

UNIVERSITI TEKNOLOGI MARA

**INVESTOR SENTIMENT AND
SHARI'AH-COMPLIANT ASSET
PRICING MODEL IN INDONESIA**

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ABSTRACT

This study investigates the emerging field of Islamic finance through the lens of a *Shari'ah*-Compliant Asset Pricing Model (SCAPM) that incorporates the principles of *Maqasid al-Shari'ah*. By redefining the conventional risk-free rate based on necessities (*daruriyyat*) and integrating the investor sentiment risk rooted in the concept of *nafs* in Islam derived from *Maqasid al-Shari'ah*, the study aims to enhance the SCAPM framework within the Islamic financial paradigm. The development of a framework grounded in Islamic principles, such as *Maqasid al-Shari'ah*, is expected to provide a foundation for Islamic financial stakeholders to further develop Islamic financial models. The research focuses on the Indonesian Stock Exchange, examining the complex interplay between the market risk premium, investor sentiment, and market conditions. The empirical investigation employs a Panel Autoregressive Distributed Lag (Panel ARDL) analysis. This approach allows for the estimation of both short-run and long-run correlations, aligning with the dynamic nature of financial markets. The dataset includes 109 *Shari'ah*-compliant entities listed over a period of 164 months from October 2007 to June 2021. The findings indicate that in the long-run, the Islamic market risk premium and investor sentiment positively affect *Shari'ah*-compliant stock returns. Interestingly, in the short term, the market risk premium exhibits a negative impact on these returns, while investor sentiment continues to have a positive influence. The role of moderating market conditions in the relationship between investor sentiment and *Shari'ah*-compliant stocks is only observed in the short term. The study further enriches and unravels sector-specific nuances within the framework by testing the SCAPM in industrial sectors such as Agriculture, Basic Industry and Chemicals, Consumer Goods, Infrastructure and Utilities, Mining, Miscellaneous, Property and Real Estate, and Trade, Service, and Investment. In industry-specific testing, the market risk premium remains a significant variable affecting *Shari'ah*-compliant stock returns. However, the results of investor sentiment, measured by direct, indirect measurements and sentiment index, vary from one industry to another. This suggests that an industry-specific analysis should be considered when evaluating market risk premium and investor sentiment as risk factors for investing in *Shari'ah*-compliant stocks. By integrating the Islamic ground principle of *Maqasid al-Shari'ah* into the SCAPM framework, the research contributes to the theoretical underpinnings of Islamic finance and also provides empirical insights useful for investment decisions in *Shari'ah*-compliant markets. This study aims to promote the development of SCAPM using *Maqasid al-Shari'ah* and offer empirical evidence on market and investor risk factors. These findings can guide policymakers and researchers in fostering modern Islamic financial models grounded in Islamic principles.

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CHAPTER 1

INTRODUCTION

1.1 Introduction

This chapter presents an overview of this study. Section 1.2 discusses the background of the study. The discussion will begin with a Muslim's efforts to achieve *al-falah* through investment, followed by a discussion of the relationship between return and risk on investment in the context of developing a *Shari'ah*-Compliant Asset Pricing Model. Section 1.3 covers the problem statement, focusing on the development of the *Shari'ah*-Compliant Asset Pricing Model and the effect of market risk and investor sentiment risk on stock return in the Indonesian capital market. Section 1.4 outlines the research objectives and detailed research questions used in this study. Section 1.5 defines the scope and limitations of the study. Section 1.6 presents the significance and rationale of the study, and finally, section 1.7 summarises the overall structure of the thesis.

1.2 Background of Study

Allah SWT has created the universe and entrusted humans with the responsibility of managing the world and its resources to fulfill their needs, emphasizing the importance of balancing worldly pursuits with a focus on the Hereafter. In Islamic teachings, the prudent management of wealth and financial decisions holds a prominent position. Islam encourages individuals to strive for success in both realms, referred to as *al-falah*, while promoting responsible wealth management. This perspective serves as a fundamental distinction between Islamic finance and conventional finance, where self-interest and rationality often take precedence (Friedman, 1979; Chapra, 1996). While Islam permits financial and economic transactions, collectively known as *muamalah*, it prohibits elements such as *riba* (interest), *gharar* (uncertainty), *maisir* (gambling), and activities contrary to *Shari'ah* principles (Saleem, 2013).

In the realm of investment, Islamic and conventional finance, although rooted in different values, share similarities in their pursuit of profit. Both Muslim and non-