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Evaluation between Islamic and Conventional Mutual Fund

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Abstract:

This paper has empirically investigated evaluation between Islamic and conventional mutual funds. The data for empirical results are considered from 2013-17. Simple Independent T-test and ratios i-e profit margin ratio, return on investment and expenses ratio have been applied in this study. The finding depicts that investment returns of Islamic fund is higher than conventional funds, while the expenses of conventional fund is greater than the Islamic funds. Conventional fund is superior in net profit in comparison with Islamic fund, but high risk is associated with conventional funds.

Keywords: Islamic mutual funds, conventional mutual funds

1. INTRODUCTION

Conventional Mutual fund is managing company that collects fund from numerous investors for the purpose of investment in security such as stock bond money market instrument etc while Islamic mutual fund is a joint investment pool from numerous investors for the purpose of investment in security such as stock bond money market instrument within the boundaries of Islamic sharia. Mutual fund is a form of investment in which numerous individuals bring their surplus money for the purpose of investment collectively, it gives advantage to investor because Mutual fund Management having expertise and other resource including huge capital through which they can take advantage of diversification, getting less risk and minimum return as compare to individual. Mutual funds was introduced for the first time by a Dutch Merchant in 1774 and established in Europe with passage of time, Other countries were also adopted the concept of mutual fund. In London the mutual funds introduced in 1868 and US adapted mutual funds in 1920 (Fink,2008). All mutual funds were closed end at start closed end funds having limited share traded on stock exchange with specific duration. In 1924 open ended mutual were introduced with some differences like having no limitation in number of share, number of investor and other restriction. The modern mutual fund industry was started from 1940 and the total assets were more than $26billin in 1973 it grown up to $47million in 1977 $50 Million in 1987s 4$ trillion in year 2000s $6 trillion and it the assets grown up to $ 11 trillion (Fink,2008). In 1962 mutual fund were introduced in Pakistan but in Islamic countries as well as in Pakistan the mutual market is immature because of awareness and other reason. In Pakistan the saving ratio is just 13.8 percent and 25 percent in developing countries. The mutual fund saving ratio is very low13.8 because mutual fund deal in prohibited items, such as interest, Bank share and other product which are prohibited in sharia compliant, consequently Meezan Investment company introduced first Islamic mutual fund in 1995 which is not only the alternative of conventional mutual fund it is one part of Islamic financial system which based on sharia Laws and governed by sharia board.

The basic purpose of this comparison is to review previous research on sharia compliant funds' performance and to evaluate it to determine whether they outperform or underperform conventional funds in term of profit and volatility in the market. The research objectives are to evaluate the performance of Islamic mutual funds in terms of efficiency in Pakistan, expenses incurred for business operations and generated Revenue. To comparison between Islamic mutual funds and conventional mutual funds to find out which fund performed better in the market.

The rest of this research paper is structured as follows. Section 2 provides brief literature of previous studies. Section 3 provides data and methodology. Section 4 provides results and discussion, and conclusion in section 5.

2. LITERATURE REVIEW

Earlier many researchers of the world have worked on this topic however their topic are different from this topic in term of selection of data, methodology, sample and geographical location. Some earlier studies have discussed as follows.

Mason & Bhatti (2011) concluded that Islamic mutual funds have better performance than conventional funds specific during the financial crisis, Islamic mutual fund have systematic risk due to which those investor face shorter loss than conventional by using aggregate return of 360 conventional and 128 of Islamic mutual funds. Further suggested that an Islamic mutual fund meets the desire level of that investor who wishes to invest in highly volatile investment because conventional mutual funds are less volatile then Islamic. Elfakhani et al. (2005) studied the performance of both mutual funds by using sample of 46% funds on basis sample data suggested that 63 of sample outperform and 24 were underperform. Moreover there is no statistical difference between conventional and further suggested the performance of Islamic mutual funds is improving with passage of time because of public awareness and management expertise. The Islamic mutual funds industry is early stage it well take time to develop. Razzaq, et al.(2012) taken 9 different Islamic mutual funds which were managed by different manager, evaluated two different aspect of Islamic mutual fund firstly evaluate the returns with respect to their risk and examined the performance and expertise of fund manager by using different tools Jensen's Alpha , information ratio and Treynor ratio, the main focus of the paper were: Sharpe Ratio suggested that the overall performance of I.M.F is satisfactory but Alpha given 3.11822 value which is negative which suggested that Islamic mutual funds' performance is negative but in meanwhile some of fund like NAFA Islamic fund, Meezan Islamic Income, Atlas Islamic and JS Islamic fund etc. information ration measure two things first ability of manager that he generate excess return then it is benchmark secondly identify the investor consistency, for which they calculated excess return for every unit of risk and the per unit excess return is 0.2746 for overall . NAFA has 1.3145 values which is highest. Information ration suggested that Islamic mutual have better performance and manager achieved extra return from its benchmark. Mahmud & Mirza, (2011) evaluated the performance of mutual fund industry in Pakistan during the period of 2006 to 2010 by bearish and bullish market, the study suggested that Islamic mutual funds have strong growth and better performance as compared to the conventional mutual funds, as a consequence income funds were suffered in the immature bond market. Ali, (2012)examined the performance of mutual fund in Pakistan, for evaluation they used rates of return with respect mutual fund and expertise of the mutual funds manager in reducing risk associated with mutual funds.by using 15 mutual funds for the period of 2005 to 2009 have been taken. Sharpe and Treynor used as tool for evaluation, the study suggested that the performance connected with mutual funds is just not up for the mark within Pakistan. Magnus, Stefan &Paul Soderlind (2000) examined the relationship between Funds attributes and fund performance in the Swedish market for measuring the performance they used Alpha in a linear regression of on several benchmark assets. After estimated the performance used in a cross-sectional analysis to find out the relationship between performance and attributes like historical performance, Size flow, turnover and proxies for expense. The results suggested that better performance occurs between small equity funds and low fee funds. Mehbub Keshwani (2008)studied the performance of open-ended fund which newly introduced and fast growing fund in Pakistan and some mutual fund which existence for long time, for evaluation of performance they used Sharpe Ratio, Treynor and Jensen Models. The study suggested that the performance of fund at start was quite negative but they further observed that mutual funds have some positive features at that the time the most the funds operation have hardly completed three and four years, on the basis of this short period time it is very difficult to concluded the overall performance is good or bad it's too early. Dars (2013) Evaluated and compared Islamic mutual fund with conventional mutual fund performance during the period of 2007 to 2012, and used Trenynor ratio, Sharpe ratio and Jensen Alpha. The paper suggested that that during the period of 2007 to 2012 conventional funds shown better performance than Islamic, because Islamic mutual fund is less in number than conventional fund but Islamic mutual fund returns were stable than conventional the main reason Islamic mutual funds did not invested in many business the returns of Islamic mutual fund were more stable because less diversification. The studied predicted that Islamic mutual show more growth in future as compare conventional funds.(Kirsch,2011)et al. evaluated sample of 478 Conventional and Islamic Funds the examined the performance of both funds throughout the Bullish and Bearish Market for two different period January to 1995 to December 1998 and 2005 to 2008. They concluded that both Islamic and conventional funds have greater performed as compared Market portfolio, according to the result both funds have positive return in the period of 1995-8 in bullish market and 2005-8 Islamic mutual fund have higher return as compare to conventional fund in 1995-8 but during the period of 2005-8 Islamic mutual fund have lower return than conventional. The both fund have negative return during Bearish market which indicated that both funds comply with respect to market movement. Result from Adjusted Sharpe ratio, Treynor Index, Jensen's Alpha, Sharpe ratio, and information ratio shows that the Islamic mutual funds have better performance than conventional except 2005-8 period and Islamic mutual funds have less effect than conventional with financial downturns. Rubio et al., (2012) evaluated to find out the impact of limited assets universe, whether investor lose portfolio efficiency or not. In most of the researcher used parametric tools for measurement but they used non parametric measurement efficiency for the better result. To find out risk and return relationship they used Data envelopment analysis and Estimating single performance index to classify and compare funds with each other. The result suggested that financial crisis reason is investment in toxic assets and during the crisis all conventional funds lost efficiency but Islamic mutual funds have better performance during crisis. Irfan,& ,Junaid, Muhammad (2012)examined the performance of Islamic and conventional mutual funds on bases of risk and return, Risk Adjustment performance and diversification. For evaluation they used 125 funds data in which 31 were Islamic and while 94 were conventional funds. Shamsher 2000)et al. evaluated the performance of 41 actively and passively –managed mutual funds during the period of 1995 to 1999 in Malaysia. By used of Sharpe ratio and Jensen's Alpha. The study suggested that both funds underperformed as compared to market portfolio. There is no significant difference among the funds in performance and the diversification levels less 50 percent from the level of market index diversification (Kuala Lumpur composite index-KLCL). The passive fund manager's selection expertise is better than the passive fund managers. Khalichi, (2014) et al. Examined the sample of 111 Islamic mutual funds during 2005 to 2011 to evaluate the performance, persistence in performance and risk adjusted return. The sample period is distributed in to three different situations before crisis, after crisis and during crisis for evaluation they used Sharpe ratio, Sortino ratio, Traynor and information ratio. The result shown that Middle East and Kuwait funds have lowest returns and SD suggested that Islamic funds in Pakistan were the most risky. Malaysian Funds have higher return and less risky than other countries funds. Only two country Saudi Arabia and Malaysia funds given abnormal returns in the period 2005-2011 and other country funds fail to achieve their benchmark. The further studied persistence of Islamic mutual funds through Chi-square result shows that Islamic mutual funds trend toward performance persistence during and after crisis but not later the crisis. Haroon, &Abdul (2012) the studied the performance of mutual funds, Managers ability of stock selection and diversification, for measurement they used 25 open ended mutual funds. For data analysis they collected monthly net assets values KSE 100 index is taken as benchmark Treasury Bills rate were used as a risk free rate (RFR). Treynor, Sharpe and Sartino were used for evaluating the performance. They concluded that the overall performance is better than market but throughout the study period mismanagement observed in Pakistan mutual fund industry. Mover over Selection ability of fund managers have negative value and low performance, all the funds were positively diversified but not completely due to which funds contained unsystematic risk.

3. METHODOLOGY

The sample data of 10 mutual funds were collected from two different group, Islamic mutual funds and conventional funds. For the period of FY 2013 to FY 2017. In which 6 samples is taken form Islamic mutual funds and the remaining 6 from conventional funds. The sample size is short for evaluating the performance but it's due to lack Islamic mutual funds data available in Pakistan, the Islamic mutual fund industry is in early stage it takes time to develop. From 1995s and till 2005s few Islamic mutual funds exist with Sharia complaint. Other mutual funds also started sharia complaint service and now in Pakistan 12 companies offer Islamic financial services but at the earlier stage as compared to conventional mutual funds. This paper evaluated the performance on the basis of net income, net assets and total expense, mutual funds in Pakistan; the data is collected from total 62 annual reports which is available on annual basis on official web sites of the Islamic and conventional mutual funds companies. The data was analyzed by Assets turnover ratio, shows the efficiency of organization that how they utilized their assets and generate Revenue. Expenses Ratio shows that how much expenses incurred during operation for specific period on basis of those expenses how much Revenue generated. Profit margin ratio is used to measure the profitability level and t-test is used to evaluate the performance of two groups (Islamic mutual funds and conventional mutual funds.)

4. RESULTS AND DISCUSSION

For the purpose of analysis data was collected from secondary sources, of 12 mutual funds from their Annual Financial Report. The total data is collected from 62 annual reports of the mutual funds from their official web site. Data analysis includes inferential test and ratio. Assets turnover ratio is financial ratio which shows efficiency of the organization in terms how much income or revenue generated by the organization by using their assets. If the organization have Higher ratio it suggest that organization is utilizing their capital recourse efficiently for generating revenue but if the organization have lower ratio it suggest that the organization is not utilizing their assets efficiently for the purpose of generating revenue (Asset Turnover Ratio)Assets turnover ratio formula is net sale divided by total assets. Islamic = 0.11013518, Conventional= 0.074435398. In this analysis Assets turnover ratio studied that Islamic mutual funds having higher ratio as compare to conventional which suggested that Islamic mutual funds utilize their assets more efficiently for generating revenue than conventional fund. Reason behind the higher ratio is investing in less risky instrument and obeying the Islamic rules and regulation of Islamic during investing their funds in market. The assets of both funds during the year 2013 to 2017. Expenses ratio is equal to Total expenses / revenue. Expenses ration is also called Management expense ratio (MER) it is used to calculate cost of an operation which mutual funds investor paid to Investment Company for generating revenue. In expenses ratio includes accounting and auditing fee, legal expenses, service charges and taxes, it is contrary on basis of pervious research some of them suggested that there is positive relationship of return and expenses ration. The higher ratio suggests superior performance while lower ratio suggests worst performance of the mutual funds. Some of the previous researchers suggest there is inversely relationship between expenses ratio and return lower ratio suggest superior performance and higher ration suggest worst performance (Goel et al., 2012). The Islamic mutual funds ratio is 24.64 which demonstrate total percent of fund used in business operation which is low as compare to conventional funds. The ratio suggested that less amount of expense were used to generate revenue by Islamic mutual funds as compared with conventional funds ratio were 25.67 which suggested that thy expense amount were more used to generated revenue as compare Islamic mutual funds. Profit Margin ratio is used to calculate the profitability level of a firm or organization, it evaluate the out of every dollar sale how much that company really retains in the shape of earnings. The profit margin ratio is also used to compare within the different industry and as well as in the same industry to determine the probability. If the higher ratios indicate that the organization has better performance and lower ratio indicate poor performance (Profit Margin Ratio, 2014). Conventional = 0.74322932. The conventional funds profit margin ratio is higher than Islamic funds. Which shows conventional funds was more efficiently to convert their sales in to net income.

Islamic = 0.7221138. The profit margin ratio of Islamic mutual funds is lower than conventional funds, it indicate that Islamic funds converted their sales into income less efficiently. Reason is during 2008 many people invested in Islamic mutual it is considering boom of Islamic mutual funds after with passage of time investor withdraw their investment which affects the revenue.

4.2 t-test

A test is statistical tool which used for the examination of two different pollution whether the pollution have dissimilar average value or similar. The result of t-test depended upon the size of the data and if data is large in size the t test gives more realistic result (t-test,15) for t-test the sample size of 12 mutual funds company in which 06 is Islamic mutual funds and 06 conventional funds and 05 year data is collected.

Table 4.1: T-Test Result

	Groups	Means	Std. Deviation	Std. Error Mean
Net Assets	Islamic	5.27E+08	5.14E+07	2.14E+08
	Conventional	3.12E+09	2.62E+08	2.00E+08
Total Exp	Islamic	3.48E+07	3.82E+07	4163971
	Conventional	5.61E+07	5.97E+07	2.30E+07
Net Income	Islamic	8.19E+07	5.68E+07	2.24E+07
	Conventional	2.82E+08	2.26E+08	1.53E+07

Table 4.1 demonstrates that Std. deviation and Mean of fund conventional and Islamic mutual funds. The conventional mutual have higher mean than Islamic funds. Which suggest that the performance of conventional is better than Islamic but Islamic funds have lower std. deviation that shows consistency in the performance of Islamic mutual funds due to which the investor have trust and they investing their funds in Islamic funds rather investing in conventional.

5. CONCLUSIONS AND RECOMMENDATIONS

This study investigated the performance of Islamic mutual with conventional mutual funds that which one performed better during the specific period 2013 to 2017. To the answer the question the data of 10 mutual funds were collected from Annual report which available on their official website. For evaluating different analytical tools and technics were applied, such as Assets turnover ratio suggested that the Islamic mutual funds utilized their assets more efficiently for generating revenue than conventional funds. The studied recommended that Islamic mutual funds' performance better in utilization of assets by investing in less risky places and gain high return. Islamic mutual funds Expenses ration is low as compare to conventional funds. The ratio suggested that less amount of expense were used to generate revenue by Islamic mutual funds as compared with conventional funds ratio. The conventional funds profit margin ratio is higher than Islamic funds. Which shows conventional funds was more efficiently to convert their sales in to net income. While t-test demonstrates that Std. deviation and Mean of fund conventional and Islamic mutual funds. The conventional mutual have higher mean than Islamic funds which suggest that the performance of conventional is better than Islamic but Islamic funds have lower std. deviation that shows consistency in the performance of Islamic mutual funds due to which the investor have trust and they investing their funds in Islamic funds rather investing in conventional funds.

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