

CONFIDENCE EFFECT AMONG SUKUK INVESTORS FOLLOWING SUKUK ANNOUNCEMENTS IN MALAYSIA

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ABSTRACT

Changes in investors' confidence may trigger changes in asset prices. Investor sentiment may be an important factor of the market pricing process in explaining changes in the stock market index. This research looks into the determinants of investors' confidence for selected Sukuk issuing firms listed in the FTSE Bursa Malaysia Emas Shari'ah Index (FBM EMAS) which was launched on January 22, 2007. This study gathers data on stock market volatility based on the news and events of Sukuk announcements. Thus, the results are categorized as highly risk averse, moderately risk averse, risk neutral, moderately risk seeking and highly risk seeking. This work employs the Equity Market Sentiment Index (EMSI) to classify investors' confidence on FBM EMAS by using data from January 22, 2007 to December 31, 2011. The findings indicate that the daily price trends of the FBM EMAS are significantly related to investor sentiments. In addition, Sukuk investors do not exhibit high risk seeking behavior prior to 2008. Policymakers and regulatory bodies may utilize the information of Sukuk investors' confidence to further enhance and regulate Sukuk industry market behavior.

Keywords: EMSI, Sukuk, confidence effect, stock market, FBM EMAS

Introduction

Risk is one aspect of Sukuk industry that is well-researched. Sukuk market has grown tremendously and has gained attention from many investors around the world. The subject of the Sukuk risk whereby the risk structure needs to be brought out and conformed with Shari'ah values. According to Hancock and Meussa (2009), when some originators find themselves in financial trouble, or worse, become insolvent, Sukuk investors discover that they are unexpectedly competing with a general body of creditors, rather than simply enforcing against or taking possession of the assets to support their Sukuk. The research problem comes with the increasing number of defaulted Sukuk should be one of the concerns because it is nearly related to risk that will affect the investors' confidence to invest in Sukuk. Confidence among Sukuk investors is important in the Sukuk market that will influence the number of issuances and their returns. This issue becomes the motivation to study the Sukuk investors' risk profile. Confidence in the economic system, specifically in the Islamic capital market, is an important driver of economic and financial fluctuations. Investors desire to buy the securities and invest at prevailing prices when confidence increases in the strong economic conditions. Otherwise, their risk-taking tend to fall when confidence decreases as seen in the 2008 global financial crisis. Confidence has deteriorated since the beginning of the crisis and changes in confidence can be tied to several economic variables and events (Dailami & Masson, 2009). Investors' confidence is the anticipation of future stock market stability, which is an important element in finding stock market volatility. Investor confidence is a subject that is important in the stock market or securities exchange markets. Public confidence in the securities market depends on the ability to issue securities without withholding material facts from public security holders (Dante, 2004).

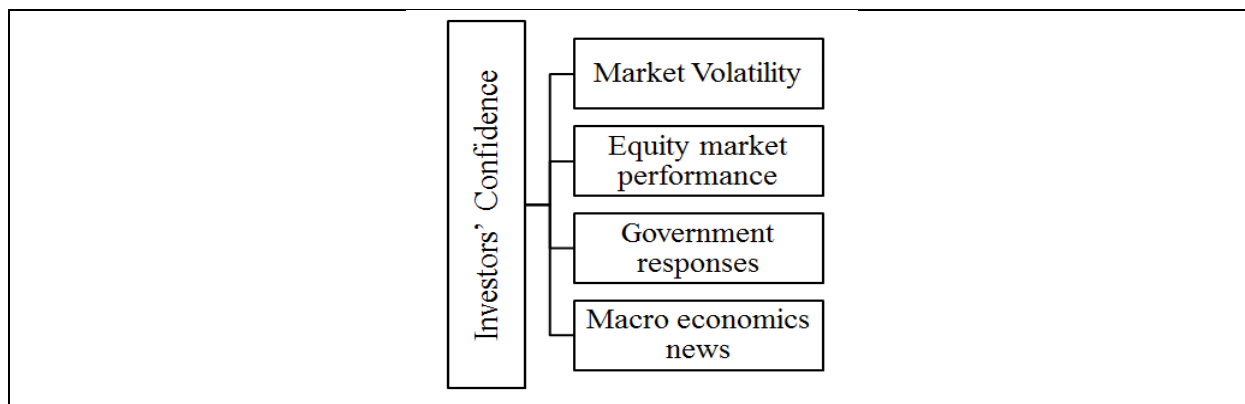
The research objective of this study is to examine the confidence effects among Sukuk investors in Malaysia following the 2007/2008 global financial crisis. This research contributes to the literature since the empirical work on Sukuk investors' confidence is relatively few. The rest of the paper is structured as follows. Section two converses the related literature and provides a brief background on investors' confidence. Section three discusses the theoretical framework. Section four highlights the research methodology. Section five discusses the findings and the final section concludes this study.

Literature Review

Investors' confidence may decrease because of the risks. Although bearing certain risks, Sukuk is considered to be a relatively secure financial instrument (Nanaeva, 2010). The most common risks associated with a Sukuk issue are; (i) risk of default: a risk that the issuer would not be able to make regular payments (coupons) or to repay the principal amount; (ii) downgrade risk: the issuer is downgraded, the Sukuk price can drop significantly; (iii) inflation risk: due to its fixed-income nature, the investor faces the risk that inflation can be higher than the coupon payment; (iv) liquidity risk: Sukuk are considered to be less liquid instruments than stocks; and (v) foreign exchange risk: risk can affect Sukuk issued in a foreign currency as unfavorable currency fluctuation can decrease the initial value of investments. Dailami and Masson (2009) have postulated four dimensions

of investor trust. They identify a link between investor and consumer confidence. They indicate that liquidity provision and easing of interest rates had only a limited effect on financial market spreads during the crisis, arguing for extra amounts to address the loss of trust. Figure 1 shows the dimensions of investor confidence.

Figure 1: Four Dimensions of Investor Confidence



Source: Dailami & Masson, 2009

The first dimension in investor psychology is strongly determined by the scale of abnormal volatility in the marketplace, especially when that volatility spans several asset classes, signaling an overall mood of doubt and risk aversion. Second, investor trust is also linked up to the carrying out of their investments, as measured by wealth creation or destruction. Third, investors and traders are also affected by macroeconomic news that provide insights into economic fundamentals and shape perceptions of the future state of the economic system. Fourth, market participants and traders pay close attention to the stance of government policy makers and continually assess the credibility of their answers. Governments could influence investors' confidence in many ways: through macroeconomic policy, regulatory policy, and other legislative actions that can strengthen transparency and enhance corporate financial disclosure and integrity (Dailami & Masson, 2009).

Brown and Cliff (2004) measured individual investors' sentiment and investor intelligence, and found that the sentiment of individual investors and investment intelligence sentiment were related to other sentiment measures and market returns. Bandopadhyaya and Jones (2005) constructed the EMSI so that changes to the underlying riskiness of the market did not directly affect the proposed measure. Thus, these measures more accurately reflected the changes in the market's attitude towards risk. The EMSI related specifically to the risk or return tradeoff embedded in prices and therefore focused solely on the market's willingness to take any risks were inherent in the marketplace at applied time. Schmeling (2009) measured consumer confidence and establish that changes in consumer confidence had a statistically significant negative consequence on future stock returns (1, 6, 12, and 24 months) on average across states. Nevertheless, the negative effect diminished as the forecast horizon increased. Mohammed and Radzi (2012) pointed to the governments' failure to tender the best solutions to diminish the impact of Sukuk default and protect the involved parties. This will also damage the reputation of Islamic finance. Such issues will seriously reduce investors' confidence in the Islamic financial system.

Theoretical Framework

Confidence theory explains how the equity market sentiment index is computed and how Sukuk investors respond to the different risk classifications. Pangano (1993) states that regulatory and institutional factors may determine the performance of stock markets. For example, mandatory disclosure of reliable information about firms might enhance investor participation whilst regulations that instill confidence in brokers should encourage investment and trading in the stock market. Julius, Andrew & Lucy (2011) say that investor confidence is an attitude where there is a feeling that nothing can go faulty with the investment, permitting the investor to sleep easy since there is naught to care about. This is a major investor attitude and belief that is commonly observed by observers of speculative markets as being able to commute with time and cause important effects on the marketplace.

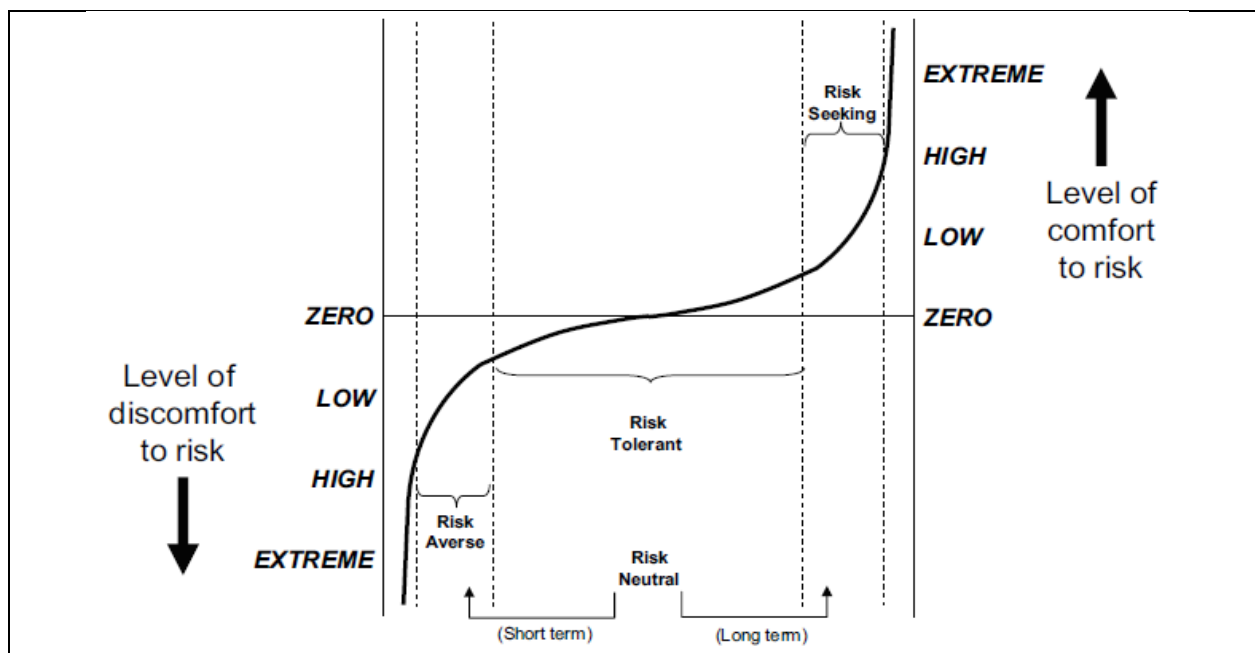
Micheal (2005) mentions that when confidence increases, investors want to invest at prevailing prices. When confidence decreases, risk-taking activities tend to be reduced. Investors are said to be confident when news about the future is good and stock prices are going up. Nevertheless, rising costs are linked both to sound fundamentals, such as growth in industrial output and productivity, as easily as to the underlying sentiment or mood of investors. Confidence depends on support and resistance. Support is a point in a declining stock market where buyers start buying. In contrast, resistance is the point where sellers start selling. Sometimes, support or resistance levels are at exactly the same spot. At other times, they are not so precise, but instead are in a range of stronger support or more substantial resistance. High confidence should correspond to a situation where there are high support and low resistance. On the other hand, low confidence should correspond to a situation where there are low support and high resistance.

Thus, in that location is a lineal relationship between risk and return for both issuers and investors. Investors in equities who put their money into an organization, expose themselves to high risk. As a consequence, they await a high return, whether through the increase in the value of their shares, through the dividend paid on the percentages, or both (Walter, et al., 1999).

Risk can be separated into a few categories. Investors feel strongly positive when they are assuming risks and have low confidence when they are risk averse. The prospect theory of Kahneman and Tversky (1979) is a psychology-based behavioral theory emphasizing 'loss aversion'. The loss aversion feature states that people are much more sensitive to reductions than to increases in wealth. Based on this theory, the maximization of a weighted sum of utilities, which are based on the probabilities of events, which is the higher the risk, the higher the returns. When they are successful in investment activities, for example, in the property market, they will tend to assign a heavy weight to the event of speculative success in the stock market. Consequently, they will be more willing to take on additional risks.

Hillson and Murray-Webster (2007) state that in risk theory, there are several types of risk attitude: risk averse, risk neutral and risk seeking. These types of risks can also be the results for Equity Market Sentiment Index (EMSI), which is used to examine the categorization of risks among Sukuk investors. They define risk averse to be when an investor dislikes risk, and so will remain out from adding high-risk stocks or investments in their portfolio. As a consequence, the investor will often miss out on higher rates of recurrence. Investors looking for "safer" investments will generally stick to index funds and government bonds, which generally have lower returns. Meanwhile, risk neutral is when an investor would be in the middle of a continuum where risk-seeking investors are at one end, and risk-averse investors are at the opposite extreme. Risk-neutral measures an extensive application in the pricing of derivatives. Finally, risk seeking is when an investor is searching for greater volatility and uncertainty in investments in exchange for anticipated higher returns. That existence said, risk-seeking investors should take even more capital due diligence when considering a riskier investment, due to the increased implied risk of such investments. The fact that individuals tend to be risk averse in the face of gains and risk seeking in the face of losses can lead to some very poor financial decisions. The words 'averse', 'neutral', or 'seeking' to represent a preferred response to the uncertainty that matters, driven by perception. Figure 2 below shows the risk attitude spectrum.

Figure 2: Risk Attitude Spectrum



Source: Todd, 2007

Figure 2 shows the risk attitude spectrum between risk averse, risk neutral and risk seeking. Risk averse is when the investor dislikes risk and looks for safer investments. In this situation, investors have low confidence to invest. Risk neutral is when the investors are in the center of the continuum where risk-seeking investors are at one end, and risk-averse investors are at the other extreme. Risk-seeking investors are those who look for greater volatility and uncertainty in investments in exchange for anticipated higher returns. They are investors with high confidence levels and will agree to both invest and issue Sukuk. The investors are willing to accept a return on their investment that is lower than what they might get from riskier investments such as equities. The higher the risk taken, the higher the return as the investor requires compensation to that risk (Todd, 2007).

Methodology

Sample and Data Collection

Data of Sukuk issuance in Malaysia are obtained from the Bloomberg database, the Securities Commission of Malaysia, Bursa Malaysia, and Zawya Sukuk. The point of the subject area is set to be between 2007 and 2011. This period of study have chosen because of the launch date of the FBM EMAS Shari'ah index is on January 22, 2007. This research focuses on post the 2007/2008 global financial crisis, which are 2009 till 2011 only, since the theory of random walk mentioned that there is no memory of its past prices, which means the history of the series cannot be used to forecast the future. The Sukuk data that are

garnered in this research are from 50 selected of listed companies that issue Sukuk in Malaysia. The data of stock markets are collected from the historical prices available in the Data Stream database, excluding Saturdays and Sundays, giving a total of about 265 days a year.

FTSE Bursa Malaysia Emas Shari’ah Index (FBM EMAS)

FTSE Group (2012) states that the FTSE Bursa Malaysia Emas Shari’ah Index has been designed to provide investors with a broad benchmark for Shari’ah-compliant investment. Constituents are screened according to the Malaysian Securities Commission's Shari’ah Advisory Council (SAC) screening methodology. The index is designed for the creation of Shari’ah-compliant investment products and as a benchmark. The Shari’ah-compliant companies must not be involved in any financial services based on riba (interest), gambling, manufacture or sale of non-halal products or related products, conventional insurance, entertainment activities that are not permissible according to Shari’ah, manufacture or sale of tobacco-based products or related products, stock broking or share trading in Shari’ah non-compliant securities and other activities deemed not permissible according to Shari’ah. This index includes general industries, mobile telecommunications, electricity, food producer, chemical, fixed line telecommunication, and oil and gas industries. This field has chosen this Shari’ah index because it is one of the Shari’ah indices in Malaysia as the biggest Sukuk market in the world.

Measuring Confidence among Sukuk Investors

The construction of the Equity Market Sentiment Index (EMSI) started when Persaud (1996) developed a measure of the market's attitude towards risk, a measure that he describes as the market's appetite for risk in the context of currency markets. He argues that over the short run, in the foreign exchange market, the market's changing appetite for risk is a dominant force and at times the most influential factor affecting currency returns. If the market's appetite for risk were fixed, exchange rate change will be driven only by unanticipated shifts in economic risk. If the appetite for risk grow and economic risks are unchanged, investors will feel overcompensate for these risk levels and the sense of overcompensation will grow as the level of risk grows.

The Equity Market Sentiment Index (EMSI) will be used in this study to measure changes to the underlying riskiness of the market. It does not directly affect the measures. Thus, these measures more accurately reflect the changes in the market’s attitude towards risk. This research computes daily returns for each of the companies that issue Sukuk securities. This study also computes the average standard deviation of the daily returns over the previous days (the “historic volatility”) for each day of the sample period. This study ranks both the daily rate of return and the historic volatility of the returns for each Sukuk issuance and multiplies the result by 100 (to obtain the percentage).

The changes in investor sentiment may trigger changes in asset prices, and that investor sentiment may be an important component of the market pricing process. EMSI can be used in a stock market setting by studying the price movements of a group of Sukuk issuance from many companies. News events that affect the underlying market studied are quickly captured by changes in this measure of investor sentiment, and the sentiment measure is capable of explaining a significant proportion of the changes in the stock market index (Bandopadhyaya & Jones, 2006).

The EMSI is calculated as follows:

$$EMSI = \frac{\sum(R_{iR} - \bar{R}_r)(R_{iV} - \bar{R}_v)}{[\sum(R_{iR} - \bar{R}_r)^2 \sum(R_{iV} - \bar{R}_v)^2]^{\frac{1}{2}}} \times 100; \quad (-100 \leq EMSI \leq +100) \quad (1)$$

where R_{iR} is the rank of the daily return for Sukuk issuance, R_{iV} is the historical volatility of Sukuk issuance, \bar{R}_r is the population Sukuk issuance’s mean return and \bar{R}_v is the historical volatility rankings.

The fraction in the EMSI formula has similar variables in both the numerator and the denominator. The only difference between the numerator and denominator are: (1) the denominator must be the square of the difference between the rank of the daily return for Sukuk issuance and the population Sukuk issuance mean return, and also the square of the difference between the value of the historical volatility for Sukuk issuance and the historical volatility rankings, (2) the value of the denominator is taken as the square root. The denominator is squared and the square root of the product of the two squares is taken as the final value, to make sure the value of the denominator is a positive number. The calculated daily EMSIs’ result is recorded in five different categories that may include all trading days between 2004 and 2011. The range of -30 and below indicates highly risk averse, -10 to -30 indicate moderately risk averse, -10 to +10 show risk neutral, +10 to +30 indicate moderately risk seeking, and +30 and above indicate highly risk seeking. A summary of the risk categorization of daily EMSIs is presented in Table 1:

Table 1: Risk Categorization of Daily EMSI

RANGE OF EMSI CALCULATION	RISK CATEGORIZATION
-30 and below	High Risk Averse
-10 to -30	Moderate Risk Averse
-10 to +10	Risk Neutral
+10 to +30	Moderate Risk Seeking
+30 and above	High Risk Seeking

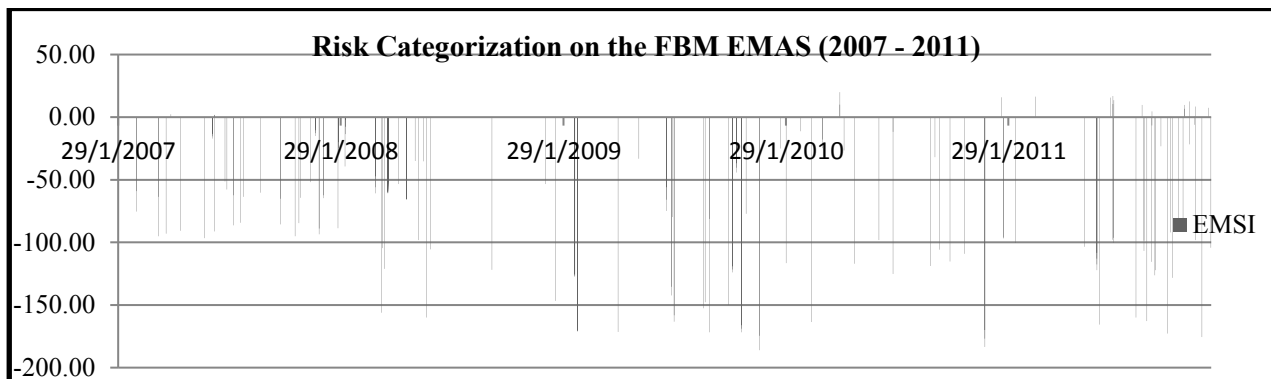
Source: Bandopadhyaya & Jones, 2006

By considering the similar characteristics of bonds and equity, this research is able to explain market reactions to Sukuk by using the EMSI method. Sukuk does not pay interest, but generate returns through the commoditization of capital gain. It cannot be classified exclusively in the debt category because it also shares some stock features. This is considered to be the common characteristics of Sukuk and equity (Modirzadehbami & Mansourfar, 2011).

Findings and Discussion

This study examines the confidence factors among Sukuk investors using the Equity Markets Sentiment Index (EMSI) for the Sukuk issuances between 2007 and 2011. This method is important to determine risk behavior in terms of five categories of risk, as this study shows the level of confidence among the Sukuk investors. Figure 3 and Table 2 show the results of risk categorization by EMSI.

Figure 3: Risk Categorization following Sukuk Issuances on FBM EMAS (2007-2011)



Source: Authors' calculation

Table 2: Summary of Risk Categorization by EMSI Following Sukuk Issuance of FBM EMAS (2007-2011)

Risk Categorization Following Sukuk Issuance												
No.	Categorization of Risk EMSI	No. of Sukuk Issuance							Total			
		Before crisis			During Crisis		After Crisis					
		2004	2005	2006	2007	2008	2009	2010		2011		
1	(-30 and below) Highly Risk Averse	FTSE Bursa Malaysia Emas Shari'ah Index was launched on 21 May 2007					27	41	36	13	27	140
2	(-10 to -30) Moderately Risk Averse						8	4	0	6	2	20
3	(-10 to +10) Risk Neutral						14	2	0	2	9	27
4	(+10 to +30) Moderately Risk Seeking						0	0	0	1	7	8
5	(+30 and above) Highly Risk Seeking						0	0	0	0	0	0
Total of sukuk issuances by years							49	47	36	22	45	199
TOTAL					96	103						

Source: Authors' calculation

Figure 3 displays almost all negative results that indicate the investors avoid risks during the crisis and after the crisis. There are only a few days show positive results on this index. Table 2 shows the number of Sukuk issuances after the crisis (51.8 per cent) is higher than during the crisis (48.2 per cent). Both during and after the crisis, the high risk-averse category indicate the highest number of issuances and there are no results on the high risk-seeking category. There are also no results for the moderate risk-seeking category during the crisis. After the crisis, starting the year 2009, the results show all of issuances are highly risk-averse where the investors try to avoid risks. There are no results in the risk-seeking categories, both moderate risk-seeking and high risk-seeking. The investors on the FBM EMAS show the confidence to invest the Sukuk during the crisis because of a lack of information among investors. The negative significant results following negative news indicated that investors avoided risks.

There are issuances on all risk categories after the crisis, except high risk-seeking. There is 73.8 per cent in the high risk-averse category, 10.7 per cent in the risk-neutral category, and 7.8 per cent in both the moderate risk-averse and the moderate risk-seeking categories. The highest issuances after the crisis are in the high risk-averse category. Investors avoid the high-risk stocks or investments in their portfolio. This change in investors' confidence specifies potentially important financial and economic consequences. The moderate risk-seeking and risk-neutral categories show that investors' confidence slowly recover after the crisis. In conclusion, the results during and after the crisis support the hypotheses:

- H1_{3b}**: Sukuk investors display moderate risk averse behavior during the 2007/2008 crisis.
- H2**: Sukuk investors display risk neutral behavior after the 2007/2008 crisis.

Conclusion And Future Recommendation

In conclusion, the hypothesis have accepted for both during and after the crisis. High risk-averse behavior show the maximum results during the crisis. After the crisis, highly risk-averse behavior also show the maximum results, follow by risk-neutral behavior. This risk aversion among investors stay away from adding high-risk stocks or investments in their portfolio. This change in investors' confidence has potentially important financial and economic consequences. The FBM EMAS Shari'ah index also shows the deterioration of confidence that occur as the crisis unfolded and the inadequacy of policy measures taken at that point to fully reverse the deterioration of confidence. Thus, Sukuk investors and issuers are searching for greater volatility and uncertainty in Sukuk investments in exchange for anticipating a higher return. These Sukuk investors should seek for risks, but only after the crisis. They should not avoid risks as the higher the risk, the higher the returns. Besides, the loss-averse investor is more highly motivate to anticipate bad news to avoid losses incurred by these announcements. However, there is low confidence in the high risk-averse investors to invest in Sukuk after the crisis. To put it briefly, markets react negatively and significantly both during and after the crisis. Based on the findings, this study recommends the policy makers, regulators, investors and issuers reflect on and apply the results of this study and choose the Islamic bond, although the market shows weakening, especially during the crisis. The policy makers and regulators should create policies that follow the Shari'ah and its prohibitions. This study acclaims the future research to focus on Sukuk investors' confidence after the period of this study, to see whether the confidence to invest in Sukuk have fast recovery or still have a long memory of the global crisis.

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