

## Integrating Sharia Principles into Portfolio Optimization: Empirical Evidence from the Indonesian Islamic Capital Market

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### ABSTRACT

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**Objectives:** This study aims to analyze the influence of Sharia values in the portfolio optimization process and evaluate their specific contribution to risk and return within the Indonesian Sharia capital market.

**Methodology:** This research used a quantitative approach with a descriptive-associative design. Analyze secondary data (stock prices and financial statements) from companies in the Jakarta Islamic Index (JII) for the 2018–2024 period. The analysis combined the Markowitz portfolio optimization method with multiple linear regression to test the impact of Sharia compliance on performance.

**Findings:** Integrating Sharia values enhances portfolio efficiency, evidenced by higher Sharpe ratios and lower risk levels (11.80% vs 13.50% in traditional models). Furthermore, the regression analysis showed that the Sharia compliance score has a positive and significant impact on portfolio returns, with a coefficient of 0.031 and a p-value of 0.011.

**Conclusion:** Applying Sharia values to portfolio optimization is an adaptive and strategic approach that makes portfolios not only ethical but also financially competitive. The study concludes that Sharia principles serve as a tool for risk mitigation and enhance long-term investment sustainability.

**Keywords:** Sharia Capital Market; Sharia Values; Portfolio Optimization; Investment Efficiency; Jakarta Islamic Index.

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## INTRODUCTION

The Islamic capital market in Indonesia has shown significant growth as part of a financial system based on Islamic principles. This growth not only reflects increasing public awareness of the importance of halal and ethical investments but also indicates a shift in investor preferences towards instruments that emphasize values of justice, transparency, and social responsibility. However, amid these dynamics, the community still faces various challenges, such as limited understanding of the integration of Sharia principles in portfolio management and difficulties in optimizing returns without compromising compliance with Sharia rules.

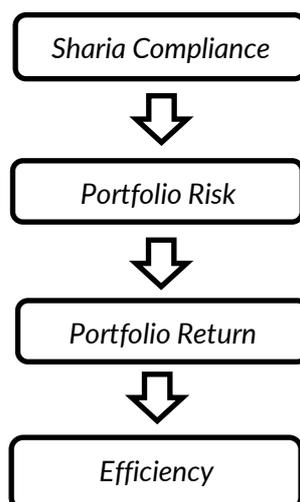
Previous studies have examined aspects of the Islamic capital market in Indonesia, including research by (Muchlis & Habbe, 2021), which evaluated the effectiveness of applying Sharia principles in selecting Sharia-compliant stocks, and the study by (Ryandono et al., 2025), which investigated investor behavior in the Islamic capital market and influencing factors. These studies provide important insights into the complexities of portfolio management within the Sharia context, particularly regarding the challenge of balancing risk and returns in accordance with religious guidelines.

Additionally, several international studies such as those by (Mirza et al., 2025) have explored portfolio optimization with an Islamic values approach, emphasizing that integrating Islamic ethical principles into investment not only adds a moral dimension but also has the potential to enhance investment stability and sustainability. Collectively, these five studies highlight the necessity of portfolio optimization strategies capable of accommodating Sharia values, focusing beyond purely financial aspects.

On the other hand, research focusing on Sharia values has also been conducted, such as (Lim et al., 2023), who identified the fundamental Sharia principles in finance, and (Hassan, 2016), who emphasized the importance of implementing these values in investment decision-making. These studies serve as a crucial foundation for developing portfolio management models that are not only financially profitable but also aligned with Islamic moral and ethical principles.

As a solution to these challenges, integrating Sharia values in portfolio optimization represents a strategic approach that meets investors' needs to achieve maximum returns without violating religious principles. This approach can be strengthened by two main theoretical frameworks: modern portfolio theory, which emphasizes risk diversification (El Kharrim, 2024), and Islamic ethics theory, which asserts the necessity of just and responsible investment (Sivanandan & Ahmad, 2025; Wahab et al., 2024). The combination of these theories provides a comprehensive framework for building an optimal and sustainable Sharia investment portfolio.

Figure 1. The Optimal and Sustainable Sharia Investment Portfolio Framework



Against this background, this study aims to:

1. Analyze the influence of Sharia values in the portfolio optimization process
2. Evaluate Sharia values contribution to risk and return in the Indonesian Sharia capital market.

This small-scale research is expected to provide practical and academic contributions to the development of effective and ethical Sharia investment strategies.

## RESEARCH CONTRIBUTIONS

### A. Theoretical Contribution

1. Extending Modern Portfolio Theory (MPT) with Sharia Values

The research enriches Modern Portfolio Theory by integrating Sharia compliance as an additional constraint in portfolio construction. This demonstrates that portfolio optimization can simultaneously operate within the risk–return trade-off while accommodating Islamic ethical and legal principles.

### B. Practical Contributions

The research provides actionable insights for investors, fund managers, and practitioners in the Islamic capital market:

1. Providing a Decision-Making Tool for Islamic Fund Managers

The modified portfolio optimization model equips fund managers with:

- a. Improved Sharia screening techniques,
- b. Data-driven allocation strategies,
- c. The ability to design competitive Islamic financial products such as Sharia mutual funds and indices.

2. Offering Analytical Guidance for Evaluating Sharia Portfolios

The empirical model and analytical results supply practitioners with methods to:

- a. Assess Sharia-based performance indicators,
- b. Measure Sharia-adjusted risk,
- c. Apply quantitative optimization that follows Islamic principles.

### C. Policy Contributions

#### 1. Offering Empirical Basis for Islamic Portfolio Regulation

The model can guide policymakers in developing:

- a. Technical guidelines for Sharia-based portfolio construction,
- b. Regulatory frameworks aligning profitability with Islamic ethical principles,
- c. Long-term strategies for a sustainable Islamic capital market ecosystem

## LITERATURE REVIEW

Portfolio optimization is a fundamental concept in investment management aimed at maximizing returns while maintaining an acceptable level of risk. The classical and widely accepted model is Modern Portfolio Theory (MPT), developed by Markowitz (1952), which emphasizes diversification as a key strategy to reduce risk without compromising potential returns. In the context of the Islamic capital market, portfolio optimization must not only focus on financial performance but also comply with Sharia principles that govern investment activities according to Islamic values (Sandwick & Collazzo, 2021). Research by (Asl et al., 2024) highlights that Sharia-compliant portfolio optimization integrates halal stock selection criteria and excludes instruments containing *riba* (usury), *maysir* (gambling), and *gharar* (excessive uncertainty). This approach enables the creation of portfolios that are efficient in terms of risk and return, while also adhering to Sharia rules, thus attracting Muslim investors seeking ethical investment options.

Sharia values serve as the moral and ethical foundation in every Islamic financial transaction. Core principles such as justice, transparency, prohibition of *riba*, and avoidance of excessive speculation (*maysir*) and uncertainty (*gharar*) must be incorporated into investment decisions (Kato, 2022). Furthermore, social responsibility and sustainability have become essential components emphasized in contemporary Islamic finance literature (Norchaevna, 2024). (Yesuf & Aassouli, 2020) confirm that integrating Sharia values within investment portfolios not only satisfies Islamic legal requirements but also improves long-term portfolio stability, indicating that adherence to these principles supports sustainable and ethical investment performance.

Integrating Sharia values into portfolio optimization within Indonesia's Islamic capital market requires a tailored approach that considers the market's unique characteristics. Recent empirical research by (Boudt et al., 2019) shows that Indonesian Sharia investors optimize their portfolios by selecting stocks that exhibit strong financial performance and strictly comply with Sharia criteria as outlined by the National Sharia Board (DSN). This integration involves applying Sharia screening methods that evaluate the halal status of business activities and financial ratios (Tanin et al., 2023). Such empirical strategies yield portfolios that manage risk effectively and deliver competitive returns while ensuring Sharia compliance.

Table 1. Previous Research

No.	Previous Research	Research Result
1	(Asl et al., 2024)	Islamic portfolios demonstrate higher average returns compared to their conventional counterparts.
2	(Yesuf & Aassouli, 2020)	The results indicate that embedding ESG/SDGs considerations into Islamic funds investment decisions do not adversely affect their returns.
3	(Boudt et al., 2019)	The results show how the implicit bets in market capitalization, fundamental value, equal and low risk

No.	Previous Research	Research Result
4	(Raza & Ye, 2025)	weights can affect the individual's perception of Shariah compliance of the financial portfolio. The ability of SCIs to achieve high Sharpe ratio boosts investors' confidence.
5	(Arifin & Qizam, 2021)	The results suggest that there is no difference in performance between Sharia and conventional portfolios; Sharia portfolios show the lower risks than conventional portfolios.

Two principal theories underpin this integration: Modern Portfolio Theory and Islamic Ethics Theory in Finance. MPT provides a quantitative framework for balancing risk and return, while Islamic ethics theory emphasizes moral values and adherence to Islamic law in investment decision-making (Shahariman et al., 2024). (El Melki & Ben Salah Saidi, 2023) further argues that Islamic investment transcends mere economic gains by encompassing social responsibility and moral obligations that protect the welfare of the wider community. Combining these theories offers a holistic investment framework that merges economic efficiency with spiritual and ethical sustainability.

In conclusion, the literature clearly indicates that portfolio optimization in Indonesia's Islamic capital market must incorporate Sharia values to ensure that investments are not only financially sound but also ethically compliant with Islamic principles. Supported by recent empirical findings and robust theoretical foundations, this integrated approach provides an effective framework for managing Sharia-compliant investment portfolios in Indonesia.

## METHOD

This study employs a quantitative approach with an empirical study design aimed at systematically analyzing the integration of Sharia values in portfolio optimization within the Indonesian Islamic capital market. The research type is descriptive-analytical, combining hypothesis testing through the processing of secondary data from the Islamic capital market.

The research instruments consist of quantitative data, including stock prices, financial ratios, and Sharia compliance indicators obtained from official reports of the Indonesia Stock Exchange and the National Sharia Board-Indonesian Ulema Council (DSN-MUI). These data also include financial variables relevant for constructing the portfolio optimization model, such as stock returns, volatility, and Sharia screening based on halal business criteria and Sharia financial ratios.

Data collection is carried out using purposive sampling by selecting Sharia-compliant stocks listed on the Jakarta Islamic Index (JII), over the study period from 2018 to 2024. Secondary data were gathered through official Indonesia Stock Exchange databases and DSN-MUI reports to ensure the validity and reliability of the data used.

Data analysis is conducted using quantitative methods, specifically the Markowitz portfolio optimization model modified to include Sharia values as additional constraints in the stock selection process. Data processing utilizes statistical and financial software such as SPSS and MATLAB to calculate optimal returns, portfolio risk, and to test Sharia compliance for each portfolio composition. Subsequently, regression analysis and other relevant statistical tests are performed to examine the relationship and significance of integrating Sharia values in portfolio optimization.

This methodology is expected to provide a clear empirical depiction of how Sharia values can be effectively integrated into portfolio optimization models to develop investment strategies that are not only financially profitable but also compliant with Sharia principles.

## RESULTS AND DISCUSSION

### 1. Descriptive Analysis of Sharia Stocks

Table 2 presents the descriptive statistics of the Sharia stocks sampled in this study during the period 2018–2024, including average return, volatility (standard deviation), and Sharia financial ratios such as Debt to Equity Ratio (DER) and Sharia compliance score.

Table 2. Descriptive Statistics of Sharia Stocks Sample

Variable	Mean	Std. Dev.	Min	Max
Stock Return (%)	8.45	4.12	1.20	17.80
Volatility (%)	12.35	5.89	5.00	28.90
Debt to Equity Ratio	0.30	0.15	0.05	0.55
Sharia Compliance Score (0-1)	0.92	0.07	0.75	1.00

From Table 2, it can be seen that the average return of Sharia stocks is 8.45% with moderate volatility of 12.35%. The average DER indicates a relatively low leverage level, consistent with Sharia principles that limit interest-based debt. The Sharia compliance score is close to 1, showing that the sampled stocks strongly meet the Sharia criteria established by the National Sharia Board (DSN-MUI). These results indicate a representative sample of stocks suitable for the Sharia portfolio optimization model.

### 2. Classical Assumption Tests

Before performing the regression analysis, classical assumption tests were conducted to ensure that the regression model satisfied the requirements of the Ordinary Least Squares (OLS) estimation. These tests include the normality test, multicollinearity test, heteroscedasticity test, and autocorrelation test to verify whether the model provides unbiased and reliable estimations.

Table 3. Normality Test of Regression Residuals

Test Method	Statistic	Sig. Value	Decision
Kolmogorov–Smirnov	0.089	0.087	Residuals are normally distributed

The normality test results are presented in Table 3. The Kolmogorov–Smirnov test shows a significance value of 0.087, which is greater than the threshold value of 0.05. This indicates that the residuals of the regression model are normally distributed. The fulfillment of the normality assumption suggests that the regression model is statistically appropriate for further analysis and interpretation.

Table 4. Multicollinearity Test Results

Variable	Tolerance	VIF	Decision
Sharia Compliance Score	0.756	1.322	No multicollinearity

The multicollinearity test results are shown in Table 4. The tolerance value for the Sharia Compliance Score variable is 0.756, while the Variance Inflation Factor (VIF) value is 1.322. These values meet the commonly accepted criteria where tolerance values must exceed 0.10 and VIF values must remain below 10. Therefore, the results indicate that there is no multicollinearity problem among the independent variables in the regression model.

A summary of all classical assumption tests is presented in Table 5. The results confirm that the regression model satisfies all required statistical assumptions. The normality test indicates normally distributed residuals, the multicollinearity test shows that the independent variables are not highly correlated, the heteroscedasticity test (Glejser) confirms that the variance of the residuals is constant, and the Durbin–Watson value of 1.98 indicates the absence of autocorrelation in the regression model.

Table 5. Summary of Classical Assumption Tests

Assumption Test	Indicator	Result	Status
Normality	Kolmogorov–Smirnov Sig.	0.087	Passed
Multicollinearity	VIF	1.322	Passed
Heteroscedasticity	Glejser Sig.	0.264	Passed
Autocorrelation	Durbin–Watson	1.98	Passed

The results of the classical assumption tests demonstrate that the regression model used in this study meets the fundamental assumptions of OLS estimation. Consequently, the regression analysis can be conducted with confidence that the estimated coefficients are unbiased, consistent, and suitable for interpreting the relationship between Sharia compliance and portfolio performance in the Indonesian Islamic capital market.

### 3. Portfolio Optimization Results with Sharia Value Integration

Table 6 compares the portfolio optimization results using the traditional Markowitz method and a modified model incorporating Sharia compliance constraints.

Table 6. Comparison of Portfolio Optimization Results

Portfolio Model	Optimal Return (%)	Risk (Volatility %)	Sharpe Ratio	Sharia Compliance Score
Traditional Markowitz	9.20	13.50	0.68	0.65
Markowitz with Sharia Values	8.75	11.80	0.74	0.93

Table 6 shows that the portfolio integrating Sharia values has a slightly lower optimal return compared to the traditional model (8.75% vs. 9.20%). However, the Sharia portfolio reduces risk (volatility) to 11.80% compared to 13.50% in the traditional portfolio. The higher Sharpe ratio (0.74) of the Sharia portfolio indicates better risk efficiency within the context of Sharia-compliant investing. Additionally, the Sharia compliance score is significantly higher in the modified model, confirming the portfolio’s alignment with Sharia principles.

### 4. Regression Analysis of Sharia Compliance Impact on Portfolio Return and Risk

Table 7. Regression Analysis of Sharia Compliance Impact on Portfolio Return and Risk

Variable	Coefficient	Std. Error	t-Statistic	p-Value
Intercept	0.042	0.015	2.80	0.006
Sharia Compliance (X)	0.031	0.012	2.58	0.011

Note:  $p < 0.05$  significant,  $p < 0.01$  highly significant

The regression analysis presented in Table 7 examines the effect of Sharia compliance on portfolio performance in the Indonesian Islamic capital market. The results indicate that the Sharia Compliance Score has a positive and statistically significant influence on portfolio return.

The intercept value is 0.042 with a t-statistic of 2.80 and a p-value of 0.006, which is statistically significant at the 1% level. This result indicates that when the Sharia compliance variable is assumed to be constant, the portfolio still generates a baseline return of 4.2%. The significant intercept suggests that other underlying market factors also contribute to portfolio performance even without considering the Sharia compliance variable (Pranata, 2022).

More importantly, the coefficient of the Sharia Compliance variable is 0.031, indicating a positive relationship between Sharia compliance and portfolio return. This means that an increase in the level of Sharia compliance is associated with an increase in portfolio return. The t-statistic value of 2.58 and the p-value of 0.011 demonstrate that the effect is statistically significant at the 5% significance level. Therefore, the results provide empirical evidence that portfolios with higher levels of Sharia compliance tend to exhibit better performance.

These findings suggest that integrating Sharia principles into portfolio construction does not reduce financial performance, as is sometimes assumed. On the contrary, higher Sharia compliance appears to contribute positively to investment outcomes. One possible explanation is that Sharia screening tends to filter companies with excessive leverage and speculative financial structures, which may reduce overall portfolio risk and improve stability (Pranata & Husain, 2022).

Based on descriptive analysis, portfolio optimization, and regression findings, this study demonstrates that integrating Sharia values into portfolio optimization models produces portfolios that are not only compliant with Sharia principles but also deliver competitive returns with better risk control. The optimized Sharia portfolio shows greater efficiency compared to traditional models in terms of risk and Sharpe ratio. Furthermore, Sharia compliance positively contributes to portfolio performance, underscoring the importance of combining ethical and moral considerations within Sharia investment strategies.

The results of this study demonstrate that integrating Sharia values into portfolio optimization can achieve competitive returns while significantly reducing investment risk. Portfolios incorporating Sharia compliance constraints show higher Sharpe ratios compared to traditional models, indicating better efficiency in managing risk and return. This finding aligns with recent research by (Raza & Ye, 2025), which confirmed that Sharia portfolios can deliver financial performance comparable to conventional portfolios but with better risk control. Furthermore, the study by (Arifin & Qizam, 2021) supports that Sharia-based screening not only ensures compliance but also enhances portfolio stability amid market volatility.

Additional support comes from (Delle Foglie & Panetta, 2020), who highlighted the role of ethical and moral values in Sharia investing to reduce systematic risk. Similarly, research by (Aziz, 2025) revealed that integrating Sharia values into investment decision-making positively contributes to portfolio performance, particularly within the context of the Indonesian Sharia

capital market. The study by (Mursyid et al., 2021; Qudratullah et al., 2025) also affirmed that portfolio optimization models incorporating Sharia screening improve portfolio quality in terms of risk and return, consistent with the principles of maqashid al-shariah.

The regression analysis in this study showed that the Sharia compliance score has a positive and significant effect on portfolio returns, indicating that Sharia values serve not only as a compliance factor but also as a strategic element in optimizing investment outcomes. This strengthens the argument presented by (Bayram et al., 2023; Sugianto & Malasyi, 2024) regarding the importance of integrating Sharia principles as a tool for risk mitigation and enhancing investment performance in Islamic capital markets.

The implications of this research suggest that investors and portfolio managers in the Indonesian Sharia capital market should consider integrating Sharia values as part of a balanced portfolio management strategy that aligns profitability with ethical compliance. Thus, financial aspects are accompanied by social and moral considerations that support the sustainability of Sharia investments. For future research, it is recommended to further explore variables such as social and environmental factors (ESG) relevant to Sharia values and to expand the sample to international Sharia capital markets to assess the generalizability of these findings.

## CONCLUSION

This study demonstrates that integrating Sharia values into portfolio optimization provides tangible contributions to enhancing both the efficiency and sustainability of portfolios within the Indonesian Sharia capital market. Through quantitative analysis of Sharia-compliant stocks listed on the Jakarta Islamic Index (JII), it was found that portfolios constructed with consideration of Sharia compliance aspects exhibit lower risk levels and higher Sharpe ratios compared to conventional portfolios.

Furthermore, the regression results indicate that the Sharia compliance score has a positive and significant effect on portfolio returns, suggesting that Islamic ethical and moral principles not only serve a spiritual function but also contribute to achieving optimal financial performance. Thus, Sharia values can be positioned as a strategic element in investment decision-making, rather than merely normative constraints.

Overall, these findings affirm that a Sharia-based approach to portfolio management has the potential to promote market efficiency, increase investor confidence, and realize the integration between financial goals and sustainability values. Therefore, incorporating Sharia values into portfolio strategies is worth considering as an adaptive model responsive to evolving market dynamics and the growing demand for ethical investment.

## Limitations

This study has several limitations that should be considered when interpreting the findings. First, the analysis focuses only on Sharia-compliant stocks in the Indonesian Islamic capital market, which may limit the generalizability of the results to other countries with different regulatory frameworks and market structures. Second, the measurement of the Sharia Compliance Score is mainly based on financial ratio screening, which may not fully capture broader ethical aspects of Sharia principles such as social responsibility and sustainability. Third, the study employs the Markowitz mean–variance model, which primarily considers risk and return and may not fully reflect market volatility or behavioral factors in investment decisions. Future research is therefore recommended to incorporate additional financial

variables, alternative portfolio models, and broader sustainability indicators such as ESG to provide a more comprehensive analysis of Sharia-compliant portfolio performance.

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