

**IDENTIFYING CRITERIA OF ETHICAL  
INVESTMENT: THE MODERATING  
ROLE OF RELIGIOUSITY IN  
INVESTMENT DECISION**

**PERPUSTAKAAN  
UNIVERSITI MALAYSIA SABAH**

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Mohd Amir Bin Masmud  
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## ABSTRACT

Social Responsibility Investment (SRI) or ethical investment and Islamic finance are investment process that considered social, ethical, and environmental issues into considerations before making investment decision. However, to there are limited studies on the ethical investment in particular the factors influencing investor to invest in SRI and Islamic investment. Hence, this study investigated what are the factors that attract people to invest in ethical investments as well as to identify the unique attributes of ethical investment from the investor's perspectives. Questionnaires were prepared in this study for ethical investor. A total of 285 surveys were collected in the current study. Data were collected in Kota Kinabalu, Sabah. The data were analyzed using various statistical analyses, such as descriptive analysis, factor analysis, reliability analysis, and structural equation model. The study findings demonstrated religiosity as the moderator has mediate social factor, personal factor and literacy factor to significantly influenced investment decision of ethical investor. However, the financial factor is not significant with investment decision of ethical investor

## **ABSTRAK**

### **MENGENAL PASTI KRITERIA PELABURAN ETIKA: PERANAN AGAMA SEBAGAI PEMBOLEHUBAH DALAM MEMBUAT KEPUTUSAN PELABURAN**

*Social responsible investment (SRI) atau pelaburan beretika dan pelaburan Islam adalah jenis pelaburan yang mengambil kira isu sosial, etika, dan alam sekitar sebelum membuat keputusan dalam pelaburan beretika. Walau bagaimanapun, kajian yang dijalankan terhadap pelaburan jenis ini khususnya faktor-faktor yang mempengaruhi pelabur untuk membuat pelaburan dalam SRI dan pelaburan Islam adalah sangat terhad. Oleh itu, kajian ini dibuat untuk menyiasat apakah faktor-faktor yang menarik para pelabur untuk melabur dalam pelaburan beretika dan juga mengenal pasti ciri-ciri unik pelaburan etika dari sudut pandangan pelabur. Borang kajian soal selidik telah disediakan dalam kajian ini untuk pelabur etika. Sebanyak 285 borang soal kaji selidik telah dikumpulkan dalam kajian semasa. Data telah dikumpulkan di Kota Kinabalu, Sabah. Data dianalisis menggunakan pelbagai analisis statistik, seperti analisis deskriptif, analisis faktor, analisis kebolehpercayaan, dan analisis struktur equation model. Hasil kajian menunjukkan faktor agama sebagai pengantara memberi kesan kepada faktor sosial, faktor peribadi dan faktor literasi untuk mempengaruhi para pelabur dalam membuat keputusan pelaburan. Walau bagaimanapun, faktor kewangan tidak mempengaruhi keputusan para pelabur*

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## LIST OF ABBREVIATIONS

<b>AuM</b>	-	Assets under Management
<b>C-ALPA</b>	-	Cronbach Coefficient Alpha
<b>CPI</b>	-	Corruption Perceptions Index
<b>CSR</b>	-	Corporate Social Responsibility
<b>EIRIS</b>	-	Persons with disabilities
<b>FA</b>	-	Factor Analysis
<b>KK</b>	-	Kota Kinabalu
<b>KMO</b>	-	Kaiser-Meyer-Olkin measure
<b>PCA</b>	-	Principal Components Analysis
<b>PERC</b>	-	Political and Economic Risk Consultancy
<b>SAC</b>	-	<i>Shariah</i> Advisory Council
<b>SEM</b>	-	Structural Equation Model
<b>SPSS</b>	-	Statistical Package for Social Science
<b>SRI</b>	-	Social Responsible Investment
<b>TPB</b>	-	Theory Planned Behaviour
<b>TRA</b>	-	Theory Reason Action
<b>TI</b>	-	Transparency International
<b>UK</b>	-	United Kingdom

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# CHAPTER 1

## INTRODUCTION

### 1.1 Overview

Ethics has received considerable attention and has become a major concern for government, private and public sector as well as for academics over the past several decades. Since 1995, Transparency International<sup>1</sup> (TI) has published the Corruption Perceptions Index (CPI) annually ranking countries "by their perceived levels of corruption, as determined by expert assessments and opinion surveys. In 2013, Malaysia scored 50, ranking 53 out of 177 countries surveyed in Corruption Perception Index 2013 (Fai, 2013). A survey in 2007 was carried out by Hong Kong-based Political and Economic Risk Consultancy (PERC), in which Malaysia was ranked seventh with a score of 6.25 in corruption ranking (Cheah, 2007). The report also stated that foreign businesses made their decision as to where to locate and invest their funds based on their perception of a particular country. In other words, the more ethical a country appears to be, the easier it will be to attract foreign investors.

However, with respect to matters relating to ethical issues, it is not only a major concern for foreign investor, it is also a concern for local investor. Even though the primary goal of investor is to gain as much profit as possible from investment, an ethical investor will pay more attention to the source where profits are derived. These investors will not invest in "immoral" or "unethical" business activities. They do not want to invest their funds in companies that have activities which will threaten to destroy the environment, human beings, or any other creature in this world. They will choose to invest in ethical investment such as

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<sup>1</sup> Transparency International (TI) is a non-governmental organisation that monitors and publicises corporate and political corruption in the international arena. <http://www.transparency.org/whoweare/history>

social responsible investment (SRI) and Islamic investment as these kinds of investment do not involve any ethical issues. However, with the exclusion of unethical business activities, the investment will thus be restricted to only a certain types. Hence, it has raised a question as to whether the ethical investment will be profitable to ethical investor.

Unlike ethical investment (SRI and Islamic investment), conventional investment offers many types of investment avenues and some of them guaranteed profit. Interestingly, ethical Investments (SRI and Islamic investments) stand on equal footing with the conventional investment in terms of investment return and company performance. Rob Bauer *et al.* (2005), in their study stated that there was no evidence of a difference in return between ethical and conventional mutual fund returns. Even with the issue pertaining to ethics that seems to have posed some limitation to the investment portfolio, people still believed and are interested to invest in ethical (SRI and Islamic investment) investment. Why does this happen? What make them believed that ethical investment is special? Is it related to gender, age or their exposure to business? In order to address these issues, this study attempts to identify the key criterion (parameters) that determine the investment decision of ethical investors. Ethical Investor in this study refers to both Muslim and Non-Muslim investors. This is because both of them follow a set of ethical rules. Nevertheless, from certain perspectives, the principles defining the ethical rules governing Muslim investor's behaviour and that of Non-Muslim investor's behaviour might be different to each other.

## **1.2 Ethics**

Before proceeding further in the discussion of ethical investment, it is helpful to define the word ethics. Oxford dictionary defines ethics as a set of moral principles, especially ones relating to or affirming a specified group, field, or form of conduct. Hellsten and Mallin (2006) view ethics as a set of values and principles accepted by any person or group. Hence, in general, ethics can be defined as the system of rules governing the ordering of values.



Moorhouse (2002) argues that morals describe personal convictions of right and wrong based on religious beliefs, cultural roots, family background, and other contributing factors. Additionally, Elmelki and Ben Arab (2009) point out that religion plays an important role in determining the values and principles that shape the personality and behaviour of individuals, in particular on some aspects of their investment decision-making. Further, Rosly (2010) asserts that principles can also mean values, major beliefs and doctrine rather rulings per se. Hence, according to the Islamic teaching, adhering to Shariah principles or staying "Shariah compliant" means observing strictly to the permissible (*halal*) and abstaining from the prohibited (*haram*) as commanded by God (Rosly, 2010).

In fact, within the Islamic context, the term ethics found in Qur'an is *Khuluq*. The words *Khuluq* (nature) and *Khalq* (creation) are derived from the same root word. *Khalq* relates to the external form or appearance, a physical existence while *Khuluq* is concerned with the spiritual dimension. According to Schwieker (2005), Prophet Muhammad described as *Khuluq* which means "extra ordinary noble character" (Qur'an 68:4). It also refers to a study to examine the moral standards of a person or society to ascertain whether these standards are reasonable or unreasonable when applying them to concrete situations and issues.

### **1.3 Research Problem**

The increasing awareness of a lot of people towards ethical issues has created a new phenomenon among investors. The report of ethical issues among large companies alerted the global world and Malaysians as well. Ethical investment structures provide ideal alternatives and opportunities for institutional and retail investors to achieve broader diversification in their investment portfolios while practicing their moral philosophy.

However, with the moral and ethical principle practiced by ethical investment, certainly it will have to exclude certain business activity which thus will narrow down the investment range. For instance, in Islamic investment, Muslims are not allowed to be involved in production of alcohol, and in SRI, they will not contribute to finance a company which produces nuclear weapons. On the other

hand, the conventional investment is nothing like ethical investment. This is because they do not limit their business activities into certain areas only as compared to ethical investment. In short, investment in the conventional system will grab every possible opportunity to make profit. This is why investment in the conventional system, the profit is guaranteed on the onset. Nonetheless, SRI and Islamic investment have been able to attract people even though they do not guarantee investors a profit.

Consequently, there remain some obvious challenges in ethical investment sector. Most notably is lack of clear regulations governing the ethical investments market, particularly SRI. Islamic investment is a notable exception here as the Securities Commission Malaysia had released "Guidelines and Best Practices on Islamic Venture Capital" way back in May 2008. Based on researcher readings, most of the SRI uses their own guideline based on moral philosophy or CSR practice. Next is lack of awareness and knowledge about ethical investment among the crowd specifically in Kota Kinabalu Sabah.

Lastly, from the scenario mentioned earlier on, it has raised a few questions as to why investors are attracted to ethical investment. Why does this happen? If the profit of a certain investment is not certain or the investment is too risky, certainly investor will not choose that investment. What make them attracted to ethical investment? What make them believed that ethical investment is special? Is it related to the philosophical belief, moral principle, gender, age or exposure to business? In order to address these issues, this study attempts to identify the key criterion to influence the decision of the ethical investors by looking at both SRI and Islamic investment.

#### **1.4 Research Question**

Many researchers have conducted studies to compare ethical investment and conventional investment. Since the ethical investment has become a new trend among investors. Many have researched on issues such as ethical dilemma, how does ethical investment work, how is the performance of ethical investment as



compared to conventional investment, and the factors affecting the investment behaviour of ethical investors.

However, to the knowledge of the researcher, there are limited studies on the ethical investment in particular the factors influencing investor to invest in SRI and Islamic investment. Most of the studies conducted by previous researchers discuss only certain factor such as, gender and ethics, or the role of religiosity in moral behaviour. Most of these studies focussed on the factors separately. What is more startling is that there is no study carried out to find out the views of Muslim and non Muslim investor towards ethical investment. Most likely this is because ethical investment is still in the developing stages. Therefore, this study intends to investigate what are the parameters that draw people towards ethical investments as well as to identify the specific attributes of ethical investment from the respective ethical investors' point of view.

Based on the previous discussion, the following research questions are formulated;

- RQ 1:** What are the parameters that determine/influence investment decision of ethical investors? (Religiosity, Financial factor, Social factor, Literacy factor and Personal factor: gender, education level, and age).
- RQ 2:** What are the attributes of investment according to the respective ethical investors?

### **1.5 Research Objective and Scope**

The aim of this study is to investigate what are the parameters that determine investment decision of ethical investors. The scope of the study is limited to Kota Kinabalu (KK), the capital city for state of Sabah in East Malaysia. KK symbolises the economic growth of Sabah and it is the most developed city in Sabah in term of infrastructure investment. It has become the centre of focus for people to find employment as well as investment opportunities. It will be interesting to compare the eventual findings of this research with findings by other researchers throughout

the world in term of comparing the differences between SRI and Islamic investment with respects to the determinants and their attributes.

The sample used in the study consisted of people who work in the financial institutions, investment agencies, education sector, oil and gas as well as individuals with interest to invest in KK. Anyone who is capable of investing or has the capacity or interest in doing investment was the target sample. The study however focuses solely on SRI and Islamic investment as the main purpose of this research is to compare the findings of this research with respect to these two forms of investment. Specifically, the objectives of this study are as follow:

- a. To identify parameters which determine the investment decision of ethical investors.
- b. To ascertain the attributes of investment according to the ethical investors.

### **1.6 Significance of Study**

The results of this study will have important implications on the supply of investments based on the demand from the investors. It is hope that the Malaysian financial market and the financial industry will improve the investment products available in order to attract more investors in particular the ethical investors. This will only happen if they know some of the key factors influencing the choice of ethical investors when they select the investment portfolio.

Besides, this study also aims to look at the various issues raised on both SRI investment and Islamic investment, and hence improve the understanding of the financial market for better development of investment products. It is also hoped that it could be used to serve as a guideline to improve the performance of investment portfolio as well as to satisfy the investors' needs for ethical investment.

Finally, not many researchers had been investigating on the SRI and Islamic investment in the country, particularly in East Malaysia where the potentials are astonishing. Therefore, this study hopes to serve as the platform for further

research covering various aspects of ethical investment and in particular Islamic investment industry in Malaysia generally and Sabah specifically.

### **1.7 Organization of the Thesis**

The thesis is organised in the following chapters. Chapter one introduces the study. Chapter two discusses the overview of the ethical investment. Whilst chapter three discusses the past literatures related to ethical investment, SRI and Islamic investment. Chapter four provides the theoretical framework for the model of investment decision of ethical investment. Specifically, the model tries to identify parameters that determine the investment decision of ethical investors, both Muslim and non-Muslim investor. Chapter five analyses and discusses the findings of the study. Finally, the last chapter concludes the study.



## CHAPTER 2

### OVERVIEW OF THE ETHICAL INVESTMENT

#### 2.1 Introduction

In this chapter discussion on SRI and Islamic investment as well as to define ethical investment and ethical investor is undertaken in order to allow a clear understanding on the differences between the two investments. Beside this chapter intend to draw out a clear defining line distinguishing the principles guiding the behaviour of a Muslim investor and Non-Muslim investor. Hence, the term ethical investor is elaborated in order to clarify in cases where the definition for Muslim and Non-Muslim differs.

#### 2.2 Ethical Investment

Ethical investing has ancient origins and is rooted in Jewish, Christian, and Islamic traditions (Renneboog *et al.*, 2007). In addition, according to Elmelki and Ben Arab (2009) the concept of ethical investment is based on the philosophical, religious or moral convictions of individual or collective investors, who exclude from their investment universe all stocks in fields which they consider opposing to their convictions. In addition, Renneboog *et al.* (2008) distinguish ancient ethical investing based on the religious traditions while the modern SRI is more based on the varying personal ethical and social convictions of individual investor.

Cowton (1994) in Sparkes and Cowton (2004) define ethical investment as "the exercise of ethical and social criteria in the selection and management of investment portfolios, generally consisting of company shares (stocks)". Hence, according to them, any individual or group which truly cares about ethical, moral, religious or political principles should want to invest their money in accordance with their principles. They further point out that the original "ethical investors" were actually the church investment bodies. It was only in the recent years that it has been explicitly reflected in the form of dedicated SRI retail funds offered to the

public. Nevertheless, ethical investment is an older term, and that it may reflect the fact that the first investors to set ethical parameters on investment portfolios were church investors in the U.K., U.S., and Australia. As time passed the term "ethical investment" however, has been replaced by that of 'socially responsible investment' (Sparkes and Cowton, 2004).

According to Forte and Miglietta (2007), at the beginning, deriving from religious schemes, screened investments were defined as "ethical" since, in a religious sense, the term is associated with a precise set of norms. Socially responsible investments (SRI), frequently also called ethical investments. Meanwhile, Elmelki and Ben Arab (2009) define an ethical investment objectively on the basis of the criteria used to select investment. Ethical investment can result from negative screening. This is the most common form where the selection of an investment universe excludes companies that operate in what are considered to be "sinful" industries: companies implicated in the production of alcohol, tobacco, nuclear energy or gambling for example. In addition, negative screening can also exclude companies based in countries in which the political regimes do not guarantee fundamental human rights. Ethical investment can also be the result of positive screening whereby selection of an investment universe is based on good practices in a particular field, such as in human rights or the protection of the environment, for example. According to them, some investment universes result from the combination of both negative and positive screening.

On the other hand, Hellsten and Mallin (2006) use the term 'ethical investment' and SRI interchangeably. In fact they refer ethical investments to investments funds and trusts, which claim to be ethical in a sense that they use negative criteria not to invest in ethically suspicious companies such as those companies which use child labour, do not respect their workers' rights, produce fire arms, pollute environment, etcetera, or they use positive criteria and promise to invest in companies that promote the public good and are committed to social responsibility, thus, their investments would then directly or indirectly increase the welfare of the communities they operate in.

Much earlier on, Wilson (1997) has already maintained that Islamic investments are ethical investments. According to him, Islamic investors have a range of choices when constructing a financial portfolio. These include *riba* free bank deposits, investments in Islamic unit trusts and investment companies, private placements in Muslim businesses and investments in conventional institutions and businesses which undertake to deploy funding from Islamic investors on a *halal* basis. Options which are regarded as *haram* include conventional bank savings and investment deposits, the purchase of interest yielding bonds, and the acquisition of shares in companies involved in alcohol production or distribution or in pork products.

Further, Lewis (2001) argues that while there were instances where investors got themselves in difficult situation whereby, they felt that it was wrong to enjoy investments selfishly yet one still could get a 'warm glow' by investing ethically. He explained that for ethical investor, they just not made profit out of their investment but they also perform their moral philosophy and religion obligation to not harm others being. Hence, a list of criteria has been made as references on activities that investors deem as having a disastrous impact on the life of the people and should be avoided when one decides to invest.

### **2.3 Socially Responsible Investment (SRI)**

Investment refers to the action or process of investing money for profit. Hernaus (2011) defines SRI as an application of corporate social responsibility (CSR) principles and sustainable development in making decisions on financial investment. While Cowton (2004) defines SRI as a set of approaches which include social or ethical goals or constraints in selecting their underlying share portfolio. SRI considers the characteristics of potential investment along with expected risks and return. SRI can be defined broadly as "an investment process that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis" (Sinha and Kumar, 2013). On the other hand, Bellendir (2004) defines SRI as an investment process consisting of financial analysis as well as the social and environmental consequences of investments. Therefore SRI can be defined as the process of selecting potential



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