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Analysis of Financial Performance of Islamic Mutual Funds & Islamic Pension Funds in Pakistan

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ABSTRACT

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The Islamic finance industry is growing exponentially at global level catering to the demands of Muslim consumers. The same trend is being observed in Pakistan as many Islamic mutual funds and Islamic pension funds are working alongside traditional funds. This research seeks to explore the financial performance of various Islamic mutual funds and Islamic pension funds in Pakistan from 2015-2022. For this purpose, we selected 10 Islamic mutual funds and 5 Islamic pension funds on random basis and employed Sharpe Ratio, Treynor Ratio, and Jenson's Alpha techniques to analyze the financial performance of these funds in terms of returns generated and their comparison with the industry results. The study's findings showed that Islamic mutual and pension funds in Pakistan are still struggling to provide market-oriented returns to their investors. This gap in generating excess returns may be due to the nature of the Islamic funds that restricts their investment options for diversification due to the Shariah guidance. This study recommends that industry stakeholders including fund management companies, investors, regulatory bodies, Shariah scholars etc. all need to work closely to address the short-comings of the existing operational restrictions of the Islamic funds and ensure a level-playing field along with the traditional fund management companies for generating maximum returns for their investors.

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1.0 Introduction

In recent times, the Islamic finance industry has experienced significant expansion and evolution, with Pakistan assuming a pivotal role in this transformative journey. The Islamic finance industry within Pakistan has evolved into a dynamic and rapidly changing sector, owing to a robust regulatory framework and a sophisticated market for financial products aligned with Sharia law. Islamic funds hold significant promise within the broader landscape of Islamic finance, providing investors with options to expand their wealth while observing to Islamic principles that prohibit interest-based transactions and investments in entities involved in prohibited activities such as gambling, alcohol, and pork. Resultantly, individuals seeking investment avenues aligned with their religious beliefs often prefer for Islamic funds. The Islamic funds sector in Pakistan has experienced remarkable growth in recent years caused by factors including supportive government policies, a rising middle class, and increased public awareness of the fundamentals of Islamic finance. Along with this, tax benefits provided to Islamic funds further encourage both retail and institutional investors to invest in the Islamic financial sector.

As explored by Warde (2010), the Islamic finance industry has experienced remarkable development in recent years. This industry offers a distinctive and ethics-based approach to finance, appealing to millions of Muslims worldwide due to its compliance to Sharia principles. The Islamic funds comply with principles such as the prohibition of interest, avoidance of forbidden investments, and promotion of risk-sharing and asset-backed transactions, separating them from traditional financial instruments. Similarly, Sergie (2014) highlighted that the higher demand from Muslim investors for financial products aligned with their ethical and religious convictions has encouraged the rapid global growth of the Islamic funds industry in Pakistan. A study by Naveed, Khawaja & Maroof (2020) checked the Islamic mutual funds risk exposure as compared to the traditional mutual funds. A similar study in the Pakistani context by Arif & Majeed (2023) examined the financial performance of the conventional and Shariah compliant funds in Pakistan and stated that Islamic funds have more absolute risk exposure. Islamic funds offer distinct advantages in risk-sharing, ethical investment, and financial stability, transcending purely religious considerations. This research study explores into the contemporary expansion of Islamic fund examining their growth and financial performance as compared to the other market based mutual and pension funds.

2.0 Literature Review

Mutual funds play a significant role in shaping investment culture particularly in developing economies like Pakistan. Shah, Hijazi, and Hamdani (2005) conducted a detailed study on Pakistani mutual funds' performance and evaluated their returns and financial performance. Their findings showed the potential of mutual funds in Pakistan and their the importance in offering multiple funds of different types both in debt and equity form along with managing their associated market risks. Globally, the Islamic mutual funds have captured attention, with Hoepner, Rammal, and Rezec (2010) conducting a significant research study across 20 countries. Their study highlighted the growth of Islamic mutual funds and stressed the industry's potential in shaping investment and saving environment with suitable government support. In the same way, Nafees, Shah, and Khan (2011) examined both open-ended and closed-end mutual funds in Pakistan to evaluate their financial performance. The results showed that the mutual fund industry has experienced significant growth, negative risk-adjusted returns during the global financial crisis raised concerns, calling for regulatory actions and developing early warning systems.

A similar study by Gohar, Ahmed and Niazi (2011) evaluated into the financial performance of mutual funds in Pakistan reporting the higher acceptability of equity funds over income funds. Their study highlighted insights into market timing function, stating managers' superior decision-making skills over brokers. Alam et al. (2011) presented a detailed analysis of mutual funds in Pakistan focusing on growth dimensions and prospects. Although growth was consistent, external factors brought significant challenges requiring regulatory support to ensure stability and better financial performance. Islamic mutual funds, particularly in Indonesia and Malaysia, have attracted attention due to the growing interest in Islamic financial instruments. To examine these trends in detail, Dewi and Ferdian (2012) evaluated the performance of Islamic mutual funds in both countries during the global financial crisis and found that Indonesia's better performance in asset allocation and debt-based funds.

A useful study by Shah, Gull & Pervez (2017) examined the financial performance of Islamic and conventional mutual funds over a five-year period and found that Islamic funds showed lower diversification and performance levels. They suggested that regulatory bodies should create more market opportunities to enhance the financial performance of the Islamic mutual funds industry. Mughal, Mubeen & Hanif (2017) checked asset allocation patterns in mutual funds providing insights for both retail and institutional investors. Despite being a relatively smaller industry, mutual funds hold potential for growth and better financial performance.

In the same way, the Islamic pension funds remain a less-explored area in research despite their market significance. Icke and Akbaba (2015) conducted a study on Islamic pension funds in Turkey highlighting their underdevelopment despite increasing interest by general public. Government regulatory initiatives and the introduction of alternative Halal funds were identified as important pillars for growth. This phenomena was also explored by Kasri et al. (2017) which examined the demand for Islamic pension funds in Indonesia, presenting the significant impact of Islamic marketing and awareness programs on investors' purchase intentions. The study also emphasized the need for a variety of technical and operational initiatives to boost investments. Anwar, Gull & Parvez (2017) studied the comparative performance of Islamic and conventional mutual funds in Pakistan and found that performance of traditional mutual funds is better than Islamic funds in Pakistan. This gap in performance may be explained by several factors including limited investment market opportunities, Shariah investment restrictions, regulatory compliance cost etc. Asad and Siddiqui (2019) examined the determinants of mutual funds in Pakistan, reporting the negative association of fund size, age, and macroeconomic factors with returns. Islamic funds revealed less than expected financial performance due to higher expense ratios. Climent, Molla & Soriano (2020) studied the performance and risk sensitivity of Islamic mutual funds in the United States and reported their outperformance in managing systematic risk. The study highlighted the demand for Islamic funds among faith-based investors due to lower associated risks.

A similar study study by Kasri et al. (2020) focused on the opportunities and challenges facing Islamic pension funds in Indonesia. Internal and external challenges, including information efficiency and limited investment alternatives, were identified, with recommendations proposed for market development. Farid & Hidayat (2022) provided theoretical insights into Shariah-compliant pension funds, particularly in Indonesia. Their research emphasized the adherence to Shariah principles in investment strategies, foreseeing growth opportunities in response to increasing demand for diversified Islamic pension options.

With reference to Pakistan, a study by Naveed, Khawaja & Maroof (2020) examined the Islamic mutual funds risk exposure as compared to their conventional counterparts. Their results indicated that Islamic funds have lower risk exposure as compared to the traditional mutual funds working in Pakistan. This lower risk exposure may work as a positive factor for attracting more customers preferring low-risk Islamic investments in Shariah-based mutual funds. A similar study in the Pakistani context by Arif & Majeed (2023) evaluated the financial performance of the conventional and Shariah compliant funds in Pakistan and reported that Islamic funds have more absolute risk exposure. With respect to systematic risk exposure, both types of funds have mixed results. The findings also depicted that both kinds of funds have beta values of less than 1 showing less volatile market.

The literature review showed a mixture of views on both Islamic and Islamic pension funds. As the Islamic mutual funds and Islamic pension funds are growing in the financial markets, their financial performance may be measured across multiple fronts. Despite challenges, mutual funds exhibit growth potential, especially in emerging markets like Pakistan where majority of population belongs to Islam. Islamic funds, while facing performance challenges, hold promise with suitable regulatory support. Similarly, Islamic pension funds offer opportunities for growth, depending upon market dynamics and investor demand. This study seeks to compare the return generated by the Islamic mutual funds as compared to the market returns. Along with this, this study fills the research gap of measuring the financial performance of Islamic pension funds based on latest data from the Pakistani financial sector.

3.0 Methodology

This study measured the performance of Islamic mutual funds through three techniques; Sharpe Ratio, Treynor Ratio and Jenson's Alpha. Along with that, the performance of Islamic pension funds is measured through Net Asset Value (NAV) and Average Return (AR). The data has been collected from various sources including Fund's Asset Management Company, from the annual reports of funds as well as from website of MUFAP managing trading data for these Islamic funds. We selected a sample of 10 Islamic mutual funds and 5 Islamic pension funds on random basis. The sample of Islamic Mutual Funds is listed below:

Table 1: Sampled Islamic Mutual Funds

Mutual Funds	Asset Management Company	Inception Date	Category
ABL Islamic Stock Fund	ABL Asset Management Company Limited e	2013	Shariah Compliant Equity
ABL Islamic Income Fund	ABL Asset Management Company Limited	2010	Shariah Compliant Income
Alfalah GHP Islamic Stock Fund	Alfalah Asset Management Limited	2007	Shariah Compliant Equity
Al Meezan Mutual Fund	Al Meezan Investment Management Limited	1995	Shariah Compliant Equity
Meezan Islamic Fund	Al Meezan Investment Management Limited	2003	Shariah Compliant Equity
AWT Islamic Stock Fund	AWT Investments Limited	2014	Shariah Compliant Equity
AWT Islamic Income Fund	AWT Investments Limited	2014	Shariah Compliant Income
Alhamra Islamic Stock Fund	MCB Investment Management Limited	2004	Shariah Compliant Equity
Al Ameen Islamic Aggressive Income Fund	UBL Funds Managers Limited	2007	Shariah Compliant Aggressive Fixed Income
JS Islamic Fund	JS Investments Limited	2002	Shariah Compliant Equity

Table 2: Sampled Islamic Pension Funds:

Pension Funds	Asset Management Company	Inception Date	Category
ABL Islamic Pension Funds	ABL Asset Management Company Limited	2014	Shariah Compliant Money Market
Alfalah GHP Islamic Pension Fund	Alfalah Asset Management Limited	2016	Shariah Compliant Money Market
Alhamra Islamic Pension Fund	MCB Investment Management Limited	2007	Shariah Compliant Money Market
JS Islamic Pension Savings Fund	JS Investments Limited	2008	Shariah Compliant Money Market
Meezan Tahaffuz Pension Fund	Al Meezan Investment Management Limited	2007	Shariah Compliant Money Market

4.0 Results and Discussion

4.1 Islamic Mutual Funds

There are three techniques used in research for performance evaluation of mutual funds:

4.1.1 Sharpe Ratio:

William F. Sharpe started to work on portfolio theory has introduced Sharpe ratio in 1960 which is defined as "measure of risk-adjusted performance of an investment or portfolio". The measure has been largely used to evaluate the performance of a fund in terms of risk and return as used by Shah & Hijazi (2005; Nafees, Shah & Khan (2011); Gohar, Ahmed & Niazi (2011); Alam, Rafique, Farooq & Akram (2011); Dewi & Ferdian (2012); and Shah, Gull & Parvez (2017); and the ratio can be calculated as: ***Sharpe Ratio = $(R_p - R_f)/\delta_p$***

Whereas, R_p = observed average fund return; R_f = average risk-free return; and δ_p = standard deviation of funds returns. This ratio depicts the excessive returns could be made by taking an additional amount of risk as compared to the risk-free investment opportunities available. If the Sharpe ratio is higher, it will lead to better risk-adjusted performance of fund and vice versa indicating that for each unit of risk the fund is generating more returns.

Table 3: Results of Sharpe Ratio

Name of Fund	Average Return 2015-2022	Standard Deviation	Sharpe Ratio
Open-Ended Funds:			
ABL Islamic Stock Fund	7.95%	0.147	-4.50
ABL Islamic Income Fund	8.53%	0.55	-3.03
Alfalah GHP Islamic Stock Fund	1.69%	0.21	0.30
Al Meezan Mutual Fund	5.54%	0.25	0.32
Meezan Islamic Fund	5.94%	0.25	0.55
AWT Islamic Stock Fund	1.74%	0.17	-0.22
Alhamra Islamic Stock Fund	4.22%	1.07	0.01
Al Ameen Islamic Income Fund	6.51%	0.60	-2.84
JS Islamic Fund	5.04%	0.22	-0.05
Average of sampled fund	5.28%	0.3854	-1.05
Industry Average	6.65%	0.18	0.57

A Sharpe ratio of -1.05 suggests that the investment has generated -1.05 units of excess return over the risk-free rate for each unit of standard deviation of its returns. This implies that investors are not adequately compensated for the risk they are taking on by investing in this asset. The sampled fund's negative Sharpe ratio (-1.05) indicates that it has underperformed compared to the industry average (0.57) in terms of risk-adjusted returns. This comparison suggests that the sampled fund has not effectively utilized its risk exposure to generate returns relative to its peers within the industry.

4.1.2 Treynor Ratio:

Treynor ratio has been named after Jack L. Treynor which also a similar measure to Sharpe measure based on the performance evaluation (risk-adjusted) of an investment of portfolio as used by Shah & Hijazi (2005; Nafees, Shah & Khan (2011); Gohar, Ahmed & Niazi (2011); Alam, Rafique, Farooq & Akram (2011); Dewi & Ferdian (2012); and Shah, Gull & Parvez (2017). Like Sharpe measure, Treynor measure is also the judgment of return earned on extra unit of risk. Treynor Ratio = $(R_p - R_f)/\beta_p$

Whereas, R_p = observed average fund return; R_f = average risk-free return; and β_p = systematic (non-diversifiable) risk of fund. The results would be similar as Sharpe measure; higher Treynor ratio will show high risk-adjusted performance of investment and vice versa. Treynor has also introduced security market line which is the definition of relationship between investment returns and market rates of returns and the slope of line is the measure of investment, portfolio and market. The greater would be the line of slope, the greater will be the risk and return tradeoff.

The variables computation for risk premium among the average returns of funds and the market risk free rate has been the same for all funds over the period of 2015-2022 and the t-bills 6 months rate has been selected for the average risk-free rate for calculating the Treynor Ratio of all funds. The beta of all funds has been witnessed significantly below 1, which means all the Islamic Mutual Funds have been defensive in their returns movements as compared to market.

Table 4: Results of Treynor Ratio

Name of Fund	Average Return 2015-2022	Beta	Treynor Ratio
Open-Ended Funds:			
ABL Islamic Stock Fund	5.94%	0.81	-2.17
ABL Islamic Income Fund	8.53%	0.41	-1.60
Alfalah GHP Islamic Stock Fund	1.69%	0.57	0.17
Al Meezan Mutual Fund	5.54%	0.61	0.19
Meezan Islamic Fund	5.94%	0.64	0.25
AWT Islamic Stock Fund	1.74%	0.89	-0.13
Alhamra Islamic Stock Fund	4.22%	0.80	0.004
Al Ameen Islamic Income Fund	6.51%	0.60	-1.44
JS Islamic Fund	5.04%	0.85	- 0.02
Average of sampled funds	5.02%	0.68	-0.53
Overall Industry Average	6.65%	0.47	0.28

A Treynor ratio of -0.53 specifically implies that for each unit of systematic risk (measured by beta), the investment has generated a negative excess return over the risk-free rate. This suggests that the investment has underperformed relative to its level of risk compared to the overall market. The sampled fund's Treynor ratio being negative (-0.53) indicates that it has performed worse in terms of risk-adjusted returns compared to the industry average (0.28).

4.1.3 Jenson’s Alpha

Jenson’s alpha may also be called as Jenson’s measure or Jenson’s differential measure is the difference of investment return and the return prediction by CAPM. Jenson’s alpha is the measure of excessive investment return as compared to expected return calculated based on the systematic risk level and used by previous studies mentioned Shah & Hijazi (2005; Nafees, Shah & Khan (2011); Gohar, Ahmed & Niazi (2011); Alam, Rafique, Farooq & Akram (2011); Dewi & Ferdian (2012); and Shah, Gull & Parvez (2017).

$$\text{Jenson's Alpha} = R_p - [R_f + \beta_p \times (R_m - R_f)]$$

Where R_p = actual fund return; R_f = average risk-free rate of return; β_p = systematic (non-diversifiable) risk of fund; and R_m = return of market. It represents the portion of investment performance which is not explained by investment exposure to the systematic risk. A positive alpha suggested that investment has outperformed the expected and vice versa. Alpha is the degree which describes manager's abilities to earn significant returns after estimating for market risks which is beta (β). Jenson's alpha is valid if CAPM is valid.

Table 5: Results of Jensen's Alpha

Name of Fund	**Alpha**
Open-Ended Funds:	
ABL Islamic Stock Fund	-0.01
ABL Islamic Income Fund	0.03
Alfalah GHP Islamic Stock Fund	0.03
Al Meezan Mutual Fund	0.03
Meezan Islamic Fund	0.03
AWT Islamic Stock Fund	0.45
Alhamra Islamic Stock Fund	0.23
Al Ameen Islamic Aggressive Income Fund	0.01
JS Islamic Fund	0.02
Average of sampled funds	0.28
Industry Average	0.47

The sampled fund's alpha of 0.28 is lower than the industry average alpha of 0.47. This comparison indicates that while the sampled fund has generated positive excess returns beyond what would be expected given its risk level, it has not performed as strongly as the industry average in this regard.

4.2 Islamic Pension Funds:

Pension funds have been in the market for the benefit of people not only interested in investment but for reaping long-term benefits over a long period of age. The pension funds are not evaluated by the fund's managers too in the same way as mutual funds. We have gathered the NAVs and average returns of the pension funds to present a summarized picture of the financial performance of pension funds. The NAVs indicate the value of investors' funds in the pension fund at a given time. A higher NAV shows a better performing pension fund in the market representing a higher investment value. The graphical presentation and certain descriptive have been gathered in Table 4 to depict the trends followed by these pension funds as compared to market for the performance overall.

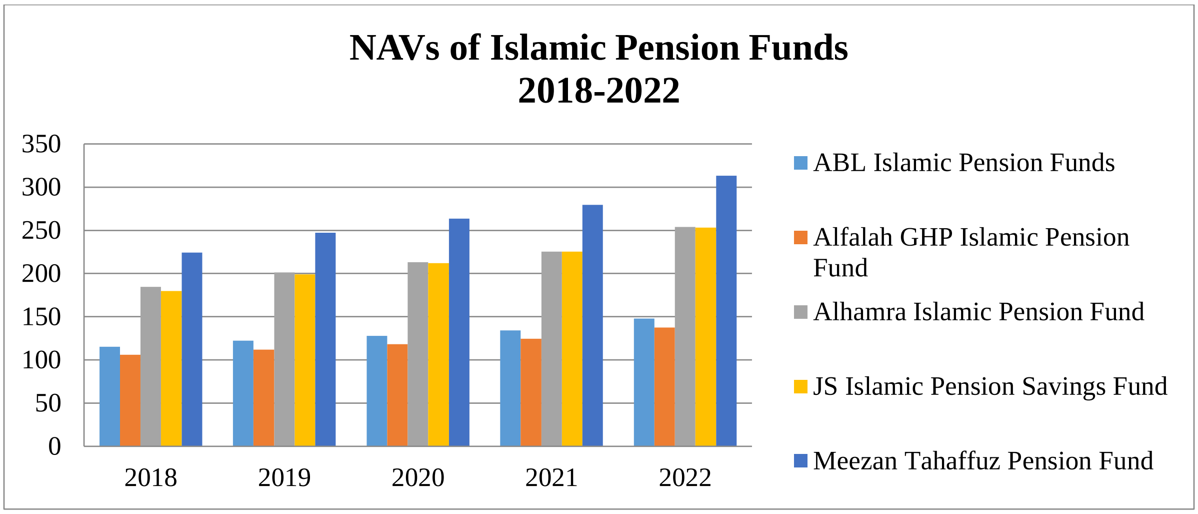
Table 4 shows the past trends of NAVs and Returns of Islamic Pension Funds and almost none of the fund has been producing negative returns showing a positive and outperformed situation as compared to industry overall.

Table 6: NAVs and Avg. Returns of Islamic Pension Funds

Sr. No.	Name of Fund	Average NAVs 2018-2022	Average Returns 2018-2022
1	ABL Islamic Pension Fund	129.56	5.71%
2	Alfalah GHP Islamic Pension Fund	119.54	6.03%
3	Alhamra Islamic Pension Fund	215.62	7.54%
4	JS Islamic Pension Savings Fund	213.93	8.20%
5	Meezan Tahaffuz Pension Fund	265.60	7.90%

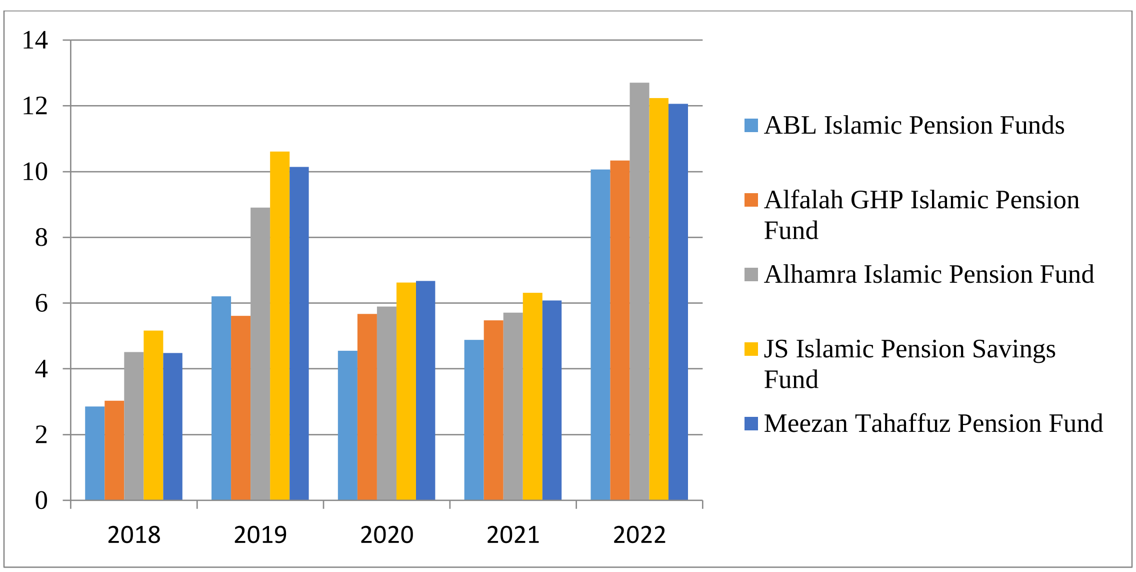
Graph 1 has a clear picture of the yearly average NAVs of the selected Islamic Pension Funds over the period of 2018-2022.

Graph 1: Net Asset Value (NAV) of Islamic Pension Funds



Similarly graph 2 shows the annual average returns of Islamic Pension Funds over 2018-2022 as;

Graph 2: Average Annual Returns of Islamic Pension Funds



5.0 Discussion and Conclusion

This paper aimed to provide insight into the Islamic funds industry with variety of mutual and pension funds working under the Shariah compliant manner. The Islamic Mutual Funds and Pension Funds have remained underperformed with respect to the market as being witnessed from the results of Sharpe measure, Treynor measure and Jensen's alpha. There could be several factors explaining this phenomenon ranging from limited investment options for Islamic funds to lack of technical expertise. Along with that, there are certain restrictions on the investment options of Islamic funds that reduces their risk diversification options.

There is a need to strengthen the investment options and market avenues for the Islamic funds so that they can also participate in the market offered options and generate maximum returns for their investors. To achieve this objective, the regulatory bodies should develop a level-playing field for both conventional and Shairah compliant funds so that both can explore their investment options and diversify their risks accordingly. The success of this Islamic funds industry is not only dependent on the variety of funds and controlled risk and return trade-offs but also on the regulatory bodies to take roper measures for the betterment and progress of Islamic funds industry.

Moazzam Ali: Problem Identification and Theoretical Framework & Supervision

Tanzeela Nadeem: Data Analysis and Drafting

Muhammad Sadil: Literature Search,Methodology

Conflict of Interests/Disclosures

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