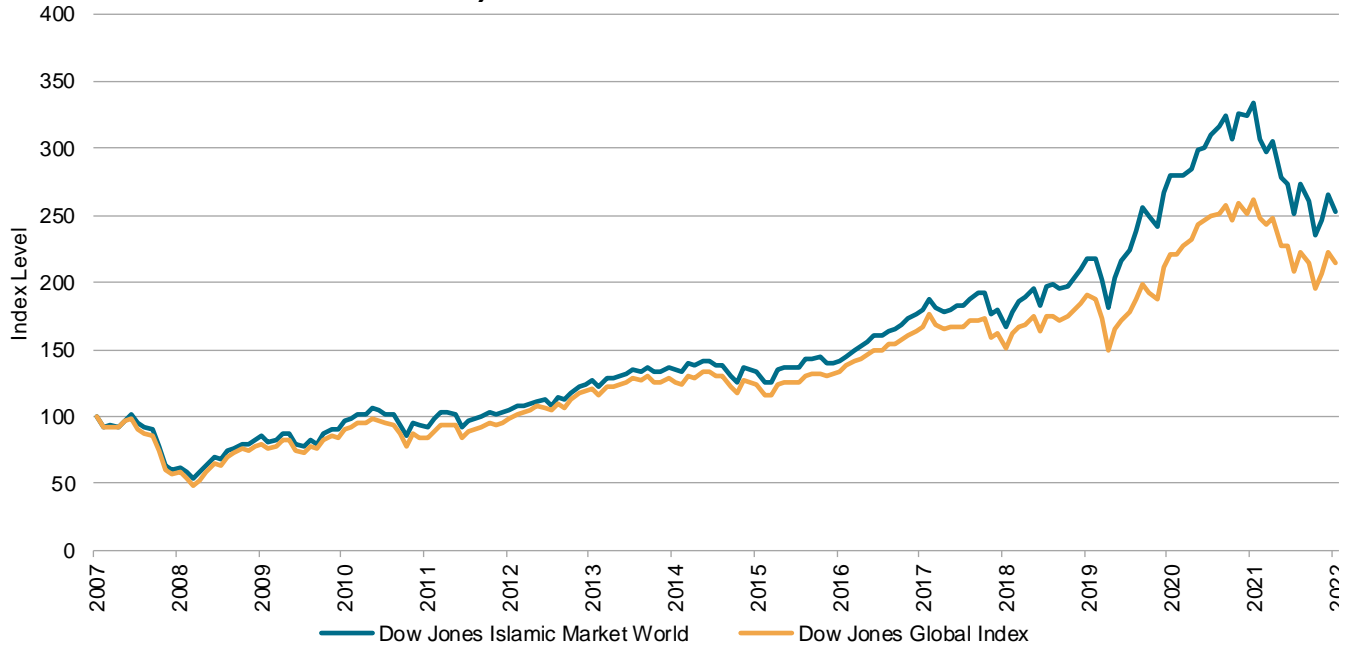


Source: S&P Dow Jones Indices LLC. Data from Oct. 31, 2007, to Dec. 30, 2011. Indices rebased to 100 on Oct. 31, 2007. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

Similar trends also occurred in global equity markets over this period. The Dow Jones Islamic Market World Index slightly underperformed the Dow Jones Global Index in the boom leading

up to the financial crisis, but it outperformed over the following years, as Financials has generally lagged the broader market since the crisis.

Exhibit 7: Comparative 15-Year Performance (Dow Jones Islamic Market World Index versus Dow Jones Global Index)



Source: S&P Dow Jones Indices LLC. Data as of December 30, 2022. Indices rebased to 100 on Dec. 31, 2007. Chart is provided for illustrative purposes. Past performance is no guarantee of future results.

Also noteworthy is that Islamic benchmarks experienced significantly lower volatility during the Global Financial Crisis because of their limited exposure to Financials. This has resulted in lower volatility over the trailing 15-year period.

3. High Correlations to Conventional Benchmarks

As illustrated in Exhibit 8, the S&P 500 Shariah and the Dow Jones Islamic Market World Index are highly correlated to their conventional counterparts. In fact, correlations have been close to 1.0 over the trailing 3-, 5- and 10-year periods.

Exhibit 8: Comparative Correlations

Period	S&P 500 Shariah to S&P 500	Dow Jones Islamic Market World Index to Dow Jones Global Index
3-Year	0.99	0.97
5-Year	0.99	0.97
10-Year	0.99	0.97

Source: S&P Dow Jones Indices LLC. Data as of December 30, 2022. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

What about Bonds?

Because the charging or paying of interest is not permissible under Islamic law, conventional bonds are inherently not Shariah compliant. Consequently, standard fixed income benchmarks cannot be screened for Shariah compliance, and Islamic investors seeking fixed income exposure have limited options. In order to meet the demand for Shariah-compliant fixed income products, Islamic financial institutions have created an alternative structure, called sukuk, which complies with Shariah investment principles.

Unlike conventional bonds, which are a promise to repay a loan, sukuk constitutes partial ownership in a debt, asset, project, business or investment. Most commonly issued sukuk structures replicate the cash flows of conventional bonds. They are structured to have a similar payoff and risk/return profile as conventional bonds, and they are made tradable through conventional organizations such as Euroclear or Clearstream.

By their nature, sukuk meet Shariah guidelines, so there is no further screening necessary to make them eligible for inclusion in a Shariah-compliant index or portfolio. S&P Dow Jones Indices launched the first sukuk index, the Dow Jones Sukuk Index,¹ in 2006. As of December 2022, it included 108 issues, primarily entities headquartered in the Gulf Cooperation Council and Southeast Asia.

Exhibit 9: Dow Jones Sukuk Index Country Weights

Country	Index Weight (%)	Number of Securities
United Arab Emirates	35.9	46
Saudi Arabia	33.1	27
Indonesia	18.6	15
Malaysia	6.1	10
Qatar	4.5	7
Hong Kong	1.0	1
Bahrain	0.5	1
Cash	0.3	1
Total	100.0	108

Source: S&P Dow Jones Indices LLC. Data as of Dec. 30, 2022. Table is provided for illustrative purposes. Past performance is no guarantee of future results.

¹ For more information on this index, please see: [Dow Jones Sukuk Index \(ex-Reinvestment\)](#).

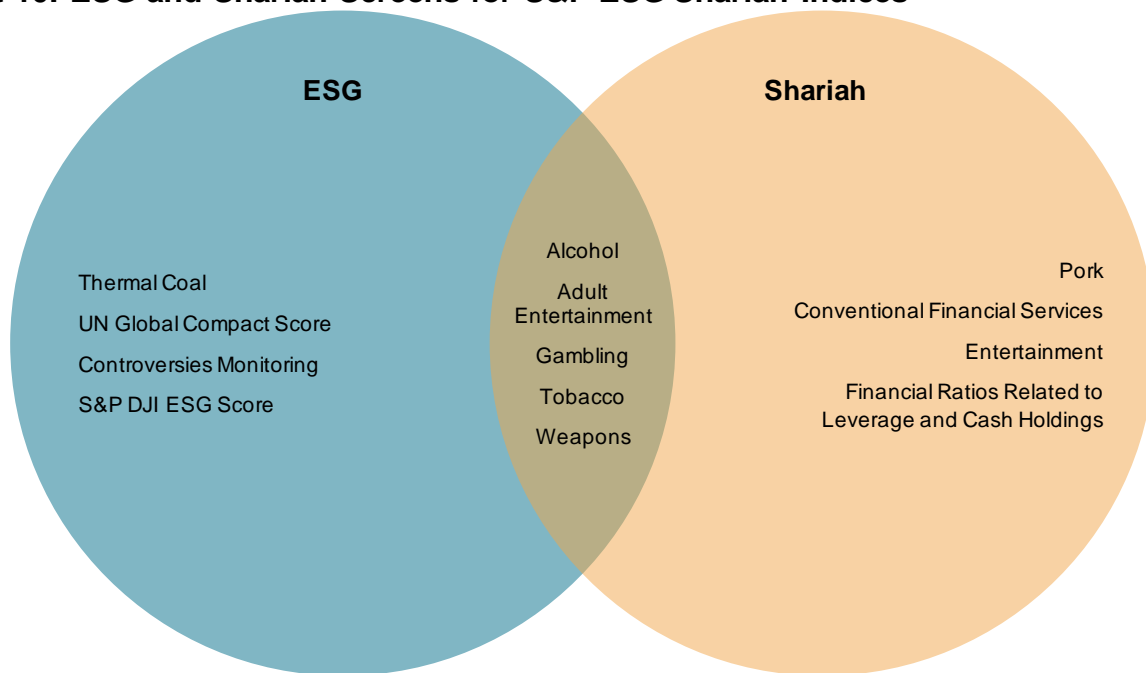
Trends in Islamic Indexing

Trends in Islamic indexing tend to mirror the broader market. Sustainability indices continue to be a major theme around the world.

In response to growing demand from market participants, S&P Dow Jones Indices has launched Shariah-compliant versions of major headline environmental, social and governance (ESG) indices such as the [S&P 500 ESG Shariah Index](#), [S&P Global 1200 ESG Shariah Index](#) and [S&P Europe 350[®] ESG Shariah Index](#), to name a few.

The combination of ESG and Islamic finance principles in an index framework ensures applicable quantitative and qualitative screens are applied to identify and exclude companies violating specific ESG and Shariah compliance criteria. This approach seeks to more adequately satisfy investors looking to combine ESG and Shariah benchmarks.

Exhibit 10: ESG and Shariah Screens for S&P ESG Shariah Indices



Source: S&P Dow Jones Indices LLC. Data as of Dec. 30, 2022. Chart is provided for illustrative purposes.

Additionally, there has been interest in Shariah-compliant indices that focus on more specialized themes, such as real estate, infrastructure and dividends. These indices follow a similar approach in their construction by applying the relevant Shariah screens on top of the methodology used to create their respective headline indices. The [S&P Global Property Shariah](#), [S&P Global REIT Shariah](#), [S&P Global Infrastructure Shariah](#), [S&P High Yield Dividend Aristocrats Shariah Index](#) and [S&P Pan Arab Composite Shariah Dividend](#) are examples of these types of indices.

Conclusion

As Shariah-compliant investors seek to create a diversified portfolio, Islamic indices provide market participants with a comprehensive set of benchmarks. These benchmarks define the universe of securities that can be utilized in constructing a wide array of Shariah-compliant investment solutions. Although Islamic equity indices are necessarily limited in coverage, particularly in certain sectors such as Financials, they have historically been highly correlated to and have had similar risk/return characteristics to conventional indices. Because interest is prohibited under Shariah law, gaining Shariah-compliant fixed income exposure is particularly challenging. However, sukuk indices have been developed to meet the demand for Shariah-compliant fixed income solutions.

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