Rationality of the Capital Market: Capitalistic System vs. Islamic System

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Abstract

Efficient Market Hypothesis (EMH) is founded on the theory of expected rationality but the theory of behavioural finance concludes that stock market investors are quasi-rational. Therefore, under the capitalistic system, the efficient markets have already failed to protect the rights of investors that have led to chronic capital market crashes and failure to achieve efficiency, justice, fairness, accountability, fair distribution of benefits, and a rational behaviour among investors. However, recently, Islamic financial institutions and markets have been emerging, which stand on the *Shariah* provision – the guided way to behave rationally or guided rationality. Based on the empirical experiences and evidences of both market systems, this paper discusses and compares the performances of the markets under the theoretical arguments of “rationality”, “quasi-rationality”, and “guided rationality”. This paper suggests that capital market based on guided rationality under the Islamic System can be a better alternative over the conventional market system.

Key Words: rational expectation; efficient market hypothesis; EMH; random walk model; behavioural finance; guided rationality; quasi-rationality; Islamic capital market; Islamic finance; *Shariah*; *Mudaraba*; *sukuk*; *zakaah*

JEL Classification: G11; P1; P47; P5

1. Introduction

The theory of *adaptive expectations* states that the expectations about a variable are based on the past values of that variable and it changes slowly over time. In the 1960s, economists assumed that *adaptive expectations* are the foundation of decision among the economic agents. However, in reality, people consider all relevant data when deciding on an expectation about a variable because the variable may be affected by many other variables. Moreover, expectations are not fixed, but vary and change very quickly. Thus, most of the economists believe in a more realistic model of expectations, *rational expectations*, and not *adaptive expectations*. Rational expectations are formed using all available information to make the best possible forecast which is also known as the optimal forecast.

There is a strong implication of rational expectations in the capital market. In the market, a better expectation gives better decisions to beat the competition. The theory of Efficient Markets Hypothesis (EMH) is based on the theory of *rational expectations* which assumes that asset or stock prices reflect all available information of the company. People who trade in stocks have an incentive to use all of the past information to forecast future earnings, sales, market share, new products, etc. to make a profit. Thus, the price set by buyers and sellers reflects all of this information. Moreover, under the theory of EMH, a stock price always returns to an equilibrium point that reflects the expected future earnings and risks. If the stock is earning an abnormally high return, people will buy the stock and bid up the price until the price drives down the returns to an equilibrium level. Similarly, if the stock is earning an abnormally low return, people will sell the stock and drive down its price until the price returns back to an equilibrium level. However, expectations are not always rational. Whilst making decisions, people rarely pause to gather background information thus they are not always informed about the alternative options available to them. The EMH also considers this issue and argues that in the market, it is not necessary for everyone to use all the available information to determine the price of a security, but that if enough buyers and

sellers are behaving rationally, the price will reflect that. Thus, the market has a near perfect reflection of stock prices indicating correct market fundamentals. The one rational individual in the market always overwhelms the influence of the irrational ones on the stock prices.

On the other hand, starting in the 1970s, a group of researchers discovered some return patterns in the stock markets that were inconsistent with the EMH. This is known as the theory of *behavioral finance* which typically weakens rationality assumptions with a view towards explaining "*market anomalies*." In contrary to the assumptions of EMH, the theory of behavioral finance assumes imperfect capital markets and uses looser notions of rationality-not complete irrationality but "*quasi-rationality*". The assumptions of imperfect capital markets also create the possibility that quasi-rationality will have a real impact on the market phenomena. Thus, behavioral finance explains how stock market investors are irrational and shows that future stock price movements are at least partly predictable from past behavior. If markets are efficient, stock prices become unpredictable, or follow the "*random walk model*." Any technical analysis, such as looking for past price patterns to predict future prices are useless. However, the behavioral finance theory stands on the basis of finding many inconsistencies in the market, which are referred to as *anomalies*; such as small-firm effect, January effect, day-of-the-week effect, over-reaction of stock prices to news (good or bad), excess volatility pattern, macro variable relationship, information adjustment delay, private information, etc. These anomalies help to get extra returns from the market.

The debates between the behavioral finance theories and EMH are now the central dispute in modern financial theory. One view of rationality, where the rational overwhelms the influence of the irrational through perfect capital markets, is competing against another view of rationality where imperfect capital markets have the real influence on quasi-rationality. It is interestingly noted that both EMH and behavioral finance deals with the issue of rationality under the capitalistic system. At the same time, recently, another aspect of rationality – "*guided rationality*" gives a new dimension of arguments to the central modern financial theory. Islamic financial institutions and markets are emerging based on the "*guided rationality*" which stands on the "*Shariah principles*". The *Shariah* principle is considered the guided way to behave rationally against the capitalistic system. The capitalist system is considered the unguided way to behave rationally. Thus, the theory and form of rationality and its performances under both the market systems are considered eminently testable.

This paper is an attempt to look at the issue of rationality under both conventional capital markets run by a capitalistic system, and the Islamic capital market run by the guided principles of religion. Thus, this study is an initiative on the debate on rationality under two market systems and compares the experiences and performances of both market systems based on the evidences of theory of "rationality", "quasi-rationality", and 'guided rationality'.

2. Failure of Rationality in the Capital Market under the Capitalistic System

EMH states that there are three forms of measuring stock market efficiency: the "weak-form", the "semi-strong form", and the "strong form". The weak form of market efficiency uses information based on historical or past prices. This form claims that all past prices of a stock are reflected in today's stock price. Therefore, technical analysis cannot be used to beat the market as it uses past values of the index to forecast the current values. The semi-strong form makes use of past information as well as all publicly available information. This implies that all public information is incorporated into a stock's current share price and that neither fundamental nor technical analysis can be used to achieve superior gains. The strong form

holds if the market incorporates all information, both public and private (insider information). Therefore, any information known to the public or a private source should be fully reflected in the security's current price for the Efficient Market Hypothesis (EMH) to hold. Generally, the markets in developing and less developed countries or emerging markets are not efficient in the semi-strong form or strong form.

Early findings on market efficiency differ among researchers. Working (1960), Fama (1965), and Samuelson (1965) used the random walk model and found that the market was efficient. Branes (1986) demonstrated Kuala Lumpur Stock Exchange as being weak-form efficient. Shiller (1989) revealed that stock prices follow a random walk and explained the reason behind the behavior of the stock prices. In recent findings, one group of researchers who found weak-form efficiency are Chan, Gup, and Pan (1992) (on major Asian markets), Dickinson and Muragu (1994) (on the Nairobi Stock Exchange), and Ojah and Karemera (1999) (on four Latin American countries market) despite the problems of thin trading.

However, several early studies also rejected the random walk model, such as Niederhoffer & Osborne (1966). Poterba & Summers (1988) argued that there is little theoretical basis for strong attachments to the null hypothesis that stock prices follow a random walk. Lo & MacKinlay (1988) investigated the sampling distributions of variance ratios over different sampling intervals and found that stock returns do not follow a random walk. Among recent studies, many researchers are also supporting the rejection of EMH. Cheung, Wong, and Ho (1993) claimed that the stock markets of Korea and Taiwan are not efficient in the weak-sense. Harvey (1993) stated that stock returns of emerging countries are highly predictable and have low correlation with stock returns of developed countries. He concluded that emerging markets are less efficient than developed markets and that higher return and low risk can be obtained by incorporating emerging market stocks in investors' portfolios. Claessens, Dasgupta, and Glen (1995), in a World Bank study, reported significant serial correlation in equity returns from 19 emerging markets and suggested that stock prices in emerging markets violate the weak form of EMH. Similar findings are reported by Harvey (1994) for most emerging markets. Balaban (1995), Urrutia (1995), Grieb & Reyes (1999), and Kawakatsu & Morey (1999) demonstrated the non-randomness of stock prices for emerging markets. Poshakwale (1996) found evidence of non-random stock price behavior and market inefficiency (excluding weak-form efficiency) in the Indian market. Khababa (1998) examined the behavior of stock price in the Saudi Financial market seeking the evidence for weak-form efficiency and found that the market was not weak-form efficient. He explained that the inefficiency might be due to delay in operations and high transaction cost, thinness of trading, and illiquidity in the market. Uddin and Alam (2007), Alam et al. (2007), and Alam et al. (2011b) also showed that the Dhaka Stock Exchange (DSE) is not weak-form efficient by analyzing the randomness of market return, market risk-return relationships, and the frequency of the market depth or liquidity and impacts of policy changes. Alam and Uddin (2009) worked on 15 developed and developing countries and concluded that none of them were weak-form efficient.

While working on a single market, surprisingly, researchers found different types of results. While working on the Johannesburg Stock Exchange (JSE), Jammie and Hawkins (1974), Hadassin (1976), Roux and Gilbertson (1978), and Du Toit (1986) rejected the weak-form efficiency, but Affleck-Graves and Money (1975), Gilbertson and Roux (1978), and Alam et al. (2011a) found weak-form efficiency; Knight and Afflect-Graves (1983) rejected semi-strong form efficiency, but Knight, Afflect-Graves and Hamman (1985) revealed semi-strong form efficiency; Gilbertson (1976) found evidence supporting strong-form efficiency,

while Knight and Frier (1989) rejected the strong-form efficiency. Given the mixed evidence on the efficiency of JSE, Thompson and Ward (1995) showed that there are some share price dependencies but they were too small to be profitably exploited and concluded that JSE is “operationally efficient”, which means only a small group of investors are able to outperform the market. Similarly, some studies (Balaban 1995, Urrutia 1995, Grieb & Reyes 1999, Kawakatsu & Morey 1999) supported non-randomness of emerging markets’ stock prices, whilst some other studies related to these same markets (Butler & Mailaikah 1992, and Panas 1990) did not support the notion.

On the whole, the findings on EMH are mixed and in most cases it does not hold, especially for the markets of developing countries. Under this circumstance, these real life experiences indicate a failed case of rationality in the capital market under the current capitalistic system. Moreover, though few evidences of market efficiency are available from developed countries, the recent financial crash around the world shows that the EMH or quasi-rationality behavioral theories were not enough to protect stock market crashes among the most efficient or inefficient markets.

The capital market is considered one of the most important economic indicators of a country. It represents the industrial growth and economic health of a nation. From the perspective of the overall economy, Ologunde (2006) mentioned that the capital market makes it possible for the economy to ensure long-term commitments in real capital. Mankiw (1999) stated that, “Whenever the stock market experiences a substantial decline, there is reason to fear that a recession may be around the corner.” Under the unguided capitalistic market system, when efficient markets, according to the EMH, have already failed to protect the rights of investors, it is virtually impossible for most of the markets of the world that are considered inefficient. If it is not possible to secure the rights of investors, it will cause future chronic financial crisis and stock market crashes around the world. Thus, now everyone is looking for an alternative form of capital market where investors will be guided to behave rationally and to consider the interest of others.

3. Capital Market under the Islamic System: A Journey of “Guided Rationality”

It is assumed that the guided principle of Islam (Shariah) generally works as a guideline for guided rational behavior. The world has observed the superiority of the Islamic principles and values based on the banking system, generally known as Islamic Banking, in the recent financial crisis. While standing from the heart of a capitalist world, whilst very big and old financial institutions collapsed, the Islamic Banking system demonstrated its financial and moral strength in protecting customers and investors’ rights. As a consequence, researchers have also pointed out the recent emergence of Islamic economic institutions around the world. Kuran (1986), for example, highlighted the emergence of Islamic economic institutions in the MENA region, which is due to the superior principles of the Islamic system over the Western and Marxist economic principles. Moreover, many conventional banks are now opening Islamic Banking wings, such as HSBC Amanah, SCB Saadiq, Islamic Account of Lloyds TSB Bank, J. P. Morgan Islamic Banking Group, etc.

Emphasizing on the desirability and ethical superiority of the profit and loss sharing principle (*Mudaraba*) and the Islamic bond (*sukuk*) for funding development and business projects, various credible quarters in the North, for example Prof. Rodney Wilson of London School of Economics, Lord Mayor of the City of London, and the Vatican, recognize and appreciate the superiority of Islamic banking and financial principles for a viable and stable

global financial system (Islamic Finance Expert 2010, The Brussels Journal 2009). Ultimately, the superiority of the Islamic system attracts investors, scholars, researchers, policy makers, and the public, both Muslims and non-Muslims. Now, they strongly feel the necessity of a capital market under Islamic principles and think that it can be an alternative to the current form of faulty capitalistic system under the capital market (El-Gari 1993).

Islam is a realistic religion that allows all activities of human life within given guidelines. The guidelines are known as Islamic law or Islamic principles, or *Shariah* law. Islamic law permits all areas of the wider Islamic system, which includes economics, finance, law, politics, government and its integral component parts, social, ethical and religious aspects, including values and social justice (Asutay 2007, Iqbal 1997, Molla & Alam 2013). Since Islam considers every single aspect of public and private interests, the guidelines about the capital market have already been in place by *Shariah*. Al-Kasani (1983) and Zaman (1986) pointed out that the traditional jurists have agreed upon partnership business and *Mudarabah* contracts, which was widely practiced during the pre-Islamic period and also practiced by many companions of the Prophet Muhammed (S). Al-khaiyyat (1989) further emphasized the issue and mentioned that there is no prohibition in *Shariah* in forming share companies or a partnership company or selling shares to anybody. According to Al-Khaiyyat (1989), Fahd (2007), and Osmani & Abdullah (2009), a stock market is perfectly legal and there is no prohibition for establishing the capital market in Islam. Recently, Khatkhatay & Nisar (2007) again pointed out that portfolio investment equities in stock market is close to the Islamic profit and loss sharing paradigm, which conveniently opens the main investment avenue to ordinary Muslims.

Thus, a fundamentally capital market is allowed in Islam, but *Shariah* provision sets out certain rules and regulations which differentiate the Islamic capital market from the capitalistic market, and provides a guideline regarding investment approaches and guided rational behavioral approaches of investors based on nature, types, characteristics, and operations of the business. The guidelines are summarized below.

3.1 Characteristics of the Company

i. Nature of the Business of the Company

Share means ownership, and shareholder means owner of the company. When an investor or trader buys shares of a company, he becomes a partial owner of the company. The investors as well as the sponsors or founders are the long term shareholders who are mostly responsible for the characteristics of the company. However, the ownership of traders, who are not investors in nature but frequently trade in the secondary market to gain short term price gain, have very little influence on the operations, nature of the business, and strategic decisions of the company. Therefore, the investors, not traders, are fully responsible for the company's overall *Shariah* provisions, and to avoid the violation of *Shariah* principles, a trader must look at the characteristics of the company.

Shariah provides a few guidelines about the nature of the company, mostly focusing on the religious value and social wellbeing (Al Quran 5:2, 2:188). At the starting point, the main business of the company must be accepted (*halal*) according to Islamic principles (Sahih al-Bukhari, Book 9, Volume 89 (Judgments), Hadith 266). There are some companies which are involved in completely *haram* activities, such as the company's manufacturing, selling or offering liquors, *haram* meat like pork, or involved in immoral services like gambling, discos, prostitution, night club, pornography, pubs etc. *Shariah* does not permit

any Muslims to invest in these companies or the companies where the core income is based on these activities (Al Quran 5:62).

Secondly, Islam never allows any kind of interest. The divine authority (Allah) mentions that trade is permitted, but interest is forbidden (Al Quran 30:39, 2:275-281). Along with this prohibition, the final prophet Muhammad (PBUH) cursed the practice of receiving and giving interest (Sahih al-Bukhari, Book 7, Volume 63 (Divorce), Hadith 259). According to Islamic principles, it is not permissible to acquire the shares of the companies which are directly or indirectly attributed to *riba* (interest), and also providing financial services on interest, like conventional banks, insurance companies, finance and leasing companies, etc.

In reality, the world is so complex and interlinked that in many cases, for local or international business, it is not possible to avoid the transaction from any interest based banking or any sort of involvement with interest. Furthermore, in cases like mixed business, where multisectoral companies are involved in both *halal* and *haram* activities, the Islamic jurists from four major school of Islamic thoughts - Hanafi, Maliki, Shafi, and Hanbali - agreed on the permissibility of the company under specific conditions (Khatkhatay & Nisar 2007, Jamal et al. 2010). According to the Malaysian Securities Commission's *Shariah* Advisory Council (SAC), mixed types of companies are permitted by *Shariah* on the following conditions:

- The core activities of companies must be *halal* and the *haram* elements must be small compared to core activities;
- Public perception or image of the companies must be good; and
- The core activities of the companies should have important benefit to the nation (*maslaha*) and the country, and the *haram* elements - including *umum balwa* (common plight and difficult to avoid), *uruf* (customs and rights of the non-Muslim community), which are accepted by Islam, must be very small.

According to the Justice Mufti, Muhammad Taqi Usmani, if the main business is *halal*, but the company borrows money on interest or places its money into an interest-bearing account, shareholders should raise their voice against this practice in the AGM of the company (Usmani 2010). When Muslim shareholders receive dividends, they must ascertain the proportion of dividend coming from interest-bearing activities and give them to charity. He also mentioned that *Shariah* scholars have permitted the investment in stocks of companies whose income from interest-related activities is less than 5% of the company's total income while some have allowed up to 10%. In a broader perspective, the *Shariah* Advisory Council (SAC) of the Securities & Exchange Commission Malaysia (2007) set several benchmarks to determine a tolerable level of permissible and non-permissible activities such as:

- a. The five-percent (5%) benchmark: This benchmark is applied to measure the level of mixed contributions from the activities that are clearly prohibited such as interest-based companies (e.g., conventional banks, insurances, financing and leasing companies, etc.), gambling, liquor, pork, pornography, etc.
- b. The ten-percent (10%) benchmark: This benchmark is applied to measure the level of mixed contributions from the activities that involve the element of *umum balwa* (prohibited elements affecting most people and difficult to avoid). For example, interest income from fixed deposit in conventional banks, revenue generated from tobacco-related activities as a tiny part of an overall *Shariah*-compliant business.

- c. The twenty-percent (20%) benchmark: This benchmark is applied to assess the level of contribution from mixed rental payment from *Shariah* non-compliant activities, such as rental payment from the premise that is involved in gambling, sale of liquor, etc.
- d. The twenty-five percent (25%) benchmark: This benchmark is applied to assess the level of mixed contribution from the activities that are generally permissible according to *Shariah* and have an element of *maslahah* (*public interest*) to the public, but there are other elements that may affect the *Shariah* status of these activities. For example, hotel and resort operations, share trading stock brokerage house, aeroplane company, etc., as these activities may involve other relevant activities that are deemed non-permissible under *Shariah*.

ii. Nature of the Assets of the Company

Shariah also provides some guidelines on the nature of the assets of the company focusing on safeguarding investors' interests and rights. First, it does not permit investing in a company, which only has liquid assets. If the company does not have any non-liquid assets, it would only be permissible to trade at the par-value of the shares, because in this case the shares represented are similar to cash money. Thus, trading above or below the par-value would not be considered as *Riba* under Islamic principles. In reality, nearly all the companies have both liquid and non-liquid assets. In these cases, the jurists have different views towards the ratio of liquid assets to total assets. The Shafi and Hambali school of thought have set a minimum of 51%, while scholars from the Hanafi school of thought have opined that the ratio must not be more than 33% (Jakhura 2010). The Dow Jones Islamic Market Index (DJIMI) allows up to 33%, whereas the Meezan Islamic Fund Criteria in Pakistan has set the ratio of net illiquid assets of the investee company as a percentage of the total asset of up to 10% (Khatkhatay & Nisar 2007).

Moreover, Hanafi scholars also added two mandatory conditions. Firstly, the non-liquid part of the combination should not be in an ignorable quantity. Secondly, the price of the mixture should be more than the price of the liquid amount contained therein. Usmani (2010) provided a good theoretical example. A share for \$75 cash and some fixed assets holding the company's price must be above \$75. If the price is set at \$70, it is considered as *Riba* due to the lesser price than the liquid assets. If the price is set at \$75, it is also not permissible due to insignificance or zero value for fixed assets. As such, any value above \$75 is valid due to having a value for the fixed assets. In the real world, it is very difficult to imagine a situation where a price of the share goes lower than its liquid assets.

iii. Debt to Equity ratio

Ideally in Islam, there should not be any interest-bearing debt. However, based on Islamic principles, *Shariah* scholars have allowed investment into a company if debt-financing is not more than 33%. The Dow Jones Islamic Market Index excludes the companies in which debt to asset ratio is greater than or equivalent to 33%. Meezan Islamic Fund Criteria in Pakistan allows up to 45% (Khatkhatay & Nisar 2007). However, the *Shariah* Advisory Council (SAC) of the Securities & Exchange Commission in Malaysia did not place any restrictions on the proportion of debt in the total assets.

3.2 Characteristics of the Investor

i. Nature of the Ownership

Shariah allows only common stock to be traded. Common stock holders have voting rights and are considered the real owners of the company. Selling a common share is like selling a portion of the share of the company; and it is considered an individual's property, where the owner has the right to sell or lend as long as it does not cause harm to other shareholders (Osmani & Abdullah 2009). On the other hand, preferred shareholders do not have the right to vote and they are not considered actual partners of the company, and the extra money they get is like *Riba* as they take it without sharing the risk of profit and loss (Zaky 1992).

ii. Nature of the Intention

Due to the nature of the conventional stock market, *Qimar* or gambling is strictly prohibited (Al Quran 5:90). There are two types of gambling – one way is to try to invest with the concept of being lucky based on excessive risk, just like spending money in the general case of gambling (Chapra 1985); and another way is trying to get extra or abnormal profit by pulling up the price using any type of manipulation such as syndicating, spreading rumours, etc. (Sahih al-Bukhari, Book 3, Volume 34 (Sales and Trade), Hadith 367). This concept also covers unusual, illogical, manipulated, and unethical speculation in the stock market, which refers to trading in the stock market purely for short-term gains, resulting in an uncertainty in the market and sure losses, or longer term positioning of the share for others. Under the *Shariah* provision, the baseline of speculation is founded on the intention or behaviour of the investors (Sahih al-Bukhari, Book 1, Volume 1 (Revelation), Hadith 1). The decisions must not be based on uncertainty or generate excessive risk, but be based on the fundamental analysis with the intention of getting a normal profit from the market.

3.3 Characteristics of the Transaction

i. Nature of the Transaction

The pattern of transaction and its form differs among markets as well as Islamic juries. There are several trading practices available in the stock market, such as margin trading, derivatives, options and futures, short-selling, etc. The legality of these issues varies among markets, conventional laws, and Islamic scholars. Many markets prohibit them because of their involvement in market manipulation and speculations. Islamic scholars prohibit them because of their involvement in interest and speculations. According to Osmani and Abdullah (2009), many scholars disagree on the validity of forwards, future, and options as the sold commodity and payment of the price are made in a future date resulting in the elements of *gharar* (uncertainty) and gambling (Sahih Muslim, Book 10 (The Book of Transactions), Hadith 3614). Al-Barwari (2002) (cited by Osmani & Abdullah 2009) pointed out that the council of the Islamic Fiqh Academy of Mecca decided that forward contracts with all of its categories prevailed in the stock market are invalid, as they sell items that people do not actually own (Sunan Abu Dawud, Book 23 (The Book of Wages), Hadith 3496). Similarly, short-selling violates the *Shariah* principle for the same reason. Chapra (1985) strongly opposed the existence of short-selling in an Islamic market arguing that such sales are speculative and involve *riba* and *gharar* in the whole transaction whilst also failing to perform any useful economic function. Naughton & Naughton (2000) observed that the public *masalahah* (public interest) is bitterly served by prohibiting short sales.

As opposed to this prohibition, a few scholars have also permitted this type of contracts based on the tradition of prophet Muhammad (PBUH) where he himself was involved in a forward contract. Prophet Muhammad (PBUH) purchased a thin weak camel from Jabir with a price of one gold coin, which he paid later and Jabir also handed over the camel at a later date (Sahih Muslim, Book 10 (The Book of Transactions), Hadith 3888).

Osmani & Abdullah (2009) resolved the issue under the condition that forward, futures, and options are only valid when both parties agree on the stipulated duration and price without any uncertainty in the transaction. Based on a similar concept, the SAC legalized this through regulated short-selling (RSS) with the inclusion of security borrowing and lending (SBL) principles in Malaysia. According to them, under the RSS, fulfillment of delivery, settlement of contracts and payment of financial obligations are always guaranteed, monitored and regulated, which reduces the elements of *gharar* resulting in short-selling to be *Shariah*-compliant. However, Dusuki & Abozaid (2008) analyzed this permissibility further and argued that the SAC should reconsider this position due to the probability of benefiting from the loan, which refers to *riba*, but this is still undefended. It is obligatory for Muslims to seek legitimate (*halal*) earnings.

ii. Nature of the Zakaah (compulsory tax) Probation

There is compulsory tax gain in many of the conventional capital markets. In Islam, under the *Shariah* principles, there is no mandatory tax gain but there is an annual tax, called *zakaah*, on the selected assets if it goes beyond a certain level. The *zakaah* (compulsory tax) on shares is obligatory for the owners of the shares. The *zakaah* may be paid by the company or the shareholder personally. Companies pay it if it is stated in the company's constitution, or by law, or management decision, or based on shareholders' authorizations to pay on behalf of them.

If the *zakaah* is not paid by the company, the shareholder needs to pay it individually. In that case, there are two ways to calculate it, which depends on the nature of the investors. If the shareholder is a trader in nature, having the intention for price gain and sells the share anytime when the price increases, every year the *zakaah* will be calculated on full market value of the share. If the shareholder is an investor by nature, with no intention to take any short price gain but invests for dividend gain, every year, the *zakaah* will be calculated only on the dividend amount and a one-time *zakaah* on the full selling price at the time of selling the share. In the investors' case, the calculation of *zakaah* also depends on the nature of the company, such as:

- For manufacturing and service companies that do not engage in any kind of trade, such as hotels, transportation companies, etc., no *zakaah* is needed for assets but only on the profits of these shares, because the value of these shares is based on equipment, tools, buildings, furnishings and so on, which are needed in order to do the work;
- For the companies that engage only in trade, such as distributors, importers, exporters, international traders, etc., and for the companies that engage both in manufacturing and trade, such as petroleum companies, textile companies, metal companies, chemical companies, etc. that extract or buy raw materials, and trade them with some changes, *zakaah* must be calculated on the assets of these companies, after deducting the value of the buildings, tools, equipments, etc., and also on the profit of the share; and
- For the agriculture and livestock companies, *zakaah* needs to be calculated on the crops, fruits and livestock beyond a certain level of production, such as 10% if the crops are irrigated naturally and 5% if they are irrigated artificially when the shares reach a certain level.

The annual *zakaah* rate is 2.5% generally for the lunar calendar year (Arabic/ Hijri calendar) or 2.58% for solar calendar year (any normal calendar such as Gregorian calendar). The *zakaah* is mandatory only in the case of when the total share value of the shareholder is

either equal or above the price of 595 grams of silver or 85 grams of gold, and it should be in continuous possession for a period of one lunar year. The calculated value of the *zakaah* can be paid from personal cash fund if it is not possible to pay by selling the share at the end of the year.

Another option is to keep the *zakaah* due till the time of finally selling the share. In this way, *zakaah* is calculated on market value for each year and all due amounts should be disbursed together from the final selling price. A hypothetical example for the trading case: holding a share of which the current market price is \$100. Thus, (year 1) the due *zakaah* is: 2.5% of \$100 = \$2.5. The following year (year 2), suppose the current market price is \$200. As such, (year 2) the due *zakaah* is: 2.5% of \$200 = \$5. Now, the total due for two years is \$7.5. If the share is sold at the end of the 2nd year, total *zakaah* of \$7.5 will be paid from the selling amount. If any dividend is received within the period, *zakaah* also needs to be calculated on that gained amount.

The *zakaah* amount can be distributed personally, or by the government, to eight categories of people who are eligible to receive *zakaah* – for example the poor, needy, employed to collect or administer the Zakat funds, non-Muslim or Muslim who need to be attracted to Islam (Al Quran 9:60). In addition, one can present the money to free slaves and captives, to pay off the debt on behalf of an unable person, or to give to those who are fighting for the sake of Allah including those who are seeking Islamic knowledge.

4. Performance and Prospects of the Journey to “Guided Rationality”

The concept of the capital market was first introduced in France in the thirteenth century, but the concept of *Mudrabah*, which resembles the modern capital market concept, can be dated back to the age of Prophet Muhammad (PBUH) in the sixth century (Al-Barwari 2002, as cited by Osmani & Abdullah 2009). Researchers also traced the origin of stocks to medieval Muslim traders (Robertson 1933).

Though Muslims are considered the pioneers of the capital market, the current form of capital market restricts them from seeking economic bounties from it due to not being able to satisfy several provisions of the Islamic law or *Shariah*. As a consequence, in spite of religious encouragement for Muslims to seek economic opportunities (Al-Quran 2:172), they cannot engage in trading and investing in the conventional capital market. On the other hand, the capital market under the shade of Islamic law is not yet focused and matured. There are only a few capital markets available across the globe, such as the Khartoum stock market (KSE) in Sudan, the Kuala Lumpur Stock Exchange (KLSE) in Malaysia, and the Tehran Stock Exchange (TSE) in Iran, etc., which are operated according to Islamic laws.

Stock markets based on Islamic principles are in the early stage of development as observed by Naughton and Tahir (1988). In 2002, Tag El-din further mentioned that most of the stock exchanges in Muslim countries are basically western-style markets with tolerated practices that do not comply with Islamic principles. Recently, Hearn et al. (2010) mentioned that due to the limited focus on Islamic finance, there are limited literatures available on the role and principles of the Islamic stock market. Thus, based on the limited experiences, here, the researchers provide a few evaluations from past researches on Islamic capital market around the world.

While studying the Kuala Lumpur Stock Exchange (KLSE) in Malaysia, Zaky (1992) outlined the *Shariah* principles for the stock market and compared the market from both Islamic and western perspectives, and suggested improvements from an Islamic perspective. Bacha and Abdulla (2001) examined halal stock designation and its impact on price and trading volume in the Malaysian stock market. Their study showed that inclusion in the list of halal stock by the *Shariah* Advisory Council (SAC) had a positive impact with an increase in volume and price while exclusion had negative impacts, which decreased in volume and price. Their study further explains that in the former case, price impact is gradual with significant increase in post 30 and 60 days and volume effect is immediate but temporary while in latter cases, impact on both price and volume is delayed. Muhammad (2001) investigated the performances of the KLSE Composite index, the KLSE *Shariah* index, and the RHBI index in Malaysia during the period of 1992-2000 and found that the movements of both the conventional and Islamic indices are fairly parallel. Yusof and Majid (2007) compared the risks and returns volatilities of the Islamic and conventional stock markets in Malaysia for 1992-2000 and found that the risk as measured by the conditional standard deviation does not affect stock returns during the period of analysis. Hence, there is no evidence of significant time varying risk premium for both conventional and Islamic stock returns. They further examined the stock market volatility of the Islamic and conventional stock markets in Malaysia based on various monetary policy variables' impact on stock market volatility and revealed that interest rate volatility affects the conventional stock market volatility while Islamic stock market volatility remained unaffected. Sadeghi (2008) examined the impact of the introduction of the *Shariah* compliant index by Bursa Malaysia on the performance and liquidity of included shares and demonstrated that the introduction of the *Shariah* compliant index had a positive impact on the financial performance of the included shares with positive increase in mean cumulative abnormal returns (MCAR) and trading volume.

While working on the Dow Jones Islamic Stock Market Index (DJIMI) in USA, Hassan (2002) examined the issues of market efficiency and the risk return relationship in terms of time variance for the period of 1996-2000. He showed that DJIMI returns are normally distributed and the DJIMI has remarkable market efficiency. He also examined the volatility of the DJIMI returns and concluded that there are operational inefficiencies in DJIMI which needs to be corrected to make the risk behavior of DJIMI stable over time. Hakim and Rashidian (2002) examined the causality between DJIMI, Wilshire 5000 index, and the Treasury bill rate over the period of 1999-2002. They found that the DJIMI did not correlate with either the Wilshire 5000 index or the Treasury bill and was influenced by factors independent of the broad market or interest rate. Their study also revealed that the filtering criteria adopted to eliminate non-*Shariah* compliant companies led to an Islamic index with unique risk-return characteristics that were not affected by the changes in the Wilshire 5000 or Treasury bill. Ludwig (2005) adopted a comparative approach towards the performance of the Amana Islamic Income Fund with the performance of S&P500 and a SRI fund tracked by Bloomberg. Their study revealed that Amana Fund value increased by 25% while there was a 9% increase in the S&P 500. However, it was -3.3% for the average SRI fund tracked by Bloomberg.

Hussein (2004) examined the performance of the FTSE Global Islamic Index and the FTSE All-World Index from the UK market in two sub-periods, bull period (July 1996 – March 2000) and bear period (April 2000 - August 2003). He found that the FTSE Global Islamic index performed as well as the FTSE All-World index over the entire period. He further explained that the Islamic index yielded statistically significant positive abnormal

returns in the bull market period and underperformed in the counterpart index in the bear market period. He concluded that the application of *Shariah* compliant screening did not have an adverse impact on the FTSE Global Islamic Index performance.

Realizing the potential of the Islamic stock market, many large western organizations have also established their own Islamic subsidiaries and have offered Islamic Financial instruments. For example, the Dow Jones Islamic Market World Index, which tracks global shares that meet Islamic investment guidelines and has a market capitalization of \$12.8 trillion, climbed 7 percent this year, while the Dow Jones Global Index gained 6.4 percent in the same period (Muslim Village 2010). The *Shariah*-compliant assets of Islamic financial institutions have grown rapidly, such as \$230 billion in 2002, and \$1 trillion in 2010 (Hakim & Rashidian 2002, Islamic Finance Outlook 2010).

The broader Islamic view of efficient security markets is close to the concept of social efficiency as financial markets in general, and capital markets in particular, should be efficient in supporting social justice, fairness, and the wellbeing of the society (Samuels & Yacout 1981). Moreover, Islamic investment resembles socially responsible investments as both prohibit investment in business activities that are harmful to humans and society. Thus, in any form, the reality of shifting socially responsible investments towards Islamic investment is now much closer. There has been a good trend in socially responsible investment in the major financial markets over the last decade. In USA alone, from 1997 to 2000, the size of socially responsible investment doubled from \$1.185 trillion to \$2.16 trillion (Hakim & Rashidian 2002).

Recent studies on stock market focused on investors' rights, ethics, and fairness in the market. Lev (1988: 1-22) defined ethics and fairness as entitlement to equality of opportunity, whereby all parties in a fair market are entitled to equal access to information relevant for asset valuation. Tag El-Din (1996) discussed the traditional concept of market efficiency in light of the Keynes Theory with the arguments of excessive speculative activities that create inefficiencies in stock market and emphasized the need for an optimum level of speculative activities for efficiency in stock market. He further emphasized the necessity of normative Islamic stock exchange to deal with excessive speculative activities and its adverse impact on the economy, such as a financial crisis. Using the data from the Canadian Stock Exchange, Kia (2001) tested whether excessive speculative activities create instability in the market and wasteful information from the efficiency point of view, and concluded by supporting Tag El-Din's view of establishment of normative Islamic stock exchange in order to achieve greater efficiency in stock market.

Obaidullah (2001) mentioned that there is no negative relationship between Islamic ethics and market efficiency while analyzing ethics and efficiency of Islamic stock market based on Islamic ethical norms of freedom from *riba* (interest), *gharar* (uncertainty), *qimar* (gambling), *najas*, *ihtiker* (artificial shortage of supply), etc., and the ethical norms in mainstream finance. He also suggested that attempts to ensure Islamic ethics in the stock market would lead to the enhancement of efficiency. Tag El-Din (2002) further critically examined the efficiency criteria of the stock market in light of theories of P. Cootner, P.A. Samuelson, and J.M. Keynes, and discussed the Islamic point of view. He argued that exchanges of financial claims are more vulnerable to hazards, lack of information, and unregulated free markets. Critically reviewing the classical and modern literatures in Islamic stock exchange, Osmani & Abdullah (2009) observed that the Islamic stock market develops

sound and ethically guided securities where many products of the conventional stock market can be easily incorporated into the Islamic stock markets.

5. Conclusion

The conventional efficient market theory focuses on the rights of the investors and works as a safeguard from unusual financial crisis and any extraordinary return by any group, which is not yet ensured since inception under the current form of capitalistic market system. The research on chronic financial crisis suggests that the market should be run by a system, which will ensure efficiency, justice, fairness, accountability, fair distribution of benefits, and a rational behavior among investors. EMH provides the efficiency theory but it cannot ensure proper regulation, governance, and ethical characteristics of the investors. The theory of behavioral finance denies EMH but does not suggest anything to achieve rationality or wellbeing of common investors. The capitalistic format of the capital market including its efficiency theory and behavioral theory is not able to protect small and less efficient investors.

In contrary to the above, the Islamic principles of capital market take care of all these issues, which are ignored by the capitalistic market system. The return of the existing Islamic markets and funds shows enough competencies and better returns with more efficiency than conventional markets and funds. Understanding the superiority of the Islamic system, many countries are starting Islamic capital markets and indexes, such as the 'Tasis *Shariah* 50' index in the Bombay stock exchange (BSE), the '*Shariah* index' in the Indonesia stock exchange (IDX), etc. The necessity, reliability, and superiority of the Islamic capital market, not only for Muslims but also for investors in general, are clear from the view of the Director of Research and Operations of 'Tasis *Shariah* 50'. He boldly mentioned that this index would unlock the potential for *Shariah* investments in India, as all the Muslim countries in the Middle East and Pakistan together do not have as many listed *Shariah*-compliant stocks as are available on the BSE (BBC 2010).

In light of the above, it can be suggested that the capital market based on the guided rationality of the *Shariah* provision performs better than the theoretical basis of rationality and quasi-rationality of the capitalistic system. Thus, the capital market under Islamic principles can be a better alternative to the conventional market system.

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