Halal investing versus ethical investing

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Halal investing is a process that aligns with Islamic principles and is sometimes called Shariah investing or Shariah-compliant investing. Ethical investing, also referred to as socially responsible investing, involves selecting and managing investments based on ethical or social criteria. The growth of both halal and ethical investing has been driven by the fact that the corporate world is becoming more sensitive to the growing social awareness of shareholders and concern about how corporations contribute to real economic activities.

Halal investing

Halal investing is based on religious belief, which means that all investments must adhere to Shariah principles. Halal investment must therefore follow the principles of Shariah, which means it must be free from prohibited elements, including riba (interest), maysir (gaming) and gharar (uncertainty).

Riba or interest is expressly forbidden in the Quran. Riba is the excess money paid by the borrower to the lender in addition to the principal for the use of the lender's money over a certain period of time. Therefore, financial products bearing the riba element, such as interest-bearing deposits, bonds, private debt securities and money market instruments are considered prohibited, or 'haram'.

Maysir means a way to get something easily and gain an undeserved profit from it, driven by pure chance. For instance, as a game of chance, gambling often leads people to take high risks and behave irrationally in order to 'win big'. In Islam, it is forbidden to take extreme risks and to invest money with a view to achieving a particular outcome but with the possibility of losing money.

Gharar essentially refers to the uncertainty of contractual terms that could lead to the exploitation and deception of people—which in turn could result in litigation and contract manipulation. In addition to the three prohibited elements, halal investment is also based on the principle that Islam prohibits any involvement with illegal activities (haram), this includes actions such as consumption of alcohol, adultery, gambling, tobacco, banks and conventional insurance, and meat—pig. Therefore, the actions of companies contaminated by one of these prohibited elements are considered non-compliant with Shariah.

Ethical investing

On the other hand, ethical investing means incorporating corporate values and personal concerns into investment decisions. Ethical investing considers both the financial needs of investors and the impact of the investment on society. Ethical investing applies ethical and social criteria to the selection and management of investment portfolios. Investors are concerned not only with the financial returns of their portfolios and the associated risks, but also with the characteristics of the companies in which their funds are invested. This includes the nature of the company's goods or services, the location of the company and the ways in which it conducts its business operations.

The ethical investment strategy can employ a 'positive screening' or 'negative screening' approach. The positive approach is favourable to companies that enjoy a high reputation in terms of investing in products, activities or business methods that are viewed as ethical, while the negative approach aims to avoid investing in companies involved in products or countries that are considered unacceptable or whose business methods are considered unethical.

The ethical investment decision is mainly influenced by issues such as environmental protection, climate change, genetically modified foods, gambling, human rights violations, nuclear energy and military, animal testing, and health and safety violations among others.

The concept of ethical investing has evolved to provide appropriate policies according to the changing environment. In its most recent adaptation, ethical investing is moving away from negative selection and towards positive selection to promote innovation and positive contributions to society—rather than simply to reduce the negative impact of business and industry practices.

Common values

Despite the differences, both halal and ethical investing generally share an investment philosophy which is a values-based approach aligning an investor's portfolio with religious or ethical beliefs. Both focus on real economic activities such as improving people's living conditions and well-being, creating social equity, and preventing injustice in trade and commerce.

Halal and ethical investment also focus on the protection of natural and environmental resources, and invest in the same economic sectors—namely industry, health, consumer goods, services utilities, consumer services and basic materials such as technology. In addition, both investment approaches apply measures that eliminate a group of companies or entire sectors based on social or religious beliefs. For example, industries such as tobacco, alcohol, and pornography are excluded due to the nature of the products and services they produce that are harmful to society.

Screening process

Both halal and ethical investment use a screening process in managing their portfolios. The application of the screening process should identify distinct companies from which the portfolio manager can select investments.

Ethical screening

Ethical investing applies the screening process to ensure that the companies invested in adhere to their ethical principles. The screening process weeds out companies deemed to be negative and will encourage investment in companies viewed as positive. In ethical investment, negative screening avoids certain types of investments including, for example, gaming companies or arms manufacturers. Positive filtering, on the other hand, favours activities or characteristics deemed desirable such as those associated with the renewable energy or healthcare industries. Some managers also use the 'best-in-the-industry' rule, which selects leading companies in each business sector based on their social and environmental credentials, and the 'overlapping social responsibility' rule, whereby the characteristics of a portfolio are evaluated and selected according to the usual procedure, but an additional process is added to address social responsibility issues.

Halal screening

While the ethical investment screening process limits the inclusion of companies that lack awareness or consideration of human rights and environmental concerns, halal investing applies a different approach based on a business' compatibility with human rights according to Shariah principles. Halal investment is subject to the Shariah screening methodology determined by the Shariah Supervisory Board or the Shariah advisors of fund management companies. In some jurisdictions, for instance, Malaysia, the Shariah screening methodology is determined by a centralised Shariah advisory body established by the regulator, the Malaysian Securities Commission, as a higher authority in assessing Shariah issues concerning Islamic capital market activities which include Shariah-compliant investments.

The Shariah screening process generally includes two categories of screening, namely qualitative screening and financial screening.

Quality screening excludes companies involved in prohibited activities such as alcohol, tobacco, gambling, pork products, and conventional banking and insurance. Shariah screening is usually made available by index companies such as FTSE, S&P Dow Jones and MSCI, which offer a wider range of Islamic indices for fund managers to compare against.

Financial screening is applied using financial ratios to ensure securities are Shariah compliant. This involves calculating ratios, such as the ratio of interest-bearing debt to assets or the ratio of the total debt to the average market capitalization of a company. The wisdom behind financial screening is to avoid investing in debt-embedded securities.

The quote

Both focus on real economic activities such as improving people's living conditions and well-being, creating social equity, and preventing injustice in trade and commerce

Shariah screening is an absolute screening which means that it is set against fixed principles dictated by a global peak body, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) on the basis of traditional Islamic texts, for instance, the Quran. Ethical investment screening requirements are not as consistent and are often subjective, as everyone's definition of ethical is different.

This makes it very difficult for an investor seeking an ethical investment to be clear as to exactly what it is that their investment is screening out and investing in, which is not the case with halal investments as the principles are absolute and clearly defined.

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Halal investment is also based on the principle that Islam prohibits any involvement with illegal activities

Other considerations

Halal investing is further characterised by strict requirements such as the purification process and exclusion of investments in interest-bearing securities, to which ethical investing is not subject.

Halal investment includes a process designed to purify any investment income that is considered tainted according to Islamic financial principles. Impure income could result from investments in companies or ventures that do not meet the requirements of Shariah law. For example, this may be required for companies that are joint ventures that have passed the tolerance test of the Shariah screening process but still result in some tainted income generated from the investment. Purification may involve donating a certain percentage of that income to charity as a form of repentance for being connected with a certain level of non-Shariah-compliant investments.

Conclusion

In a nutshell, halal and ethical investments share similarities, but they are not the same. It can be argued that Shariah principles often go beyond the requirements of ethical investing and have the additional benefit of providing clearer ethical coding and standards as well as an enforcement mechanism overseen by a supervisory board of Shariah advisors.

The convergence of values between halal and ethical investment highlights the importance of their shared commitment to ethical and social protection agreements. The halal investment screening criteria applies a more standardised negative screening approach for industries and companies that do not meet the basic halal investment criteria.

Although there are differences in the interpretation of the appropriate filters in the Islamic investment screening process, the differences tend to be minor and have in fact harmonised as the market develops and progresses.

Above all, the decision to invest in halal or ethical investments will hinge on the investor's values as well as their broader portfolio and financial planning objectives. Investors interested in halal and ethical investing often seek out fund managers who offer a high level of disclosure and transparency in terms of investment process, portfolio listings and detailed reports, all of which factor into their investment decisions. **FS**