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Planning an Islamic Retirement

Investments, accounts, and shariah compliance

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بسم الله الرحمن الرحيم

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In the name of Allah, the Most Merciful, the Grantor of Mercy

Introduction

Until fairly recently, there was one main model for investing, whether for capital growth or retirement: maximize the potential profit for investors at any given risk tolerance level. In recent years, however, there has been increased demand for what has been called socially responsible investing – limiting an investor's portfolio only to investments that they deem to be a socially responsible choice, even if an opportunity for greater returns exists elsewhere. This principle has been at the heart of Islamic financial law for centuries, and recent innovations in other forms of socially responsible investing options have made it easier than ever for American Muslims to invest in a halal manner, though some key challenges still remain.

This paper aims to provide American Muslim investors with a blueprint for developing a halal retirement portfolio. It begins with an overview of the main investment vehicles available to investors today, why each type of investment is used, and broadly whether they tend to be halal, haram, or allowable but requiring purification. Next, it discusses the types of accounts that can be used in order to save for retirement, namely regular brokerage accounts and tax-advantage dedicated retirement accounts like employer-sponsored plans and individual retirement accounts, and considerations that Muslim investors should keep in mind about each account type. Then, it addresses the unique challenges facing Muslim investors seeking to develop a shariah-compliant retirement plan, including the calculation of annual zakah dues, purification of income from non-halal sources that cannot or should not be excluded entirely from the portfolio, and the process used to assess the degree to which investments are shariah-compliant, or may be subject to purification. It finishes with a case study discussing how an investor would go about ensuring shariah compliance on a portfolio over which they had little control of the contents, as in the case of an employer-sponsored 401(k) plan.

American Muslims preparing for retirement have more investment options than ever, but a halal retirement still requires knowledge of the many options which are available, strategies for dealing with mixed portfolios, and knowledge of the applicable rulings to make a retirement portfolio shariah compliant.

WHAT IS AN INVESTMENT?

An investment is something that is used with a goal to generate a return. Investments can be primarily distinguished by how they are bought or sold, what they contain, and the risk level they present to investors. This section discusses common investment types found in investor portfolios such as bonds, equities, mutual funds, and ETFs and briefly touch upon private funds and managed accounts.

FIXED INCOME

Fixed income instruments[1] are debt securities, more commonly known as bonds, which effectively pay the bearer interest in exchange for making a loan. For this reason, they are generally considered haram. However, it is still important to understand the role they play in investment portfolios, so that an investor can know how to properly substitute for them.

Bonds can broadly be classified into government, municipal, or corporate issues. US government bonds or T-bonds are considered the safest investment, municipal bonds are issued by local entities, while corporate bonds are issued by private companies and have the widest range of returns and risk.

Investors buy bonds for three reasons: they are a conservative investment that pays a set amount, they can be used a means of diversification in a portfolio, and some government and municipal bonds are taxed at a reduced rate or not at all.[2] Due to the stable nature of T-bonds, investors tend to flock to them during periods of economic uncertainty or market volatility. This pushes up the value of a bond, which can offset losses in other parts of an investor's portfolio.

The role bonds play in diversifying risk by generating a non-correlated[3] cash-stream is crucial to most portfolio managers. In fact, investment portfolios without bonds are typically seen as more aggressive and volatile. However, from an Islamic standpoint, bonds and other interest-based investments are considered haram, and must be avoided. This presents an enormous challenge for shariah-compliant investors, as it closes off the traditional method of

1 A fixed income instrument is an investment which provides an investor with regular returns at an agreed-upon schedule, with the initial investment amount being returned in full at the end of the contract.

2 Some municipal (muni) bonds in the United States are "triple tax free", meaning they are exempt from municipal (local), state, and federal taxes. This means that a municipal bond paying 5% interest can have the same after-tax return as a taxable investment which nominally pays a higher rate of return. How much of a difference this makes depends upon the investor's taxation rate; the higher the tax rate, the bigger the difference. For a married couple from California filing jointly with a household income of $100,000 per year, a 5% municipal bond would yield the same after taxes as a 7.25% return on a taxable investment. That same couple making $500,000 per year would get the same yield from a 5% municipal bond as they would from a 9.127% taxable investment.

3 A non-correlated asset is one which moves in a different direction from other parts of the market

portfolio diversification and risk mitigation. This, among other reasons, led to the development of an Islamic hybrid investment called Sukuk. Sukuk are asset-backed instruments, rather than debt instruments, and do not involve interest payments. However, Sukuk remain fairly rare in the United States, with only one known domestic issuer.[4] Additionally, they are not as low-risk as government bonds, since they are closely tied to the value of the underlying asset and its ability to generate sufficient cash flows. For an American investor, Sukuk are not yet an adequate substitute for the role played by T-bonds in conventional portfolios.

Equities

Equities, also called stocks or shares, represent ownership in a publicly held company. A publicly held company is a corporation which lists its shares on public exchanges[5] or through brokers[6], and can be bought or sold by investors. A stock's current price is a reflection of what investors believe the company will be worth in the future. Due to uncertainty around forecasting future cash flows, stock prices fluctuate, especially around the time of material information releases, such as earnings. Stocks can vary significantly in terms of the risk they present, but they are always higher risk than T-bonds. As a result, potential returns should be measured against the risk-free rate, which is equal to the current return on a T-bond.

Investors concerned about constructing a shariah-compliant portfolio out of individual securities can either research the companies themselves, or rely upon external ratings companies to screen potential investments for them. These external evaluations can either be done by a firm's own shariah board, based upon a set of criteria established by that firm, or by IdealRatings, an investment research firm which uses multiple rulebooks, including AAOIFI, to screen companies for shariah compliance.

Mutual Funds

Until fairly recently, mutual funds were the only way for smaller investors to adequately diversify their portfolios. Mutual funds are pooled investment vehicles designed to buy a range of assets, ownership of which is then divided up between the investors. This way, an investor can effectively own part of a share, and have their portfolio managed by a professional.

4 University Bank has been issuing sukuk which fall under New York state law since early 2016.

5 Exchanges are places where equities are bought and sold publicly. In the US, the two largest are the New York Stock Exchange (NYSE) and NASDAQ.

6 A broker is the person who acts as intermediary between buyer and seller of an investment vehicle, facilitating the transaction in return for a commission.

Mutual funds are organized around specific strategies, depending upon the types of securities they contain and their investment goals. Common mutual fund categories include fixed income, market index, specific balances of stocks and bonds, money markets, specific sectors, and alternative funds. Since mutual funds are fully customized by the investment manager, this means that shariah-compliant mutual funds not only exist, but there are now multiple offerings available to American investors. Amana Funds, Iman Funds, and Azzad Funds are the three largest and most established companies offering shariah-compliant mutual funds in the United States. These funds use IdealRatings, internal shariah boards, or a combination of both to screen potential investments. Outside of these shariah-based funds, however, investors will need to purify their investment by donating a portion of their portfolio returns. The specific amount would be calculated based upon how much of the returns are from haram sources of revenue.

ETFs

Relative newcomers to the investment scene, Exchange Traded Funds (ETFs) have been around for only about 25 years. They are frequently compared with mutual funds, because both contain many investments within a single share purchase. However, where mutual funds are more likely to be actively managed, many ETFs are index funds, tracking market indices passively in accordance with a set of established rules. This tends to make them less expensive and more transparent than mutual funds. They are also easier to buy, as they are traded like regular securities on exchanges, whereas mutual funds must be purchased through the fund itself, or an authorized broker.

For a DIY investor without much capital, ETFs may offer an easy way to diversify a portfolio. However, they do not provide much customisability for investors with special concerns; currently, there are no ETFs traded in the United States which are designed to be shariah-compliant. Investors concerned about avoiding haram investments must either monitor the ETFs' components regularly, purify their portfolios of income from the haram components of their ETFs, or invest in narrowly defined sector ETFs that invest only in specific industries which happen to be shariah-compliant.

Private Funds

Private funds are similar to mutual funds in that they pool investor money, except they are not transparent, and must be purchased and sold through private transactions. In order to qualify as a private fund, there must be fewer than 100 accredited investors or 2000 qualified investors.[7]

Private funds allow a group of investors to invest in strategies not allowed in public markets, including illiquid investments like real estate and business assets. They also allow for relatively small groups of individuals with similar investment objectives and values to invest together. However, they generally require substantial initial investment amounts, and may restrict when and how much of the investment can be liquidated at any time. It is possible to find shariah-compliant private funds, but the investor must meet the minimum investment requirements, and be willing to adhere to investment lock-down periods.

Managed Accounts

A managed account offers a sort of hybrid between mutual funds and individual securities, and an alternative to private hedge funds. Typically available only to high net worth individuals, managed accounts are highly customized solutions tailored to the specific needs of the investor. Like a mutual fund, a portfolio manager operates the account on behalf of the investor in accordance with an agreed-upon set of objectives, but with a managed account, these objectives are set by only one investor. Managed accounts are popular with high net worth individuals in part because the relationship between investor and manager is a fiduciary one, meaning that the manager must always manage the funds in the best interests of the client, whereas mutual funds require the investor to determine their own risk tolerance and objectives for themselves.

Where mutual funds follow a broad set of rules meant to appeal to many investors at once, managed accounts are like mutual funds created for a single investor, with active management dedicated to monitoring and modifying the portfolio as required. Of course, this level of customization comes with a higher price tag than mutual funds or ETFs. This makes them good solutions for high net worth individuals, especially those with particular investment requirements like shariah compliance, but leaves them inaccessible to many average investors.[8]

7 Accredited and qualified investors are individuals and groups allowed to buy and sell unregistered securities. In the United States, an accredited investor must have more than $1 million in net worth beyond the primary residence or over $200,000 in annual income ($300,000 for a married couple), while a qualified investor needs to hold more than $5 million in assets.

8 Wahdy Capital and Shariah Portfolio are two of only a few investment managers in the United States offering a shariah-compliant solution for managed accounts.

Market Indices

A market index is not an investment in itself, but is rather a list of potential investments that meet certain criteria. They are hypothetical portfolios that give investors and investment managers an idea of how certain segments of the market are performing. Market indices can be used as both a starting point in portfolio construction, and as a benchmark to determine how well the portfolio is performing compared to what it is intending to track. In the United States, there are many low-cost ETFs and mutual funds which are designed to track specific market indices. For example, the SPY ETF tracks the S&P 500 index.

Of interest to observant Muslim investors are the Dow Jones Islamic Market (DJIM) index, the S&P Shariah index, and the MSCI ACWI Islamic Index. Both the DJIM and S&P Shariah track the shariah-compliant components of the Dow Jones Industrial and S&P 500 indices, in accordance with conditions set out by third-party screeners. The DJIM index has both world and regional variants, while the S&P Shariah has global, regional, strategy-specific, and sector-specific variants. The MSCI ACWI Islamic Index tracks large- and medium-sized companies in 47 countries, and components are screened based upon business activity and financial ratios.

TYPES OF RETIREMENT ACCOUNTS

When saving for retirement, an investor can choose one or both of two strategy types: use regular investment accounts, earmarking their contents for retirement as well as other short- and long-term savings goals, or use dedicated retirement accounts that can only be used for other purposes in exceptional circumstances. Some investors may choose to opt for a regular brokerage account because of the flexibility and customization it offers, but they should also be aware of the potential advantages that they are missing out on by not combining it with a dedicated retirement account. For most investors, a tax-advantaged retirement account makes saving for retirement not only easier, but less expensive.

REGULAR BROKERAGE ACCOUNTS

One of the most common ways that investors save for their retirement is with a regular brokerage account. This is an option that is favored by investors who fear they may need to access their retirement funds for another purpose prior to retirement, but it is not an ideal solution because there are no added tax benefits or other advantages that come from using a specialized retirement account.

Regular brokerage accounts offer investors access to a full range of investment options, can be fully customized based on the investor's needs, impose no restrictions on withdrawals, and incur no penalties if the money is used for a purpose other than retirement. However, profits on any non-tax advantage investment in these accounts are fully taxable. The tax rate depends upon how long an investment is held before being sold; profits on investments held for less than a year are taxed at the investor's regular tax rate, while investments held for more than a year are taxed at a reduced capital gains tax rate ranging from 0% for investors in the 12% bracket to 20% for those in the 37% tax bracket.

Most investment advisors suggest that investors have both a regular brokerage account and at least one retirement account, in order to maximize their possible returns and take advantage of benefits unique to certain account types, while minimizing the risk of incurring unnecessary taxes or fees. Brokerage accounts can be made fully shariah-compliant, making them attractive for investors with strict religious requirements seeking a simple solution, but this does not mean they are the best way for religiously observant investors to save for retirement.

DEDICATED RETIREMENT ACCOUNTS

In the United States, there are two types of specialized retirement accounts available: self-established and directed, or through an employer. Investors may choose to use one or both types of accounts when saving for retirement, depending on their needs. Additionally, dedicated retirement accounts are tax advantage, meaning that the money which goes into or comes out of the account is taxed only once, whereas the money invested into traditional brokerage accounts is taxed both when initially received as income, and then any profits on that initial investment amount are taxed when withdrawn from the portfolio.

Employer Plans

Investors who are eligible for employer-sponsored plans are frequently encouraged to take advantage of the unique advantage that these plans offer. The most common type of employer-sponsored plan in the United States is the 401(k), offered to private sector employees, but a similar plan exists as the 403(b) for employees of non-profits, religious groups, and governmental organizations. A less common plan is the 457(b), which is similar to the 401(k) but has no penalty for early withdrawal, among other differences that will vary by plan.[9]

Employer-sponsored retirement plans work by establishing an agreement between employee and employer to defer some part of the investor’s annual salary, which will become post-retirement income. A traditional 401(k) subtracts any contributions from the investor’s annual taxable income at the time the contribution is made, to be taxed upon withdrawal, whereas Roth 401(k)s makes contributions with after-tax income which are then tax-free upon withdrawal.

One of the main advantages of employer-sponsored plans is that nearly all companies offer contribution matching, either in full or in part;[10] this means that an investor is putting aside more for retirement than they are deferring in salary. 401(k) contributions are capped at $18,000 per year,[11] and investors can borrow up to $50,000 or 50% of the account value, albeit at penalty. The biggest drawback for investors with specific religious concerns for their investments is the low degree of flexibility in employer-sponsored plans. Typically, employees

9 For the purpose of simplicity and clarity, employer-sponsored plans are referred to generically in this section as 401(k)s, except where rules differ between plan types.

10 Around 94% of all employer-sponsored retirement plans involve some sort of contribution matching, though the maximum amount that will be matched varies by employer.

11 $24,000 per year if the investor is age 50 or older

can only pick between a pre-determined set of investments; occasionally, employers offer management by outside professionals, but even these offerings can be limited. This means that investors seeking to avoid haram industries and sectors may be unable to do so, and will have to cleanse their portfolios of the interest from these sources.

IRAs

Individual Retirement Accounts (IRAs) are established individually, and rely completely upon contributions made by the investor. IRAs can come in either traditional or Roth forms, depending on when the money will be taxed. Traditional IRAs subtract any contributions from the investor's annual taxable income at the time the contribution is made, to be taxed upon withdrawal, whereas for Roth IRAs, contributions are made with after-tax income and then are tax-free upon withdrawal.

Unlike 401(k)s and other similar employer-sponsored retirement accounts, IRAs can invest in almost any type of investment, including bonds, securities, ETFs, and even real estate for non-personal use. This makes them popular with investors with specific ethical or religious needs. However, annual contribution limits are relatively low, at $5500 per year,[12] and investors cannot borrow from the principal, but they are able to borrow up to $10,000 from the IRA tax-free in order to purchase a first home. As with 401(k)s, the minimum age of distribution without penalty is age 59.5; a traditional IRA requires distributions to start by age 70.5, while a Roth IRA has no maximum age for first distribution.

Rollovers

When an employee leaves a company where they had a 401(k), they can either choose to leave the money in that plan, or roll it over into an IRA. In certain rare cases, an employer may also allow employees to roll over their 401(k)s into IRAs while still at the firm. This can be an attractive solution for investors who find the investment options in their 401(k)s too limiting, but it means giving up some of the other advantages that a 401(k) has over an IRA, and should only be pursued after careful consideration and consultation with an investment professional.

12 $6500 per year if the investor is age 50 or older.

BUILDING A HALAL RETIREMENT

Beyond choosing and opening a dedicated retirement account, religiously observant investors have additional steps to ensure that their retirement portfolio is set up in a halal manner, and remains that way. This involves establishing a procedure for payment of zakah, purification of income from haram sources within the portfolio, and regular screening for shariah compliance.

ZAKAH

Observant investors who have accumulated capital and wealth beyond what is necessary to meet their required living costs and expenses, referred to as nisab, are expected to donate 2.5% of that excess wealth annually.[13] This nisab amount is calculated separately on each class of wealth, and includes investments, whether they are held in a taxable brokerage account or a dedicated retirement account. Zakatable wealth includes money, goods, business properties, most agricultural crops, commercial livestock and their by-products, and unexpected windfalls. Cash, stocks, ETFs, mutual funds, and other money-based investments are considered to be of the same category, and so are added up together when calculating zakah, while land and agricultural crops are two separate categories, and must each reach the nisab threshold before they are subject to zakah.

However, the amount of zakah to which an investment is liable is not simply calculated based upon its liquidation value, but the investment's purpose, tax advantage status, and taxes or penalties that would be incurred by withdrawing the necessary funds. In a regular brokerage account, investments held for the purpose of capital gains are subject to a zakah on the full market liquidation value, while investments held for the purpose of generating income are subject to zakah only on the income stream.[14] With these types of accounts, zakah should generally be paid yearly. With dedicated retirement accounts, the amount subject to zakah is equal to the total accessible amount minus any mandatory penalties and taxes, and this amount is cumulative over the life of the accounts.[15] This zakah is not due, however, until the money becomes accessible without penalty,[16] though some investors choose to pay it yearly if

13 This is the case for most excess wealth, but certain forms of nisab may be subject to higher zakat. Most agricultural or livestock products have a zakat rate of between 5 and 10%, while rikaz (windfall treasure troves) are subject to a zakat of 20%.

14 An exception to this would be shares in companies which already pay zakah on all shares, as double payment of zakah is not required

15 See Al-Qudah, AMJA Fatwa 76302 for calculating zakah due, and Al-Qudah, AMJA Fatwa 76499 for calculating zakah on an investment that has been held for many years prior to payment of zakah.

16 "No zakah is due until [the investor] claims this retirement money" Al Meneesey, AMJA Fatwa 2113

they have alternative sources of wealth in order to reduce the hardship of paying it as a lump sum once the funds become available.

When an investor holds a combination of different investment vehicles across multiple types of accounts, the calculation of zakah can be a complicated process. Some investment managers specializing in catering to a Muslim clientele will calculate this for their clients, while other investors will need to calculate it for themselves.

PURIFICATION

There are many reasons why an observant investor may not be able to construct a completely halal retirement portfolio. It is not necessarily haram to own stock in companies that derive some profit from haram activities, so long as there is good reason for holding these investment vehicles, and any income that comes from haram activities is purified by being donated to charity.[17] For example, investors with 401(k)s often have only a limited number of predetermined plans to choose from, and these may contain financial companies or other haram industries. Alternatively, investors with smaller portfolios may find that they would be forced to take on excessive risk in their IRA or regular brokerage account if they tried to construct an entirely securities-based portfolio with only halal stocks, instead of using ETFs to reduce risk and increase diversification. Rather than abstain entirely from investing in the 401(k) – and benefitting from the employer matching funds and tax advantages of the account – or taking on excessive risk in an IRA, the investor can calculate what portion of the portfolio's profits came from haram activities, and donate that amount to charity in order to purify their account of the haram income when the funds are withdrawn.[18]

There are two documented approaches from Islamic scholars on how to purify a portfolio to make it shariah compliant. In the most common method, the investor needs to know how much of the increase in value of an investment vehicle was due to profit from a source considered to be haram.[19] This is done using a list of firms held in the portfolio, either as individual securities or within an ETF or mutual fund, and cross-referencing it with lists compiled

17 "If the haram… part of a mixed company is incidental, the percentage is small, and it is not the essential target of the company's activity, there is nothing wrong with investing in it, as long as the investor takes out an amount of profit equal to… the percentage comprised by the haram source in this company" Al-Sawy, AMJA Fatwa 1820

18 "When you start to get the pension, you should purify it by spending in the way of Allah a percentage of the income (that doesn't count as charity, but you will be rewarded for purifying your money)" al-Haj, AMJA Fatwa 1871

19 The other, less commonly used method for purification which is advocated by the AAOIFI, involves calculating the proportion of haram revenue on a per-share basis, without reference to share price or the investor's profit. This can result in investors purifying on losses, or even purifying more than the share itself is worth. (See AAOIFI Guidebook, Standard 21 3/4)

by shariah evaluation companies. In this method, any gains in value attributed to those haram sources are then added up to give the total amount that needs to be donated to charity in order to purify the portfolio. Without access to third party shariah evaluations, this can be a time-consuming process.

Determining Shariah Compliance

Evaluating a potential investment for shariah compliance goes beyond an industry-level analysis. While some companies can be quickly eliminated because their primary business is a haram activity, most companies are rather ambiguous as to their halal status. A company may engage in no haram business, but may hold too much debt, making them too risky, or they may own subsidiaries that engage in haram activities. Determining shariah compliance of any given company involves knowledge of applicable shariah rules, measuring a firm's debt levels against market capitalization,[20] identification of all significant sources of income for haram activities, and evaluation of whether the investment would be contrary to shariah principles, like excessive risk or gambling.

Investors and even investment managers typically do not perform start-to-finish shariah evaluations themselves, as these would require extensive knowledge of shariah law and competing rulings, knowledge on how to read and evaluate companies' public financial statements, and in-depth qualitative and quantitative screening tests of every company being evaluated. Instead, each of these three tasks tend to be performed by separate organizations. Precision is more important than speed when determining whether an investment is entirely haram, how much of an investment will require purification, or whether an investment is safely halal.

AAOIFI and Shariah Boards

The Accounting and Auditing Organization for Islamic Financial Institutions is a Bahrain-based organization founded in 1990 to establish standards for Islamic finance, business, and investing. Along with an accounting and auditing procedure, the AAOIFI has developed a manual which provides instructions on how to evaluate potential investments for shariah compliance, incorporating the most recent rulings on the newest investment vehicles. Alternatively, some investment management firms use in-house or third-party shariah boards, comprised of scholars specializing in Islamic finance. These boards are often established to be

20 The hypothetical total market value of a company and all its assets if it were to be sold off. This is equal to the total shares outstanding, multiplied by current share price.

complements to, rather than replacements for, AAOIFI guidance, offering investors additional peace of mind that proper oversight is being conducted.

IdealRatings and Amanie

IdealRatings and Amanie are two established vendors of Islamic ratings that base their analysis on AAOIFI, or other similar standards. Both firms perform analysis at the industry and company level to determine whether a potential investment is shariah compliant. While Amanie focusses solely on companies' shariah compliance, IdealRatings provides additional ethical and ESG (Environmental, Social, Governance) screening.

A typical report consists of a description of the firm and its operations, followed by a breakdown of revenue streams, debt levels and liquidity. However, since these companies evaluate thousands of companies on an ongoing basis, they place a heavier emphasis on quantitative analysis than on qualitative assessments of the companies in question. This means that some cases may be incorrectly marked as either shariah compliant or non-compliant, necessitating a third round of screening before being placed into a halal portfolio. In addition, companies need to be updated each time new earnings data is released, on a quarterly basis. A company may go from being in and out of shariah compliance from one quarter to the next.

INVESTMENT MANAGERS

When constructing a halal portfolio for a client, investment managers typically use IdealRatings or Amanie evaluations to either confirm their own short-lists of companies that meet shariah standards, or flag them for further qualitative and quantitative analysis. This is a time-consuming process, but it is a necessary final step to verify shariah compliance, and determine how much of a portfolio would be subject to purification of income from haram sources.

A Note about "Ethical" Portfolios

One thing that observant Muslim investors looking for a shariah-compliant portfolio should be aware of is the ESG or "ethical" portfolio. It is important to first discern what "ethical" means for the firm that is offering the portfolio before investing in it, because it may contain investments which, while considered ethical by secular investors, are haram for a Muslim investor. For example, while many ethical portfolios preclude investments in environmentally deleterious industries like oil and gas or weapons manufacturing that a shariah-compliant investor would also seek to avoid, they may make up for this by being overweighted[21] in the financials industry compared to a broader market index-based portfolio. Additionally, these portfolios may contain bonds or other interest-based investments, all of which are entirely haram and would need to be purified from the portfolio. This means that, in some cases, a portfolio marketed as "ethical" may be less ethical by shariah standards than the broader market.

For example, the financial services sector currently accounts for 13.3% of the S&P 500, a commonly used investment benchmark in the United States. Among popular ETFs specifically marketed as being ethical, however, the financials industry typically ranges from 15% to over 20% of the entire portfolio.[22] This means that an observant investor would have to purify more of their profits from one of these ethical ETFs than they would from a broad market-based portfolio. This is not to say that all ethical portfolios are haram, but a religiously observant investor should carefully examine the contents of an investment marketed as ethical before investing, and keep in mind that ethical standards vary between portfolio managers.

Options for American Investors

In the United States, the major investment managers offering shariah compliant investments use the following screening methods to develop and screen their portfolios:

Mutual Funds

- Saturna Capital, which manages the Amana line of mutual funds, is the only major investment firm in the United States that has an in-house shariah board. Investments in Amana mutual funds are also pre-screened by the Fiqh Council of North America, and the process is regularly reviewed by Amanie Advisors Sdn Bhd, a financial services company based in Malaysia.
- Iman Funds track the Dow Jones Islamic Market World Index and DJIM US Index.
- Azzad Funds offers both mutual funds and wealth management, and uses a proprietary screening tool based upon AAOIFI standards for its shariah-compliant investments.

21 A portfolio is overweighted in a certain industry when it contains more of that industry as a proportion of the total portfolio than the rest of the market.

22 In preparation of this document, only one popular ethical ETF – the MSCI KLD 400 Social – was found to hold a smaller proportion of financial services stocks than the S&P 500 as a whole, but it was still 10.2% of the holdings as of end 2018.

Investment and Wealth Managers[23]

- Shariah Portfolio, a traditional wealth manager, uses IdealRatings to screen investments.
- Wahdy Capital, a traditional investment manager, uses IdealRatings to screen investments, followed by additional manual screening of each potential investment to ensure greater accuracy.

Robo-Advisors[24]

- Wahed Invest uses a third-party shariah board called Straightway Ethical Advisory, an Islamic consulting firm based in New York. Straightway uses AAOIFI standards to determine shariah compliance, and then calculates the amount of any investment portfolio that would need to be purified by the investor.
- WealthSimple Halal tracks the MSCI ACWI Islamic Index.

Alternative Investments

- Bena Capital, a real estate fund manager, does not use additional shariah screening because it engages only in all-cash real estate deals.

23 A wealth manager offers comprehensive investment and financial planning services all in-house, whereas an investment manager focuses on creating investment portfolios, and will refer clients to a network of other specialists for tax planning and other related financial planning services.
24 Robo-advisors are financial advisors that rely on algorithms and proprietary software to create investment portfolios, instead of human advisors picking and choosing the individual portfolio components. Robo-advisors tend to cost less than traditional human advisors, but they are less flexible and react to changing market conditions more slowly.

CASE STUDY: A DIY HALAL 401(K)

A Muslim investor in the United States planning for retirement has more options than ever before if they want to hire a professional to help them build a halal plan, but they can also, with enough time and patience, construct and purify a retirement portfolio to be shariah-compliant. Even if an investor has little control over the contents of their portfolio, it is possible to create a halal retirement by being diligent about annual zakah, and then purifying any profits from haram sources once the contents of the portfolio become available for withdrawal. When doing it alone, without the assistance of a financial professional, it will take additional time and effort, but for an investor that prioritizes their religious values, following these three steps and then repeating them as necessary are worthwhile strategies to help ensure that those ethical needs are met.

STEP ONE: YEARLY ZAKAH

One of the most important things that an investor can do to simplify the process of making their retirement plan shariah-compliant is to stay up to date on zakah, even on retirement accounts where the funds are not yet accessible. Rather than earmark the amount within their dedicated retirement accounts in order to pay the accumulated zakah as a lump some once the money becomes available, DIY investors are advised to calculate the zakah on any dedicated retirement accounts, and use funds from other sources to pay it on a yearly basis. This avoids the financial hardship of making the payment all at once, at a time when the investor is already making a significant life transition from working to retirement. Additionally, it simplifies the math, as zakah is calculated on an additive rather than cumulative basis, meaning that the amount owed is calculated separately for every single year, and is not simply a matter of multiplying a percentage owed by the number of years outstanding.

STEP TWO: IDENTIFICATION OF ASSETS SUBJECT TO PURIFICATION

Without a lump sum zakah to worry about, the investor can then focus on purifying the portfolio of any income from haram sources. First, the investor needs to know what items in their portfolio would be subject to purification. This includes impermissible investments that could not be removed from the portfolio, as in the case of pre-set 401(k)s, mixed ETFs or mutual funds, as well as investments that otherwise pass an initial shariah screening but still derive some income from haram sources. The investor accomplishes this by looking at both individual stocks and the components of any mutual funds or ETFs owned in their portfolio.

Step Three: Purification

At this point, the investor needs to choose which purification method they will follow. The most common purification method is to purify on profit, and so they need to know how much of the investment's revenue came from haram sources, and how much profit was made on the investment.[25] In the case of fully haram investments, the original investment amount can be kept, but the full increase in value gets purified. For example, if the portfolio held stock in a gambling company which was purchased for $100 and sold at $125, the difference of $25 must be purified. In the case of investments which pass a broad shariah screening but are not fully halal, the investor needs to calculate what portion of the company's revenue comes from haram sources. With this number in hand, the investor then knows how much of their profit from the investment to purify accordingly. For example, a company may report $10 billion in annual revenue, $300 million of which comes from haram activity, or 3% of the total revenue. If the portfolio acquired the stock at $100 and sold it at $140, then $1.20 or 3% of the profit gets purified for each share held.

25 Alternatively, if following AAOIFI standards, the investor would divide the total haram revenue by outstanding shares in the company to arrive at the haram revenue per share, which is the amount to be purified for every share held in that company. For example, a company may report $10 billion in annual revenue, $300 million of which comes from haram activity, and have 30 million shares outstanding. This would mean that $10 must be purified for every share held, regardless of profit, loss, or even share price.

CONCLUSION

Ensuring a shariah-compliant retirement is a common worry for American Muslims who do not want to compromise between their ethical values, and the desire to invest wisely. Observant investors are sometimes confused about the rules of shariah-compliant investing, unsure if they need to take on excessive risk with an all-stock portfolio containing no interest-bearing bonds, or forego the advantages of employer contributions to pre-set 401(k) plans because they contain haram stocks. In the United States, however, it is possible for an observant investor to have a shariah-compliant retirement plan, whether they choose to seek the help of an investment professional, or opt for the 401(k) plan offered through their employer.

This paper has sought to provide American Muslim investors with an overview of how to plan for a halal retirement, from the initial stage of familiarizing themselves with common investment vehicles and retirement account types, to understanding how investment professionals screen for shariah compliance, and then monitoring the portfolios to ensure continued compliance. A halal retirement is not a set-it-and-forget it style of investing, but requires ongoing oversight and active maintenance on the part of the investor. However, for many observant Muslims, the added effort it takes to set up and manage a halal retirement plan is a small price to pay for staying true to their beliefs.