

THE EFFECT OF INVESTORS' RISK APPETITE ON THE BIST PARTICIPATION INDEX

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ABSTRACT

Interest-free finance is a financing system based on the concept of risk. This study aims to analyze whether the relationship between interest-free finance and risk is reflected in investor perception. For this purpose, the impact of the Risk Tendency Index, Dollar, Euro, Gold, and TL Reference Rate on BIST Participation Indices in the period 2021-2023 is analyzed. ARDL bounds test is applied to weekly data. Empirical results show that the USD and TL Reference Rates have a significant effect on BIST Participation Indices. However, the Risk Tendency Index does not have a significant effect on BIST Participation Indices. The observation that the index designed for participation finance is unaffected by investors' risk appetite is a significant insight into how investors perceive the participation finance system in Turkey.

Keywords: Investor Behavior, Interest-Free Finance, BIST Participation Index.

JEL Codes: C58, F31, G11, G40.

1. INTRODUCTION

Religious sensitivities and new searches in financial markets have made participation in finance crucial. Participation finance is a financing model based on the Islamic financial system and replaces interest-based conventional banking. In this system, financial services and investments are realized based on profit and loss sharing. Participation finance envisages the joint assumption of risks and gains by complying with Sharia rules in its financial transactions. Its prominent features include the investor and the business agreeing on a common risk and profit-loss sharing model, interest-free transactions, and transparency. This model offers a financing alternative that complies with moral and legal standards for both individual and institutional investors (Ozdemir, Savasan and Ulev, 2023).

The participation index is a stock index created in accordance with the principles of Islamic finance. This index includes shares of companies that operate according to or comply with the rules of participation finance (Çömlekçi and Sondemir, 2020). The Borsa İstanbul Participation Index includes shares of firms that operate in line with Islamic finance principles. To qualify for inclusion in the index,

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companies must refrain from activities that are forbidden under Islamic law, such as the manufacture or sale of alcohol, tobacco, pork products, conventional financial services that involve interest (riba), gambling, or adult entertainment. Furthermore, businesses that engage in practices detrimental to the environment or society are excluded. Financial metrics are also evaluated. The proportion of interest-bearing debt to total assets and the proportion of interest-bearing securities to total assets are required to fall below specific limits, ensuring limited participation in non-compliant financial practices. These criteria are reviewed every six months, and companies are assessed for adherence to maintain the index's integrity. This structure provides investors looking for Shariah-compliant investment options with a dependable benchmark consistent with Islamic ethical principles (Canbaz and Baykut, 2021).

Investors in financial markets act according to their risk appetite and return expectations. An investor with high return expectations may take more risk than another investor profile with low return expectations (Köycü and Ege, 2023). Thus, there is an extensive literature examining the impact of risk appetite on stock markets (Aravind and Manojkrishnan, 2024; Demirci and Sinoplu, 2023; Eskandari, Sadegheih, Zare and Lotfi, 2022; Qadan, 2019; Bekaert and Hoerova, 2016; Yang and Lee, 2013; Cao, Deng and Li, 2010; Hui, Wang and Zheng, 2010; Baek, Bandopadhyaya and Du, 2005).

There are two key dimensions to the relationship between the participation index and investor risk appetite. The influence of investor preferences is affected by risk appetite, according to research. Studies have shown a substantial correlation between risk appetite and indices. As a result, risk appetite could also play a role in determining the participation index. (Saiti, Mwangi, Okiro and Gathiaka, 2023; Can Ergün, Cagli and Durukan Salı, 2023). Secondly, the concept of risk is important for participation in finance. Hence, another important issue is whether the risk-based approach carried by participation finance has a significant impact on the investor side (Seaverson, Gingerich, Mangen and Anderson, 2019; Terzi, 2013).

This study aims to examine the impact of investor risk appetite on the participation index. For this reason, the impact of the domestic and foreign risk appetite indices calculated by the Central Registry Agency, gold, foreign exchange, and TL reference rate on BIST Participation indices (Kat30, Kat50, Kat100) in the period 2021-2024 is investigated with the ARDL bounds test. Studies analyzing the relationship between risk appetite and participation index are limited. Examining the effect of Borsa Istanbul investors' risk appetite on the participation index may contribute to the literature by revealing the relationship between risk appetite and participation finance.

This paper is organized as follows: Section 2 presents the theoretical background, Section 3 reviews the literature, Section 4 deals with methodology and data, Section 5 presents the empirical results, and we conclude this study in Section 6.

2. THEORETICAL BACKGROUND

This study aims to investigate the impact of risk appetite on participation indices. The participation index is a market where shares determined according to interest-free finance principles are indexed. Thus, the study is grounded in the principles of interest-free finance. Participation finance prohibits interest and uncertainty and is based on profit-loss partnership and risk (Arzova and Şahin, 2021).

The relationship between participation finance and the concept of risk may provide insight into the impact of the investor's risk appetite on the participation index. In participation finance, the relationship between risk and return is intrinsically linked to the fundamental principles of risk-sharing and equity participation. Unlike traditional interest-based finance, which compensates lenders with predetermined interest regardless of the outcome, participation finance structures such as profit-sharing and joint ventures align the interests of all parties involved. Investors and entrepreneurs share both the risks and rewards of a venture, meaning that returns are contingent on the performance of the underlying asset or business. This model encourages more equitable risk distribution and fosters closer alignment between the parties' interests, as profits and losses are directly tied to the success of the project, leading to more collaborative decision-making and potentially more sustainable financial outcomes (Mansoor Khan, M. and Ishaq Bhatti, 2006).

The working model can also be based on theories explaining investor behavior. According to the Expected Utility Theory, an investor's risk propensity is explained by a personal utility function that determines how he or she makes decisions under risk and uncertainty; this function measures the satisfaction or utility that the investor derives from different outcomes. Risk-averse investors seek more certain but lower returns by favouring low-risk alternatives, while risk averse investors are willing to take more risk for higher potential returns. As investors seek to maximize expected utility, risk appetite determines how the utility function is shaped and how they respond to risks when choosing between risky and risk-free situations (Jammernegg and Kischka, 2007).

Behavioral finance addresses risk appetite through the psychological and emotional dispositions of investors since, in this field, individuals' risk-taking behavior is often shaped by cognitive biases and emotional influences rather than rational ones. In this context, concepts such as fear of loss, overconfidence, and the framing effect influence investors' responses to risk; for example, investors may fear losses more and therefore avoid risky investments, or they may make risky decisions in pursuit of higher returns. Behavioural finance provides tools and theories used to understand how these biases and emotional factors affect risk appetite, thus helping to model investor behaviour in a more complex and realistic way (Köycü, 2022).

According to prospect theory, which is one of the basic theories of behavioural finance, decision makers maximise their utility in situations of risk and uncertainty; in expected utility theory, they

maximise their utility with rational inferences, and in uncertainty, they like risk, escape or hedge. According to prospect theory, cognitive contradictions may distort rational thoughts and behaviors, and emotions and thoughts may irrationally affect individuals' decisions in the decision-making process. Investors who make decisions based on human emotions such as ethics, expectations, fears, pleasure, etc., may make systematic mistakes and tend to be risk averse in case of gains and risk loving in case of losses (Cao et al., 2010).

3. LITERATURE REVIEW

Behavioral finance theory focuses on the cognitive characteristics of investors in capital market movements. Therefore, there is an extensive literature analyzing the impact of investors' risk perception on stocks (Marfatia, 2020; Sarigül and Şengelen, 2020; Kahyaoğlu and Ülkü, 2012).

Investor risk appetite is the degree of risk an investor is willing to accept when making investment decisions, influenced by their financial goals, time horizon, and personal tolerance for potential losses. It determines how aggressively or conservatively they allocate their investments across different assets (Beyhaghi, M. and Hawley, 2013).

The literature emphasizes the significant role of risk in relation to equities. These studies specifically focus on the risk propensity index determined by the Central Registry Agency. Nur (2022) discovers that risk appetite significantly impacts the Borsa Istanbul Financial Index. Can Ergün et al. (2023) demonstrate a strong interconnectedness in the risk preferences of different investor categories? Notably, domestic investors are greatly influenced by both professional and foreign investors, indicating the enduring impact that foreign and more sophisticated investors have on domestic investors in Borsa Istanbul. Demirez and Kandır (2020) demonstrate that risk appetite affects stock returns in Borsa İstanbul.

Saiti et al. (2023) examine the correlation between risk appetite and stocks in the Nairobi Stock Exchange and find that there is no significant relationship between risk appetite and stock return. Qadan (2019) discusses the impact of risk appetite on expected returns and idiosyncratic volatility. Bekaert and Hoerova (2016) indicate that the variance premium contains substantial information about risk aversion, while the credit spread provides insights into uncertainty.

There is a limited number of studies that have looked into risk appetite and participation index. Firmansyah and Andanawari (2020) investigated how investors' risk appetite affects the Indonesian Stock Exchange. Their findings indicate that Indonesian investors tend to be risk-averse and take sharia aspects into consideration when making investment decisions. Bhatti, Saleem and Sajjad (2021) studied risk appetite in investment strategies for Sharia-compliant stocks in the Pakistan Stock Exchange. Their empirical findings suggest that risk appetite and returns have a direct relationship.

The impact of risk appetite on Borsa Istanbul Participation Indices is investigated in this study. Thus, while contributing to the literature on risk appetite and stock markets, the first empirical findings in the Borsa Istanbul sample are presented.

4. DATA AND METHODOLOGY

The study examines the relationship between the Risk Tendency Index, BIST Participation Index (30, 50, 100), golden, TL Reference Rate, and foreign currency. For this purpose, ARDL bounds test is applied to weekly data for the period 26.11.2021-28.06.2024. The analysis period is determined according to the trading date of the BIST Participation Index. The data is accessed from Investing and the logarithm of the data is taken. The description of the variables is given in Table 1.

Table 1. Variable List

Variable	Abbreviation	Definition
Risk Tendency Index	Logriskyerli, Logriskyabancı	A dynamic index that measures the risk appetite of investors based on their risk-taking tendencies. Weekly score of investor risk appetite.
BIST Participation Index (30, 50, 100)	Logbistpar (30, 50, 100)	BIST Participation Index (30, 50, 100) Index weekly closing data.
Golden	Loggold	Gram gold weekly closing data.
Dollar	Logdol	Dollar weekly closing data.
Euro	Logout	Euro weekly closing data.
TL Reference Rate	Logtlref	It is a benchmark interest rate for financial institutions and real sector firms in Turkey based on actual transactions in liquid market conditions.

The impact of an investor's risk appetite on the BIST Participation Index is analyzed with the ARDL bounds test. The primary benefit of this approach is its flexibility in accommodating variables with varying degrees of stationarity in the study. However, the ARDL model cannot be used on variables that are stationary at the second level. Using an unrestricted error correction model increases the reliability of ARDL model outputs. Another notable feature of the ARDL model is that it may be applied to smaller sample sizes (Narayan and Smyth, 2005). The ARDL limits test is calculated as follows:

$$\Delta Y_t = \rho_0 \sum_{i=1}^m \rho_{1i} \Delta Y_{t-i} + \sum_{i=0}^m \rho_{2i} \Delta X_{1t-i} + \sum_{i=0}^m \rho_{ki} \Delta X_{K2-i} + \varepsilon_i Y_{t-i} + \varepsilon_2 X_{1t-1} + \dots \varepsilon_k X_{kt-1} + U_t \quad (1)$$

The ARDL bounds test consists of three basic stages. In the first stage, the cointegration relationship between the variables is analyzed. If cointegration is present, both the long and the short term relationships between variables are examined (Gülmez, 2015).

5. EMPIRICAL RESULTS

In this section, the effect of independent variables on BIST Participation is analyzed by ARDL bounds testing approach. Before the ARDL model, unit root test is applied to the variables. There are three analysis models. The first model reflects BIST Participation 30, the second model reflects BIST Participation 50 and the third model reflects BIST Participation 100.

Table 2. Unit Root Tests

	ADF		PP	
	Level	Differences	Level	Differences
Logriskyerli	0.038**	0.000***	0.027**	0.000***
Logriskyabancı	0.178	0.000***	0.094*	0.000***
Logbistpar30	0.566	0.000***	0.589	0.000***
Logbistpar50	0.569	0.000***	0.599	0.000***
Logbistpar100	0.629	0.000***	0.653	0.000***
Loggold	0.834	0.000***	0.912	0.000***
Logdol	0.868	0.000***	0.853	0.000***
Logeur	0.924	0.000***	0.907	0.000***
Logtlref	0.976	0.000***	0.986	0.000***

Notes: *, **, and *** indicate the significance at the 10, 5, and 1% levels, respectively.

Table 2 shows that all variables are stationary at the level or first difference. Therefore, the variables are suitable for analysis. Table 3 presents the ARDL models. When determining the ARDL model, the lag length is calculated according to the Akaike Information Criterion. As a result of the analysis, the ARDL model's lag length is (3,3,1,3,3,0) for Model 1, (3,3,1,3,3,0, 0) is lag length for Model 2, and (2,3,1,0,3,3,0) is lag length for Model 3.

Table 3. ARDL Models

Model 1			
F Statistic	Critical Values	Lower Limit	Upper Limit
4.30	%10	1.75	2.87
	%5	2.04	3.24
	%1	2.66	4.05
Model 2			
F Statistic	Critical Values	Lower Limit	Upper Limit
4.39	%10	1.75	2.87
	%5	2.04	3.24
	%1	2.66	4.05
Model 3			
F Statistic	Critical Values	Lower Limit	Upper Limit
4.10	%10	1.75	2.87
	%5	2.04	3.24
	%1	2.66	4.05

In Table 4, the long-term coefficients are presented. According to the results, the BIST Participation Index (30, 50, 100) is positively influenced by the Dollar exchange rate, whereas it is negatively affected by the TL Reference Rate.

Table 4. Long Term Coefficients

Dependent Variable: Logbistpar30		
Independent Variables	Coefficients	P-Value
Logriskyerli	-0.737	0.205
Logriskyabancı	-0.230	0.394
Loggold	-0.033	0.897
Logdol	2.960	0.010**
Logout	-0.628	0.662
Logtlref	-0.379	0.005**
Dependent Variable: Logbistpar50		
Independent Variables	Coefficients	P-Value
Logriskyerli	-0.786	0.179
Logriskyabancı	-0.242	0.370
Loggold	-0.010	0.969
Logdol	3.263	0.005**
Logout	-0.966	0.506
Logtlref	-0.369	0.007**
Dependent Variable: Logbistpar100		
Independent Variables	Coefficients	P-Value
Logriskyerli	-0.843	0.147
Logriskyabancı	-0.132	0.607
Loggold	-0.012	0.966
Logdol	3.442	0.003***
Logout	-1.299	0.371
Logtlref	-0.278	0.034**

Notes: ***, **, and * indicate statistical significance at 1, 5, and 10 percent significance level, respectively.

The error correction model and short-run coefficients are analyzed to determine the short-run relationship between the variables. The empirical results show that the short-run coefficient is statistically significant and has a negative value. Table 5 shows the error correction model and short-run coefficients.

Table 5. Error Correction Form

Variables	Coefficients	P-Value
Model 1 CointEq(-1)*	-0.090	0.000
Model 2 CointEq(-1)*	-0.091	0.000
Model 3 CointEq(-1)*	-0.089	0.000

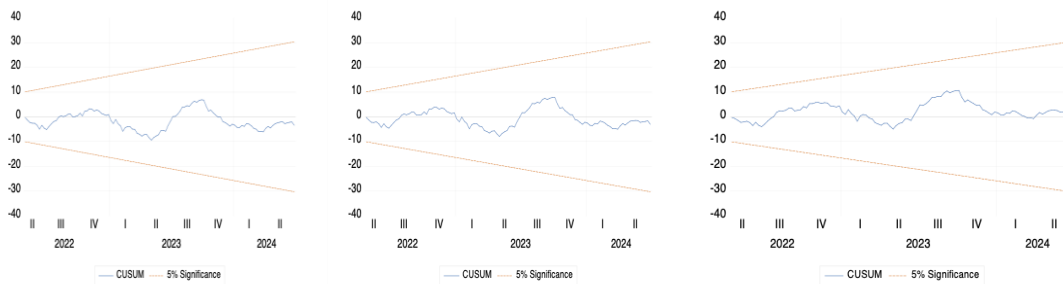
The significance of the ARDL model is tested with varying variance, serial correlation, and normality in Table 6. The probability values of the analyses are above 5%. Therefore, the model is statistically significant.

Table 6. Heteroscedasticity, Serial Correlation, and Normality

Model 1	Coefficients	P-Value
Breusch-Pagan-Godfrey	20.181	0.383
Breusch- Godfrey-LM	0.871	0.649
Jarque-Bera	2.737	0.254
Model 2	Coefficients	P-Value
Breusch-Pagan-Godfrey	21.574	0.305
Breusch- Godfrey-LM	0.865	0.648
Jarque-Bera	2.768	0.250
Model 3	Coefficients	P-Value
Breusch-Pagan-Godfrey	21.941	0.234
Breusch- Godfrey-LM	3.596	0.165
Jarque-Bera	2.913	0.233

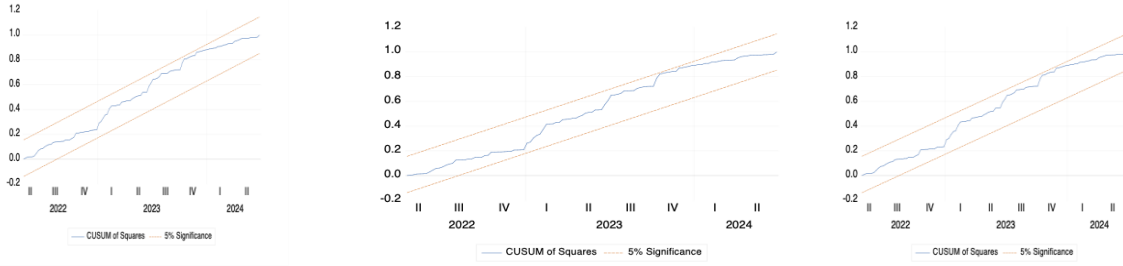
The model's structural break is examined using CUSUM test. According to Graphic 1 there is no structural break in the models.

Graphic 1. CUSUM Tests (Model 1, Model 2, Model 3 Respectively)



Another test that analyzes the structural break in the ARDL bounds test is CUSUMQ. Graph 2 shows CUSUMQ results. Findings Support the CUSUM test. There is no structural break in the model.

Graphic 2. CUSUM of Squares Tests (Model 1, Model 2, Model 3 Respectively)



According to the ARDL bounds test, USD and interest rates have a significant effect on the participation index. The relationship of the results to the literature is complex. The findings indicate that the Dollar has a positive effect on the BIST Participation Index. However, the TL Reference Rate has a negative impact on the BIST Participation Index. The literature finds a negative relationship between the dollar and the BIST Participation index (Tekin and Görmüş, 2022; Sertkaya, 2022). The positive effect of the Reference Interest Rate on the BIST Participation Index is consistent with the literature (Gençtürk, Senal and Aksoy, 2023; Tekin and Görmüş, 2022).

The positive relationship between the USD/TRY exchange rate and the BIST Participation Index can be attributed to several factors. First, the depreciation of the Turkish Lira (TL) against the US Dollar (USD) may lead to an increase in the revenues of export-oriented and USD-denominated firms, which are common in the BIST Participation Index. This exchange rate movement increases the profitability of these companies and positively affects their stock prices and the overall index. Moreover, during periods of TL depreciation, investors may seek refuge in equities to hedge against currency risk, pushing stock prices even higher. In addition, a rising exchange rate may increase foreign investor interest in stock values.

On the other hand, the adverse effects of the Turkish Lira Reference Rate (TLREF) on the BIST Participation Index can be analyzed through the framework of Islamic finance principles. A rise in TLREF leads to higher borrowing costs, which can discourage corporate investments and consumer expenditures, resulting in lower profit expectations for companies listed in the index. Additionally, since the BIST Participation Index consists of Shariah-compliant businesses that refrain from interest-based financing, an increase in TLREF may indicate a general economic tightening, negatively impacting investor sentiment and stock valuations.

Risk appetite has no significant effect on the BIST Participation Index. The findings suggest that the level of risk tolerance among investors does not substantially affect the performance or valuation of the Participation Index. This could imply that the Participation Index is perceived as relatively stable or less sensitive to market fluctuations compared to conventional stocks. It might also reflect the inherent characteristics of Islamic finance, which emphasizes ethical investments and risk-sharing principles,

potentially leading to a more uniform investment approach that is less influenced by changes in investor sentiment or risk appetite. Thus, the stability of Islamic equities may stem from their alignment with specific ethical guidelines and financial principles rather than from investor risk preferences. Nevertheless, the findings should also be evaluated with respect to the impact of risk appetite on other indices. The BIST Participation Index may move in line with the impact of exchange rates and interest rates on other indices.

6. CONCLUSIONS

Risk is an important element of financial markets. However, risk has a separate role in the interest-free finance system. The relationship between participation finance and the concept of risk is based on the fundamental principles of this financial system.

Since participation finance operates in accordance with interest-free and ethical investment principles, it focuses on risk sharing and cooperation. In this system, risks are shared between investors and entrepreneurs, so risks are managed through different dynamics resulting from the elimination of direct interest-bearing borrowing and fixed return expectations. Participation in finance provides a more equitable distribution of risks, which can affect investors' risk appetite. As a result, participation finance aims to create a more sustainable and ethical financial environment by adopting the principle of joint assumption of risks.

The literature lacks sufficient analysis of the influence of investors' risk appetite on participation shares despite the significance of risk in participation finance. This study seeks to examine the effects of the Risk Tendency Index, Dollar, Euro, Gold, and TL Reference Rate on BIST Participation Indices during the period of 2021-2023. ARDL bounds test is applied to weekly data. Empirical results show that the USD and TL Reference Rates have a significant effect on BIST Participation Indices. However, the Risk Tendency Index does not have a significant effect on BIST Participation Indices.

The findings reflect the outlook of BIST Participation Indices from the perspective of investors' risk appetite. Contrary to the relationship between participation finance and risk, there is no significant relationship between investors' risk appetite and BIST Participation Indices. An important question is whether this finding can be explained by behavioral finance or the movements of BIST indices. Therefore, this result can be interpreted as investors having questions about the sincerity of the Participation Index or its potential return expectations.

The study has some limitations. Since weekly data were analyzed, some financial variables could not be included in the model. Besides, due to the availability of data, the period 2021-2024 is analyzed. Future studies can analyze different variables and periods. Moreover, investigating investors' perception of participation indices with the perception of risk perspective may contribute to the literature.

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