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ETHICAL INVESTMENT AND SHARIAH COMPLIANCE MUTUAL FUNDS IN INDIA

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ABSTRACT

This article introduces the basic concept and principles of Shariah compliance mutual funds in India, highlighting their growth amid rising demand from Muslim investors seeking ethical, interest-free (riba-free) investment options aligned with Islamic principles. It analyzes the performance within last five years, factors affecting their performance, limitation and challenges, pros and cons of these funds. Shariah screening methodologies for halal compliance and how is it differ compared to conventional funds, drawing on qualitative insights from experts on operational challenges like limited asset pools and purification processes. It also reveals Relevance of Shariah Compliance mutual funds in Indian context, the sectors of economy which are admissible to invest and the prohibited sectors as well, future potentials of this MF.

KEYWORDS: *Halal Mutual Funds, Ethical Investment, Shariah Law, Expense ratio.*

INTRODUCTION

Shariya (or Shariah) Compliant Mutual Funds are investment funds that strictly follow Islamic finance principles as outlined under Shariah law. These funds are intended for Muslim investors or anyone seeking investments that adhere to specific ethical and moral guidelines. These Mutual Funds are a halal investment vehicle for individuals who wish to grow their money while strictly adhering to the moral and ethical guidelines set by Islamic law. Shariah-compliant mutual funds in India, also known as "Halal mutual funds," are investment vehicles that operate in accordance with Islamic principles. These funds are designed for investors who want their investments to align with their faith and ethical beliefs. Shariah mutual funds in India are highly relevant. They serve a vital role in providing faith-based investment options, aligning with the global ethical investing movement, and offering a unique approach to portfolio diversification. Their continued growth will depend on greater investor awareness, the launch of more fund options, and favorable market conditions for the sectors they invest in.

OBJECTIVES

Through this study we can understand the meaning, objectives, principles and the performance of shariah compliance mutual funds in India. We would try to understand that how they work, the key principles they follow, and some examples of such funds in India.

LIMITATIONS

This study is limited and focused to the Indian mutual fund market only, any other country will not consider. The mutual funds which works on the basis of shariah rules will be discussed here.

Core Principles of Shariah-Compliant Investing

Shariah law sets strict guidelines for financial transactions and investments. Shariah-compliant mutual funds must adhere to these principles:

Prohibition of Interest (Riba): The fund cannot invest in any instrument that generates income from interest, such as conventional bonds or fixed deposits.

Avoidance of Haram (Forbidden) Industries: The fund cannot invest in companies involved in activities considered unethical or forbidden under Islamic law. This includes: Alcohol and tobacco, Gambling and casinos, Pork and non-halal food products, Conventional banking and insurance, Weapons manufacturing, and Adult entertainment etc.

Ethical and Financial Screening: Funds employ a rigorous screening process to select companies. In addition to avoiding haram industries, they also look at a company's financial health.

Debt Ratio: A company's total debt should be within a specific limit, often not exceeding 33% of its market capitalization. This is to avoid companies that are heavily reliant on interest-based financing.

Non-Compliant Income: Any income derived from non-permissible sources (e.g., interest income) must be less than 5% of the company's total revenue. Any such income is "purified" by donating it to charity.

Shariah Advisory Board: These funds are overseen by a board of Islamic scholars who ensure that all investments and practices comply with Shariah law. They provide guidance and conduct regular audits.

Shariah-Compliant Mutual Funds in India

While the number of Shariah-compliant funds in India is limited compared to conventional funds, there are a few notable options. These funds typically invest in sectors like technology, healthcare, and consumer goods, which are generally considered Shariah-compliant. Some of the well-known Shariah-compliant mutual funds in India include:

Tata Ethical Fund: One of the oldest ethical mutual funds in India.

Taurus Ethical Fund: This fund screens companies based on both Shariah and ESG (Environmental, Social, and Governance) filters.

Quantum Ethical Fund: This fund is specifically marketed as Shariah-compliant and undergoes regular audits by Shariah advisors.

Nippon India ETF Nifty 50 Shariah BeES: This is a passively managed fund that replicates the Nifty 50 Shariah index.

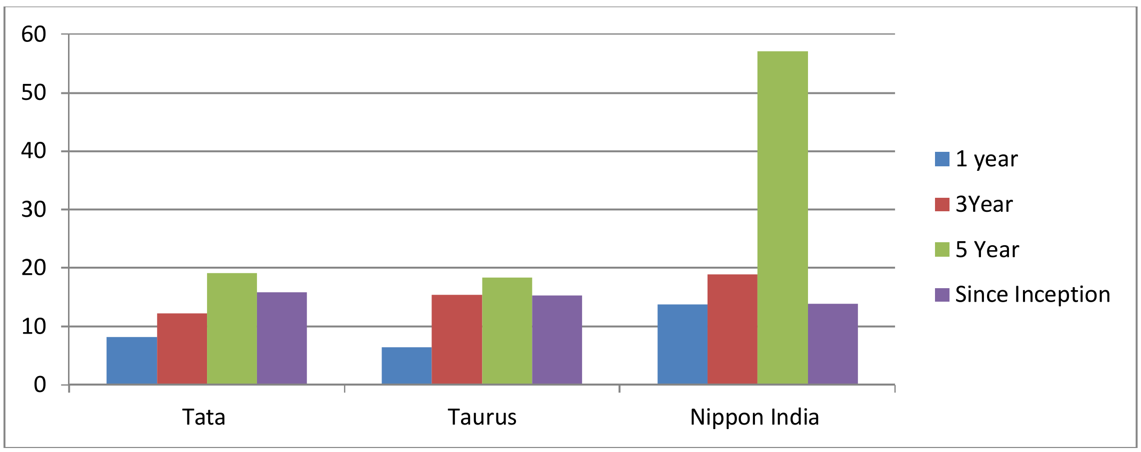
Key Funds and Their Performance

The performance of Shariah mutual funds in India requires looking at the returns of specific funds over various time periods. It's also helpful to compare their performance against broader, conventional market benchmarks to understand how the Shariah screening process impacts returns. Based on data from various financial platforms, here's a snapshot of the performance of some well-known Shariah funds as of late August 2025.

Name of the Fund	1-Year Return (%)	3-Year Return (%)	5-Year Return (%)	Since Inception CAGR (%)
Tata Ethical Fund	-9.23% to -8.23%	11.22% to 12.26%	18.61% to 19.11%	15.06% to 15.82%
Taurus Ethical Fund	-7.38% to -6.52%	13.25% to 15.45%	16.71% to 18.36%	15.3%
Nippon India ETF Nifty 50 Shariah BeES	-14.00% to -13.76%	5.01% to 18.94%	11.52% to 57.05%	13.24% to 13.9%

Source: www.smallcase.com

Note: The return data can vary slightly across different financial websites due to different calculation methodologies, the specific date of data retrieval, and whether it's for the Direct or Regular plan.



Performance against Benchmarks

A crucial aspect of evaluating these funds is to see how they perform relative to their benchmarks and the broader market.

Tata Ethical Fund: This fund often benchmarks itself against the Nifty 500 Shariah Total Return Index. While it has shown solid long-term returns, its short-term performance (1-year) has underperformed the Nifty 500 benchmark.

Taurus Ethical Fund: This fund is often compared to the S&P BSE 500 Shariah Index. Like the Tata Ethical Fund, its long-term performance has been strong, but recent short-term returns have been negative.

Nippon India ETF Nifty 50 Shariah BeES: As an Exchange Traded Fund (ETF), its performance is designed to closely track the Nifty 50 Shariah Index. Its returns, particularly in the short-term, reflect the performance of this specific index.

Key Factors Influencing Performance

The performance of Shariah-compliant funds is directly tied to the principles they follow, which can create a unique return profile compared to conventional funds.

Sectoral Exclusion: Shariah funds cannot invest in high-performing sectors like conventional banking, finance, and alcohol. In periods where these sectors perform exceptionally well, Shariah funds may lag behind broader market indices like the Nifty 50 or Sensex.

Focus on Specific Sectors: Conversely, these funds tend to be overweight in sectors that are considered Shariah-compliant, such as technology, healthcare, energy, and consumer goods. If these sectors are performing well, Shariah funds can outperform the market.

Lower Debt Exposure: The financial screening process requires companies to have a low debt ratio, making these funds more focused on fundamentally sound and financially stable businesses. This can provide some stability during times of market volatility.

Relevance in India

The relevance of Shariah-compliant mutual funds in India is growing, driven by a combination of a large Muslim population seeking faith-based investment options and a broader trend toward ethical and socially responsible investing. While the market is still niche, several factors contribute to its increasing significance.

1. Catering to a Specific Investor Base

The primary relevance of these funds lies in their ability to provide a viable investment avenue for India's substantial Muslim population. For many Muslims, traditional financial instruments that involve interest (riba) or invest in industries like alcohol, gambling, or conventional banking are prohibited. Shariah-compliant funds offer a solution, allowing them to participate in the capital markets without compromising their religious and ethical beliefs.

2. Alignment with Ethical and Socially Responsible Investing (SRI)

Beyond their religious appeal, Shariah funds are increasingly relevant to non-Muslim investors as well. They fall under the broader category of ethical or socially responsible investing (SRI).

The screening process that Shariah funds follow—avoiding companies with high debt, non-permissible income, and those involved in unethical activities—aligns with the principles of ESG (Environmental, Social, and Governance) investing. As awareness of sustainable and ethical business practices grows in India, these funds attract a wider group of investors who prioritize social impact alongside financial returns.

3. Market Diversification and Risk Management

The investment philosophy of Shariah funds, with its focus on tangible assets and low debt, can offer a unique risk-return profile. *Lower Debt Exposure*: Shariah screening criteria limit investments in companies with excessive debt, which can make these funds more resilient during periods of financial instability. *Focus on Core Sectors*: These funds are often overweight in sectors like technology, healthcare, and consumer goods, which are generally considered Shariah-compliant. This provides diversification away from the financial and alcohol sectors that are dominant in conventional indices.

Pros of Shariah Mutual Funds

Ethical and Faith-Based Investing: The most significant advantage is that these funds provide a vital investment option for India's large Muslim population, allowing them to participate in the capital markets in a way that is compatible with their religious beliefs. The funds strictly avoid industries like alcohol, gambling, pork products, and conventional banking, which are prohibited under Islamic law. This also appeals to a growing number of non-Muslim investors interested in ethical and socially responsible investing.

Focus on Financially Sound Companies: Shariah screening criteria are not just about business activities; they also have financial filters. Funds avoid companies with high debt levels (typically, debt should be less than 33% of market capitalization). This emphasis on low-leverage companies can make the portfolio more resilient during economic downturns and periods of high-interest rates.

Encourages Long-Term Investing: The Shariah-compliant framework discourages speculative and short-term trading, as it is seen as a form of gambling. This focus on long-term, fundamental-based investing aligns with a disciplined approach to wealth creation.

Transparency and Governance: These funds are overseen by a Shariah advisory board of Islamic scholars who ensure that all investments and practices are compliant. This adds a layer of transparency and governance, reassuring investors that their money is being managed according to strict ethical guidelines.

Cons of Shariah Mutual Funds

Limited Investment Universe: The biggest disadvantage is the narrow range of investment options. By excluding major sectors like conventional banking, financial services, and insurance, Shariah funds have a much smaller pool of stocks to choose from compared to conventional funds. This can limit diversification and potential growth opportunities.

Potential for Underperformance: The exclusion of key sectors, particularly the high-performing financial sector, can lead to underperformance when those sectors are experiencing a market boom. While the focus on low-debt companies can provide stability, it may also cause the fund to miss out on significant returns.

Lower Liquidity in Some Cases: Due to the restricted stock selection and specific screening criteria, some Shariah-compliant funds may hold a portfolio of less-liquid stocks, which could make it challenging to buy or sell units quickly, especially for large investment amounts.

Higher Expense Ratio: The costs associated with maintaining a Shariah advisory board, conducting regular audits, and the purification process (donating non-compliant income to charity) can sometimes result in a higher expense ratio compared to conventional funds. This can eat into an investor's net returns over the long term.

Challenges and Limitations

Despite their growing relevance, Shariah mutual funds in India face certain challenges:

Limited Fund Options: The number of Shariah-compliant mutual funds is very limited compared to the vast universe of conventional funds. This restricts investor choice and diversification opportunities. *Sectoral Concentration*: The exclusion of key sectors like banking and finance, which are major components of conventional market indices, can lead to underperformance when those sectors are booming. *Lower Awareness*: There is a general lack of awareness and financial literacy regarding Shariah-compliant funds, even within the Muslim community. This has been a key reason for the slow growth of this segment. *Regulatory Framework*: While the Securities and Exchange Board of India (SEBI) has enabled the launch of these funds, a more dedicated and comprehensive regulatory framework could help streamline the process and boost investor confidence.

Future Outlook

The future of Shariah-compliant mutual funds in India appears promising, driven by the following trends: *Increased Financial Inclusion*: These funds are a crucial tool for financial inclusion, enabling a significant portion of the population to engage with the formal financial system in a way that is compatible with their beliefs. *Rising Ethical Investor Base*: As global and local trends in ethical and ESG investing gain traction, Shariah funds are well-positioned to attract a new generation of value-driven investors. *Technological Advancement*: The rise of FinTech and online investment platforms is making it easier for investors to access and understand niche products like Shariah-compliant funds.

Suitability of the Shariah Mutual Funds

The suitability of Shariah-compliant mutual funds for Indian investors depends heavily on their individual financial goals, risk tolerance, and, importantly, their ethical or religious beliefs. These funds are not a one-size-fits-all solution and have distinct characteristics that make them suitable for some investors while less so for others.

Who are Shariah Mutual Funds Suitable for?

***Muslim Investors Seeking Halal Investments*:** This is the most direct and obvious group. For Indian Muslims who want to invest their money in a way that aligns with their faith, these funds are an essential and often the only suitable avenue for participating in the equity markets. They provide a structured way to avoid prohibited industries and interest-based transactions, ensuring their investments are in line with Islamic principles.

***Ethical and Socially Responsible Investors*:** Shariah funds are a form of socially responsible investing (SRI). Their strict screening process, which excludes businesses involved in alcohol, gambling, tobacco, and weapons, appeals to a growing number of non-Muslim investors who prioritize ethical business practices and social impact. These investors see Shariah funds as a way to invest in companies with strong corporate governance and a positive social footprint.

***Risk-Averse Investors*:** The investment philosophy of Shariah funds, with its focus on companies with low debt-to-equity ratios and a ban on interest-based income, often leads to a more conservative portfolio. This can make them suitable for investors who are looking for a lower-risk investment option, as financially sound companies with less debt may be more resilient during economic downturns.

Factors to Consider Before Investing

While Shariah funds can be a good fit, investors should be aware of their potential limitations:

***Limited Diversification*:** The most significant drawback is the restricted investment universe. By excluding major sectors like conventional banking, finance, and insurance, Shariah funds have a narrower selection of stocks. This can lead to a more concentrated portfolio and may result in underperformance during periods when the excluded sectors are performing well.

***Potential for Underperformance*:** The performance of Shariah funds is often correlated with the sectors they are over-weighted in, such as technology, healthcare, and consumer goods. If sectors underperform the broader market (e.g., the Nifty 50 or Sensex), the Shariah funds may also show lower returns. However, some studies suggest that in bearish or crisis periods, Shariah funds may show more resilience due to their focus on low-debt companies.

Higher Costs: The additional work involved in the Shariah screening process, including the cost of a Shariah advisory board and regular audits, can sometimes lead to a slightly higher expense ratio compared to conventional mutual funds.
Lack of Standardization: While the core principles are universal, the specific screening criteria and interpretations can vary among different fund houses and Shariah advisory boards. This means that a company considered Shariah-compliant by one fund might not be by another, making it important for investors to understand the specific screening methodology of the fund they are considering.

Key Points to Remember about Expense Ratios

Direct vs. Regular Plans: In India, all mutual funds, including Shariah funds, offer two types of plans: *Direct Plan*: This plan has a lower expense ratio because it does not include a commission for a distributor or broker. *Regular Plan*: This plan has a higher expense ratio as it includes a commission that is paid to the distributor. For long-term investors, the difference in expense ratios between direct and regular plans can significantly impact the final return on investment.
Impact of AUM: According to SEBI regulations, the expense ratio of a mutual fund is linked to its Assets Under Management (AUM). As the AUM of a fund increases, the maximum allowable expense ratio decreases. Since many Shariah funds have smaller AUMs compared to large conventional funds, their expense ratios may be at the higher end of the permissible range.
The "Purification" Cost: Shariah funds must conduct a "purification" process, where any income from non-permissible sources (e.g., interest income) is identified and donated to charity. The cost and administrative effort involved in this process are factored into the fund's operating expenses, which can contribute to a slightly higher overall expense ratio.
Comparison with Conventional Funds: While there are no hard and fast rules, the average expense ratio for conventional equity funds in India can range from 0.50% to 2.50% (for direct plans) depending on the fund's size and category. Shariah funds, with expense ratios generally falling within a similar band, are not necessarily more expensive but reflect the unique operational requirements of their investment philosophy.

As an investor, it is always recommended to check the most recent expense ratio of a specific fund on the official website of the Asset Management Company (AMC) or on a reliable financial platform before investing.

Expense Ratio of Leading Shariah Funds

The expense ratios of Shariah-compliant mutual funds in India vary depending on the fund house and whether it's a direct or regular plan. Generally, the expense ratio for Shariah funds is considered to be on par with, or in some cases, slightly higher than, conventional funds due to the additional costs associated with Shariah compliance. Here are the approximate expense ratios for some of the leading Shariah-compliant mutual funds in India, based on recent data:
Tata Ethical Fund: The direct plan of this fund has an expense ratio of around 0.65%. The regular plan has a higher expense ratio, typically around 1.90%.
Taurus Ethical Fund: The direct plan of this fund has an expense ratio of approximately 0.97%.
Nippon India ETF Nifty 50 Shariah BeES: As an Exchange Traded Fund (ETF), its expense ratio is relatively low, around 0.96%.

CONCLUSION

Shariah-compliant mutual funds are highly suitable for Indian investors who prioritize their religious or ethical beliefs. They offer a unique investment vehicle that aligns faith with financial goals. For those who are not motivated by religious reasons, these funds can still be a viable option, particularly for investors interested in ethical and socially responsible investing or those seeking a portfolio with a lower debt exposure. Ultimately, like any other investment, the decision to invest in a Shariah mutual fund should be made after careful consideration like financial objectives, risk tolerance, and a thorough analysis of the specific fund's performance, expense ratio, and investment strategy. Shariah-compliant mutual funds in India, like any other investment vehicle, come with their own set of advantages and disadvantages. For Indian investors, understanding these pros and cons is crucial for making an informed decision that aligns with their financial goals and personal values.

For Indian investors, Shariah mutual funds are a double-edged sword. For investors seeking a faith-compliant or ethical investment option, the pros of aligning their financial decisions with their values far outweigh the cons. These funds provide a critical tool for financial inclusion and peace of mind. For investors whose primary goal is to maximize returns without regard for religious or ethical filters, the cons of limited diversification and potential for underperformance may make conventional mutual funds a more suitable choice.

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