Investing in Unit Trust Funds, & Cytonn Weekly #20/2019

Focus of the Week

Everyone has financial goals that are unique to them and their financial needs. Personal finance is about meeting personal financial goals, whether it's having enough for short-term financial needs, owning a home, buying a car, funding education, planning for retirement etc. There are various avenues of investments. In this week's focus note, we focus on investing in Unit Trusts, also referred to as Mutual Funds. To cover this topic, we shall address the following:

?. What a unit trust is and what investments products it offers,
i. The structure of unit trusts,
ii. Industry analysis on the growth of the assets under management,
iii. Conclusion: Under this we give our view based on the merits of investing in a unit trust and why one should consider unit trusts for investment.

Section I: What is a unit trust and what investments products does it offer?

A unit trust is defined as an investment scheme that pools money together from many investors who share the same financial objective to be managed by a professional fund manager who invest the pooled money in a portfolio of securities such as shares, bonds and other money market instruments or other authorized securities to achieve the objectives of the trust. The pooled money in the unit trust fund earns income in the form of dividends, interest income and/or capital gains, depending on the asset class the funds are invested in.

Investors in a unit trust fund are usually issued with units, which act as a share of the entire fund's underlying portfolio of securities, in exchange for the amounts invested. To compute the underlying value of assets of the unit trust, one multiplies the total number of units issued by the unit price. The price of each unit, in most instances, is made public in most jurisdictions.

Investors in unit trusts have a variety to choose from as they offer different investment vehicles/funds which have different risk exposures as investors have different risk appetites. The most common funds include:

?. Money Market Fund: Under this type of fund, money is invested in liquid interest-bearing securities that have a maturity of less than 12-months. These securities include bank deposits, and other short-term money market instruments including short- dated treasury bills and commercial papers. The Fund is best suited for investors who require a low risk investment that offers capital stability, liquidity and a high-income yield. The Fund is a good safe haven for investors who wish to switch from a higher risk portfolio to a low risk, high interest portfolio, especially during times of high stock market volatility,
I. Equity Fund: The objective of this type of Fund is to offer superior returns over the medium to longer term by maximizing capital gains through investing in listed securities. This fund is designed for investors seeking medium to long term capital growth in their portfolios and who

want to gain exposure to equity investments. The Fund is suited to investors who want to invest their money over a period of at least 3 years and beyond. The Fund has a medium to high risk profile. Due to the volatile nature of the stock markets, risk is usually reduced through holding a diversified portfolio of shares across different sectors,

II. Fixed Income Fund: The main objective of this Fund is to achieve a reasonable level of current income as well as maximum stability of the capital invested. Funds are invested in interest-bearing securities that include, treasury bills, treasury bonds, preference shares, corporate bonds, loan stock, approved securities, notes and liquid assets and any other securities that are consistent with the portfolio's investment policy.The Fund is suitable for investors who are seeking a regular income from their investment, including those who intend to secure a safe haven for their investments in times of stock market instability, and,
III. Balanced Fund: The investment objective of a Balanced Fund is to offer investors a reasonable level of current income and long term capital growth. This would be achieved by investing in a diversified spread of equities and fixed income securities. The Fund is suited to investors who seek to invest in a balanced portfolio offering exposure to all sectors of the market. It is also suitable for pension schemes, treasury portfolios of institutional clients, co-operatives and high-net worth individuals amongst others. The Fund is a medium risk fund and has a medium risk profile.

Section II: The Structure of Unit Trusts

Unit trusts in Kenya are regulated by the Capital Markets Authority (CMA). A unit trust is required to have a fund manager, a custodian and trustees with the roles of the three parties prescribed under the Capital Markets (Collective Investment Schemes) regulations, 2001. The roles of the different parties are as summarized below:

?. Fund Manager: The role of the fund manager is to provide investment advice as well as investing the unit trust's funds in the approved asset classes and ensure overall good performance of investments. Other main duties as prescribed by CMA include:
   - Formulating a prudent investment policy and investing the scheme's assets in accordance with the scheme's investment policy as well as reinvesting any income of the scheme fund which is not required for immediate payments;
   - Ensuring that the shares or units in the collective investment scheme are priced in accordance with the information memorandum;
   - Publishing daily the price of shares, or yield on units in at least two daily newspapers of national circulation, published in the English language; and
   - Interaction with investors in the fund, including onboarding them as clients, receiving withdrawals and investment instructions, and notifying members of any material happening, e.g. Annual General Meetings.

I. Trustee: The core mandate of a trustee is to play the oversight function in respect to the fund manager. They are responsible for management of the scheme and act in the best interests of the beneficiaries. For a company to be appointed as a trustee it is required to be either a bank or financial institution approved for that purpose by the Capital Markets Authority (CMA). Some of the main functions of a trustee as prescribed under the Capital Markets (Collective Investment Schemes) regulations, 2001 include, but are not limited to:
   - To ensure that the custodian takes into custody all the collective investment scheme portfolio and holds it in trust for the unit holders;
   - To take all steps and execute all documents which are necessary to secure acquisitions or disposals of assets properly made by the fund manager; and
   - To collect any income due to be paid to the scheme and or claim any repayment of tax and direct any income received in trust for the holders to the custodian.

II. Custodian: The role of the custodian is to ensure safe custody of all assets of the unit trust. Similar to the trustee a custodian of a collective investment scheme must be a bank or a financial institution approved by the CMA. The core functions of the custodian as prescribed by the CMA include, but are not limited to:

- To receive and keep in safe custody title documents, securities and cash amounts of the collective investment scheme;
- Opening an account in the name of the collective investment scheme for the exclusive benefit of such collective investment scheme; and
- Transferring, exchanging or delivering in the required form and manner securities held by the custodian upon receipt of proper instructions from the fund manager, trustee or board of directors.

Due to the structure set in place by CMA as discussed above, unit trusts are relatively a safe investment vehicle. For instance, all assets, including investments and money awaiting investment, are held by the custodian for safekeeping on behalf of the unit trust, and thus the fund manager does not directly take clients' funds into its bank accounts. This ring-fences the client's funds from company funds. Payments as well can only be made once the custodian receives instructions from the unit trust's authorized signatories.

Section III: Industry analysis on the returns, profitability growth of the assets under management

The number of unit trust schemes licensed by the Capital Markets Authority currently stands at twenty-six (26). As per our analysis on the 2018 performance by unit trust fund managers, total assets under management ("AUM") held by Unit Trust Fund Managers stood at Kshs 58.0 bn in 2018 with Money Market funds remaining the most popular product with a market share of 84.3%. The below summarizes the distribution of the various funds as at close of 2018:

No	Product	FY'2018	FY'2018 Market Share
1	Money Market Funds	48,895.5	84.3%
2	Equity Funds	4,797.9	8.3%
3	Balanced Funds	1,947.8	3.4%
4	Other Funds	2,383.1	4.1%
	Total	58,024.3	100.0%

Industry statistics indicate that Money market funds AUM has recorded an 8-year compounded annual growth rate of 19.3% to Kshs 48.9 bn in 2018 up from Kshs 11.9 bn recorded in 2011, showing that Money Market Funds are growing faster than the overall market at 12.2%. We are of the view that this acceleration in performance has largely been driven by:

?. Increased awareness and sensitization on unit trusts and the benefits accrued, which has been facilitated by improved distribution networks across all firms, coupled with technological advancements which has eased access of information as well as improving efficiency,

a. A rise in the number of new entrants with market players rising from 12 in 2011 to 26 as at the end of 2018. This has led to a wider range of choice for investors based on their risk profile in order to align their expectations with the objectives of the various market players,

b. The performance by unit trust funds has also picked up, following the repeal of the floor rate on deposits, in September 2018, which has seen bank deposits rates decline making money market funds more attractive to investors,

c. The sustenance of a favorable regulatory framework cemented by structures put in place by the Capital Markets Authority which have served to ensure that collective schemes are relatively safe havens for investors fund and thus enhancing their popularity and acceptance,

d. Entry level has been made affordable with the minimum investment amounts shrinking from levels of as high as Kshs 1.0 mn in early 2000's to as low as Kshs 5,000 currently, making investing in collective schemes accessible even to retail investors.

The table below summarizes the top five money market funds in terms of average effective annual yield declared in 2018:

No.	Money Market Fund	2018 Average Effective Annual Yield p.a.
1	Cytonn Money Market Fund	11.5%
2	Nabo Africa KES Money Market Fund	10.2%
3	CIC Money Market Fund	10.1%
4	Madisson Money Market Fund	9.9%
5	Zimele Money Market Fund	9.9%

Section IV: Conclusion

There are various pros in support of investing in a Unit Trust, which include:

- Professional Fund Management: Unit trusts are run by investment managers who have successfully made investment decisions through a wide variety of market conditions over a long period and thus have the expertise to screen for high yielding investments opportunities in the market, coupled with other support functions such as operations which process the day to day transactions to ensure efficiency.

- Security of Fund: Unit trusts are well regulated through the Capital Markets Authority and controlled by the Collective investment Schemes Act, which prohibits investment managers from taking certain risks. They also come with safeguards as each unit trust fund is compelled by law to appoint a trustee who looks after all the cash, shares or bonds that the fund owns which means that if anything happens to the unit trust company or the asset manager the investments will not be affected.
- Transparency and Effective Communication: Unit trusts are required to publish their daily and effective annual yields on the daily newspapers, and thus an investor can therefore always confirm the value of their investment as well as benchmark the performance against other unit trusts. It is also mandatory for the scheme to issue monthly statements showing an investor’s investments position.
- Excellent Returns: History has shown that average returns from unit trust companies compare very favorably with returns from more traditional investment products. Unit trusts have also proven themselves as an excellent way of beating inflation.
- Easy Access to the Investment: Funds invested in unit trust investments can easily be redeemable either the full or partial investment based on the prevailing unit price.
- Diversification: Unit trust Funds ensure diversification of risk through investing in a variety of asset classes. Through this they provide an avenue for small scale investors to get exposure to a wide range of investments which would otherwise require one to have a lot of capital in order to access. Due to this nature, unit trusts have universally been identified as the small investor’s answer to achieving wide investment diversification without the need of huge and prohibitive sums of money, while still offering a safe haven for the less sophisticated and less capitalized, conservative individuals as the market becomes sophisticated and more volatile as the funds are managed by qualified fund managers who screen for viable investment opportunities.

Like any other investment security, unit trusts are also subject to market/investment risks as the various investment vehicles/funds have different risk exposures based on the different risk appetites. For instance, the fixed income fund mainly focuses on investing in Treasury bills and Treasury bonds, which are guaranteed by the government through the Central Bank of Kenya where the risk of default is low and thus the returns are fixed and less volatile. On the other hand, investments in an equity fund, where the funds are invested in shares of companies listed in a Securities Exchange may be exposed to market risk, this is however usually reduced through diversification. Investors are therefore advised to choose the fund to invest in based on their risk profile as well as the desired tenor of investment in order to align their expectations with the objectives of the fund. The fund's investment objective and strategy, investment limits, its current portfolio and any commentary on its recent performance should serve as guide to an investor of the risk level of the fund.

In conclusion, with markets becoming more sophisticated, unit trusts present an avenue for investment where:

- You can invest as much amounts that you are comfortable with;
- You stand to earn potentially higher returns that are inflation beating at moderate risks;
- You stand to meet your financial aspirations in a structured manner which is also enhanced by the availability of different funds that help you achieve your financial objectives with the possibility of switching between funds to manage your risk exposure; and,
- Lastly, it instills financial self-discipline in the long run through pursuing a systematic Regular Investment Plan.

Liason House, StateHouse Avenue
The Chancery, Valley Road
www.cytonn.com