OmniScience India Shariah

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OMNISCIENCE CAPITAL RESEARCH

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OMNISCIENCE INDIA SHARIAH

INTRODUCTION TO SHARIAH INVESTING

Shariah investing, or Shariah-compliant investing, are investment opportunities and funds that are governed by the requirements of Shariah law and the principles of Islam. This is a type of socially responsible investing, which would restrict itself to investments in industries which would be considered conscientious according to Islam, and refraining from investments considered immoral, including alcohol, tobacco, gambling, leisure/media and pork products, as well as companies that charge interest for profit.

NEED FOR SHARIAH INVESTING FOR INDIAN AND NRI CLIENTS

With the global market for Shariah investments growing at 15-20% annually, Shariah-compliant investments hold promise for Indian Islamic investors with a conscientious bent. India has one of the largest Islamic communities in the World and it is important that there are investment products which can cater to their requirements. However, to our knowledge there are hardly any investment products designed to be Shariah-compliant except for a couple of mutual funds and a couple of specialized indexes.

Similarly, there is a significant population of Indian NRIs who find themselves constrained from investing in Indian equities due to the non-availability of Shariah-compliant products.

A conscientious investor is willing to compromise on the returns if they come at the cost of his beliefs and is, consequently, satisfied with even lower returns if the investment meets his criteria. However, returns are an important factor in choosing any asset class and hence it would be good to know the potential returns from Shariah-compliant investing.

With that in mind we carried out a research project to understand how a Shariah-compliant investment might behave over different market conditions.

THE SHARIAH RESEARCH PROJECT

We started out with extensive research to understand the concept. There are numerous Shariah-compliant equity products in the global markets and we tried to understand the spirit and form of these.

Based on these studies we framed the screening criteria in two parts. First are the screening criteria in terms of sector selection; i.e. sectors which are acceptable and which are not. There will always be some niche industries or sub-industries which some will accept as Shariah-compliant and some will not.

Here we need to note that different Islamic scholars from different countries or regions, and, even from the same country, could have slightly different criteria. For example, Malaysian and UAE scholars will differ on some aspects. But one needs to keep in mind that there are a set of generally accepted criteria of what Shariah-compliance means. We have tried to adhere to those generally accepted Shariah principles.

Typically, we tried to be conservative and eliminated an industry which we were not sure would be compliant. For example, in terms of media, several Shariah-compliance processes might accept News Media but reject other media focusing more on entertainment. But we removed all media from consideration.

This led to a subset which should be acceptable to most Shariah-belief systems. However, there can never be any assurance that every single selection we make is compliant with every single community's belief. Hence, in practice, the investment portfolio for an individual should be found acceptable by that person. Any larger goal is going to be difficult to meet. This emphasizes the need for a customized portfolio creation service for individuals. Hence, a direct equity customized portfolio is more suited for a Shariah-compliant investment as compared to a mutual fund.

THE SHARIAH SCREENING PROJECT

The Shariah-screening process consists of the following conditions:

1) Initial Investment Universe

- India-listed stocks (NSE or BSE) with a market cap of more than INR 1,000 crores, and a minimum daily average liquidity of INR 1 crore over the preceding 3 months. The market cap criterion was reduced for earlier years in the portfolio returns simulation.

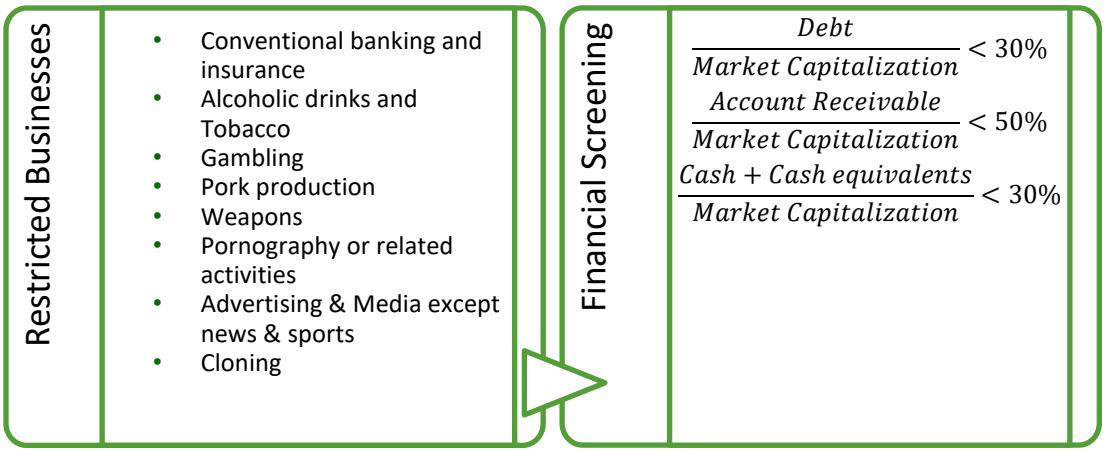
2) Excluded sectors and sub-sectors:

- Financials (Banks, NBFC's, Insurance Firms)
- Brewers
- Broadcasting & Entertainment
- Distillers & Vintners

- Farming, Fishing & Plantations
- Food Retailers & Wholesalers
- Hotels
- Media Agencies
- Publishing
- Restaurants & Bars
- Tobacco

3) Financial Ratio Restrictions (For Non-Financial Sectors not included above)

- Debt-to-Mkt Cap < 30%
- Cash-to-Mkt Cap < 30%
- Account Receivables-to-Mkt Cap < 50%



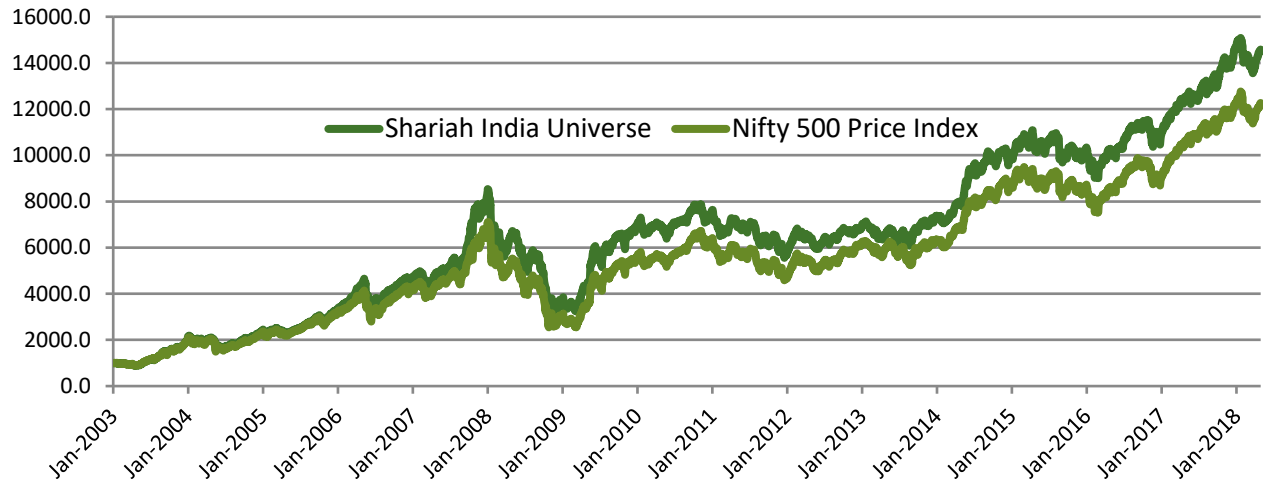
THE PORTFOLIO RETURNS SIMULATION

We used our Indian investment universe going back to 2003 to run the simulation. A market-cap weighted portfolio of stocks was created with all the companies which passed through the above Shariah screening process. The returns of this portfolio were compared to the returns of the Nifty 500 index.

Given that so many sectors have been removed and additional criteria have been imposed, the general expectation would have been a slightly lower return than the market returns as represented by Nifty 500 index returns. However, the results were surprising.

THE SHARIAH-COMPLIANT INDIA PORTFOLIO

Given the sector and financial ratio restrictions, it is observed that the overall Shariah-compliant market in India outperforms the overall market on a long-term basis, with an excess return of ~1.3% against the Nifty 500. The following comparisons show the portfolio-simulation results for the last 15 years, and the current difference in valuation and fundamental ratios between the Shariah-compliant India universe and the Nifty 500.



Total Return (%)	1 yr	3 yr	5 yr	10 yr	Since Inception
Shariah India Universe	16.6%	12.6%	17.1%	8.2%	19.1%
Nifty 500 Price Index	15.6%	12.1%	15.4%	8.4%	17.8%

Risk-Return Analysis

As can be seen the returns are quite encouraging. Our initial expectation that the Shariah universe returns might be lower than the overall market returns turned out to be untrue. The outperformance is not only over the full period but exists for most periods.

Capital Preservation

But even before outperformance analysis, let us look at the chances of preserving capital. A value-oriented—in the footsteps of Benjamin Graham and Warren Buffett—Shariah Investor would have this as the most important aspect to focus on, as far as, risky asset classes like equities are concerned. It is clear from the chart that the chances of preserving capital are 80% or higher for holding periods of more than 1 year and 97% for 5 years or more.

Capital Protection	1YR	2YR	3YR	4YR	5YR	6YR	7YR	10YR
Shariah India Universe	80.1%	79.8%	88.5%	95.5%	97.1%	97.3%	100.0%	100.0%

Outperformance

A look at the chart below showing the outperformance percentage across all rolling period portfolios for different holding periods. The chances of outperformance are above 50%.

% Outperformance	1YR	2YR	3YR	4YR	5YR	6YR	7YR	10YR
Shariah India Universe	58.5%	60.2%	58.9%	60.3%	54.0%	53.4%	57.4%	94.8%

Excess Returns

The median excess returns over different holding periods, too, shows an outperformance of about 0.5% to 1% range.

Median Excess Returns	1YR	2YR	3YR	4YR	5YR	6YR	7YR	10YR
Shariah India Universe	0.7%	0.8%	1.0%	0.9%	0.8%	0.2%	0.6%	1.2%

Risk Factors

While we have already considered the most important risk factors that an actual Shariah Investor should look at, viz. the likelihood of losing capital and the likelihood of underperforming, we now look at the academically accepted risk factors.

Beta of the Shariah Universe is 0.94 meaning it is relatively less volatile compared to the market.

Risk-adjusted return in terms of Sharpe ratio (0.87) is superior for the Shariah Universe (0.77).

Maximum drawdown of the Shariah Universe, too, is lower than the Market Universe.

The Shariah Universe generates a Jensen's Alpha of 2.33% over the Market Universe.

	Shariah India Universe	Nifty 500 Price Index
Maximum Drawdown	-63.6%	-64.3%
*Sharpe Ratio**	0.87	0.77
Beta	0.94	-
Jensen's Alpha	2.3%	-

Fundamental Analysis

While the superior risk and returns of the Shariah Universe are encouraging, we need to dig a little deeper to understand the root cause of what is causing this and to form an opinion as to the sustainability of it.

The return on equity, return on assets and return on capital of the Shariah Universe are all superior to the Market Universe. This means that the current Shariah Universe is more capital efficient compared to the Market Universe and likely to compound capital at a higher rate.

The asset turnover ratio of the Shariah Universe is higher which means the assets are being used more efficiently.

Gross and net debt of the Shariah Universe is lower, which is not surprising since the selection criteria screened specifically for that for creating the Shariah Universe. Margins also look superior, except EBITDA, for the Shariah Universe.

It can be concluded that the Shariah Universe provides a fundamentally superior investment universe currently.

Key Fundamentals	Shariah India Universe	Nifty 500
ROE	14.6%	10.1%
ROA	6.4%	1.9%
ROCE	13.6%	11.0%
5 Yr Average ROCE	15.9%	12.5%
Sales to Asset	0.77	0.67
Gross Debt to Equity	0.53	0.78
Net Debt to Equity	0.34	0.63
Interest Coverage	6.99	4.15
Gross Margin	18.6%	18.0%
EBITDA Margin	17.2%	19.2%
EBIT Margin	13.4%	11.9%
Net Margin	8.3%	6.5%
PBT/EBIT	61.7%	54.4%

Valuation Analysis

The PE ratio of the Shariah Universe is lower signifying that the Universe is available relatively cheaper. This is quite interesting given that the fundamentals of the Shariah Universe were superior. On a PBV (price-to-book value) basis the Shariah Universe is slightly expensive but then the fundamental superiority of the universe too is significantly higher.

The other valuation parameters are roughly similar, though some are slightly on the higher side.

Key Valuation Metrics	Shariah India Universe	Nifty 500
P/E	23.45	27.18
P/BV	3.42	2.74
EV/EBITDA	12.75	10.80
EV/EBIT	16.33	17.44
P/Sales	1.94	1.76
Div. Yield	1.2%	1.4%
EV/Sales	2.19	2.07
Net Cash/Mcap	0.06	0.04

Shariah Universe has superior risk-adjusted returns

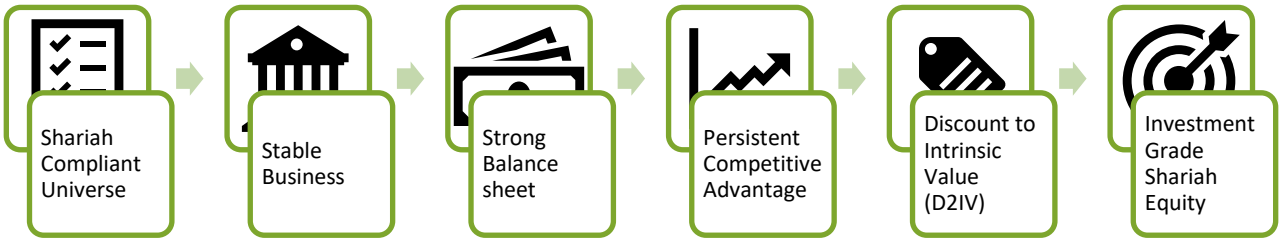
The results from our Shariah-compliant market-cap weighted universe was surprising and quite promising. However, an important factor driving the better performance is not that surprising for us.

The financial criteria which remove the highly leveraged companies is a very important factor. OmniScience's Scientific Alpha framework based on the value investing principles of Graham and Buffett, too, is highly focused on removing the leveraged companies from the investment universe. This improves the quality of the portfolio and makes it resilient to adverse economic conditions since the portfolio companies can survive external shocks with a strong balance sheet.

Encouraged by this overlap in the financial investment criteria, we decided to further evaluate the impact of applying the full Scientific Alpha framework on the Shariah-Complaint Investment Universe of India which we created and simulated above.

THE SCIENTIFIC ALPHA FRAMEWORK

The OmniScience Scientific Alpha is a structured value-investing framework that generates an investment-grade portfolio. The following illustration lays down the process for identifying SuperNormal Companies at SuperNormal Prices.

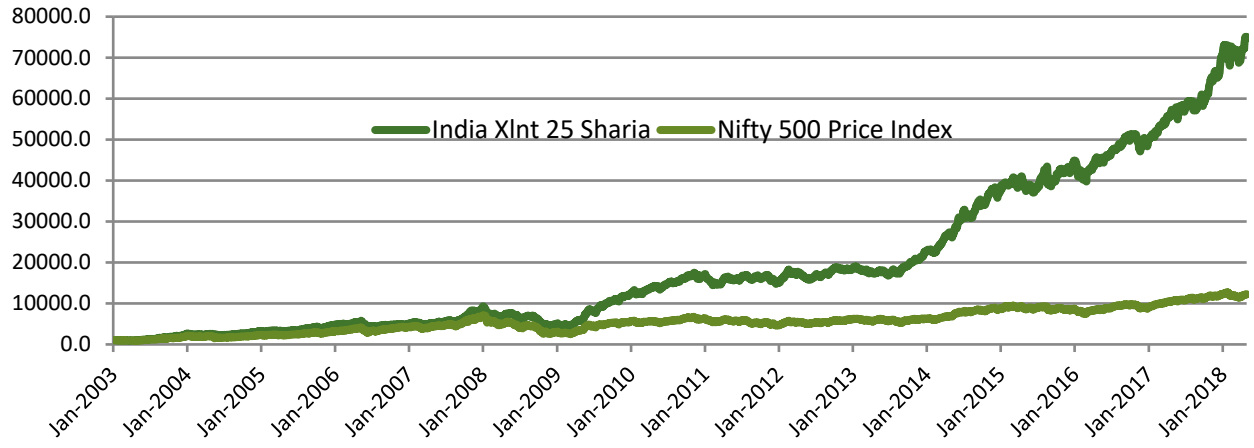


OUR SOLUTION OF SCIENTIFIC ALPHA SHARIAH INDIA FOR RESIDENT INDIAN AND NRI CLIENTS

At OmniScience, the "Scientific Alpha India XInt Shariah" is a strategy designed to provide undervalued, high-quality stocks in a risk-mitigated and alpha-generating framework, while still adhering to the constraints under Shariah-compliant conditions. The result is a strategy that significantly outperforms the market while staying away from investing in any companies that would be considered out of bounds by Islamic law.

THE SHARIAH-COMPLIANT SCIENTIFIC ALPHA PORTFOLIO

Once we have identified the return profiles and fundamentals of the Shariah-Compliant India Universe, we then apply our proprietary Scientific-Alpha framework to this Shariah universe and select the top-25 stocks at each annual rebalance. The resultant strategy provides an annualized return of 32.5% from inception (Jan 2003) till the end of April 2018, which corresponds to a significant excess return of almost 15% against the Nifty 500. We also do a similar comparison between the fundamental and valuation ratios of our portfolio and the Nifty 500.



Total Return (%)	1 yr	3 yr	5 yr	10 yr	Since Inception
India Xlnt Shariah	32.5%	25.3%	33.9%	25.8%	32.5%
Nifty 500 Price Index	15.6%	12.1%	15.4%	8.4%	17.8%

Risk-Return Analysis

As can be seen the returns are exceptional. We are not surprised since outperformance of Scientific Alpha vis-à-vis Nifty 500 is already expected and we are now running Scientific Alpha on the Shariah Universe which has already been shown to outperform Nifty 500.

Again, the outperformance is not only over the full period but exists for most periods. We will get deeper into the returns analysis in the next few paragraphs.

Capital Preservation

But even before outperformance analysis, let us look at the chances of preserving capital. A value-oriented—in the footsteps of Benjamin Graham and Warren Buffett—Shariah Investor would have this as the most important aspect to focus on, as far as, risky asset classes like equities are concerned. The chances of capital preservation are quite high. For 1 year and above they are more than 90% and for 4 years and above they are 100%. (Of course, going forward they need not be the same, but this

simulation shows that they are likely to be quite high.) These results are much better than the market-cap weighted Shariah Universe.

Capital Protection	1YR	2YR	3YR	4YR	5YR	6YR	7YR	10YR
India Xlnt Shariah	91.1%	97.4%	98.3%	100.0%	100.0%	100.0%	100.0%	100.0%

Outperformance

A look at more detailed statistics, too, shows that over most 3- and 5-year periods the outperformance is maintained. The chances of outperformance have also improved significantly compared to the Shariah-compliant market-cap weighted universe.

% Outperformance	1YR	2YR	3YR	4YR	5YR	6YR	7YR	10YR
India Xlnt Shariah	82.4%	86.1%	87.3%	99.1%	100.0%	100.0%	100.0%	100.0%

Excess Returns

Another important aspect to look at is how much is the excess returns. Excess returns for the Scientific Alpha (Shariah) are significantly higher compared to Shariah-Universe (market-cap weighted). (Again, remember that this is a simulation and actual results going forward can be different. However, in our opinion having research data is much better than not having any data at all.)

Median Excess Returns	1YR	2YR	3YR	4YR	5YR	6YR	7YR	10YR
India Xlnt Shariah	14.5%	13.5%	12.9%	14.3%	14.5%	14.4%	14.5%	14.0%

Risk Factors

While we have already considered the most important risk factors that an actual Shariah Investor should look at, viz. the likelihood of losing capital and the likelihood of underperforming, we now look at the academically accepted risk factors.

Beta of the India Xlnt Shariah is low at 0.73.

Risk-adjusted return in terms of Sharpe ratio is much superior for the India Xlnt Shariah.

Maximum drawdown of the India Xlnt Shariah, too, is much lower than the Market Universe.

The India Xlnt Shariah generates a Jensen's Alpha of 19.3% over the Market Universe.

	India Xlnt Shariah	Nifty 500 Price Index
Maximum Drawdown	-51.9%	-64.3%
*Sharpe Ratio**	1.74	0.77
Beta	0.73	-
Jensen's Alpha	19.3%	-

Fundamental Analysis

While the superior risk and returns of the Scientific Alpha (Shariah) are encouraging, we need to dig a little deeper to understand the root cause of what is causing this and to form an opinion as to the sustainability of it.

The return on equity, return on assets and return on capital of the Scientific Alpha (Shariah) are all significantly superior to the Market Universe. This means that the current Scientific Alpha (Shariah) portfolio is much more capital efficient compared to the Market Universe and likely to compound capital at a higher rate. In fact, the return on equity is nearly twice that of Nifty 500 and return on capital employed is even more superior. If the companies in a portfolio can compound capital at a higher rate, then the portfolio itself is likely to compound at a higher rate if it is bought at a fair or undervalued price.

The asset turnover ratio of the Scientific Alpha (Shariah) portfolio is twice the Market Universe; meaning that the assets are being used twice more efficiently.

Gross and net debt of the Scientific Alpha (Shariah) portfolio are practically nil to slightly cash rich. This is a much lower leveraged portfolio than even what Shariah allows. In general, margins look significantly superior.

It can be concluded that the Scientific Alpha (Shariah) provides a fundamentally superior investment universe currently.

Key Fundamentals	India Xlnt Sharia	Nifty 500
ROE	21.0%	10.1%
ROA	13.9%	1.9%
ROCE	27.3%	11.0%
5 Yr Average ROCE	0.33	0.13
Sales to Asset	1.39	0.67
Gross Debt to Equity	0.06	0.78
Net Debt to Equity	-0.27	0.63
Interest Coverage	35.66	4.15
Gross Margin	20.0%	18.0%
EBITDA Margin	16.1%	19.2%
EBIT Margin	14.4%	11.9%
Net Margin	10.0%	6.5%
PBT/EBIT	69.5%	54.4%

Valuation Analysis

The PE ratio of the Scientific Alpha (Shariah) portfolio are much lower than Nifty 500, in fact, nearly half. signifying that the Universe is available relatively cheaper. In fact, except for PBV (price-to-book value) the Scientific Alpha (Shariah) portfolio is substantially cheaper on all the valuation parameters.

This is quite interesting given that the fundamentals of the Scientific Alpha (Shariah) are substantially superior as well.

Key Valuation Metrics	India Xlnt Sharia	Nifty 500
P/E	14.90	27.18
P/BV	3.12	2.74
EV/EBITDA	8.49	10.80
EV/EBIT	9.51	17.44
P/Sales	1.49	1.76
Div. Yield	1.9%	1.4%
EV/Sales	1.37	2.07
Net Cash/Mcap	0.11	0.04

RESULTS AND CONCLUSIONS

- The Shariah compliant universe, combined with our Scientific Alpha methodology, provides an outperformance that extends to a range of different holdings periods. The above results show that the last 1, 3 and 5-year returns, as well as the alpha/excess return over the benchmark (Nifty 500) for the India Xlnt 25 Shariah and the Shariah India Universe itself.
- A comparison of current valuation and fundamental ratios also shows that both the Shariah universe and the Xlnt 25 Shariah are more undervalued and deliver a higher performance (in terms of return on equity and return on assets) than the benchmark, as well as its parent Shariah-Compliant Universe

The market for Shariah-compliant funds, while growing significantly overseas, is still a nascent sector in India, with limited opportunities for Indian and NRI clients to gain exposure in Indian Shariah-compliant companies. While the Shariah-compliant universe in India itself outperforms the overall Indian market, investors can reap much higher returns if they combine this with a value-investing outlook. The Scientific-Alpha India Xlnt 25 Shariah aims to do just that, demonstrably providing significant long-term returns at lower risk, all the while remaining in a safe territory for any conscientious investor.

***DISCLAIMER**: Our Shariah-Compliant variants adhere to the described methodology on a best efforts basis subject to data availability and correctness of that data. No representation is being made as to the absolute Shariah-Compliance of the portfolio. Investors with their own Shariah-compliance constraints can share those with OmniScience and OmniScience will try to accommodate those in the best manner practically possible. If investors are not convinced about the Shariah-compliance of the above methodology, they should seek advise from their Shariah consultants before investing.*

Disclaimer

Past performance is not necessarily indicative of future results.

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We have recommended stocks, or stocks in the mentioned sectors to clients, including having personal exposure. Further, some of the stocks or stocks in the mentioned sectors might also be recommended for sale or being sold in personal portfolios given our rebalancing process which is also guided by stock limits, sector limits and rebalances into the most undervalued stocks from the whole market at each rebalance.

About OmniScience Capital

OmniScience is an all IITian global investment management firm that has developed a proprietary investment engine Scientific Alpha which is based on a structured value investing framework focused on enhancing safety & designed to capitalise on market inefficiencies and capture alpha.

Scientific Alpha

Scientific alpha is built on decades of deep research on value investing philosophy as formulated and developed by Ben Graham and Warren Buffett and the first principles of investment management. It is the next stage of evolution of this philosophy focusing on alpha from safety. Resulting portfolio is what is termed a SuperNormal Portfolio or an investment grade equity portfolio (note: investment grade equity doesn't imply capital protection.)

Global Product Suite

Our offerings are built for global listed equities (USA, UK, Europe, Japan, India) and aimed at Indian & global UHNWI, family offices & institutional clients. Through its partnerships with custodian registered with SEBI (India), SEC (USA), FCA (UK), FSC (Mauritius) & DIFC/ESCA (Dubai)- OmniScience Capital offers India's only separate account investment platform for taking exposure to Scientific Alpha portfolios of Indian and global equities.

Investment Team

Dr. Vikas V. Gupta
CEO & Chief Investment Strategist
- Inventor of Scientific Alpha concept
- Formerly served as Professor/ faculty at IIT Kharagpur & University of California, Irvine.
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