The Path to Positive Screens

Shar’ah (or Islamic) compliant equity screening can be said to have come into global prominence in 1999, when the Dow Jones Islamic Market IndexSM (DJIM) was launched in Bahrain. Fast forward nearly a decade, and there are a variety of funds (index and actively managed), ETFs, certificates, structured products, etc., totaling nearly $20 billion (Source: www.failaka.com), that apply Islamic screening principles.

Islamic equity investing has common shared values with social-ethical investing, where the emphasis is on negative screening, i.e., exclusion of the proverbial sin sectors. However, social-ethical screening has generally migrated to sustainable investing, where the emphasis is on the positive screening. Now, Islamic equity investing needs to look at its sustainable brethren.

Launched in 1999, the Dow Jones Sustainability World IndexSM (DJSI World) is provided through the cooperation of Dow Jones & Company, Inc. and SAM Group, a Zurich-based research firm that conducts detailed sustainability analyses of thousands of global market-cap leaders each year. The index comprises more than 300 companies that represent the top 10% of the leading sustainability companies out of the biggest companies in the Dow Jones World IndexSM in terms of long-term economic, environmental and social criteria.

Then, in 2006, the Dow Jones Islamic Market Sustainability IndexSM was launched, representing companies that are compatible with Islamic investment guidelines, while at the same time determined to be corporate sustainability leaders. To be included in the Dow Jones Islamic Market Sustainability Index, companies must be components of both the Dow Jones Islamic Market Index and the Dow Jones Sustainability World Index. Currently, 113 companies with a free float market capitalization value of $4.34 trillion are included in the Dow Jones Islamic Market Sustainability Index and are thus compatible with stringent Islamic screens, as well as best-in-class sustainability criteria.

For Islamic investors, Islamic sustainability represents adherence to the spiritual (Shar’ah screening) compliance plus important secular corporate movements involving governance, environment, etc. For non-Islamic investors, Islamic sustainability represents an asset class diversification strategy without compromising performance.

The following graph demonstrates that, in the given market cycle period, the Dow Jones Islamic Market Sustainability Index has outperformed the Dow Jones Islamic Market Index, which has outperformed its conventional counterpart index.

The conclusion is that the Dow Jones Islamic Market Sustainability Index represents a pioneering approach to combine both negative and positive screens in one index. It showcases the beginning of Islamic CSR (corporate social responsibility) and governance. It showcases the interest in monitoring the performance of companies compatible with Islamic principles and builds bridges to the sustainable communities that share common goals and objectives. It shows the maturing and migration of the approach to monitoring the performance of companies compatible with Islamic principles beyond mere static and technical screening.

Islamic investing is for all investors. The Dow Jones Islamic Market Sustainability Index represents an opportunity to access a unique style of market performance measurement: low-debt, non-financial socially sustainable companies; to access a performance monitoring strategy that resembles an exotic Beta or Alpha; to impose a review discipline (companies are reviewed quarterly for continued compliance); and to monitor companies that are less sensitive to interest rate movements (gearing screen).
Shari’ah Compliant Funds: The Pace of Asset Growth May Finally Begin to Quicken

While the past 15 years have seen tremendous interest and growth in the field of Islamic finance, a close examination specifically on the Islamic funds sector reveals that growth fund has been nothing if not gradual. In 1994, there were a scant nine Shari’ah-compliant funds in the GCC; the number is now approaching 400 (Source: www.failaka.com). Over the years, the number of funds has grown and eventually trickled across the globe, though always in a very measured way. While many funds prospered, especially those in Saudi Arabia and Kuwait and those with large retail distribution capabilities, others have experienced more than their fair share of frustration, and a number of funds have tried and failed.

The main complaint by managers has traditionally been the same: problems with distribution — the other challenges of creating an Islamic-compliant fund have largely been figured out. The work of Dow Jones on their popular “screens and ratios” and the many variations thereof have gained near universal acceptance, and securities conforming to these guidelines are generally found in sufficient quantities to allow for the creation of viable funds. In fact, for many years there has been wide consensus that you can structure a Shari’ah-compliant fund on nearly all of the major world bourses. By way of example, it is claimed that approximately 90% of shares on the KLSE in Malaysia are Shari’ah-compliant and therefore eligible investments for a Shari’ah fund; and not long ago, the DFM in Dubai became the world’s first Shari’ah-compliant stock exchange. In short, the knowledge and experience is there, but very often the monies do not follow…or follow quickly enough. This may be changing.

The cause for optimism is two-fold: the rise of Takaful, or Islamic insurance and the first sign of government support.

For many industry observers, the least developed, and therefore the area with the most potential within Islamic finance is Takaful. By comparison, Islamic funds are in many ways a mature product in the field, with a history stretching back in the 1960s and 1970s (although the major push came in the 1990s). However, Takaful has one key similarity, in that its potential market is comprised of both retail and institutional clients that span the globe. While the past five years have seen Islamic private equity, investment banking and most especially Sukuk making headlines, it is quite possible that the next five years may belong to the expanding number of Takaful houses that are springing up across the globe.

The point about Takaful is simply that, just like conventional insurance companies, Takaful companies should become large buyers of funds for their excess premiums. The catch is that of course an Islamic Takaful company should not be investing in conventional funds, but rather in one of the relatively few Shari’ah-compliant funds. Although they will likely have a markedly low risk/reward profile, their growth could provide an additional area of support for eager fund managers.

The second encouraging factor is the involvement of governments. It is fair to say that, thus far, assets in Islamic funds have grown organically, primarily through the greater awareness and acceptance of retail investors. While many of these investors, especially early investors, may have been high net worth investors, Islamic funds have been primarily supported by grass root individual investors. This is particularly so in the major markets of Saudi Arabia and Malaysia. While the growth has been steady, total assets in Shari’ah-compliant equity and balanced funds (listed shares) stand at a mere $19 billion. While it may be an unfair comparison, it is illustrative that the total for socially responsible fund assets stands at roughly 49bn ($76 bn) from a universe of nearly 500 funds.*

Given this state of affairs, and with the GCC especially flush in recent years, many have questioned why the regional governments have not been major investors. Surely they have their reasons, but recently the FT reported that the Dubai government would be committing $250m into an Islamic-compliant hedge fund product, a subset of the Islamic funds industry that has found it especially difficult to attract investment. Might this be the tip of the iceberg? With most GCC governments solidly behind the industry in terms of establishing regulatory regimes and supporting development initiatives, and with oil now in its sixth year of a bull market, perhaps actual investment is the next step. If we are indeed in the midst of Goldman Sachs’ “super spike” in oil prices, with $200 per barrel the next stop, just think of what would happen if even a percentage of this sovereign wealth was diverted into this gradualist industry. It could grow tenfold overnight. *http://www.reponsible-investor.com

Mark Smyth is a founding partner of the Failaka group and has contributed to Failaka’s development since the firm’s inception in 1996.
Capacity Building Needs for Issuing Sovereign Sukuk

Global Sukuk Market

Sukuk started as a recognized Islamic financial instrument about nine years ago. The $100m Bahrain sovereign issue in 2001, and two Malaysian international issues, the $600m Sovereign benchmark and Guthrie $150m corporate issues in 2001-2002, led the global Sukuk market development. As shown below, total issues through June 2008, including Malaysian domestic, exceeded $111 billion.

IIFM Analysis

It can be seen that whilst Sovereign issues have not shown any significant growth, International Corporate issues have been growing annually at about 150% through 2005 and 400+% by December 2006.

Salient Features

Listing - Corporate issues are generally listed on local rather than international exchanges, with the two largest being listed on the DIFX. There are some exceptions, such as the Tabreed and Wings Issues, which have been listed on either Luxembourg or London. However, nearly all the Sovereign issues have been listed on Luxembourg, and many are dual-listed regionally on LFx, DIFx or Bahrain SE.

Maturities - These range from three months (Bahrain Salam Sukuk) to ten years, with the average being around four to five.

Price basis - Of the issues analyzed (20% of data), 50% were floating and the other half were fixed in some way. However, nearly all the Sovereign issues, except most of those in Bahrain, have been floating. If the Bahrain fixed issues are excluded, the percentage of fixed issues falls nearer to 40%. Of the total 17 benchmark issues, only 29% were fixed-rate; even less, 10%, of the Sovereign benchmark issues were fixed-rate. This is in stark contrast to the conventional market, where 95% of all issues are fixed-rate.

Sukuk compared to Conventional

The distinction between the Malaysian and mainstream Islamic approaches is germane to an analysis of the distinctive nature of Sukuk when compared with traditional fixed-income instruments. The Islamic preference for asset-backed financing and risk-sharing mechanisms creates built-in safeguards that protect both institutions and investors. In an Islamic finance culture, there is a strong aversion to high levels of debt, interest and speculations. This essentially implies financial prudence and encourages a greater asset orientation, which some may
consider being collateralization, and transaction-delimited risk sharing Sukuk as an innovative Islamic product may be structured and issued to achieve exactly these qualities. But first, how do Sukuk stand up to conventional fixed-income products?

This is in stark contrast to the conventional market, where 95% of all issues are fixed-rate. The reasons for this present predomination of floating rate issues appear to result primarily from the self-interest of liquidity-rich Islamic banks looking for assets, paucity of issues along with a very shallow investor base.

Outside of Malaysia, only Bahrain (and recently Brunei) has regular issues of fixed-rate short tenor (91-day) Sukuk, which could be used for bank liquidity management. Continuous government issues with regular and planned auctions are fundamental to market development, as are benchmark fixed-rate issues with a wide spread of maturities, which could be used for infrastructure funding.

The low total volume issued to date, scarcity of fixed-rate instruments and lack of a diverse investor base makes the Islamic bond market one-sided, with a predominance of buy-and-hold investors leaving the secondary markets quite inactive.

Other fundamental aspects of a developed bond market concerning issues presently missing from the Islamic market are the absence of Benchmark fixed-rate issues extending yield curves out to long maturities (even SABIC, at 20 years, was an FRN) and cost-effective hedging instruments.

Sukuk Capacity Building

Legal framework is a key part of the infrastructure. Under Shari’ah, a company owned by a natural person has to be established and then contracted to perform the required duties to become a de facto trustee. This requires restrictive covenants to represent the investor’s best interests and being owned by nationals leads to questions concerning foreign control, ownership, collateral and nature of capital flows.

However, most Islamic markets are not governed by Shari’ah courts, but subject to a local version of civil code not particularly supportive of capital markets, especially in the areas of trust law and SPV structures. Specific amendments in most markets still need to be made to local code, trust law, banking and securities regulations. Some other issues are as follows:

Clearing and Settlement Systems - International Sukuk are scripless issues with a global certificate lodged with Euroclear/Clearstream, enabling orderly settlement.

A primary dealer network should be established for those houses that cannot meet Euroclear requirements.

Late Payment – This can be resolved by agreement with clearing-houses to change their penalty mechanism.

A suitably capitalized Special Purpose Company should be formed to settle any claims on behalf of Islamic institutions.
A Central Counter Party (CCP) is a financial institution that acts as an intermediary between security market participants. This reduces the amount of counterparty risk to which the market participants are exposed. CCPs must have adequate risk management systems, including sound marging policies, collateral management procedures and strong capital cushions.

**Primary Market** - A well-functioning primary market underpinned by government securities is fundamental to ensure orderly funding of capital market and government borrowing needs. The choice of issue procedures and distribution will depend on the stage of market development and country circumstances. Local exchanges have to be brought up to international standards and should look to establish links with other exchanges, if they are to play a role in the cross-border market. Setting up a primary dealer system will facilitate the changeover from the usage of captive internal sources of Sovereign financing to a system of market-based financing.

**Investor Diversity & Education** - There is no real depth or diversity to investors in the Islamic markets outside Malaysia, with financial institutions being the largest holders of Sukuk. Banks’ average take is more than 75% of all issues. In the conventional market, it’s around 25%.

**Transparency & Disclosure** - Outside Malaysia, there is relatively little depth of information, consistency or transparency. Without this information, it is difficult for market makers or investors to gain the facts they need to determine strategy or pricing. There should be consistent prospectus information and availability of primary issue information.

**Market Practice** - Many areas of issue structure and practice are still at odds with the developed markets, and even in advanced developing markets, such as Malaysia. These include aspects such as pricing, fixed-rate, tenors, yield curve, issue quality and rating.

**Liquidity & Secondary Market** - A secondary market is effectively absent for several reasons, including too few issues; some structures are not or are not always tradable; lack of experienced market makers; RAR issues, particularly on corporate bonds; and few money market instruments, including sovereign Repo facilities.

**Settlement & Custody** - The similarity between the way international Sukuk and conventional bonds are treated is clearly illustrated by 16 being listed on Euroclear.

**Other aspects** - These include a lack of professional (and independent) interdealer brokers with established, global distribution; absence of hedging instruments; relatively poor professional qualifications; other (non-bond) trading systems.

**Recommendations**

In order to have a truly well-developed and integrated international Sukuk market, following measures must be adopted vis-a-vis Sovereign Sukuk issuance:

- Legal and regulatory framework
- Arbitration
- Primary market
- Fixed-rate and long-term maturity
- Short-term Ijarah type Sukuk necessary for Islamic Money Market
- Settlement and custody – international and national level
- Inter-dealer brokers
- Hedging instruments
- Yield curve creation based on Sovereign Sukus

Ijlal Alvi is the Chief Executive of IIFM since mid-2005. Mr. Alvi has two decades of extensive financial services industry experience mainly in the areas of Islamic corporate and development finance, treasury, capital markets and corporate re-organization. Prior to moving to the Gulf, he had spent 10 years at senior positions in the areas of Treasury & Capital Markets with international and regional financial institutions. Since 1997, Mr. Alvi has served at senior positions with a number of Middle East-based financial institutions.
Dow Jones Islamic Market Indexes in July: The Comeback of Asia’s Beaten Down Composites

The month of July has seen a turnaround for the major Dow Jones Islamic Market indexes in Asia. While India had been at the bottom of the board with a loss of 15.89% in June, Shar’iah-compliant stocks of the Dow Jones Islamic Market India IndexSM advanced in July, up 7.68%. The Islamic index even beat its conventional counterpart, the Dow Jones Wilshire India IndexSM (which was up 6.87%). The same applies for the Dow Jones Islamic Market Philippines IndexSM: so far in 2008, it has been one of the worst composites on a YTD-basis. In July, the South-East Asian IndexSM surged 2.9%, followed by the Dow Jones Islamic Market Amana Sri Lanka IndexSM (gaining 1.51%).

It is of little surprise that the Dow Jones-Js Pakistan Islamic IndexSM is at the bottom of the results list with a loss of 19.71%. Pakistan, a pioneering country in Islamic banking and investing, is currently undergoing its worst stock market crisis in at least 18 years. In fact, the Karachi Stock Exchange (KSE) has lost 40% of its value since its record of 15,676.34 points on April 18, 2008. Indeed, Karachi’s banking district was a no-go zone recently, with riots spurred by angry investors who lost fortunes.

The Dow Jones Islamic Market ThailandSM and Dow Jones Islamic Market IndonesiaSM indexes took heavy losses as well. They had retreats of 13.85% and 10.65%, respectively.

The Dow Jones Islamic Market GCC IndexSM made its debut in July (it lost 3.4%). It combines Shar’iah-compliant stocks listed on the exchanges of the Gulf Cooperation Council (GCC). The countries included in the index are Kuwait, UAE, Bahrain, Qatar and Oman. Although GCC member Saudi Arabia has the biggest stock market in terms of market capitalization, its stocks are excluded, since Riyadh is not open to foreign private investors (as of yet). On July 14, Dow Jones Indexes also launched the Dow Jones GCC Titans 40 IndexSM.

Islamic finance is not concentrated in the Middle East or East Asia alone. It is a global phenomenon. The Dow Jones Islamic Market U.S. Titans 50 IndexSM (down 3.84%) and the Dow Jones Islamic Market Europe Titans 25 IndexSM (4.96% lower) enable monitoring to put faith into finance in the world’s developed markets as well. Examples of Shar’iah-compliant stocks are Exxon Mobil and Microsoft in the U.S., or BP and Vodafone Group in Europe. These firms do no or little business with alcohol, pork and tobacco products, weapons, entertainment or interest-based financing.

Among the sector composites, only the Dow Jones Islamic Market Health Care IndexSM headed into positive territory last month (up 3.53%). Since oil prices dropped significantly in July, the Dow Jones Islamic Market Oil & Gas IndexSM had the biggest loss, down 14.19%. Islamic Banks and insurers of the Dow Jones Islamic Market Financials IndexSM exited the month almost unchanged, as did the Dow Jones Citigroup Sukuk IndexSM (down .31%).

With the majority of Islamic and conventional indexes of the Dow Jones Indexes family heading down in the third consecutive month, pundits are justified in asking important questions: After years of a global boom, is there a global bust ahead? Further, are we already in one (and do not know it)?

The Hong Kong-based Swiss asset manager Dr. Marc Faber came up with this boom-bust theory at the start of 2008. Faber argues that the “excessive printing of dollars” in order to save the shattered financial sector after the subprime crisis might lead to the point of no return for the Federal Reserve. This would mean that an inflated greenback would lose its status as a world currency. Add to that the potential of Western conflict with Iran, investors may face stormy months ahead.

Gérard Al-Fil started his journalism career in 1999 in Zurich, after working as a portfolio manager in Switzerland and Liechtenstein. In 2004 he founded his own media company in Dubai. He is a correspondent for the Swiss financial website moneycab.com, for the Swiss banking magazine “Schweizer Bank” and for the German weekly “Euro am Sonntag”. Gérard has reported extensively from the UAE, Kuwait, Bahrain, Qatar, Oman, Iran and Turkey. Gérard studied economics and business administration at University of Konstanz, at London School of Economics and at University of Düsseldorf, where he achieved his diploma as the youngest candidate at age 24. He also holds a postgraduate diploma in Islamic Banking from the Institute of Islamic Banking and Insurance (IIBI) in London. He lives in Dubai.
Dow Jones Islamic Market Indexes Performance Report

In part based on backtested performance. Data as of July 31, 2008.

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<th>1 MONTH</th>
<th>YTD</th>
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<th>3 YR</th>
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*This Dow Jones Islamic Performance Report contains index performance data for certain indexes prior to the date that the applicable index was first published, and such index performance data is based on backtesting (i.e., calculations of how the index might have performed in the past if it had existed using the same index methodology employed by Dow Jones today). Backtested performance information is purely hypothetical and is provided in this Report and the Newsletter solely for informational purposes. Backtested performance does not represent actual performance, and should not be interpreted as an indication of actual performance. Past performance is not indicative of future results. Index performance is not the same as fund performance, as it does not reflect management and other fees.*
New Index Introductions

The following new indexes are now available for licensing:

Dow Jones GCC Titans 40 Index℠
Launched July 9, 2008
Measures the performance of the leading stocks traded in the GCC region countries of Bahrain, Kuwait, Oman, Qatar and United Arab Emirates.

Dow Jones GCC Index℠
Launched July 1, 2008
Measures the performance of companies in the GCC region, which covers Bahrain, Kuwait, Oman, Qatar and United Arab Emirates. The index excludes Saudi Arabia because it is not open to foreign investment.

Dow Jones Islamic Market GCC Index℠
Launched July 1, 2008
Measures the performance of companies in the GCC region that pass rules-based screens for compliance with Islamic principles. The index covers Bahrain, Kuwait, Oman, Qatar and United Arab Emirates.

Dow Jones Islamic Market China Offshore Hong Kong Index℠
Launched May 9, 2008
Measures the performance of companies listed in Hong Kong, with primary operations in mainland China, that are also screened for compliance with Islamic principles.

Dow Jones ASE 100 Index℠
Launched February 13, 2008
Measures the performance of the largest 100 companies trading on the Amman Stock Exchange by full market capitalization.

Dow Jones Islamic Market Malaysia 25 Titans Index℠
Launched January 21, 2008
Measures the performance of the leading Malaysia-domiciled companies that pass rules-based screens for Shari’ah compliance.

Dow Jones Dharma Indexes℠
Launched January 15, 2008
Measure the performance of companies selected according to a methodology designed to reflect the value systems and principles of Dharmic religions, especially Hinduism and Buddhism. The series currently includes a global index and four country indexes, covering the U.S., the U.K., Japan and India.

Dow Jones MSM Index℠
Launched January 14, 2008
Measures the performance of all companies listed on the Muscat Securities Market.

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