Conventional and Islamic Stock Indices during COVID-19 Pandemic

Subjects: Business, Finance

Contributor: Muhammad Alamgir, Ming-Chang Cheng

Islamic finance encompasses financial activities such as Islamic banking, Islamic insurance (Takaful), and Sharia-compliant credit, all adhering strictly to Islamic law (Sharia law). The term also includes Sharia-compliant investments and broader capital and equity markets.

Keywords: Islamic stock indices ; COVID-19 ; market performance ; financial crisis

1. Introduction

Islamic finance encompasses financial activities such as Islamic banking, Islamic insurance (Takaful), and Sharia-compliant credit, all adhering strictly to Islamic law (Sharia law)[1]. The term also includes Sharia-compliant investments and broader capital and equity markets. While these practices have historical roots, formal institutional Islamic finance only emerged in the twentieth century. S&P Global Ratings predicts that the global Islamic finance industry will grow from 10% to 12% during 2021–2022. This growth can be attributed to the rapid expansion of Sukuk issuances, particularly those exceeding maturities, which have contributed to the increase in Islamic banking assets in certain Gulf Cooperation Council (GCC) countries, Malaysia, and Turkey. Remarkably, Islamic finance experienced significant expansion in 2020, with total assets increasing by 10.6%, despite the severe economic impact of the COVID-19 pandemic and the decline in oil prices.

The Islamic finance industry consists of over 1400 institutions spread across 80 countries and territories. Its fundamental principle is profit-and-loss sharing, ensuring that returns are tied to proper risk sharing. Unlike conventional financial systems, which rely on interest rates and the time value of money, Islamic finance operates on an asset-based system that prioritizes profit generation. Notably, Islamic financial instruments undergo Shariah (Islamic law) screening[2], setting them apart from conventional counterparts. The FTSE Shariah screening process can differentiate Islamic financial firms or Shariah firms from conventional ones.

As mentioned earlier, Islamic financial assets encompass various instruments, with banks and equities being particularly dynamic elements. However, the Islamic equity market holds special significance within the realm of Islamic finance. To ensure compliance with Shariah law, Islamic equity investments are subject to Shariah-compliant screening procedures. The primary screening method is qualitative in nature, focusing on adherence to Islamic investment principles. This involves excluding stocks of companies involved in activities such as alcohol, tobacco, pork, gambling, interest-based finance, and non-Shariah-compatible entertainment. By doing so, it determines whether a specific firm is considered halal (i.e., permissible) or haram (i.e., prohibited) for investment (Derigs and Marzban 2008). The second screening method is quantitative, utilizing financial ratios to identify and eliminate companies that generate a significant portion of their revenues from non-Shariah-compliant activities, such as interest-based borrowing and lending or holding a large proportion of assets in liquid form. As a result, this process filters firms under heavy debt, leading to a smaller but more stable universe of Sharia-compliant investment opportunities (Hussein and Omran 2005).

Previous research on Islamic equity markets often centered around comparative analyses between Islamic and conventional equities, driven by the decoupling hypothesis (Dharani et al. 2019; Jawadi et al. 2020; Umar 2017; Umar and Gubareva 2020). This hypothesis suggests that Islamic equity investments may demonstrate distinct behaviors and characteristics compared to conventional investments, further underscoring the unique nature of the Islamic equity market.

Islamic finance operates on a central principle of profit-and-loss sharing, which means that any returns earned must be tied to actual risk sharing. This sets it apart from conventional financial systems that primarily rely on interest rates and the time value of money. In Islamic finance, the focus is on an asset-based system that emphasizes profit sharing instead of interest income, thus promoting investments in the real economy. The growth of the Islamic finance industry received a significant boost because of the relatively moderate impact of the 2008 Global Financial Crisis (GFC) on Islamic finance assets (Kayed and Hassan 2011). This was attributed to factors like the cautious use of risky asset classes and the prohibition of speculative practices within the industry. As a result, Islamic financial assets performed better during the 2008 GFC compared to their conventional counterparts (Ho et al. 2014; Shahzad et al. 2017).

After the 2008 Global Financial Crisis, the COVID-19 pandemic was the biggest crisis that affected the whole economic system of the world, and the aftershocks were more severe than the Global Financial Crisis3. The COVID-19 pandemic, first noted in early 2020, has led to turbulence in global financial markets. American stock markets experienced circuit breakers twice in one week, and markets in other major countries and territories were affected as well. Many studies concluded that stock market turbulence due to the COVID-19 pandemic was the same or more severe than during the 2008 financial crisis. In late February and early March 2020, financial markets experienced a period of risk aversion characterized by a significant surge in volatility. During this time, stock markets witnessed a rapid decline, with their market value plummeting by approximately 30% within a few weeks. The sell-off was even more rapid than what was observed during the global financial crisis of 2008. The COVID-19 pandemic had a strong negative impact on stock markets, prompting a need for assessment by both investors and academia. However, after the announcement of bailout programs, some level of market recovery was observed (Rahman et al. 2020).

Amid the recent pandemic crisis, investors and policymakers are actively seeking safe havens to find refuge and protection in the financial markets. Safe havens are assets that exhibit little to no correlation, or even a negative correlation, with other assets or portfolios during specific periods, especially in times of crisis (Baur and McDermott 2010; Baur and Lucey 2010). To mitigate the risk of losses during times of high uncertainty, equity investors often turn to traditional safe-haven assets like gold (Baur and McDermott 2010; Baur and Lucey 2010) and cryptocurrencies (Feng et al. 2018). However, empirical evidence shows that even these well-known safe havens, such as gold and cryptocurrencies, did not entirely shield investors from the impacts of the COVID-19 pandemic (Conlon and McGee 2020; Conlon et al. 2020). Despite their reputation, they faced challenges during this crisis. Interestingly, research during the Global Financial Crisis (GFC) indicated that Islamic stocks performed favorably as a safe haven compared to conventional stocks (Hkiri et al. 2017; Aloui et al. 2018), highlighting the potential resilience of Islamic stocks for investors during periods of market turmoil.

2. Co-Movement and Performance Comparison of Conventional and Islamic Stock Indices during the Pre- and Post-COVID-19 Pandemic Era

Several authors have conducted studies aimed at assessing the performance of Islamic and conventional stocks, leading to diverse outcomes. For instance, Narayan and Bannigidadmath (2015), Aloui et al. (2018), Milly and Sultan (2012), Abdullah et al. (2007), Azad et al. (2018), and Ebrahim et al. (2016) have put forth arguments suggesting that Islamic stocks have shown better performance than their conventional counterparts during various timeframes. Additionally, researchers have explored the concept of decoupling and co-movements between Islamic and financial indices. As an example, Hkiri et al. (2017) examined the hypothesis of decoupling Islamic and conventional stock indices during different crisis periods experienced in diverse regions, including Asia, Russia, Argentina, Brazil, and the United States. Their findings demonstrate the existence of a contagion effect, indicating that Islamic indices tend to decouple from their conventional counterparts during periods of financial turmoil. On the other hand, some studies argue that Islamic equity funds do not underperform in comparison to that of their conventional counterparts (Kraeussl and Hayat 2011), while Albaity and Ahmad (2008) argue that Islamic equity indices have no significant edge in return over conventional ones.

Some studies argue that because of crises, the volatility in the market increases, and there exist chances for integration and decoupling between Islamic and conventional stock indices. But there are different views on this. In 2016, Majdoub et al. found strong cointegration between Islamic and conventional stock markets in France, Indonesia, the UK, and the US but not in the UK. They also observed significant correlations in developed countries. In 2018, Cevik and Bugan revealed a nonlinear relationship between these markets, with conventional markets impacting Islamic ones during bear and bull market periods. In summary, Majdoub et al. (2016) identified long-term relationships in specific countries, while Cevik and Bugan (2018) emphasized the nonlinear and market-dependent nature of the Islamic–conventional stock market relationship. However, the study found that conventional stock markets affect Islamic stock markets during bearish and bullish market. Jebran et al. (2017) and Majdoub et al. (2016) argued that the two markets (conventional and Islamic) are co-integrated, and that Islamic indices receive spillover effects from conventional indices. More recent studies, on the other hand, including by Abu-Alkheil et al. (2017), Hkiri et al. (2017), and Saadaoui et al. (2017), found evidence of the decoupling of Islamic stocks from their conventional counterparts, especially during periods of market instability. Hoque et al. (2016), on the other hand, argue that as the Islamic index is a part or subset of the main index, therefore, the news, which has a positive or negative impact on the market, will have the same impact on both Islamic and conventional indices.

Several recent studies have used the wavelet coherence approach, which is novel in the field of economics. For example, Dewandaru et al. (2014) identified multiscale relationships between Islamic and conventional stock markets, which intensify during crises. Rivzi et al. (2015), using the same approach, found evidence of a fundamental contagion effect in Asia and a pure contagion effect between Asia and the US in early 2000.

The recent literature delves into how the COVID-19 pandemic impacts both Islamic and conventional stock indices. Baker et al. (2020) assert that its effect surpasses that of previous outbreaks like the Spanish flu. However, there are conflicting findings. For instance, Sharif et al. (2020) discover a potent impact when combined with oil volatility shocks. Yan et al. (2020) investigate various industries' responses to the outbreak, observing short-term panic selloffs but anticipating long-term market corrections. Liu et al. (2020) contend that the Asian stock market swiftly reacted to the pandemic, with a partial recovery in the later stage of the outbreak. Sansa (2020) focuses on the impact of COVID-19 on Chinese and US markets during March 2020, revealing a significant positive association between confirmed COVID-19 cases and both countries' markets. Furthermore, Ngwakwe (2020) examines the COVID-19 impact on Chinese, European, and US markets using a paired *t*-test of mean stock prices during the pandemic period (−50, +50 days). The results indicated an increase in mean stock values for the Chinese stock index, surpassing normal levels. In contrast, the Dow Jones Industrial experienced a significant decrease during the pandemic period. However, no differences in mean stock values before and during the pandemic were observed for the S&P 500 and Euronext 100 indices.

Overall, the recent literature highlights the complex and multifaceted influence of the COVID-19 pandemic on global stock markets, with varying short-term and long-term effects observed across different regions and industries.

Yarovaya et al. (2021) studied the resilience property of Islamic equity funds during the COVID-19 pandemic. The study found that Islamic funds outperformed their conventional counterparts during the peak months of the COVID-19 pandemic and, thus, proved to be more resilient to COVID-19 shocks. While analyzing the relationship between COVID-19 and stock prices, Ramelli and Wagner (2020) suggest that high levels of corporate debt and liquidity problems are the main drivers of volatility in the stock market. Islamic stocks have lower leverage because of Shariah screening requirements, they are still expected to be more immune to market risks during turbulent periods compared to their conventional counterparts. Interestingly, Pagano et al. (2020) found that more resilient companies greatly outperformed less resilient companies. They define pandemic resilience as robust social distancing that relies on technologies and/or organizational structures. The cumulative return for resilient firms' differential from 2014 to 2019 was of the same magnitude as during the pandemic. Hasan et al. (2021) examined the performance of the Dow Jones and FTSE indices (conventional and Islamic) during the first 10 months of COVID-19 and found there was high co-movement and decoupling between the two types of indices, and they also claim that Islamic stocks did not provide any shelter to investors against risk during the financial crisis. Saleem et al. (2023) examined the hedging risk characteristics of gold and Sharia complaints during the COVID-19 pandemic and found that gold and Sharia-compliant stocks can hedge risk during periods of market recession.

Yarovaya et al. (2021) studied Islamic equity funds' resilience during the COVID-19 pandemic and found that they outperformed conventional funds during the peak months, indicating greater resilience. Ramelli and Wagner (2020) attributed stock market volatility during the pandemic to high corporate debt and liquidity issues. Islamic stocks, with lower leverage due to Shariah requirements, were found to be more immune to market risks during turbulent times. Pagano et al. (2020) discovered that companies demonstrating pandemic resilience also performed better overall. Resilience was defined as implementing robust social distancing measures using technology and organizational structures. The cumulative return for resilient firms in the years leading up to the pandemic was comparable to their performance during the pandemic. Hasan et al. (2021) analyzed the performance of the Dow Jones and FTSE indices (both conventional and Islamic) during the first 10 months of the pandemic. They found a high degree of co-movement and decoupling between the two types of indices. However, they argued that Islamic stocks did not provide significant protection to investors during the financial crisis. Saleem et al. (2023) investigated the hedging risk characteristics of gold and Sharia-compliant stocks during the pandemic and found evidence that both could effectively hedge risk during market recession. Hasan et al. (2023) examined the different asset classes during crisis periods and found that gold and Islamic stock can better hedge various uncertainty factors than Bitcoin and crude oil, depending on the market conditions.

References

1. Derigs, Ulrich, and Shehab Marzban. 2008. Review and analysis of current Shariah-compliant equity screening practices. International Journal of Islamic and Middle Eastern Finance and Management 1: 285–303.
2. Hussein, Khaled, and Mohammed Omran. 2005. Ethical investment revisited: Evidence from Dow Jones Islamic Indexes. Journal of Investment 14: 105–26.
3. Dharani, Munusamy, M. Kabir Hassan, and Andrea Paltrinieri. 2019. Faith-based norms and portfolio performance: Evidence from India. Global Finance Journal 41: 79–89.
4. Jawadi, Fredj, Nabila Jawadi, and Abdoulkarim Idi Cheffou. 2020. Wavelet analysis of the conventional and Islamic stock market relationship ten years after the global financial crisis. Applied Economics Letters 27: 466–72.
5. Umar, Zaghum. 2017. Islamic vs. conventional equities in a strategic asset allocation framework. Pacific Basin Finance Journal 42: 1–10.
6. Umar, Zaghum, and Mariya Gubareva. 2020. A time-frequency analysis of the impact of the COVID-19 induced panic on the volatility of currency and Cryptocurrency markets. Journal of Behavioral and Experimental Finance 28: 100404.
7. Kayed, Rasem N., and M. Kabir Hassan. 2011. The global financial crisis and Islamic finance. Thunderbird International Business Review 53: 551–64.
8. Ho, Catherine Soke Fun, Nurul Afiqah Abd Rahman, Noor Hafizha Muhamad Yusuf, and Zaminor Zamzamin. 2014. Performance of global Islamic versus conventional share indices: International evidence. Pacific Basin Finance Journal 28: 110–21.
9. Shahzad, Syed Jawad Hussain, Román Ferrer, Laura Ballester, and Zaghum Umar. 2017. Risk transmission between Islamic and conventional stock markets: A return and volatility spillover analysis. International Review of Financial Analysis 52: 9–26.
10. Rahman, Md Lutfur, Amin Abu, and Mamun Mohammed. 2020. The COVID-19 outbreak and stock market reactions: Evidence from Australia. Finance Research Letters 38: 101832.
11. Baur, Dirk G., and Thomas K. McDermott. 2010. Is gold a safe haven? International evidence. Journal of Banking & Finance 34: 1886–98.
12. Baur, Dirk G., and Brian M. Lucey. 2010. Is gold a hedge or a safe haven? An analysis of stocks, bonds, and gold. Financial Review 45: 217–29.
13. Feng, Wenjun, Yiming Wang, and Zhengjun Zhang. 2018. Can cryptocurrencies be a safe haven: A tail risk perspective analysis. Applied Economics 50: 4745–62.
14. Conlon, Thomas, and Richard McGee. 2020. Safe haven or risky hazard? Bitcoin during the COVID-19 bear market. Finance Research Letters 35: 101607.
15. Conlon, Thomas, Shaen Corbet, and Richard J. McGee. 2020. Are Cryptocurrencies a Safe Haven for Equity Markets? An International Perspective from the COVID-19 Pandemic. Research in International Business and Finance 54: 101248.
16. Hkiri, Besma, Shawkat Hammoudeh, Chaker Aloui, and Larisa Yarovaya. 2017. Are Islamic indexes a safe haven for investors? An analysis of total, directional and net volatility spillovers between conventional and Islamic indexes and importance of crisis periods. Pacific-Basin Finance Journal 43: 124–50.
17. Aloui, Chaker, Rania Jammazi, and Hela Ben Hamida. 2018. Multivariate co-movement between Islamic stock and bond markets among the GCC: A wavelet-based view. Computational Economics 52: 603–26.
18. Narayan, Paresh Kumar, and Deepa Bannigidadmath. 2015. Are Indian stock returns predictable? Journal of Banking & Finance 58: 506–31.
19. Milly, Maher, and Jahangir Sultan. 2012. Portfolio diversification during the financial crisis: Analysis of faith-based investment strategies. In Building Bridges across the Financial Communities: The Global Financial Crisis, Social Responsibility, and Faith-based Finance. Cambridge, MA: Harvard Law School, Islamic Finance Project, pp. 334–52.
20. Abdullah, Fikriyah, Taufiq Hassan, and Shamsher Mohamad. 2007. Investigation of the performance of Malaysian Islamic unit fund trusts: Comparison with conventional unit fund trusts. Management Finance 33: 142–53.
21. Azad, A. S. M. Sohel, Saad Azmat, Abdelaziz Chazi, and Amirul Ahsan. 2018. Sailing with the non-conventional stocks when there is no place to hide. Journal of International Financial Markets, Institutions, and Money 57: 1–16.
22. Ebrahim, M. Shahid, Aziz Jaafar, Fatma A. Omar, and Murizah Osman Salleh. 2016. Can Islamic injunctions indemnify the structural flaws of securitized debt? Journal of Corporate Finance 37: 271–86.

23. Kraeussl, Roman, and Raphie Hayat. 2011. Risk and Return Characteristics of Islamic Equity Funds. Emerging Markets Review 12. Available online: https://ssrn.com/abstract=1320712 (accessed on 30 April 2023).

24. Albaity, Mohamed, and Rubi Ahmad. 2008. Performance of Syariah and Composite Indices: Evidence from Bursa Malaysia. Asian Academy of Management Journal of Accounting and Finance 4: 23–43.

25. Majdoub, Jihed, Walid Mansour, and Jamel Jouini. 2016. Market integration between conventional and Islamic stock prices. The North American Journal of Economics and Finance 37: 436–57.

26. Cevik, Emrah Ismail, and Mehmet Fatih Bugan. 2018. Regime-dependent relation between Islamic and conventional financial markets. Borsa Istanbul Review 18: 114–21.

27. Jebran, Khalil, Shihua Chen, and Muhammad Zubair Tauni. 2017. Islamic and conventional equity index co-movement and volatility transmission: Evidence from Pakistan. Future Business Journal 3: 98–106.

28. Abu-Alkheil, Ahmad, Walayet A. Khan, Bhavik Parikh, and Sunil K. Mohanty. 2017. Dynamic co-integration and portfolio diversification of Islamic and conventional indices: Global evidence. Quarterly Review of Economics and Finance 66: 212–24.

29. Saadaoui, Foued, Nader Naifar, and Mohamed S. Aldohaiman. 2017. Predictability and co-movement relationships between conventional and Islamic stock market indexes: A multiscale exploration using wavelets. Physica A: Statistical Mechanics and Its Applications 482: 552–68.

30. Hoque, Hafiz, Sarkar Humayun Kabir, El Khamlichi Abdelbari, and Viktor Manahov. 2016. Islamic and Conventional Equity Market Movements During and After the Financial Crisis: Evidence from the Newly Launched MSCI Indices. Financial Markets, Institutions, and Instruments 25: 217–52.

31. Dewandaru, Ginanjar, Syed Aun R. Rizvi, Rumi Masih, Mansur Masih, and Syed Othman Alhabshi. 2014. Stock market co-movements: Islamic versus conventional equity indices with multi-timescales analysis. Economic Systems 38: 553–71.

32. Rivzi, Syed Aun R., Shaista Arshad, and Nafis Alam. 2015. Crises and contagion in Asia Pacific—Islamic v/s conventional markets. Pacific-Basin Finance Journal 34: 315–26.

33. Baker, Scott R., Nicholas Bloom, Steven J. Davis, Kyle J. Kost, Marco C. Sammon, and Tasaneeya Viratyosin. 2020. The Unprecedented Stock Market Impact of COVID-19. Cambridge, MA: National Bureau of Economic Research, pp. 1–19.

34. Sharif, Arshian, Chaker Aloui, and Larisa Yarovaya. 2020. COVID-19 pandemic, oil prices, stock market and policy uncertainty nexus in the US economy: Fresh evidence from the wavelet-based approach. SSRN Electronic Journal 70: 1–20.

35. Yan, Binxin, Logan Stuart, Andy Tu, and Tony Zhang. 2020. Analysis of the Effect of COVID-19 on the Stock Market and Investing Strategies. SSRN Electronic Journal.

36. Liu, Haiyue, Aqsa Manzoor, Cangyu Wang, Lei Zhang, and Zaira Manzoor. 2020. The COVID-19 outbreak and affected countries stock markets response. International Journal of Environmental Research and Public Health 17: 2800.

37. Sansa, N. A. 2020. The Impact of COVID-19 on the Financial Markets: Evidence from China and USA. Electronic Research Journal of Social Sciences and Humanities 2.

38. Ngwakwe, Collins C. 2020. Effect of COVID-19 Pandemic on Global Stock Market Values: A Differential Analysis. Acta Universitatis Danubius Oeconomica 16: 255–69.

39. Yarovaya, Larisa, Ahmed H. Elsayed, and Shawkat Hammoudeh. 2021. Determinants of Spillovers between Islamic and Conventional Financial Markets: Exploring the Safe Haven Assets during the COVID-19 Pandemic. Finance Research Letters 43: 101979.

40. Ramelli, Stefano, and Alexander F. Wagner. 2020. Feverish Stock Price Reactions to COVID-19. The Review of Corporate Finance Studies 9: 622–655.

41. Pagano, Marco, Christian Wagner, and Josef Zechner. 2020. Disaster Resilience and Asset Prices. SSRN. Available online: https://ssrn.com/abstract=3603666 (accessed on 30 April 2023).

42. Hasan, Md Bokhtiar, Masnun Mahi, M. Kabir Hassan, and Abul Bashar Bhuiyan. 2021. Impact of COVID-19 pandemic on stock markets: Conventional vs. Islamic indices using wavelet-based multi-timescales analysis. The North American Journal of Economics and Finance 58: 101504.

43. Saleem, Kashif, Osama AlHares, Haroon Khan, and Omar Farooq. 2023. FAANG Stocks, Gold, and Islamic Equity: Implications for Portfolio Management during COVID-19. Risks 11: 19.

44. Hasan, Md Bokhtiar, M. Kabir Hassan, Zeynullah Gider, Humaira Tahsin Rafia, and Mamunur Rashid. 2023. Searching hedging instruments against diverse global risks and uncertainties. The North American Journal of Economics and

Finance 66: 101893.