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Market Timing and Stock Rotation between Islamic and Conventional Banking Stocks During a Financial Crisis

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Research is inundated with empirical evidence indicating that Islamic banks outperform conventional banks some of the time. There is also varied evidence indicating that Islamic banking stocks behave differently from conventional banking stocks and are resilient during an economic crisis. With the foregoing, this paper employs the active portfolio strategies of market timing and stock rotation strategies to exploit the unique features of the Islamic banking stocks as a unique sub-equity asset class. The paper splits the two sub-equity classes into unique sub-portfolio constituents, using Bank Scope data for the UK and Middle East banks for the sample period 2000–2015, a unique sample period that captures sub-periods of economic boom and recession as classified by the NBER. The main aim of the paper is isolating episodes of Islamic banks stocks outperformance suitable for rotational shifts. The paper presents empirical evidence on the profitability of timing and rotation indicating sample-period underperformance by Islamic banking stocks. While there is cyclical outperformance by either sub-portfolio equity class, such outperformance is persistent and significant when we split the portfolio by market capitalisation. Conventional banks outperform Islamic stocks and most of the indices during economic growth sub-periods and large-cap Islamic bank stocks outperform conventional banking stocks during the economic recession periods, but underperform most of the benchmarks. Thus, while the results are conditional on the sample-period, they nevertheless support stock rotation and market timing literature and indicate that a portfolio of banking stocks can be rotated between large-cap Islamic banking stocks and conventional banking stocks with success.

Keywords: financial crisis, stock rotation, market timing, Islamic banks, conventional banks and portfolio management