Cytonn INVESTMENTS

Investment Options in the Kenyan Market, & Cytonn Weekly #12/2021

Focus of the Week

The COVID-19 pandemic has drastically affected all economies world over, leading to a 4.4% contraction in the world GDP for the FY'2020. This effects spread to the investment markets which saw major stocks markets across the world such as FTSE 100 decline. The Nairobi Securities Exchange was not spared with the NASI declining by 8.6% in 2020. This performance was mainly driven by a decline in the prices of large cap stocks such as Bamburi, Diamond Trust Bank, Equity Group and KCB Group which declined by 52.7%, 31.7%, 31.2% and 29.4%, respectively but the performance was cushioned by the 8.7% gains recorded by Safaricom. Key to note, Safaricom continues to be a key part of Kenyan equities portfolios, accounting for 51.1% of Nairobi Stock Exchange (NSE's) market capitalization as at 26th Mach 2021. In light of these developments, we saw the need to revisit the topic on investment options in the Kenyan market to shed some light on the available investment options amid this operating environment as an update to the previously done topic where we covered;

Investment options in the Kenyan Market – In July 28, 2019, we wrote about the investment options in the Kenyan market and concluded that the market continues to be an attractive investment destination following the diverse investment product offering.

We shall then focus on the investment options in the Kenyan market, where we shall discuss the following:

i. Overview of Investment,
ii. Categories of Investment products in the Kenyan Market,
iii. Considerations when choosing an investment option, and,
iv. Conclusion and recommendation to investors.

Section I: Overview of investments

An investment is the acquisition of an asset or instrument with the goal of generating income or increasing value over time. Investments involve the purchase of goods that are not consumed today but are used in the future to create wealth. There can be either direct investments or indirect investments depending on the sophistication of the investor. When looking at what investments one needs to take, below are the key considerations:

a. **Risk –** Investment risk is a measure of the degree of uncertainty of achieving the returns as per the expectations of the investor. Investments risks include among others: Interest Rate risk which is the risk associated with changes in interest rates, liquidity risk which is the uncertainty surrounding the buying or selling of an asset in a given size over a given period without affecting the price of the asset, etc. There is general principle that the higher the risk the higher the return and so before investing one should understand their risk tolerance levels,
b. **Return** - This is compensation received for making an investment. The return may be received in

the form of yield, dividend, and/or capital appreciation. One should understand the potential return and the timing of receiving the said returns and ensure that they are in line with their investments objectives, and,

c. **Liquidity** - This is the level of ease with which an investment can easily be converted to cash without taking a significant discount in value. Liquidity plays an important role in balancing an investor's portfolio with trade-offs between risk and return.

The table below shows the various characteristics of each asset class in terms of risk, return and Liquidity:

Asset Class	Returns	Volatility	Liquidity	Suitability	Examples
Equities	Dividends and Capital appreciation	High Volatility	Relatively Liquid	For long term Investors	NSE listed stocks e.g. Safaricom
Fixed Income	Interest Income	Low Volatility	Moderately Liquid	Short to medium term investment requirements	Deposits, Bonds and Commercial Papers
Property	Rental Income and Capital Appreciation	Relatively Stable	Illiquid	Long term Investors with a semi fixed horizon	Project developments & REIT's
Private Equity	Dividends and Capital Appreciation	Relatively Stable	Illiquid	Long term	Investments into a private company
Derivatives	Discount Rate	High Volatility	Relatively Liquid	Short term	NSE NEXT Derivatives
Exchange Traded Funds	Dividends and Capital Appreciation	High Volatility	Relatively liquid	Long term	Barclays ETF
REITS	Interest income	High volatility	Relatively Liquid	Long term	Stanlib Fahari I-REIT

Section II: Categories of investment products in the Kenyan markets

There are different ways of categories investments either Traditional Investments and Alternative Investments or Direct or Indirect Investments. Traditional investments involve putting capital into well-known assets that are sometimes referred to as public-market investments. Traditional Investments includes Equities, Fixed Income and Mutual Funds/Units Funds. Alternative Investments on the other hand are outside the conventional investment types. The most common alternative investments today are Real Estate, Private Equity and Exchange traded funds. In Real Estate, investors invest in property and land while Private Equity involves buying shares in companies that are not listed on a public exchange or buying shares of public companies with the intent to make them private. Below in detail are the various types of investments in both the traditional and alternative investments category;

I. **Traditional Investments**

This category of investments are well known and easy to understand as updated information is easily available to investors. The main categories of traditional investment products include:

i. **Equities** – Equities represent ownership interest in a company and is considered to be relatively liquid and highly volatile. The returns from equities are in two forms i) Capital appreciation -this is when you sale the security at a higher price than the original purchase price and ii) Dividends which is when listed companies offer cash compensation to equities investors. Investments in equities are largely for medium to long term investments as they come with some level of

volatility,

ii. **Fixed Income Securities** – These are debt instruments that offer a return in the form of fixed periodic interest payments and principal redemption upon maturity or expiration of the securities' tenor. Investors earn a fixed amount of income in the form of coupon payments on their bond portfolios at regular intervals. Usually the yields on the securities increase with the increase in the tenor of investments. The following are some of the types of fixed income securities:

    a. **Treasury Bills** – These are low risk **short-term instruments** issued and fully guaranteed by the government. They can have tenors of 91, 182 or 364-days and the interest rates vary from week to week. Key to note, T-Bills are offered at a discount in that, when investing in a T-Bill, investors pay less than the face value, however, after the maturity of the T-Bill, the investor receives the full-face value,
    b. **Treasury Bonds** – Treasury Bonds (T-Bonds) are **long-term investment instruments** that pay periodic coupons, in the case of Kenya, semi-annually (every 6 months) throughout the bond's maturity. Treasury bonds are available in both the primary market and the secondary market through the Nairobi Securities Exchange (NSE). Bond Investors have 2 main motives, (I) investing for trading purposes and (ii) investing with the aim of holding them to maturity. Investors with the aim of holding the bonds to maturity earn their returns from the semi-annual interest and get the face value of the bond upon maturity. Investors with a trading motive on the other hand earn their returns from the fair value gains made from the yield curve movements and also coupons for the period they hold the bond,
    c. **Commercial Papers** – These are **short-term unsecured debt instruments** issued by companies or corporates, as a form of raising short-term debt. In most cases, the issuer is required to maintain the pre-specified interest payment throughout the period. In addition, commercial papers have higher yields as compared to other fixed income securities due to the elevated risk. Notably, Investors must be willing to buy the unsecured Commercial Paper based on the company's reputation and review of the company's financial position, and,
    d. **Corporate Bonds** – These are **long-term debt instruments** issued by the private sector with approval from the Capital Markets Authority (CMA) and are priced at a premium to Treasury Bonds. Corporate Bonds are issued by companies in order to finance their operations and most firms issue bonds since the bond market offers lower interest rates. The yield offered is normally higher than the government bonds due to the high risk involved.

Individuals and companies can invest in Treasury bonds through a commercial or investment bank in Kenya, but it is cheaper to invest directly through the Central Bank and reduce extra fees if one has a bank account with a local commercial bank. An investor is required as a pre-requisite to trading, to register their CDS account information and the names of a stockbroker(s) who will serve as their agents with CBK. For more information on government securities and how to invest in them, click here.

II. **Alternative Investments**

Alternative investments are the asset classes that fall outside the conventional category of investments such as publicly-traded equities and fixed income securities. We have seen a lot of growth in the alternative markets with the regulators even coming up with regulations that shall help govern this market. The alternative markets are slightly complicated and most the time the regulations provides that only sophisticated investors can play in this market. The clientele of this investment category is mainly institutional investors and high-net-worth individuals. The main types of alternative investment products in the Kenyan market include:

1. **Private Equity -** Private equity funds invest and acquire equity ownership in private companies, typically those in high-growth stages or those of public companies that go private, with a strategy to exit at the opportune moment. Traditionally, people have invested together in companies but we have seen more formalised investments. Some of the key successful investments by private

equity firms would include: Equity bank, Family bank, Java and Nairobi Women's among others. Investment in Private equity might be capital intensive and might not be easily available to retail investors,

2. **Derivatives Market** – A derivative is a financial instrument that derives its value from one or more underlying assets which can be based on different types of assets such as commodities, equities, bonds, interest rates, exchange rates, or real estates. They are legal contracts in which two parties agree to pay off each other depending on the value of an underlying asset at a certain point in time. Additionally, derivatives can either be traded over-the-counter (OTC) or on an exchange. An Over the Counter transaction involves trades done directly between two parties without any supervision of an exchange as opposed to trading on an exchange characterized by standards and rules upon which the parties venture. The main types of derivatives contracts include: forward contracts, options contracts, futures, swaps and warrants which involve buying and selling of assets under a specified set of rules.

   The Nairobi Securities Exchange derivatives market (NEXT) which was launched on 4th July 2019 and has provided a platform for the trading of two futures contracts, in particular: Equity Index Futures and Single Stock Futures. For more information see our topical on Understanding the Derivatives Market,
3. **Real Estate** – This involves the purchase of land or buildings, ownership, management, rental and/or sale of property for income generation. The real estate market is divided various categories namely; the residential sector, the industrial sector, the commercial and retail sector, and mixed-use developments. The investments in Real estate can be either directly which will involve actual ownership in the brick and mortar or through ownership in Real Estate trust or shares in a real estate company. Real Estate Investment Trusts (REITs), are pooled investments typically designed to enable the investors to profit from investing in large-scale real estate enterprises and offer investors a liquid interest in real estate and mortgage-backed securities. There are three main types of REITs which include:
   a. **Income REITs (I-REITs)** – this is a REIT which invest in completed yielding buildings with the aim of benefiting from both Capital appreciation and Rental income. As such, income returns are predictable and generally less volatile,
   b. **Development REITs (D-REITs**) – This is a REIT whose main purposes is the acquisition and development of Real Estate projects . eligible real estate for development and construction projects,
   c. **Islamic REITs** – This is an Islamic REIT that invests primarily in income-producing Shariah-compliant real estate. In this case, a fund manager is required to conduct a compliance test before investing in real estate to ensure it is Shariah-compliant and that no non-permissible practices are carried out on the land, or if they are, they are done on a limited basis, and,
   d. **Property funds -** Property funds are investments in commercial property, for example, offices, factories, warehouses and retail space. Investors make lump-sum investments, which are pooled together and used to purchase a range of assets, invested either directly through commercial property or indirectly, by buying shares in property companies or other property funds. For more information, please read our article on Real Estate Investment Trusts in Kenya.
4. **Exchange Traded Funds (ETFs) -** This are publicly traded investment products that monitor the performance of a diversified portfolio of stocks, bonds, and commodities. An ETF can also track a single commodity such as oil or a precious metal like gold. This funds give investors the chance to buy units that track whole indices as easily as buying shares listed on the Exchange. An example of an ETF is the Barclays NewGold ETF which was launched on 30th June 2017 and listed on the Johannesburg Stocks Exchange the fund enables investors to invest in an instrument that monitors the price of Gold Bullion. Price movement of the ETF are determined by the price movement of gold and each gold security corresponds to approximately 0.01 troy ounces of gold bullion. Consequently, the allocated gold held as collateral must be of South African origin, which means it must comply with Reserve Bank of South Africa regulations. ETFs provide liquidity,

diversification and potentially high returns to investors,

Advantages and Disadvantages of Traditional and Alternative Investments

Some of the advantages of traditional investment products include:

a. **Information Availability** – Companies listed on the Exchange are required by regulation to publish information on a regular basis. The management of the said companies are also readily available to meet with the analysts and explain to them the performance of the companies,
b. **Standardized**, well known and easy to understand structures,
c. **High Liquidity** – Majority of the traditional investment classes have a ready market for the sale of assets and thus can be easily converted to cash, and,
d. **Regulation** - Traditional investment products operate under the supervision of the regulatory bodies such as the CMA and the Retirement Benefits Authority (RBA) among others, who layout procedures to follow when making a transaction or allocation of funds for the mutual funds which presents a form of safety to any investment made.

The main disadvantages of traditional investment products include:

a. **Lower returns relative to alternative markets** – The real returns from traditional investments, when inflation is taken into account, tends to be lower than alternative investments which are less volatile,
b. **High Correlation of Returns** – This is the relation of movement in prices of assets in the market. Traditional investment products such as equities are known to have similar movements in the market, especially when there is a movement in the large-cap stocks, this affects the performance of other equities in the market, and,
c. **The volatility of Returns** – traditional investment products such as stocks and bonds are highly sensitive to market changes such as inflation and interest changes and thus performance is pegged on the prevailing market conditions. Furthermore, when the returns are adjusted for price changes as a result of inflation, the real return may not be as high as expected.

The main advantages of alternative investment products include:

i. **Potential for High Returns**- Alternative investments offer the potential for higher returns when compared to traditional investment products in the long term. Structured products are intended to provide investors with highly focused investments that are customized to their risk profiles, return expectations, and market expectations. High returns can also be achieved through consolidation, in which economies of scale are achieved by the accumulation of client funds, which are then invested, by professionals with business expertise and experience,
ii. **Low Correlation of with the market** – Alternative investment products typically have their value that is independent on factors that affect prices of conventional asset classes they can mitigate shocks from financial meltdowns using their contrarian strategies, and,
iii. **Alternative Source of Funding for Businesses** – Alternative investments have enabled businesses to raise capital on more favourable terms for both parties. This has been made possible by banks or institutions that deal with alternative investments by bringing real estate opportunities to the market through venture capital funds. As a result, investors get diversified avenues that reduce the overall portfolio risk and at the same time provide them with capital.

The main disadvantages of alternative investment products include:

i. **Operating in a Less Regulated Environment** - Alternative investments, in contrast to conventional investment products, are subject to less strict oversight, which increases the risk of investments made,
ii. **Lengthy Process to Carry out a Transaction**– Most alternative investment offerings are tailored to the needs of their customers hence the process of initiating a contract, conducting due

diligence on the transaction, structuring the deal, and eventually completing the transaction takes time,

iii. **Limited Availability of Information** - The majority of alternative investments entail private transactions and thus there is little information on the details of deals carried out subject to the information released by the parties involved,
iv. **Low Liquidity** - Alternative investment products are mostly designed for long-term investors, making it impossible to sell them until they reach maturity unless there is already a willing buyer in the market, and,
v. **Restricted to highly sophisticated Investors** which makes them eligible for certain benefits and opportunities unavailable to other classes of investors who would also wish to invest in alternative investments.

Direct and Indirect Investments

Investors can either invest in the above products either by directly buying into them or indirectly by investing through collective investment schemes. When doing direct investments one needs to understand what they want and buy that through a broker. This will involve opening a CDSC account and selecting the broker they want. On the other hand, indirect investments is done through funds and there are two main ways that investors can invest in pooled funds;

i. **Mutual Funds/Unit Trust Funds** - This is a collective investment scheme that pools money together from many investors and is managed by a professional fund manager who invests the pooled funds with a view of paying a return in accordance with specific shared investment objectives that have been established for the scheme. The funds in the mutual fund give returns in the form of dividends, interest income and/or capital gains depending on the asset class the funds are invested in. The following are the main types of Unit Trust Funds:
   a. **Money Market Fund** – This fund mainly invests in short-term debt securities with high credit quality such as bank deposits, treasury bills, and commercial paper. The fund offers high-income yield, liquidity as well as capital stability. In the current market, one can invest in select Money Market Funds with as little as Kshs 1,000,
   b. **Equity Fund** – this fund buys shares in publicly traded common stocks. The fund aims to offer superior returns over the medium to longer-term by maximizing capital gains and dividend income. Equity funds employ the rationale of investing in various undervalued equity securities, which not only presents significant growth potential, thereby optimizing an investor's real return, but also limits downside risk should any individual securities enter any bearish phase. Investors can investment in select Equity Funds with as little as Kshs 5,000,
   c. **Fixed Income Fund** – This fund invests in interest-bearing securities which include treasury bills, treasury bonds, preference shares, corporate bonds, loan stock, approved securities, notes and liquid assets consistent with the portfolio's investment objective. Fixed income funds give returns to investors at minimal risks,
   d. **Balanced Fund** – This fund invests in a diversified portfolio that contains an equities component, a fixed-income securities component and sometimes a money market component to offer investors a reasonable level of current income and long-term capital growth. The equity component seeks to deliver long term returns, while the debt component provides stability to the portfolio. This diversification limits the portfolio from downside risks if either equity or debt enters a bearish phase. Investors interested investing in Balanced Funds can do so with as little as Kshs 5,000 with select Fund Managers, and,
   e. **Sector specific funds-** A sector fund is an investment fund that invests solely in businesses that operate in a particular industry or sector of the economy. This funds have higher volatility because they concentrate on a single sector of the economy and hence lack diversification. However, sector funds may offer diversification through multiple holdings in a portfolio but, due to their targeted sector exposure, overall sector funds may have idiosyncratic risks that affect the entire portfolio. If one industry performs badly, the rest of the economy suffers.

For more information, please read our topical on Investing in Unit Trust Funds.

ii. **Pension Funds** – This refers to an investment fund into which individuals contribute their investments with the aim of saving for retirement. The investments are guided by the provisions of the Retirement Benefits Act and the specific characterises of the fund as set out in the Investment Policy statement. Pension funds can be categorized into two in terms of returns; guaranteed funds, which provide a guaranteed minimum rate of return, and segregated funds, which offer market-based returns. Alternatively, they can be categorized by mode of contribution, where we have individual retirement benefit schemes, where individuals can contribute directly into the fund towards saving for their retirement, and umbrella retirement benefit schemes, that pool the contributions of multiple employers and their employees. For more information, see our topical on Retirement Benefit Schemes in Kenya.

Section III: Considerations when choosing an investment option

Investors may invest in single assets or a portfolio of assets, depending on the intended outcome. Below are some of the factors that an investor should consider when making an investment decision;

i. **Returns** - These are the incomes made from an investment. A rational investor seeks out a venture that offers maximum returns for a given level of risk. The returns available and the investor's preference for producing a stream of income or capital appreciation in their portfolio should be basic determinants of an investment option. The aim is to ensure that the returns earned are higher than inflation and there is compensation for any additional risk undertaken,
ii. **Risk Tolerance** - This is the uncertainty that the investment will not generate the expected return on investments. Risks affecting investment asset classes differ from one asset to another with the riskiest ones yielding the highest returns. As such, an investor needs to understand his/her risk appetite before investing and you should not invest in that which you do not understand,
iii. **Liquidity** -This refers to how quickly one can convert an asset to cash. Key to note, liquidity varies from one asset to another. For investors who would prefer high liquidity, it is important to consider investing in short-term liquid assets such as treasury bills and equities,
iv. **Time Horizon** - This is the length of time that an investor intends to hold an investment. The Investment Horizon is largely dictated by the use of the investments. Investments with a short term horizon should not be invested in risky or volatile Asset classes like equites. Key to note, younger people have a longer time horizon and can, therefore, make riskier investment decisions as they have time to recover if they end up making losses,
v. **Investment Capital** – One's investment capital determines their investment choice, since certain investments need more capital, making it more difficult for investors with less capital to invest. Further, any trading strategy relies heavily on the distribution and utilization of investment capital. To counter the possible losses that may arise from market fluctuations, an investor can choose to diversify their portfolio across a variety of asset classes and products. In the current market, one can invest in equities directly or through Collective Investment Schemes like Equity fund with as little as Kshs 1,000, or in government papers through Collective Investment Schemes like Money Market Funds with as little as Kshs 100 in select equities, and,
vi. **Investors Investment Knowledge and Level of Sophistication** – A sophisticated investor is a high-net-worth investor who is considered to have a depth of experience and market knowledge that makes them eligible for certain benefits and opportunities unavailable to other classes of investor, such as pre-IPO securities. Such investors do not need to liquidate investment assets in the short term, and can even sustain a loss of their investment without damage to their overall net worth. As such, an investor should first asses his/her capital sufficiency, experience, net worth and liquidity needs before investing.

Section V: Conclusion and Recommendations to investors

When making Investments it is always advisable to work with a financial Advisor to ensure you have got the right objectives in place and select the best portfolio for oneself. In the Kenyan market, a wide range of investment products based on one's investment goals, risk appetite, liquidity status, and desired return have been availed to investors. For an investor to thrive in the investment market, one is required to apply informed investment strategies on the selected investment options. As such, it is important that before investing, you know your risk tolerance. It is also important to ensure diversification in ones portfolio as it proves to be the most crucial component of attaining long-term financial goals at minimal risks therefore setting up a safety net for your investment portfolio. However, amidst the risks that emanate from the COVID-19, there lies a variety of opportunities for investors as outlined below;

i. **Equity Investors:** For investors with a long-term horizon, selective entry into the equities market given the current attractive valuations would be recommendable as it presents an opportunity for potential upsides for companies with strong financial fundamentals. Investors keen on the capital markets can also consider investing in the Nairobi Securities Exchange Derivatives Markets (NEXT) which provides an opportunity for investors to protect their portfolios against volatile stock prices,
ii. **Fixed Income Investors:** Given the low volatility of the fixed income securities and the moderate liquidity aspect of these securities, such as the Treasury Bills and the Treasury bonds, investors keen on investing in fixed income securities should be biased towards short-term fixed income securities in order to reduce the duration risk, and,
iii. **Real Estate Investors:** Real Estates are a good investment option as they provide investors the opportunity to participate in real estate projects and a platform to get high yields on the longer term. An investor can choose to invest in REITs which are still at the initial stages with only one being listed, the Fahari I-REIT. One of the main drawbacks REITs market is minimal investor knowledge on the instrument. There are however pockets of value for investors in this sector owing to the increased government support, and public sector sensitization of the REITs.

Investors who are keen on investing in the capital market but have no crucial information on how to go about it, can invest through **Collective Investments Schemes** such as the Money Market Fund, Balanced Funds, Equity Funds etc. Collective Investments Schemes allow investors to re-align their investments with their risk appetite by pooling money together and investing in safe havens. With the help of a professional fund manager, investors can tap into the expertise of fund managers who have crucial information of the market and can screen for better investment opportunities. Additionally, CIS will ensure investors maintain a diversified portfolio as well as gain access to investment products inaccessible to an individual investor such as government and corporate bonds, which are restricted to institutional investors.

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