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Is there a diversification “cost” of Shari'ah compliance? Empirical evidence from Malaysian equities

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Abstract

Islamic equity portfolios work with a smaller investment universe given the filtering of non-Shari'ah compliant stocks. It has been theoretically argued that this culminates in suboptimal portfolio diversification, which in turn adversely affects risk-adjusted returns. We offer empirical evidence that such a conceived portfolio diversification “penalty” is far from a foregone conclusion, at least empirically. Our results tend to indicate that Islamic portfolios are not invariably handicapped in terms of portfolio diversification. We also explored dimensions that may account for differences in the relative investment performance between Islamic and conventional portfolios, such as portfolio constraints, short selling and market conditions. We believe this paper is among the first to apply substantial empirical analysis specifically with respect to the portfolio diversification perspective on Islamic equity investments.