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Shariah-Compliant Mutual Funds' Investment Preference: The Islamic Perspective

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Abstract--- *The paper aims to examine if sustainability engagement by business firms is able to attract investments from Shariah-compliant mutual funds. This study believes that the influence of Islam through the principles of tawhid (faith), khalifah (vicegerency) and ukhuwwah (brotherhood) may lead Shariah-compliant mutual funds to consider firms with good sustainability commitment in their investment decision making. A total of 236 firms listed on Bursa Malaysia in the years 2014 and 2015 have been selected as sample. Sustainability engagement is measured by the quality of sustainability disclosure, while the ownership of Shariah-compliant mutual funds is measured by their percentage of shares held in the ownership structure of the sampled firms. The findings from this study suggest that Shariah-compliant mutual funds do have positive preference towards firms with good sustainability engagement. The results thus confirm the Islamic influence in shaping the behavior of Shariah-compliant mutual funds in their investment decision making process.*

Keywords--- *Sustainability, CSR, mutual funds, Shariah-compliant, Islam, Malaysia*

JEL Classification--- *M41*

I. INTRODUCTION

Sustainable development refers to "meeting the needs of our present without compromising the ability of future generations to meet their own needs" (World Commission on Environment and Development, 1987). The concept of sustainable development or sustainability requires business firms to focus not only on maximizing profits for the shareholders, but also to engage in activities which may benefit their stakeholders as well. The importance of sustainable development has prompted researchers globally to study not only on the determinants of such engagement, but also on its consequences. Past studies found that sustainability engagement leads to a number of consequences, such as high financial performance (McPeak & Tooley, 2008; Saleh, Zulkifli, & Muhamad, 2011) and the ability to attract investments from institutional investors (Abd-Mutalib, Muhammad Jamil, & Wan-Hussin, 2015; Cox, Brammer, & Millington, 2004; Cox & Wicks, 2011; Saleh, Zulkifli, & Muhamad, 2010).

The purpose of the current study is to further examine the consequences of sustainability engagement towards the level of institutional shareholdings, specifically the mutual funds. Previous findings conclude that mutual funds do not prefer to invest in firms with good sustainability engagement as they are transient, having short-term investment horizon that focus on short-term profit(Abd-Mutalib, Muhammad Jamil, et al., 2015; Cox et al., 2004; Cox & Wicks, 2011). Despite these findings, this study believes thatthe Islamic values of *tawhid* (faith), *khalifah* (vicegerency) and *ukhuwwah* (brotherhood) (Dusuki, 2008; Mukhazir, Muhamad, & Noordin, 2006) may influence

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the investment preference of Shariah-compliant mutual funds. *Tawhid* is referred to as faith, devotion and reliance to Allah SWT, *khalifah* refers to the guardian of the earth, while u*khuwwah* brings the notion of brotherhood. Combining these three principles, a good Muslim shall have good *tawhid* to the creator, to act as His *khalifah* and at the same time maintain good relationship between all other Muslims, and all these are related to the concept of sustainability. Therefore, this study postulates that in making investment decision, mutual funds which adhere to Islamic principles may act differently in making investment decision, by taking sustainability engagement by potential firms as priority.

This study contributes to a number of significance. Among others, there is a significant growth of Shariah-compliant mutual funds may be seen for the last 10 years. For instance, in Malaysia, statistics show that 97 approved funds and 92 launched funds was recorded at the end of the year 2006, and the figure escalates to 199 approved funds and 198 launched funds in year 2016 (Securities Commission Malaysia, 2006, 2016b). In term of net asset value (NAV), the amount has increased from RM9.1 billion in 2006 to RM56.7 billion in 2016 (Securities Commission Malaysia, 2006, 2016b). Therefore, it is interesting to gauge whether the large amount of money being kept by the Shariah-compliant mutual funds is being invested in activities that support sustainability development and engagement, as such engagement is closely related to Islamic values. Furthermore, the literature on whether Islamic investments, or in this study referred to as Shariah-compliant mutual funds' investments, put emphasis on potential firms' sustainability engagement in doing investment decision making has yet to be observed. This study hopes to shed some lights on this matter.

The rest of this paper is organized as follows. In the next section, the study presents the review of the related literature, followed by the development of hypotheses. Next, the discussion is focused on the research methodology, followed by the findings. The paper ends with the discussion, conclusions and avenues for future research.

II. LITERATURE REVIEW

Sustainability Engagement and Mutual Fund Investment in Malaysia

Unit trust funds or mutual funds are institutional investors who specializes in collecting and pooling savings from retail investors and other institutional investors (Abdullah, Hassan, & Mohamad, 2007). The pooled money is then being invested in authorized investments (Bashir & Wan Nawang, 2011), with the aim of helping investors to grow their wealth by diversifying their investment portfolios. Besides investment diversification, investors may also gain several benefits such as professional management, liquidity and also risk minimization (Choong, 2001).

Unit trust and mutual funds are categorized as funds with transient or short-term investment horizon (Cox et al., 2004; Cox & Wicks, 2011), where they will not hold an investment in a long period of time. The situation can be explained by their close connection with the banking sectors, where the capability of the fund and bank managers would be assessed according to the funds' and the banks' financial performance. As such, this type of peer group benchmark may force the fund managers to concentrate on daily profit making (Cox & Wicks, 2011).

Another possible explanation for the transient behavior of unit trust and mutual funds is due to the funds' activities. A beneficiary to a unit trust and mutual fund may redeem their investment by selling them back to the fund on any business day (Cox & Wicks, 2011), or may also switch from one fund to another in the same fund family (Cox & Wicks, 2011). In this case, the fund managers would be responsible to have sufficient amount of cash to meet the demand of the redemption. Such activity will also highly depending on the funds' profit making performance, thus, unit trust and mutual funds will only hold an investment in a portfolio which may provide them with good amount of profit which may provide them with good liquidity (Cox & Wicks, 2011). Since the unit trust and mutual funds have transient investment behavior, they may not be emphasized to invest in environmentally and socially responsible portfolios. Portfolios which are environmentally and socially responsible may likely spend large amount of money on sustainability activities, therefore, unit trust and mutual funds, who prefer cash liquidity, may not be amused by the idea of sustainability engagement, since the engagement means extra cost to be incurred, thus less profit to be shared.

Despite the transient behavior of unit trust and mutual funds being discussed by previous researchers, a unique situation is evidence in Malaysia as the funds may be categorized between the government-managed and private-managed funds (Abd-Mutalib, Muhammad Jamil, et al., 2015). The results justify that such impact exist only when mutual funds are controlled by government through public bodies (Abd-Mutalib, Muhammad Jamil, et al., 2015). This is consistent with the Stakeholder Theory, where firms that cater for the needs of the stakeholder will have the ability to attract potential investor, particularly those with long-term investment behavior such as the government-managed mutual funds (Abd-Mutalib, Muhammad Jamil, & Wan Hussin, 2016). On the other hand, Myopic Institutions Theory posits that institutional investors are myopic or short-sighted while making investment decision. Hence, the myopic or short-sighted attitude may direct the fund managers of the institutions to risk aversion and focus on achieving short-term profit from an investment (Hansen & Hill, 1991). Since short-term profit is the main objective in investment, sustainability engagement, which benefits may only be observed in long-term, may not become an attraction to such investors.

A unique situation in the Malaysian market for mutual funds is the fact that there exist a classification which divides the mutual funds between those of Islamic funds and conventional funds. The Islamic funds, also known as the Shariah-compliant funds, are those funds which are invested in accordance with the principles of Islam. Since the establishment of this type of fund in the 1990s, rapid growth may be evidenced, not only by the number of approved and launched funds, but also in the net asset value (NAV). The growing demand towards Shariah-compliant funds has triggered the question if the vast amount of money in the funds' control is being invested in a socially responsible way. Previous studies have provided evidence that there is a strong connection between Islam and the concept of sustainability (Dusuki, 2008; Dusuki & Tengku Mohd Yusof, 2008; Mukhazir et al., 2006). Therefore, this study believes that the investment preference by this type of funds may show different inclination to sustainability agenda. The subsequent paragraphs explain on the meaning of Shariah-compliant funds and the connection between Islam and sustainability, followed by the hypotheses statements developed for this study.

Shariah-compliant Mutual Funds

Shariah-compliant mutual funds are those mutual funds which are regulated under Islamic or Shariah law. According to an international body that brings together the world's securities regulators, the International

Organization of Securities Commission (IOSCO), "*An Islamic Collective Investment Scheme (CIS) or Islamic Fund must operate in accordance with Shariah principles, not only in its relations with investors but also in its investment and other fund management activities*". The effects of this include the following:

(i) The prohibition against interest (*riba'*) will prevent a fund lending or borrowing at interest, or investing in interest-bearing securities.

(ii) The fund may not invest in unethical or socially detrimental activities such as those involving alcohol, pornography or gambling. It may also not invest in conventional financial institutions, or enterprises which receive or pay substantial amounts in interest.

(iii) Where an investment produces a small proportion of its return from unacceptable sources – for example a trading company which also arranges interest-bearing loans for its customers – that investment may be regarded as acceptable if it is "purified" by giving the unacceptable proportion of the return to charity.

(iv) The prohibition against *gharar* (excessive uncertainty/ambiguity) will also limit some types of contract, including for example contracts for differences. On the other hand, this prohibition can encourage a high level of disclosure and precision in contracts with investors.

(v) Debt obligations are generally not considered to be tradable. However, baskets of investments which contain a proportion of debt obligations may be accepted as tradable, although the precise limit of this proportion remains a topic of debate.

(vi) Unlike most conventional funds, some Islamic CIS may incorporate profit sharing with parties other than investors. The most obvious example is where investments are "purified" by giving part of the return to charity. "

With relations to the Shariah-compliant mutual funds, they are nevertheless similar to the other conventional mutual funds, where they provide the opportunities for the investors to grow their wealth by diversifying their investment portfolios. Besides investment diversification, investors may also gain several benefits such as professional management, liquidity and also risk minimization (Choong, 2001). The only difference between the Shariah-compliant funds and the mutual funds is that the former are being administered according to the Shariah or Islamic law. In Malaysian situation, the administration in accordance to the Shariah or Islamic law brings the notion that the funds need to appoint an individual or a corporation as an independent Shariah adviser, approved and registered by the Securities Commission (SC) (www.sc.com.my). The functions of the Shariah adviser are:

(a) To advise on all aspects of Islamic fund management business in accordance with Shariah principles;

(b) To provide Shariah expertise and guidance on all matters, particularly in documentation, structuring and investment instruments, and ensure compliance with relevant SC regulations and/or standards, including resolutions issued by the Shariah Advisory Council (SAC);

(c) To provide Shariah expertise and guidance on all matters, particularly in documentation, structuring and investment instruments, and ensure compliance with relevant Securities Commission (SC) regulations and/or standards, including resolutions issued by the Shariah Advisory Council (SAC);

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(d) To review reports of compliance officers of the Islamic fund manager or an investment transaction report to ensure that investment activities are Shariah compliant; and

(e) To provide a written opinion and/or periodic report to confirm and certify whether the Islamic fund management business has been managed and/or administered in accordance with Shariah principles.

Muslims investors are found to be looking forward to invest in companies that implement ethical, social and environmental activities in their business operation(Tahir & Brimble, 2011). This is due to the better performance and lower risk for socially-ethical companies (Hickman & Teets, 1999; McGuire, Sundgren, & Schneeweis, 1988), which also could attract the mutual fund manager to consider this type of companies for their investment decisions. Similarly, Derigs and Marzban (2008) also suggest that Muslim investors are interested to invest in company that practice a social and ethical business because this type of business are conform with their Islamic belief.

Sustainability and Islam

The close connection of Islam and sustainability has been largely justified in previous studies (Abd-Mutalib, Yahya, & Taib, 2015; Dusuki, 2008; Farook, Hassan, & Lanis, 2011; Gambling & Karim, 1991; Ibrahim, Abdalla, & Yahya, 2016; Maali, Casson, & Napier, 2006; Mukhazir et al., 2006; Ousama & Fatima, 2010; Wan Jusoh, Ibrahim, & Mohd Napiah, 2015; Zainal, Zulkifli, & Saleh, 2013a). The findings thus provide the justification on what Islamic sustainability is all about and the reasons why Islam stresses on preserving the environment and social beings.

Mukhazir et al. (2006) and Wan Jusoh et al. (2015) explains that among the important factor which shapes Islamic sustainability is the concept of *tawhid* (faith). *Tawhid* brings the notion of belief, dependence and reliance to Allah SWT, who is the sole owner of all the resources in this world, including the capabilities, knowledge and skill of human being(Wan Jusoh et al., 2015). A good Muslim with good faith to the creator needs to manage all the resources according with Shariah framework that are fixed by Allah through Al Quran and Sunnah. Shariah, which is developed based on *maqasid Al-Shariah* (objective) to guarantee the eminence of life for the current and next generation (Harun, 2016).

The connection between Islam and sustainability may also be explained through the principle of *khalifah* (vicegerency) (Dusuki, 2008; Wan Jusoh et al., 2015). This principle explains that every Muslim is Allah's *khalifah* that has a responsibility to defend their connection with Allah, other human and also the earth. In addition to defense the main relationship with Allah, as a *khalifah*, Muslims are accountable to ensure this universe is well preserved not only for human beings but also for all flora and fauna. Therefore, they need to safeguard the consumption of current resources in a good manner to ensure a quality of life for future generation(Wan Jusoh et al., 2015).

Another principle that connects Islam and sustainability is the principle of *ukhuwwah* (brotherhood) (Dusuki, 2008; Wan Jusoh et al., 2015), which explains that Muslim are brothers, as such, they need to take care of each other and maintain good relationship among themselves. Islam encourages people to take appropriate measures to check the concentration of wealth into a few hands, to redistribute resources, to minimize social gaps and to share the fortunes of the wealthy with unfortunate people in society by paying *zakat* (alms) and *sadaqah* (charitable donations)(Gambling & Karim, 1991). By taking care of the society through *zakat* and *sadaqah*, Muslims are fulfilling the principle of *tazkia* (growth and purification) of their wealth, which contributes to social justice and spiritual improvement (Gambling & Karim, 1991).

These three values of *tawhid*, *khalifah* and *ukhuwwah* are closely related to each other. Muslims with good faith to Allah SWT (*tawhid*) are obligated to uphold His principles and rules. In Islam, everything in this entire live belongs to the creator. On the other hand, the humans, creations who are being blessed with *aqal* (mind) to make proper justifications are required to become His messenger in protecting the environment. Besides, Islam stresses out that Muslims are brothers, therefore, they should take care each other in the spirit of brotherhood. Blending these three principles, we may acknowledge that a good Muslim who has strong faith to Allah SWT will always uphold His requirement of values and requirements, thus fulfilling the relationship not only with the creator, but also with the environment and the social surroundings.

The concept of social responsibility is not only applied to individual Muslim but need to be implemented together by all Muslims(Wan Jusoh et al., 2015). In the application of sustainability to business entities, the business firms are owned and managed by a group of people, therefore they need to promote a good corporate social responsibility because it is an honorable practice and in Islam can be considered as '*ibadah*' (worship) and one of a way to prevent evil. In doing the corporate social responsibility, companies need to avoid the destruction of the environment during their business operation. They also need to protect their employees, community and consumer by having a good corporate social and environmental policy to show their worship to Allah because they are only trustees. As trustees, they are answerable to Allah of all actions and activities conducted by them in hereafter.

The connection of Islam with sustainability engagement is also investigated by Maali et al. (2006), who attempted to investigate the influence of Islam on social reporting and develop a benchmark set of social disclosures to Islamic banks. The actual social disclosures contained in the annual reports of twenty-nine Islamic banks (located in sixteen countries) was content analysis to measure the volume of social disclosures. The findings suggest that social reporting by Islamic banks falls significantly short of the expectations. This is also consistent with findings more recent findings(Farook et al., 2011) which measured the social disclosure levels of 47 Islamic banks, operating in 14 countries.

Another empirical study that dealt with Shariah approved companies listed on Bursa Malaysia is the study which investigate the extent of voluntary disclosure (conventional and Islamic disclosure) in the annual reports of these companies (Ousama & Fatima, 2010). A disclosure index was developed, which consists of 59 items (including items related to the Shariah, i.e. Islamic items), to measure the extent of voluntary disclosure in the annual reports. The findings indicate that the extent of voluntary disclosure is comparable to other Malaysian studies. However, the Islamic disclosures is unexpectedly low for Shariah approved companies as they are generally expected to disclose more information voluntarily, particularly for Islamic items, to fulfil their responsibility towards stakeholders(Ousama & Fatima, 2010).

Additionally, Ibrahim et al. (2016) provides evidence on the significance of the characteristics of Shariah Supervisory Board that can possibly assist in explaining variations in the quantity and quality of social responsibility disclosure in the annual reports of Sudanese Islamic banks. The study indicates that the characteristics of Shariah Supervisory Board; particularly, the board size, educational qualification of the members, cross-membership, and reputation of the board members will enhance the level of monitoring and compliance with Islamic Shariah and subsequently, lead to a high level of social responsibility disclosure in the annual reports of Islamic banks.

In Malaysian scenario, past studies conclude the connection of Islam with sustainability engagement. Abd-Mutalib et al.(2015) examine if Muslim directors exhibit positive and significant influence on firms' sustainability engagement. The results reveal that Muslim directors, proxied by three measurements: (1) the proportion of Muslim directors over total directors; (2) having Muslim Chairman; and (3) having Muslim CEO indicate positive and significant relationship with sustainability reporting. The findings thus justify the importance of Islam in shaping CSR engagement among corporate firms. In other study, Zainal et al. (2013a) examine if there is a significant difference in sustainability reporting between the Shariah-compliant and non Shariah-compliant firms. The results reveal that significant difference has been found in the environmental sustainability reporting during the period where sustainability reporting was still voluntary. This might be explained by the Shariah-compliant firms' adherence to the Islamic principles, thus has enhanced their accountability in protecting the environment

The awareness of Islamic sustainability has been observed not only in business firms, but also among Muslim investors. For instance, the increase awareness of Muslim investors about the requirement of the Islamic law in conducting the business lead them to prefer investment in a company that follows the Islamic rules and regulations (Ahmad & Ibrahim, 2002). Investors and management of Shariah-compliant funds are predominantly Muslims. In Islam, Muslims are required to conduct a business operation and make an investment decision according to Islamic law that are from the Al-Quran and Al-Sunnah (Hussain, 2004; Tahir & Brimble, 2011). Religious Muslim investors are found to be more likely to invest in companies that comply with the Shariah principal such as companies that are not involved in uncertainty activities (*gharar*), gambling (*maisir*), interest-bearing financing (*riba*) and forbidden (*haram*) activities namely alcohol, pork and tobacco. Additionally, in conjunction with Islamic belief, law and regulation, Muslim investor are more likely to avoid investment in preference share and derivatives financial instrument such as forward futures contracts, options and swaps(Derigs & Marzban, 2008).

Recently, there is a trend of increasing in the mutual fund industry around the world following the better development of the security market and the existence of specific regulation (Mahmud & Mirza, 2011). In Malaysia, there is gradually development in the Islamic capital market which is expected to achieve RM2.9 trillion in 2020 (Haron & Ibrahim, 2012)**.** Fund managers are the responsible person that manage the money invested by shareholders to Islamic securities (Mansor & Bhatti, 2011).

Development of Hypotheses

The close connection between Islam and sustainability may be expressed through the principles of *tawhid*, *khalifah* and *ukhuwwah* (Dusuki, 2008; Harun, 2016; Mukhazir et al., 2006; Wan Jusoh et al., 2015) that are embedded in the religion itself. *Tawhid* refers to faith to the Almighty, to believe that Allah is the creator of the universe, while *khalifah* refers to the role played by the humans in protecting and to take care of the resources provided by the Almighty, to be His obedient servant in guarding His property. Furthermore, *ukhuwwah* connects to the spirit of brotherhood that needs to be embedded in life of the Muslims, to take care of each other and to make sure that no one is left behind.

The connection between Islam and sustainability can also be observed in modern research. For instance, the presence of Muslim directors is found to be positively and significantly affecting sustainability reporting (Abd-Mutalib, Yahya, et al., 2015). Furthermore, firms which are Shariah-compliant disclose CSR more compared to their counterparts (Zainal et al., 2013a). Additionally, Shariah Supervisory Board has been found to play significant role in enhancing sustainability engagement and reporting (Ibrahim et al., 2016).

Based on these justifications, we may conclude that Islam and sustainability is related to each other. Therefore, this study hypothesizes:

H_1: The level of sustainability engagement would be significantly higher in firms with the ownership of Shariah-compliant mutual funds compared to firms without such ownership.

H_2: Sustainability engagement exerts significant positive impact on the ownership of Shariah-compliant mutual funds.

III. METHODS

In determining the sample size, and for a population of 893, the adequate sample would be 269 (Krejcie & Morgan, 1970). The study utilizes secondary data collection, and implements a one year lag data for sustainability engagement and contemporaneous data for the ownership of Shariah-compliant mutual funds.

Sustainability engagement (SE) is captured from the sustainability disclosure in the 2014 annual reports of the sampled firms, which covers the four focal areas recommended by Bursa Malaysia, namely the environment, workplace, marketplace and community (Bursa Malaysia, 2006). Content analysis technique is used to capture the SE data, where researchers make replicable and valid references from data to their context (Krippendorf, 1980), and is commonly done on written documents (Myers, 2009). This technique has largely been used in previous research in the area of sustainability engagement and reporting (Abd-Mutalib, Muhammad Jamil, & Wan Hussin, 2014; Aras & Crowther, 2008; Said, Zainuddin, & Haron, 2009; Saleh et al., 2010).

SE is measured by the quality of reporting, using an index with a scale of 0 to 3, where a score of 3 is for quantitative disclosure, 2 for qualitative disclosure with specific explanations, 1 for general qualitative disclosure and 0 for non-disclosure, which has been used in previous studies (Abd-Mutalib et al., 2014; Saleh et al., 2010; Zainal, Zulkifli, & Saleh, 2013b). A total of 29 items representing the four focal areas of environment (EV), workplace (WP), marketplace (MP) and community (CM) is listed based on previous research on Malaysian CSR, which is adapted from previous research (Abd-Mutalib, Muhammad Jamil, et al., 2015). The total score for each firm is finally calculated using percentage of disclosure.

The data for unit trust and mutual funds is being captured from the "30 largest shareholder" section in the 2015 annual reports of the sampled firms. The data collection is being done in stages. In the first stage, the study identifies all the unit trust and mutual funds in the ownership structure of the sampled firms. The identification is based on the "List of Launched Funds in Relation to Unit Trust Funds" (Securities Commission Malaysia, 2016a), and this data is coded as Unit Trust and Mutual Funds (UTMF). In the second stage, the UTMF is divided into those of the government-managed unit trust funds (GUT) and the private-managed mutual funds (PRMF). The identification is based on their UTMCs, where the former is managed by the government such as Amanah Saham Nasional Berhad or the UTMCs that belong to the state governments. For the latter, the UTMCs are those which are privately managed, for instance the BIMB Investment Management Berhad or Mayban Asset Management Sdn Berhad. In the third stage, the PRMF is divided into those of the non-Shariah mutual funds (NSMF) and Shariah-compliant mutual funds (SMF) as classified by the "List of Launched Funds in Relation to Unit Trust Funds" (Securities Commission Malaysia, 2016a). The measurement used for all types of unit trust and mutual funds are using the percentage of ordinary shares owned by such funds to the number of ordinary shares issued, which has been practically utilized in past studies (Abd-Mutalib, Muhammad Jamil, et al., 2015; Abdul Jalil & Abdul Rahman, 2010; Saleh et al., 2010; Wahba, 2008). To fulfill the objective (2), SMF is also measured by the presence of Shariah-compliant mutual funds in the ownership structure, where 1 refers to "present" and 0 vice versa.

From the stages discussed above, the data for Shariah-compliant funds are obtained from among the private-managed mutual funds, while the government-managed unit trust funds are disregarded. Two reasons to justify this are (1) previous studies found positive link between sustainability engagement with government-managed unit trust funds. By including the government-managed Shariah-compliant funds into the dependent variable data, bias may incur in the results as government-managed funds are previously found to be inclined in investing in socially responsible firms (Abd-Mutalib, Muhammad Jamil, et al., 2015); and (2) most of the government-controlled unit trust funds are not Shariah-compliant (Securities Commission Malaysia, 2016a), therefore, the exclusion of such category will not affect the findings.

Besides the main independent and dependent variables, several other variables are also controlled in this research. In past studies, institutional investors have been identified to be attracted to the financial performance (FPERF) of the potential firms in which they want to invest (Bushee & Goodman, 2007), and to firms with large size (Abd-Mutalib, Muhammad Jamil, et al., 2015; Saleh et al., 2010). Both FPERF and FSIZE are extracted from the Thompson Reuters Datastream. FPERF is measured by Retun on Assets (ROA), while FSIZE is measured by Total Assets (TA).

The study also controls for size of the board (BSIZE) and the type of the firms' external auditor (AUD_TYPE). Previous studies justify that firms with larger board size deliver more disclosure (Holder-Webb, Cohen, Nath, & Wood, 2008), while small board size is associated to lack of expert advice (Shakir, 2008). Additionally, investors are also found to be attracted to firms that engage with Big 4 auditors as their external auditors. This is due to the association of the Big 4 auditors with enhanced audit quality (Khurana & Raman, 2004) and improved financial reporting timeliness (Schmidt & Wilkins, 2013). BSIZE is measured by the number of directors sitting on the board, while dummy measurement is used to measure AUD_TYPE. Both BSIZE and AUD_TYPE data is extracted from the 2014 annual report of the sampled firms.

Another control variable in this study is the firms' Shariah-compliant status (SHARIAH). As the study focuses on the shareholding or ownership by Shariah-compliant mutual funds, which are sensitive to the conformity to Shariah principles in its investment decision, the study predicts that SHARIAH will have positive impact on SMF. SHARIAH is measured by dummy measurement. The data for SHARIAH is extracted from the List of Shariah-Compliant Securities by Shariah Advisory Council of Securities Commission Malaysia (Securities Commission Malaysia, 2014).

The hypothesis H_2 posed previously is tested two regression lines stated below. Since The first regression line tests the impact of cumulative SE towards the shareholdings by SMF, while the second regression line tests the effect of SE categories (environment, workplace, marketplace and community) specified by Bursa Malaysia.

$$SMF = \alpha + \beta_1 SE + \beta_2 FSIZE + \beta_3 FPERF + \beta_4 BSIZE + \beta_5 AUD\_TYPE + \beta_6 SHARIAH + \varepsilon \quad \ldots\ldots\ldots\ldots \text{ Eq 1}$$

$$SMF = \alpha + \beta_1 EV + \beta_2 WP + \beta_3 MP + \beta_4 CM + \beta_5 FSIZE + \beta_6 FPERF + \beta_7 BSIZE + \beta_8 AUD\_TYPE + \beta_9 SHARIAH + \varepsilon \quad \ldots\ldots\ldots\ldots \text{ Eq 2}$$

IV. RESULTS

The main objective of this study is to determine whether sustainability engagement by corporate firms may attract the investments from Shariah-compliant mutual funds. In order to ensure the reliability and validity of information, before the hypothesis is tested, the data is firstly screened for missing values. This is followed by several procedures to ascertain whether the multivariate assumptions of normality, multicollinearity and heteroscedasticity are met. Following the identification for missing values, the sample for this study is reduced from 269 to 236 observations.

The variables are then checked for their univariate normality using the score for skewness and kurtosis. From the normality test, 2 variables namely the SMF and FSIZE indicate non-normality, thus has been transformed using natural log transformation (Osborne, 2002; Osborne, 2010). After the transformation process, all variables under study are finally achieved the univariate normality. The data has also been tested for multicollinearity correlation analysis (Table 1) and Variance Inflation Factor (VIF). The results reveal that none of the correlations statistics between independent variables indicate a score of more than 0.9 (Gujarati, 2003; Hair, Black, Babin, & Anderson, 2010; Pallant, 2001), and the variables indicate variance inflation factor (VIF) of more than 10 (Gujarati, 2003; Hair et al., 2010). Therefore, it may be concluded that multicollinearity does not exist in the model.

Table 1. Correlation Analysis

	SMF	SE	EV	WP	MP	CM	FSIZE	FPERF	BSIZE	AUD_TYPE	SHARIAH
SMF	1.000										
SE	.347**	1.000									
EV	.275**	.858**	1.000								
WP	.304**	.846**	.631**	1.000							
MP	.289**	.831**	.647**	.685**	1.000						
CM	.286**	.789**	.559**	.490**	.528**	1.000					
FSIZE	.292**	.592**	.472**	.476**	.493**	.528**	1.000				
FPERF	.112	.098	.015	.093	.115	.112	.071	1.000			
BSIZE	.313**	.338**	.258**	.305**	.339**	.239**	.375*	.017	1.000		
AUD_TYPE	.112	.383**	.283**	.356**	.277**	.342**	.383*	.108	.128*	1.000	
SHARIAH	.198**	-.037	.031	-.078	-.012	-.055	-.129*	-.064	.029	-.039	1.000

Variables Definition:

SMF = Private-managed Shariah-compliant Mutual Funds, measured by the Natural Log (ln) of the percentage of shares owned by Shariah-compliant Mutual Funds; SE = Sustainability Engagement, measured by sustainability reporting in annual reports using sustainability quality index: 3 for quantitative disclosure, 2 for specific qualitative disclosure, 1 for general qualitative disclosure and 0 for non-disclosure; EV = Environmental SE; WP = Workplace SE; MP = Marketplace SE; CM = Community SE; FSIZE = Firm size, measured by Natural Log (ln) of Total Assets; FPERF – Firm performance, measured by Return on Assets (ROA); BSIZE = Board Size, measured by the number of directors sit on the board; AUD_TYPE = Type of Auditor, dummy measurement; SHARIAH = Shariah-compliant firm, dummy measurement.

N = 236

Descriptive statistics

Table 2 presents the descriptive statistics of this study, thus fulfilling the first objective of the research. From the findings, it is found that on average, Malaysian unit trust and mutual funds (UTMF) holds about 2.69% of shares in Bursa Malaysia listed firms. This findings is almost consistent to a previous study (Abd-Mutalib et al., 2016), where the total shareholdings by domestic unit trust and mutual funds was at 2.63%. When the unit trust and mutual funds are divided into those which are government-managed (GUT) and private-managed (PRMF), the findings disclose that the GUT holds slightly higher percentage of shares compared to the PRMF, which is also consistent to a previous study (Abd-Mutalib et al., 2016). The current study adds to the existing knowledge by segregating the PRMF into those which are Shariah-compliant (SMF) and non Shariah-compliant (NSMF). From the findings, it can be observed that the percentage of shares held by SMF is low (17.5%) compared to the percentage of shares held by total UTMF (with 0.47% out of 2.69%), and low compared to NSMF, with the comparison of 0.47% and 0.79%. But this is situation is predicted as the NAV of SMF only represents 15.9% (56.8 billion) of the total NAV (356.5 billion) of the total UTMF (Securities Commission Malaysia, 2016b).

With regards to the sustainability engagement (SE), it is found that the firms under study only scored on average of 16.19%, with the minimum of 0% and the maximum of 72.41%. By separate categories, the workplace (WP) and community (CM) mark highest level of engagement with 5.03% and 5.25% respectively. For the control variables, variations may be seen among the firms under study. The sampled firms include those with small sizes to large sizes in total assets (FSIZE), with the mean of 2 million of total assets. The financial performance (FPERF) of the sampled firms indicates the minimum ROA of -38.93, the maximum of 41.18 and a mean of 4.94. With regards to the corporate governance mechanism, mean of the board size is 7.42, and 46% of the firms have Big 4 auditors as their auditor. The descriptive statistics also indicate that 75% of the sampled firms are Shariah-compliant firms.

Table 2. Descriptive Statistics

	Minimum	Maximum	Mean	Std. Deviation
UTMF	.00	74.55	2.69	6.74
GUT	.00	73.91	1.43	6.07
PRMF	.00	17.08	1.25	2.69
SMF	.00	9.46	.47	1.27
NSMF	.00	12.68	.79	1.96
SE	.00	72.41	16.19	14.77
EV	.00	21.84	3.96	4.76
WP	.00	21.84	5.03	4.85
MP	.00	16.09	1.94	3.28
CM	.00	22.99	5.25	4.90
FSIZE	18,656	53,129,164	2,186,822	6,316,542
FPERF	-38.93	41.18	4.94	8.45
BSIZE	4.00	14.00	7.42	1.91
AUD_TYPE	.00	1.00	.46	.50
SHARIAH	.00	1.00	.75	.43

Variables Definition:

UTMF = Total Unit Trust and Mutual Funds, measured by the percentage of shares owned by unit trust and mutual funds; GUT = Government-managed Unit Trust Funds, measured by the percentage of shares owned; PRMF = Private-managed Mutual Funds, measured by the percentage of shares owned; SMF = Private-managed Shariah-compliant Mutual Funds, measured by percentage of shares owned; NSMF = Private-managed Non Shariah-compliant Mutual Funds, measured by percentage of shares owned; SE = Sustainability Engagement, measured by sustainability reporting in annual reports using sustainability quality index: 3 for quantitative disclosure, 2 for specific qualitative disclosure, 1 for general qualitative disclosure and 0 for non-disclosure; EV = Environmental SE; WP = Workplace SE; MP = Marketplace SE; CM = Community SE; FSIZE = Firm size, measured by Total Assets; FPERF – Firm performance, measured by Return on Assets (ROA); BSIZE = Board Size, measured by the number of directors sit on the board; AUD_TYPE = Type of Auditor, dummy measurement; SHARIAH = Shariah-compliant firm, dummy measurement.

N = 236

Tests of difference

The first objective of this study is to examine if different level of sustainability engagement can be found in firms with and without the shareholdings by Shariah-compliant mutual funds. The difference is analyzed using t-test and the results are depicted in Table 3. The results suggest that there is significant difference in the sustainability reporting score of the firms with and without the shareholdings by Shariah-compliant mutual funds. In Panel A, the mean score for firms with Shariah-compliant mutual funds' shareholdings is 27.59, while firms without such shareholdings have sustainability reporting score of 12.81. In Panel B, Levene's test shows that the variances of the two groups are not equal. When equal variance is not assumed, the results indicate that significant difference between the two groups ($p = 0.000$; ≤ 0.01) has been found, thus supporting H_1. The results hence confirm that Shariah-compliant mutual funds invest in firms that engage to good sustainability agenda.

Table 3.Test of Difference

Panel A: Group Statistics

	N	Mean of SE	SD
With shareholdings of SMF	54	27.59	19.62
Without shareholdings of SMF	182	12.81	10.98

Panel B: Independent Samples Test

	Levene's Test for Equality of Variances		T-Test for Equality of Means		
			t	df	Sig. (2-tailed)
Equal variance assumed	48.074	.000	7.101	234	.000
Equal variance not assumed			5.295	63.14	.000

Variables Definition:

SE = Sustainability Engagement, measured by sustainability reporting in annual reports using sustainability quality index: 3 for quantitative disclosure, 2 for specific qualitative disclosure, 1 for general qualitative disclosure and 0 for non-disclosure; SMF = Private-managed Shariah-compliant Mutual Funds, measured dummy measurement.

N = 236

Regression results

The second objective of this study is to examine if sustainability engagement by Bursa Malaysia listed firms exerts positive effect on the level of shareholdings by Shariah-compliant mutual funds. The regression results are outlined in Table 4.In Model 1, the regression results indicate that SE positively affects SMF ($p<0.01$), thus supporting H_2. In other words, the results confirm the earlier hypothesis, which propose that Shariah-compliant mutual funds consider potential firms' sustainability engagement in making investment decisions, consistent to the Islamic principles of sustainability. In Model 2, when SE is categorized according to environmental, workplace, marketplace and community engagements, the results reveal that only workplace dimension marks positive effect on the ownership of SMF.

Table 4. Regression Results

	Model 1 DV = SMF				Model 2 DV = SMF			
	Expected Sign	coeff	t-val	sig	Expected Sign	coeff	t-val	sig
SE	+	0.007	2.664	***		-	-	-
EV		-	-	-	+	0.002	0.190	
WP		-	-	-	+	0.015	1.729	*
MP		-	-	-	+	-0.001	-0.056	
CM		-	-	-	+	0.011	1.220	
FSIZE	+	0.041	1.787	*	+	0.041	1.729	*
FPERF	+	0.006	1.377		+	0.005	1.293	
BSIZE	+	0.046	2.520	**	+	0.047	2.523	**
AUDITOR	+	-0.047	-0.753		+	-0.056	-0.891	
SHARIAH	+	0.244	4.632	***	+	0.253	4.763	***
INTERCEPT		-0.968	-3.237	***	+	-0.993	-3.269	***
R-squared	0.223				0.228			
Adj. R-sq	0.203				0.197			
F-statistic	9.956				6.642			
p-value	0.000				0.000			

Variables Definition:

SMF = Private-managed Shariah-compliant Mutual Funds, measured by the Natural Log (ln) of the percentage of shares owned by Shariah-compliant Mutual Funds; SE = Sustainability Engagement, measured by sustainability reporting in annual reports using sustainability quality index: 3 for quantitative disclosure, 2 for specific qualitative disclosure, 1 for general qualitative disclosure and 0 for non-disclosure; EV = Environmental SE; WP = Workplace SE; MP = Marketplace SE; CM = Community SE; FSIZE = Firm size, measured by Natural Log (ln) of Total Assets; FPERF – Firm performance, measured by Return on Assets (ROA); BSIZE = Board Size, measured by the number of directors sit on the board; AUD_TYPE = Type of Auditor, dummy measurement; SHARIAH = Shariah-compliant firm, dummy measurement.

N = 236

For the control variables, except for AUDITOR, all other variables indicate positive association to SMF. The findings thus conclude that SMFs are likely to invest in firms with large size, sound financial performance, large board size and firms which are Shariah-compliant.

Addressing endogeneity threats using instrumental variable

Endogeneity commonly occurs due to simultaneous causality or reverse causality (Wintoki, Linck, & Netter, 2012), where two variables are co-determined, such that each variable may affect the other simultaneously (Schultz, Tan, & Walsh, 2010). As previous studies found that the presence of institutional owners in firms' ownership structure is associated with enhancement of sustainability engagement (Abd-Mutalib, Muhammad Jamil, & Wan-Hussin, 2013; Coffey & Fryxell, 1991; Hayashi, 2003; Johnson & Greening, 1999; Oh & Chang, 2011), and sustainability engagement attracts institutional owners (Cox et al., 2004; Cox & Wicks, 2011; Graves & Waddock, 1994; Hoq, Saleh, Zubayer, & Mahmud, 2010; Mahoney & Roberts, 2007; Petersen & Vredenburg, 2009; Saleh et al., 2010), the endogeneity threats to this study must not be taken lightly. Two stage least squares (2SLS) analysis with instrumental variables (Wan-Hussin & Bamahros, 2013) is used in mitigating the threats of endogeneity.

In determining the instruments for 2SLS analysis, the instrument variables selected should impact the independent variable, but not the dependent variable (Wan-Hussin & Bamahros, 2013). In Table 5 (Panel 1), when the control variables were regressed to SE, it was found that FSIZE, AUDITOR and BSIZE were positively affecting SE. In Table 5 (Panel 2) however, when the main and control variables are regressed to SMF, only AUDITOR marked non-affecting the dependent variable, while FSIZE marked least affecting. Therefore, these two variables were selected as instruments for the 2SLS analysis.

Table 5. Testing Endogeneity using Instrumental Variables

	Panel 1 (OLS) DV = SE			Panel 2 (OLS) DV = LN_SMF			Panel 3 (2SLS) DV = LN_SMF		
	coeff	t-val	sig	coeff	t-val	sig	coeff	t-val	sig
SE				0.007	2.664	***	0.012	3.485	***
FSIZE	4.622	7.133	***	0.041	1.787	*			

AUDITOR	5.365	3.421	***	-0.047	-0.753				
FPERF	0.078	0.835		0.006	1.377		0.005	1.143	
BSIZE	1.047	2.270	**	0.046	2.520	**	0.044	2.185	**
SHARIAH	0.997	0.504		0.244	4.632	***	0.234	4.517	***
INTERCEPT	-55.936	-7.034	***	-0.968	-3.237	***	-0.507	-4.116	***
R-squared	0.223			0.228			0.208		
Adj. R-sq	0.203			0.197			0.194		
F-statistic/(p-value)	9.956 (0.000)			6.642 (0.000)			14.661 (0.000)		
Hausman test (Chi-square) (p-value)							1.357 (0.244)		
Sargan statistics (p-value)							1.641 (0.200)		
Weak Instrument Test (F-statistics)							38.861		

Variables Definition:

SMF = Private-managed Shariah-compliant Mutual Funds, measured by the Natural Log (ln) of the percentage of shares owned by Shariah-compliant Mutual Funds; SE = Sustainability Engagement, measured by sustainability reporting in annual reports using sustainability quality index: 3 for quantitative disclosure, 2 for specific qualitative disclosure, 1 for general qualitative disclosure and 0 for non-disclosure; EV = Environmental SE; WP = Workplace SE; MP = Marketplace SE; CM = Community SE; FSIZE = Firm size, measured by Natural Log (ln) of Total Assets; FPERF – Firm performance, measured by Return on Assets (ROA); BSIZE = Board Size, measured by the number of directors sit on the board; AUD_TYPE = Type of Auditor, dummy measurement; SHARIAH = Shariah-compliant firm, dummy measurement.

N = 236

Panel 3 of Table 5 explains the results of 2SLS analysis. Comparing the OLS and 2SLS results, it was found that the R-squared and adjusted R-squared showed not much fluctuation either when using OLS or 2SLS, thus show preliminary results of non-existence of endoneneity bias. The important indication on whether the model suffers from endogeneity threats is based on the Hausman tests, Sargan statistics and Weak Instrument test. Hausman test refers to the specification error test that may be used to test the simultaneity problem in OLS (Gujarati, 2003), pointing out if the OLS estimates used in predicting an association are consistent. From the results in Table 5, the Hausman test (Chi-square = 1.357, p>0.1) indicate that the OLS model was consistent, and therefore, it is unlikely that 2SLS represents an improvement over OLS.

Sargan over-identifying restriction is a method to test the validity of instruments used in instrumental variables analysis (Gujarati, 2003). In instrumental variables analysis, it is appropriate to have an over-identified model, or have more instruments than the endogenous regressors (Adkins, 2013). The results in Table 5 explains that Sargan statistics indicate that the models are over-identified (Sargan statistics = 1.641, p>0.1) which points out that both instruments, FSIZE and AUDITOR, in the two models, were exogenous, and therefore, valid. On the other hand, Weak Instrument test result indicates the value of 38.861. This value is considered as strong as a value less than 10 may indicate weak instruments.

V. DISCUSSION

The aim of this study is to examine if Shariah-compliant mutual funds consider potential firms' sustainability engagement while making investment decision. The paragraphs below discuss about the findings captured in this study.

The t-test conducted reveal that significant difference has been found on the level of sustainability engagement by firms with and without the share ownership by Shariah-compliant mutual funds. The results thus indicate that firms which have good sustainability engagement have high level of ownership by Shariah-compliant mutual funds. Next, two multiple regression analyses has been conducted to test whether sustainability engagement might have impact on the share ownership of Shariah-compliant mutual funds. The result reveal that such impact exist, explaining that Shariah-compliant mutual funds put emphasis on potential firms' sustainability agenda when making investment decision. The results also reveal that Shariah-complaint mutual funds exhibits preference to firms that give good treatment to the wellbeing of its employees, but less to firms with good environmental, marketplace and community engagement. This may be due to the perception that taking good care of employees will result in employee retention, thus loyal skilled employees will remain in the firms thus helping the firm to have long-term sustainability. On the other hand, engagement to environment, marketplace and community may be perceived as cost incurring, but its direct benefits are hard to be assessed.

VI. CONCLUSION, LIMITATIONS AND AVENUES FOR FUTURE RESEARCH

The above findings provide evidence of the positive influence of Islamic principles in shaping the investment decision of Shariah-compliant mutual funds. By making the principles of *tawhid, khalifah and ukhuwwah* as the basis in conducting their operations and administrations, Shariah-compliant mutual funds are seen not only fulfilling their pursuit for wealth, but at the same time, guarding the interest of other stakeholders. This includes their operations in making investment decisions in potential firms which are not only profitable but at the same time are socially responsible. Their tendency to invest in firms with large size and sound financial performance signals their preference to profit making. However, their preference to invest in firms with good sustainability engagement and firms which are Shariah-compliant provide evidence that Shariah-compliant mutual funds are fulfilling the needs of the stakeholders.

The study provides further explanation to the body of knowledge about the intention of Shariah-compliant mutual funds to satisfy their socially responsible investors by investing in sustainability related companies. The results of this study also provide significant input to Malaysian Public Companies that the implementation of more sustainability activities could attract Shariah-compliant mutual funds to invest in their companies. Therefore, public companies in Malaysia are suggested to conduct more social and environmental activities to increase their competitive advantages. Furthermore, the results from this study also give indication on the investment preference of one type of institutional investors in Malaysian market. This is crucial in supporting the suggestion by Malaysian Code of Institutional Investors (Minority Shareholders Watchdog Group & Securities Commission Malaysia, 2014), where the investors are urged to invest in socially responsible firms. Theoretically, the findings of this study support the influence of Islam through the principles of *tawhid, khalifah* and *ukhuwwah* in shaping the investment behavior of Shariah-compliant mutual funds.

The study is not without limitation as it focuses on Malaysia, a developing nation. Future study may want to extend the research by doing comparative study of Islamic funds between countries, or to consider qualitative methods such as conducting interview with the management of Shariah-compliant mutual funds. The findings may provide richness to the literature of investment preference by Shariah-compliant funds or Islamic funds.

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