INTRODUCTION OF MUTUAL FUNDS IN KENYA'S FINANCIAL MARKET: A SURVEY

BY

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APRIL 1996
DECLARATION

THIS PROJECT IS MY ORIGINAL WORK AND IT HAS NOT BEEN PRESENTED FOR A DEGREE IN ANY OTHER UNIVERSITY

SIGNED : EUNICE WANJIKA KARAU

DATE : 13th May 1996

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THIS PROJECT HAS BEEN SUBMITTED FOR EXAMINATION WITH MY APPROVAL AS A UNIVERSITY SUPERVISOR

SIGNED : DR. KINANDU MURAGU

DATE : 13 May, 1996
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ABSTRACT

A mutual fund is a corporation or trust that accepts money from members of the public and employs a professional fund manager to place the money in investment instruments that will meet the fund's objective, that is, produce the kind of returns that the fund has as its aim.

Mutual funds provide a simple way for the non-sophisticated individual investor to grasp such concepts as investment portfolio, risk and reward, diversification, common investment and professional management of a financial portfolio.

Kenya's pooled investment vehicles are still at the infancy stage in spite of the facilitating legislation having been in place since 1967. With the licensing of Kenya's first mutual fund, this survey sort to establish if the financial sector is ready for pooled investment vehicles. This was done by way of an opinion poll and from the results obtained we have been able to establish that there is an investment gap which lies between the money market instruments, real estate and shares of both public and privately held corporations.
CHAPTER ONE
INTRODUCTION

1.1 BACKGROUND

The securities market mainly comprises of the money markets and capital markets. Money markets involve trade in short term financial instruments such as corporate commercial paper, treasury bills and bonds. Capital markets on the other hand is where long term financial instruments are traded, these include stocks and bonds. Investors seek to maximise their returns at minimum risk. They seek capital gains and/or dividend yields.

There are two types of investors in the capital markets:-

a. *Direct investors* are those people who choose the investment instruments to buy and/or sell, the time, and the amount. For an investor to profitably do this they must have access to continuously updated information on market trends; must possess expertise to enable them make the decisions of when, how much; and huge financial resources to enable them invest in a diversified portfolio.

b. *Indirect investors* are those who prefer the handling of such issues to the 'specialised investment institutions' (Beecham 1988:104).

This paper will look at the indirect investors and more specifically at the 'specialised investment institutions' that this type of investors opt to use.
The scope of this paper will be narrowed down to the study of two types of investment institutions. These are:-

a. Unit Trusts.
b. Mutual Funds.

A Unit Trust is an investment company formed under the trust deed which is an agreement between the managers and the trustees who must be independent of each other. The trustee which may be a bank, an insurance company, or a group of individuals, has custody of the trust assets, controls the issue of units, maintains a register of holders, and watches over the management of the trust. It is worth noting that the trustee does not interfere with the daily operations of the unit trust unless the interests of the management conflict with those of the unit holders (Winfield and Curry, 1991).

Unit trusts invest in other companies by purchasing their stock to compose a large diversified portfolio of securities and then offering its own shares to the public. The trust is composed of various units and each unit is as diversified as the trust itself.

The unit trust can either be closed-ended or open-ended. Closed-end funds are fixed in terms of their units which can neither be increased nor decreased during the life of the unit, that is, the management does not buy back the units until they mature. These units are traded on the stock market and may sell above or below their quoted prices and thereby reflecting the investors perception of the fund. An example of a closed-end fund in Kenya is the ICDC Investment Company.
Open-end funds can have a constantly fluctuating number of shares as they offer new shares and buy back the old shares as dictated by the market conditions. The capital of the fund may thus change on a daily basis depending on the number of new shares issued and old shares purchased back.

A Mutual Fund is a collection of stocks, bonds, and other securities purchased by a pool of individual investors and managed by a professional investment company. When an individual makes an investment in a mutual fund his/her money is pooled together with that of other investors and the total amount is used to build a large diversified portfolio.

_Open-end funds_ are also referred to as _Mutual Funds_ as they possess the same characteristics and according to Amling (1974) "the concept of mutuality is in the fact that there is only one class of owner, who shares the gains or losses of the fund with all the other owners..." All mutual fund investors bear the same risk as the fund invests in the same securities, for example in a balanced fund where the management invests in both money market and capital market instruments. There is no single investor who will be told that they fund made losses and therefore there are no earnings for him whereas there are earnings for other investors as their money was pooled together to purchase the same securities. They will thus share in the losses or gains made.

We shall use the terms Mutual Funds and Open-end funds interchangeably to refer to the same concept.
1.2 STATEMENT OF THE PROBLEM

Kenya's capital market is rapidly changing as a result of the liberalisation of the economy. This has brought about numerous changes in all sectors of the economy and people are now more aware of market opportunities than ever before. More people have began investing on the stock market as evidenced by the licensing of new brokers to assist investors in their endeavours to maximise capital gains and to seek dividend yields. For investors to profitably trade on the stock market they must possess current market information, a large pool of financial resources so as to create an almost risk-free diversified portfolio, and expertise so as to enable them make wise investment decisions. In the past stock brokers have provided investors with these services but this will change as more investment companies are registered.

It is also true that investors demand for diversified portfolios will not be met by mere reliance on brokers. They will only provide information on securities in isolation. The development of mutual funds will guarantee a diversified portfolio on a one shop basis. It is evident therefore that a study of mutual funds is important.

The study address issues relating to the introduction of Mutual Funds in Kenya's financial system. It is hoped that since mutual funds not only offer professional management and diversified portfolios and in addition assist investors reduce risk as well as transaction costs, they should be in the financial market by now. This is not the case.
1.3 OBJECTIVES OF THE STUDY

The objectives of this study are to establish if Kenya's financial sector is ready for mutual funds, what the investors are likely to gain by purchasing units of these funds as opposed to direct equity investment, and what the future looks like for these institutions in Kenya.

1.4 MOTIVATION FOR THE STUDY

Investors seek to maximise capital gains and or dividend yield at minimum risk. Investors in Kenya are increasingly investing in the stock market now that the economy has been liberalised and foreign investors allowed to participate on the stock market. It is hoped that this study can establish the benefits Kenyans are likely to gain by investing in mutual funds. It is also hoped to establish if investors are aware of the opportunities and risks that are offered by mutual funds. Lastly, it is hoped that this study will stimulate further research in this area.

1.5 ORGANISATION OF THE STUDY

The rest of the survey is divided into four sections as follows. Chapter two deals with Literature review, and goes on to explain the concept of pooled investment vehicles, their origin, and also looks at the situation in Kenya with regard to mutual funds. The chapter also briefly explains the nature of fund objectives and the services they offer.
Chapter three deals with the mode of research used, and the survey instrument which is a questionnaire, and what we hope to achieve from the study.

Analysis of the survey is dealt with in Chapter four. It tackles the different issues raised in the questionnaire and we have come up with the conclusions that are dealt with in greater detail in Chapter five.
CHAPTER TWO
LITERATURE REVIEW

2.1 UNIT TRUSTS AS INVESTMENT COMPANIES

A Unit Trust is an investment vehicle through which an investor can participate in the capital market and/or the money market through the purchase of units in an investment portfolio. They offer investors the opportunity to obtain a higher degree of diversification than is possible through a small commitment of funds directly into the stock market. As Winger (1991) clearly states, "most investors lack sufficient resources to establish adequately diversified portfolios on their own." They therefore result to pooled investment vehicles which allow them access to a diversified portfolio of securities, chosen and managed by professional fund managers who seek either high capital gains or high yields within the parameters of reasonable security.

When investors purchase units in a Unit Trust they pool their money in a fund that is managed by professional managers who invest these funds in a large diversified portfolio. They are formed under the trust deed which is an agreement between the managers and the trustees regarding the operations of the trust. The two parties must be independent of each other.
2.2 CLASSIFICATION OF INVESTMENT COMPANIES

Unit Trusts can either be open-ended or closed-ended. Investment Companies offer investors the opportunity to invest and obtain a higher degree of diversification than is possible through a small commitment of funds directly into the equity market.

Investment companies basically fall under two categories:

a) Closed-end Companies, also referred to as Investment Trusts
b) Open-end Companies, also referred to as Mutual Funds


Beecham (1988) defines an Investment Trust as "a public limited company whose shares are quoted on the stock exchange." Like any other publicly quoted company an Investment Trust is subject to a country's company laws, and stock exchange regulations, and also pays dividends to its shareholders. The distinguishing factor between Investment Trusts and other companies is that its assets are not made up of land, buildings, machinery, equipment, inventory, etc., but of shares of other companies. These shares then form the units that are sold on the stock exchange. According to Jerome et al (1967) Investment Companies are a very desirable form of investment because unlike other Financial Institutions such as Banks, and Insurance Companies, they have no liabilities to speak of and cannot therefore become insolvent. Thus when investors buy shares of an investment company they buy shares of different firms under one unit and hence benefit from the diversified portfolio.
Closed-end companies, also referred to as Publicly Traded Investment Funds are formed when a sponsor purchases a set of securities which are then handed over to the trustee for management. The sponsor in turn receives shares that represent the proportionate interest in the securities. These shares are then traded on the stock exchange whereby their prices are determined by the investors' attitude and expectations of potential value of the underlying securities in relation to their Net Asset Value (NAV). The shares may thus trade at a discount or at a premium. "Shares will sell at a discount when investors feel they are worth less than their Net Asset Value" (Jacobs: 1994) that is when future prices are expected to decline they will sell at a discount and likewise, when future prices are expected to rise they will sell at a premium.

In North America investment funds are referred to as Mutual Funds whereas they are referred to as Unit Trusts in Europe (Corner: 1977). Unit Trusts are a form of Investment Trusts as they have the same characteristics. Unit Trusts are further divided into closed-end companies (as discussed above) and open-end companies or mutual funds.

A Mutual Fund is an investment company that pools the money of many individual investors to purchase a collection of stocks, bonds, and other securities (Business Week Guide to Mutual Funds: 1995; Jacobs: 1994). They are also referred to as open-end companies because the number of units can be reduced or increased as dictated by market conditions. Units are reduced when the individual investors sell them back to the investment company which in turn sells some of the securities in its portfolio so as to reduce the value of the fund.
When creating new units, additional securities are purchased and sold to either existing or new unit holders. Units may therefore be created or liquidated at any time and the investors' concern here is the value per unit and not the number of units or the funds' total value (Beecham: 1988; Rix: 1971). A mutual Fund's share price is based on its net asset value per share, which is found by subtracting from the market value of the portfolio the mutual fund's liabilities and then dividing by the number of mutual fund shares outstanding (Fabozzi: 1994).

A Mutual Fund does not have a fixed number of shares, but issues new shares as it takes in money and redeems them as investors withdraw. This liquidity is what makes them a very attractive investment instrument.

A mutual fund is a more profitable investment because the risk facing the securities is spread through diversification. The portfolio is diversified in such a manner that the risk facing 'Asset A' is quite different from that facing 'Asset B'. Therefore if A loses, B might gain and thus the risk is spread as Bs profits will be used to cater for As losses and vice versa. Mutual funds are a form of passive investment as opposed to direct investment in the case of a direct equity investor.

Open ended unit trusts are also referred to as Mutual Funds and according to Amling Frederick (1974) "the concept of mutuality is in the fact that there is only one class of owner, who shares the gains or losses of the fund with all the other owners".
A mutual fund investor is exposed to lesser risk than a direct equity investor as the risk that the fund is exposed to is shared by all unit holders whereas a direct equity investor bears all the risks by him/herself.

According to Winger Bernard J. et al "...an Investment is any asset - tangible or intangible - that has the potential to provide a periodic return and/or increase in value" (1991).

An investment company, closed-end or open-end should perform the following roles:-

1. Administer accounts, which involves the preparation of tax records, re-investing dividends and other gains as per clients' instructions, etc.

2. Portfolio diversification, that is to hold many different securities.

3. Tailoring the portfolio, which involves selecting investment instruments that meet a specified set of conditions.

4. Controlling the portfolio, which entails ensuring that the specified set of conditions continue to be met.

5. Selecting securities that seem to be mispriced, in an attempt to 'outperform' - that is achieve a higher return relative to risk than available elsewhere (Sharpe: 1978).
2.3 HISTORICAL BACKGROUND

Investment companies have been in operation for a long time and their existence can be traced back to the early part of the 19th century in Europe from where they spread to the United States in the latter part of the 19th century (Jacobs: 1994).

Economic history indicates that investment companies formed during the onset of the industrial revolution in continental Europe failed largely due to poor management. Some of these investment companies especially in Scotland however fared well and were gradually accepted by the public. Some Scottish investment companies are still in existence to-date (Saligman: 1987).

In Holland the investment industry dates back to the sixteenth century (Corner D. C.: 1977). Barnard (1987) reports that the first investment company was probably the Societe Generale de Belgique, which was founded in the early 1900s and originally controlled by royal family of Holland.

In the United Kingdom managed funds date back to over 100 years, but unit trusts in today's concept did not exist until the 1930s.

In West Germany investment funds first appeared in the early 1920s but were very short lived. The first open-end fund in Germany was established in 1949 (Corner: 1977).
Beecham (1988) reports that Unit Trusts were formed with the objective of providing the moderate investors with the same advantage as large investors in reducing and spreading risk over a diversified portfolio. This principle is important today as it was then.

2.4 KENYA'S SITUATION

The legislation allowing investment companies in Kenya was done in 1967 through the Unit Trusts Act (Cap 521) of the Kenyan constitution. Although the enabling mechanism has been in existence for twenty-eight years, a study carried out by Deloitte & Touche Management Consultants in 1992 indicated that at the time the Capital Markets Authority in Kenya had not registered any Unit Trust or Mutual Fund although they were quite eager to do so. The study further indicated that although the Kenyan financial sector was ready for pooled investment vehicles the enabling institutions such as banks, insurance companies, and investment companies, were not willing to take the risk of being the initiators.

Perhaps the recent changes by the government to facilitate positive economic development will assist in improving the investment climate. Foreign investors were allowed to participate in the local stock market with effect from January 1995 whereby corporations were allowed to invest up to 20% of the aggregate issued share capital whereas the limit for individual investors was set at 2.5% (Profile: February 1995). The limits have since been revised and presently stand at 40% for corporations and at 5% for
individual investors (East African Standard: June 20, 1995; Daily Nation: August 26, 1995).

The government has also created the Foreign Investment Protection Act (FIPA) which acts not only as an incentive to foreign investors to increase the volume of their investments in Kenya. The Act also protects them from expropriation and guarantees repatriation of original capital and all profits (Euromoney: September 1992).

2.5 FUND OBJECTIVES AND SERVICES

A fund invests in securities that help it to achieve its stated objectives, but it should however be realised that a fund may not always achieve its objectives just as an individual investor may not achieve his/her investment objectives. For instance, many growth funds have selected securities that have not grown very much; some funds that strive for high current income might show remarkable price appreciation when interest rates fall and make heavy losses when the market rates fall (Winger: 1991).

Types of Mutual Funds

According to Jacobs (1994), Investors have various investment objectives and goals and thus no single portfolio can satisfy their needs. Consequently, a variety of mutual funds that are highly specialised offering almost unlimited diversity have been created. The availability of a wide range of funds offers the investors with the opportunity to select a fund and/or
several funds that meet their specific investment objectives. Mutual funds range from conservative funds to aggressive, from stocks to bonds, from domestic to international, and some of them are discussed here below;

a. Growth Funds

Their stock mainly comprises of "companies that have not fully matured and are expected to grow at a higher than average rate in the future" (Madura: 1992). The main objective of this type of funds is to generate an increased investment value and is less concerned with the generation of a steady income.

While some growth funds concentrate on relatively new or young companies others concentrate on firms that have been on the market for some time but are still experiencing growth.

b. Growth and Income Funds

Their main objective is to seek the long term growth or increase of the principal amount and at the same time ensure a steady flow of current income (Jacobs: 1994).

c. Income Funds

They seek to obtain a high level of current income and this makes them risky investments as they are out to gain maximum profits in the shortest period. They offer generous yields which go in line with the risk of not only the income but the principal as well. The risk varies with the nature of the securities held, for example, government
instruments are low risk investments whereas under-capitalised companies are regarded as high risk investments (Madura: 1992)

d. Equity-Income Funds
According to the BusinessWeek Guide to Mutual Funds (1995), the mission of equity-income funds is to "provide shareholders with an above-average yield from a portfolio of mainly dividend paying stocks". Buying stocks for dividends may seem simple to an investor and the question of using mutual funds arises here. For the investor to know if certain stocks are worthwhile they need to analyse and probe issues such as why some firms are paying high dividends; for instance this could be attributed to the industry e.g. automobile industry; or if the company's finances are strong; or if the firm has been out of favour and is trying to make a comeback, and answers to these questions can be provided by mutual fund managers who will continue to tailor the portfolio to cater for investors needs.

e. Balanced Funds
Jacobs (1994) reports that the objectives of balanced funds is to generate a steady flow of income plus long term growth of the principal. Their portfolios mainly consist of bonds, preferred stock, common stock, and money market instruments.

f. Sector and Specialised funds
Sector funds tailor their portfolios to concentrate on investments from only one sector of the market for example, energy, finance, and precious metals.
Specialised funds on the other hand concentrate their investments on one particular type of investment securities for example, common stocks, or bonds, (Jacobs: 1994).

g. Tax-Free Funds
Their portfolios consist of investment instruments which are free or exempted from income tax e.g. municipal bonds. The yields from this type of funds is usually low and hence is only attractive to investors in the high tax bracket who are trying to minimise the amount of tax they pay (Madura: 1992).

h. International Funds
Their portfolios consist of securities from one or more foreign countries. The returns on this type of funds largely depends on the economic and political stability of these countries. They are desirable to investors who prefer offshore transactions as transaction, information and monitoring costs are minimised (Jacobs: 1994; Madura: 1992).

Mutual Fund Services

Winger (1992) says that due to increased competitiveness as well as to facilitate in the smooth running and operations of mutual funds the services discussed below are offered;
a. Telephone transactions.
They make communication between the investor and the investment company easier. They can be relied upon after the investor opens an account with the fund, all additional purchases and/or sales can be made by phone. The fund must send the investor a prospectus for each fund in which he/she invests, after which the investor needs to file an application for each.

b. Reinvestment of Dividends and Capital Gains
A majority of funds offer a number of reinvestment options such as;

i. all dividends and capital gains mailed,

ii. dividends paid in cash and capital gains reinvested to purchase additional shares in the fund.

iii. reinvest both in additional shares.

iv. some allow withdrawal of a given amount each month as an annuity.

c. Fund Switching
It allows the investor to sell shares in one fund and reinvest the proceeds in another if each fund is a member of the same family. It is particularly appealing to investors who do market timing.

d. Adaptability to Retirement Plans
Most mutual funds are readily adaptable to individual retirement plans.
2.6 SUMMARY

Investment Companies are popular pooling arrangements. A closed end fund has a fixed number of shares that are traded like other stocks. A fund share has a Net Asset Value but closed end fund shares can trade at discounts or premiums to Net Asset Value. Open end funds sell additional fund shares and redeem them each at Net Asset Value in response to investor demand.

Before investors commit their money, it is important to understand a fund’s investment objective; growth, income, money market, sector, specialised, or index, that is investors should look for a fund that meets their investment objectives.

Investors should evaluate fund performance before making specific selections. When the investor puts money in a mutual fund they should not think that their problems are solved when they turn the job over to other people. The investor should carefully appraise potential mutual funds, that is look at the qualifications of the Fund Managers as some of them are known to tout their performances in the popular press but often neglect to indicate risk. Moreover, fund evaluation in the popular press usually does not link risk and performance in an adequate fashion. So, it is important for investors to be capable of making their own evaluations in terms of stated objectives and how well they are achieved.
CHAPTER THREE
RESEARCH DESIGN

3.1 POPULATION

Kenya does not have operational pooled investment vehicles in spite of the facilitating legislation having been in place since 1967. Presently only one mutual fund or open-end unit trust has been registered by the Capital Markets Authority but is non-operational. This is the Kenfund managed by the Kenya Funds Management Company, a subsidiary of Kenya Finance Bank Ltd.

The study tries to establish if Kenya's financial sector is ready for mutual funds.

There are two categories of people targeted by this research paper:-

   a) Investors who use the services of brokers.

   b) The general public.

3.2 SAMPLE

The questionnaires were distributed to various institutions and individuals. The number of questionnaires distributed to each centre was based on the expected traffic volume to come from each.
Some of the institutions included the Capital Markets Authority, Central Bank of Kenya, Equity Stock Brokers, Nairobi Stock Exchange, Loita Asset Management, Kenya Postel Services, First National Finance Bank, Euro Finance, and Standard Chartered Bank. The questionnaires were picked by respondents randomly from these centres.

3.3 DATA COLLECTION

According Jacobs Bruce (1994) Mutual Funds are still a mystery to many people. This is especially so in Kenya. The issue at hand is to establish if Kenya's financial sector is ready for mutual funds. This will be done by finding out if the investors both present and potential understand the concept of pooled investment vehicles so as to enable them use these mechanisms in their investment endeavours.

The data required to find out if Kenya's financial sector is ready for mutual funds will be collected through questionnaires targeted to the two categories of people specified above.

This paper will incorporate the questionnaires of Jacobs Bruce (1994) and Deloitte & Touche Management Consultants (1992) as shown on Appendix I.
3.4 DATA ANALYSIS

The data collected will be analysed with the motive of establishing if Kenya's financial sector is ready for mutual funds. As earlier stated the legislative mechanism for pooled investment companies in Kenya has been in place since 1967. The question that arises here is why the investors have not been provided with these services, and had they been in place then would anybody have utilised them? Twenty seven years down the line the question that still remains is if investors are willing to put their money in this institutions. We have witnessed tremendous changes in the capital markets sector over the last five years but are these changes enough to attract investors into mutual funds?

The first part of the questionnaire will establish how many of the respondents have familiarity with the concept of mutual funds and the extent of their familiarity i.e. can their knowledge regarding mutual funds assist them in making sound investment decisions?

In the next section we seek to find out how many of the respondents are willing to invest in mutual funds and what they feel they require regarding the same. We then seek to find out how many of the respondents invest in the stock market and the diversity of their portfolios.

They are also required to state if they prefer being direct equity investors or if they prefer to be indirect investors. The implication of this particular question is to assist in establishing how many of the respondents are ready to
leave their investment decisions to professional managers or if there is some satisfaction from being a direct equity investor.

The next section seeks to find out the investors' opinion as relates to risk and how they rate eight investment options provided; this will assist in establishing their investment decisions i.e. if they are risk averse, seekers or neutral. The respondents are then required to rate their investment expectations and to state their reasons for investing; this would assist the mutual fund manager in creating a portfolio that will meet the investors' expectations.

The final section involves the classification of the respondents according to income, education, and age. This classification will assist in establishing what criteria of the respondents are knowledgeable about mutual funds; willing to participate in them; and how much they would be willing to put in mutual funds investments.
CHAPTER FOUR
DATA ANALYSIS AND FINDINGS

4.1 INTRODUCTION

This study sought to establish if Kenya's Financial sector is ready for mutual funds. The objectives stated in section 1.3 are investigated in detail and analysed. The results of this study were sought from individuals within Nairobi to represent other areas as it is Kenya's capital centre and also due to the limit of accessibility to other areas. The answers were sought through questionnaires distributed to people from all walks of life, for example, people working in the money and capital markets' sectors, and the general public.

4.2 COVERAGE

Since there are no unit trusts or mutual funds that are operational in Kenya the questionnaires were targeted to the groups detailed in section 3.1 namely;

a. Investors who use the services of brokers
b. The general public

As explained in Section 3.2 above, a sampling of two hundred fifty (250) questionnaires were used as it was felt that they would be adequate to form a statistical judgement. Out of this one hundred and sixty-three (163) were
received and used for this analysis. The response was thus 65.2%. The distribution and the response are presented in Table 4.1

Table 4.1 - Distribution of Questionnaires

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4.3 INVESTOR SURVEY SUMMARIES

The study required answers to several questions as analysed here below.

4.3.1 Classification Bands

We had three bands of Classification;

i. Income
ii. Education
iii. Age
Ninety-seven (59.5%) of the respondents were aged between 20 and 30 years; 44 (26.9%) were aged between 31-40 years; 7.9% (13) of the respondents were aged between 41-50 years; while another 5 were between 51-60 years. Only one (1) respondent was over 60 years, whereas 3 people did not disclose their age.

The following income band classification was used;

i. Upper Income: Kshs.50,000/= per month and above
ii. Middle Income: Kshs.20,000/= - Kshs.50,000/= 
iii. Lower Income: Upto Kshs.20,000/= 

Thirty (30) of the respondents were upper income people and out of this 10 (6.14%) were business people whereas the rest were in employment. Fifty-nine (59) people are middle income earners while 65 respondents with 39.9% represented the lower income group. Overall about 60% of the respondents were thus in a financial position and capacity to invest.

Educationally, only 4 people were of primary level education, whereas 51 (31.28%) were of high school level, and the majority 104 (63.8%) had attained a university education. Majority of the respondents were thus highly educated people who would thus understand the concept of pooled investment vehicles and use them in their investment decisions and strategies.
4.3.2 Familiarity with Mutual Funds

First and foremost the study sought to find out the extent to which unit trusts or mutual funds were known by the Kenyan population. To this end the respondents were asked if they had ever heard of either of the two pooled investment vehicles. The response as shown in Table 4.2 indicated that at least 109 and 101 people had heard the names mutual funds and unit trusts respectively.

Table 4.2 - Familiarity with Mutual Funds or Unit Trusts or Both

<table>
<thead>
<tr>
<th>NAME</th>
<th>YES</th>
<th>%</th>
<th>NO</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mutual Funds</td>
<td>109</td>
<td>66.87</td>
<td>54</td>
<td>33.13</td>
</tr>
<tr>
<td>Unit Trusts</td>
<td>101</td>
<td>61.96</td>
<td>62</td>
<td>38.04</td>
</tr>
<tr>
<td>Both</td>
<td>93</td>
<td>57.06</td>
<td>46</td>
<td>28.22</td>
</tr>
</tbody>
</table>

This can be attributed to the fact that most of the respondents are on the average more educated and enlightened. Furthermore, these are the people who would be willing to put their money into new ventures.
Table 4.3 - Extent of Familiarity

<table>
<thead>
<tr>
<th>FAMILIARITY</th>
<th>NO. OF RESPONDENTS</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Invested in one</td>
<td>2</td>
<td>1.74</td>
</tr>
<tr>
<td>Fully aware of what they are</td>
<td>53</td>
<td>46.09</td>
</tr>
<tr>
<td>Vague knowledge</td>
<td>52</td>
<td>45.21</td>
</tr>
<tr>
<td>Heard the names</td>
<td>8</td>
<td>6.96</td>
</tr>
<tr>
<td>TOTAL</td>
<td>115</td>
<td>100.00</td>
</tr>
</tbody>
</table>

For those who responded positively we further sought to find out the extent of their familiarity as shown by the statistics in table 4.3 above. In this regard only two (2) of the respondents had actually invested in Unit Trusts. The two had invested in the *Unit Trust of India*, a unit trust outside Kenya.

Further analysis showed that fifty-three (53) people were fully aware of what Unit Trusts and or Mutual Funds were, and they were thus very knowledgeable or somewhat knowledgeable with issues such as advantages, risks, costs, diversification, monitoring the performance, types of mutual funds, and sources of information, with regard to mutual funds as detailed in questions 3 to 10 of the survey instrument. Another 52 or 45.21% had vague knowledge of what the two institutions are, whereas another 8 or 6.96% had heard of the names mutual funds and or unit trusts.

Over 60% of the respondents were either fully aware what mutual funds and unit trusts entailed, or had vague knowledge of what the two pooled investment vehicles were.
We can therefore conclude that this percentage would be willing to take advantage if the services were available together with enough information regarding the same.

4.3.3 Willingness to Invest in Mutual Funds

As pooled investment vehicles are relatively new in Kenya a follow up question asked whether the respondents would be willing to invest in them. The results as tabulated in table 4.4 below show that a total of 116 people or 71.17% indicated that they would be willing, but required more information. This implies that a larger percentage of the population is willing to venture into new areas if provided with the necessary information to enable them make an investment decision. 21 people responded 'yes' if more mutual funds were available; this shows the percentage which is aware that Kenya Fund Management Co. Ltd has been licensed to start operating Kenya's first unit trust. 7 answered 'NO' whereas 9 respondents felt that they were too new in Kenya, and another 7 indicated that there were better ways to invest.

Table 4.4 - Willingness to invest in mutual funds

<table>
<thead>
<tr>
<th>TYPE OF RESPONSE</th>
<th>NUMBER</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Require more information</td>
<td>116</td>
<td>71.17</td>
</tr>
<tr>
<td>Willing subject to availability of more funds</td>
<td>21</td>
<td>12.88</td>
</tr>
<tr>
<td>No</td>
<td>7</td>
<td>4.29</td>
</tr>
<tr>
<td>They are too new in Kenya</td>
<td>9</td>
<td>5.52</td>
</tr>
<tr>
<td>There are better ways to invest</td>
<td>7</td>
<td>4.29</td>
</tr>
</tbody>
</table>
The response above indicates that the main hindrance is lack of market information and therefore anybody or group that wishes to attract investors, first has to educate the public on the concept of pooled investment vehicles. Since 71% of the respondents have indicated that they would be willing to invest in mutual funds if given more information, we can say that this is an indication that there is a niche or investment gap to be filled by mutual funds.

4.3.4 Riskiness of Alternative Investments

We then sought to find out how respondents rated different types of investment instruments in terms of risk, the results of which are tabulated in Table 4-5 below.

One hundred and twenty-four (124) people indicated that they considered Savings Accounts as having the lowest level of risk. This was followed by land with a 71.17%. Government securities and Housing tied in third position with a 63.80% or 104 people.

Unquoted Shares on the other hand were considered as being the most risky type of investment among the options given by One hundred and twelve people giving us 68.71%. Thirty-five (35) of the respondents felt that Quoted Shares were a risky type of investment, thereby making them the second most risky type of investment. In this regard we can therefore conclude that Kenyans consider shares of whatever nature a risky type of investment, and the higher the risk level, the higher the expected returns.
The third most risky type of investment had Land and Unit Trusts that tied in the same position with a 7.36% response.

Government Securities and Housing tied once again in fourth place. Two (2) people classified Mutual funds as being very risky as contrasted with another three (3) who felt that Savings Accounts were very risky. A rather interesting response shows that whereas only two people thought of mutual funds as being very risky, twelve (12) of the respondents felt the same of unit trusts. The two types of investment are basically the same except for the origin and use of the terms as explained in Section 2.2.

The main concern for this paper is Mutual Funds and/or Unit Trusts. More than 50% (94) of the respondents classified Mutual Funds as being moderately risky.

This was followed by Quoted Shares which ninety-one (91) of the respondents classified as being moderately risky. Eighty-nine (89) people classified Unit Trusts as being moderately risky. This was followed by Government Securities and Housing with 38 and 37 respondents each respectively.

For the purposes of this analysis a multiplier of three (3) has been used for the most risky investment, two (2) for moderate risk and one (1) for investments with the lowest risk level. Savings Accounts are considered as having the lowest risk level followed by land and housing in second and third positions respectively.
Table 4.5 - Riskiness of Alternative Investments

<table>
<thead>
<tr>
<th>TYPE OF INVESTMENT</th>
<th>VERY RISKY</th>
<th>%</th>
<th>MODERATE RISK</th>
<th>%</th>
<th>LOW RISK</th>
<th>%</th>
<th>SCORE</th>
<th>RANK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Savings Account</td>
<td>3</td>
<td>1.84</td>
<td>26</td>
<td>15.95</td>
<td>124</td>
<td>76.07</td>
<td>179</td>
<td>1</td>
</tr>
<tr>
<td>Quoted Shares</td>
<td>35</td>
<td>21.47</td>
<td>91</td>
<td>55.83</td>
<td>27</td>
<td>16.56</td>
<td>314</td>
<td>7</td>
</tr>
<tr>
<td>Unquoted Shares</td>
<td>112</td>
<td>68.71</td>
<td>29</td>
<td>17.79</td>
<td>8</td>
<td>4.91</td>
<td>402</td>
<td>8</td>
</tr>
<tr>
<td>Mutual Funds</td>
<td>2</td>
<td>1.23</td>
<td>94</td>
<td>57.67</td>
<td>48</td>
<td>29.45</td>
<td>242</td>
<td>5</td>
</tr>
<tr>
<td>Unit Trusts</td>
<td>12</td>
<td>7.36</td>
<td>89</td>
<td>54.60</td>
<td>39</td>
<td>23.93</td>
<td>253</td>
<td>6</td>
</tr>
<tr>
<td>Government Securities</td>
<td>11</td>
<td>6.75</td>
<td>38</td>
<td>23.31</td>
<td>104</td>
<td>63.80</td>
<td>213</td>
<td>4</td>
</tr>
<tr>
<td>Housing</td>
<td>11</td>
<td>6.75</td>
<td>37</td>
<td>22.70</td>
<td>104</td>
<td>63.80</td>
<td>211</td>
<td>3</td>
</tr>
<tr>
<td>Land</td>
<td>12</td>
<td>7.36</td>
<td>25</td>
<td>15.34</td>
<td>116</td>
<td>71.17</td>
<td>202</td>
<td>2</td>
</tr>
</tbody>
</table>
It is evidently clear from the above table that mutual funds are classified as being moderately risky investment instruments. They are considered less risky than both quoted and unquoted shares. This further supports the previous deduction that there is an investment gap in Kenya which can be filled by the pooled investment vehicles.

The Kenya Fund Management Company Ltd. intends to initially open two types of funds;

a. Balanced Fund
b. Money Market Fund

The Balanced fund will assist in bridging the investment gap between the stock market and the money market. This is clearly shown on Table 4.5 where Savings Accounts are regarded as the least risky form of investment as compared to both quoted and unquoted shares that are regarded as the most risky form of investment. Not everybody can afford to invest in the securities such as land, and housing which are regarded as being moderately risky. Mutual funds will therefore provide an alternative and yet affordable medium of investment.

The money market fund which will invest in the money market instruments promises to deliver better returns than Savings accounts which are regarded as being safest form of investment. The respondents classified Mutual Funds and Unit Trusts as being moderately risky as opposed to Savings Accounts because the returns expected from the former are higher than those expected from savings accounts. It is therefore expected that the
money market fund will attract many investors who are seeking better returns on their money.

4.3.5 Portfolio Rankings

It is imperative from the above analysis that we find out the type of portfolios that are attractive to the respondents.

The respondents were asked to rank four potential portfolio strategies with one (1) being the best and four (4) the least. For the purposes of this analysis we have used a multiplier of four (4) for the best option and one (1) for least as tabulated here below.

Table 4.6 - Portfolio Rankings

<table>
<thead>
<tr>
<th>TYPE</th>
<th>SCORE</th>
<th>RANK</th>
</tr>
</thead>
<tbody>
<tr>
<td>High Yield</td>
<td>432</td>
<td>1</td>
</tr>
<tr>
<td>High Growth</td>
<td>363</td>
<td>2</td>
</tr>
<tr>
<td>All Shares</td>
<td>351</td>
<td>4</td>
</tr>
<tr>
<td>High Income</td>
<td>355</td>
<td>3</td>
</tr>
</tbody>
</table>

The above results indicate that most of the respondents would look for investment instruments that will give a high yield in the shortest time possible.
Fund managers would thus use strategies that will maximise each of the expected returns as classified above. They would tailor the portfolio in such a manner that the investments give high yield first priority, followed by high growth, high income and finally an all round portfolio.

4.3.6 Diversification and Spread of Risk

In another question the respondents were asked for their opinion with regard to diversification and spread of risk. One hundred forty-nine (149) people felt that spreading risk was a good thing whereas another nine (9) thought it was not. This further shows that a majority of the respondents know that the spread of risk is beneficial to the investor. Mutual funds spread risk over a diversified portfolio and therefore investors will be attracted by this aspect.

4.3.7 Fund Management

Mutual funds and/or Unit Trusts require professional fund managers, and when we enquired about the respondents' preferences in the selection of shares the responses were as tabulated in table 4.7.

Table 4.7 - Fund Management Preferences

<table>
<thead>
<tr>
<th>PREFERENCE</th>
<th>RESPONDENTS</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Self</td>
<td>47</td>
<td>28.83</td>
</tr>
<tr>
<td>Fund Manager</td>
<td>99</td>
<td>60.73</td>
</tr>
<tr>
<td>Not Sure</td>
<td>16</td>
<td>9.82</td>
</tr>
</tbody>
</table>
The results indicate that over 60% of the respondents prefer to the services of a fund manager as opposed to being direct equity investors. The reasons for this are that the individual either lacks the time to track the performance, does not have the know-how, expertise required to transform the information obtained to yield high results, and experience.

The fund management company and the fund managers have an advantage over the direct equity investor in all of the above areas as this is their area of expertise. They therefore often make better decisions than the direct equity investor. They also have more funds at their disposal and they are thus able to achieve very high yields through portfolio diversification, for example, if they make a risky investment the degree of riskiness will be compensated by another instrument in the portfolio.
CHAPTER FIVE
CONCLUSIONS

5.1 CONCLUSIONS

The main objective of this survey was to find out if Kenya's financial sector is ready for mutual funds or pooled investment vehicles. This was carried out by way of an opinion poll as shown on Section 3.2. The results of the survey are also shown on Appendix II.

Although Kenya's financial sector is rapidly changing as a result of the liberalisation of the economy, we lack the mechanism to allow investors to profitably get the highest returns on their money at the minimum possible risk.

This paper has been able to establish that there is an investment gap in Kenya's financial sector. The gap can be filled by pooled investment vehicles which according to the results obtained are considered to be of moderate risk. They have better earnings than Savings accounts which are presently deemed to be safer than government securities.

We can conclusively state that Kenya's financial sector is ready for mutual funds. This can be deducted from the our establishment that there are investment gaps in Kenya which lie between the money market; real properties like land and houses; and shares of both publicly quoted and privately held corporations.
The gap that is there is for investors looking for short to medium term instruments that are within their means and have returns higher than what the average Bank account offers.

The investment institutions that can fill this gap are pooled investment vehicles which are popularly used in other countries and will soon be operational in Kenya as the first has already been licensed.

This paper has been able to establish that there is an investment gap in Kenya and research is encouraged to find out why nobody wants to take the initiative to fill the niche in the market. Kenya is rated among the emerging markets in Sub-Saharan Africa and we would therefore expect pooled investment vehicles to be in place, but as this is not the case, research should be carried out establish why.

5.2 LIMITATIONS OF THE STUDY

The scope of this study was limited by several factors. The first limitation is that the questionnaires were distributed to people residing in Nairobi only; being Kenya's Capital city, it was assumed that it represents people from all walks of life. The second limitation is that majority of the respondents were University graduates and therefore the results might be biased towards giving a favourable response.
5.3 SUGGESTIONS FOR FURTHER RESEARCH

This study was only carried out in Nairobi and research is encouraged to be carried in other areas of the country. This should find out if what has been established here applies in other areas as well.
APPENDIX I

INVESTOR SURVEY INSTRUMENT
November 3, 1995

MUTUAL FUNDS MARKET SURVEY

Dear Respondent,

We are conducting a study to find out if Kenya's financial sector is ready for mutual funds.

A mutual fund generally refers to an investment company that pools together the resources of individual investors to buy a collection of stocks, bonds and other securities. As a mutual fund investor you are entitled to the income earned by the block of shares as each mutual fund share you own represents your proportionate share of all the stocks and bonds that make up the fund's investment portfolio. When you invest into a mutual fund, you avoid the need to buy shares directly and leave this job to the fund manager. Mutual funds assist the investor to spread the risk over a diversified portfolio and transaction costs are also minimised.

In the following pages we have questions and statements which we would be pleased if you could respond to for us. Your honest responses are sought.

Thanking you for your time and co-operation.

THE RESEARCHER
APPENDIX II

SUMMARY SURVEY STATISTICS
1. Have you ever heard of Mutual Funds?
   ☐ Yes ☐ No

Have you ever heard of Unit Trusts?
   ☐ Yes ☐ No

If you have answered NO, in both cases, go to question 11, otherwise continue.

2. If you have heard of Mutual Funds or Unit Trusts, how would you describe your familiarity with them as a form of Investment?
   ☐ I have invested in one
      (Please name it: __________________________)
   ☐ I am fully aware of what they are.
   ☐ I have vague knowledge of what they are.
   ☐ I have heard the names.

For questions 3 - 10 use the following key to indicate your level of understanding regarding mutual fund investing.

1 = very knowledgeable
2 = somewhat knowledgeable
3 = not at all knowledgeable

HOW FAMILIAR ARE YOU WITH:

3. The advantages of investing in mutual funds? ☐

4. The risks involved in investing in mutual funds? ☐
5. The process of opening a mutual fund account? □
6. The costs involved in mutual fund ownership? □
7. Tracking a mutual fund's performance? □
8. Diversification in mutual fund investing? □
9. Sources of information about mutual funds? □
10. The many varied types of mutual funds? □
11. If you have not invested in a Mutual Fund or Unit Trust would you be willing to invest in one?
   □ Yes, but I need to know more about them.
   □ Yes, if more mutual funds were available.
   □ No.
   □ They are too new in Kenya.
   □ There are better ways to invest.
12. Do you invest in the shares floated on the Nairobi Stock Exchange?
   □ Yes □ No
   If you answered NO, go to question 14, otherwise continue.
13. How diversified is your portfolio, that is, how many companies' shares do you invest in at a time?
   □ 1-3 companies □ 3-5 companies
   □ 5-7 companies □ More than seven companies
14. The main feature about mutual funds is that it takes away from the investor the need to invest in only the shares of one company at a time. He or she can spread the risk around more shares. Do you think this is a good thing?

☐ Yes  ☐ No

15. Given the choice between doing the selection of shares for yourself and having a professional manager do it for you, which would you prefer?

☐ I prefer to select for myself.

☐ I prefer to let a manager do it.

☐ I am not sure.

16. Risk is the chance that you will not get the return you had expected to get from an investment you make. How would you rate the following investments?

Use the following key

1 = Very risky
2 = Moderate risk
3 = Low risk

a. Savings account  ☐ b. Quoted shares  ☐

c. Unquoted shares  ☐ d. Mutual funds  ☐

e. Unit trusts  ☐ f. Government securities  ☐

g. Housing  ☐ h. Land  ☐
17. Some of the expected results from investing in mutual funds are listed below, please arrange them in the order you would most prefer: (1 being the best and 4 the least).

- High yield (rate of return on investment).
- High growth.
- All shares - spreading the risk all around.
- High income.

18. Which of the following would you broadly state as being your reasons for investing?

- Meeting liquidity needs.
- Saving for a large expenditure.
- Retirement planning.
- Speculating.

19. I would describe myself as:

- An upper income employed person.
- An upper income businessman.
- Middle income person.
- Lower income person.

Upper Income: KShs. 50,000/= per month and above.
Middle Income: KShs. 20,000/= - 50,000/= per month.
Lower Income: Up to KShs. 20,000/= per month.
20. My educational level is (tick highest attained).
   □ Up to Primary level    □ High School
   □ University

21. My age is
   □ 20-30 years    □ 31-40 years    □ 41-50 years
   □ 51-60 years    □ Over 60 years

Thank you very much for your time and replies.
1. Have you ever heard of Mutual Funds?
   □109 Yes □54 No ] BOTH
   Have you ever heard of Unit Trusts? ] YES 93
   □101 Yes □62 No ] NO 46
   If you have answered NO, in both cases, go to question 11, otherwise continue.

2. If you have heard of Mutual Funds or Unit Trusts, how would you describe your familiarity with them as a form of Investment?
   2□ I have invested in one
   (Please name it: UNIT TRUST OF INDIA)
   53□ I am fully aware of what they are.
   52□ I have vague knowledge of what they are.
   8□ I have heard the names.
   For questions 3 - 10 use the following key to indicate your level of understanding regarding mutual fund investing.
   1 = very knowledgeable
   2 = somewhat knowledgeable
   3 = not at all knowledgeable
   HOW FAMILIAR ARE YOU WITH :

   3. The advantages of investing in mutual funds? □ 33 67 18
   4. The risks involved in investing in mutual funds? □ 24 66 28
   5. The process of opening a mutual fund account? □ 19 41 58
   6. The costs involved in mutual fund ownership? □ 15 42 61
   7. Tracking a mutual fund's performance? □ 15 45 56
   8. Diversification in mutual fund investing? □ 28 46 42
   9. Sources of information about mutual funds? □ 22 53 41
   10. The many varied types of mutual funds? □ 19 48 48
11. If you have not invested in a Mutual Fund or Unit Trust would you be willing to invest in one?
   116 □ Yes, but I need to know more about them.
   21 □ Yes, if more mutual funds were available.
   7 □ No.
   9 □ They are too new in Kenya.
   7 □ There are better ways to invest.

12. Do you invest in the shares floated on the Nairobi Stock Exchange?
    73 □ Yes  88 □ No
    If you answered NO, go to question 14, otherwise continue.

13. How diversified is your portfolio, that is, how many companies' shares do you invest in at a time?
    48 □ 1-3 companies  11 □ 3-5 companies
    3 □ 5-7 companies   11 □ More than seven companies

14. The main feature about mutual funds is that it takes away from the investor the need to invest in only the shares of one company at a time. He or she can spread the risk around more shares. Do you think this is a good thing?
    149 □ Yes  9 □ No

15. Given the choice between doing the selection of shares for yourself and having a professional manager do it for you, which would you prefer?
    47 □ I prefer to select for myself.
    99 □ I prefer to let a manager do it.
    16 □ I am not sure.
16. Risk is the chance that you will not get the return you had expected to get from an investment you make. How would you rate the following investments?

Use the following key

1 = Very risky
2 = Moderate risk
3 = Low risk

a. Savings account
b. Quoted shares

c. Unquoted shares
d. Mutual funds

e. Unit trusts
f. Government securities

g. Housing
h. Land

<table>
<thead>
<tr>
<th>TYPE OF INVESTMENT</th>
<th>VERY RISKY</th>
<th>MODERATE RISK</th>
<th>LOW RISK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Savings Account</td>
<td>3</td>
<td>26</td>
<td>124</td>
</tr>
<tr>
<td>Quoted Shares</td>
<td>35</td>
<td>91</td>
<td>27</td>
</tr>
<tr>
<td>Unquoted Shares</td>
<td>112</td>
<td>29</td>
<td>8</td>
</tr>
<tr>
<td>Mutual Funds</td>
<td>2</td>
<td>94</td>
<td>48</td>
</tr>
<tr>
<td>Unit Trusts</td>
<td>12</td>
<td>89</td>
<td>39</td>
</tr>
<tr>
<td>Government Securities</td>
<td>11</td>
<td>38</td>
<td>104</td>
</tr>
<tr>
<td>Housing</td>
<td>11</td>
<td>37</td>
<td>104</td>
</tr>
<tr>
<td>Land</td>
<td>12</td>
<td>25</td>
<td>116</td>
</tr>
</tbody>
</table>
7. Some of the expected results from investing in mutual funds, are listed below, please arrange them in the order you would most prefer: (1 being the best and 4 the least).

- High yield (rate of return on investment).
- High growth.
- All shares - spreading the risk all around.
- High income.

<table>
<thead>
<tr>
<th>EXPECTATIONS</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td>High Yield</td>
<td>57</td>
<td>43</td>
<td>29</td>
<td>17</td>
</tr>
<tr>
<td>High Growth</td>
<td>25</td>
<td>40</td>
<td>62</td>
<td>19</td>
</tr>
<tr>
<td>All Shares</td>
<td>44</td>
<td>27</td>
<td>18</td>
<td>58</td>
</tr>
<tr>
<td>High Income</td>
<td>30</td>
<td>43</td>
<td>33</td>
<td>40</td>
</tr>
</tbody>
</table>

18. Which of the following would you broadly state as being your reasons for investing?

- 33 High yield (rate of return on investment).
- 49 High growth.
- 35 All shares - spreading the risk all around.
- 48 High income.

Meeting liquidity needs.
Saving for a large expenditure.
Retirement planning.
Speculating.
9. I would describe myself as:
   20 ☐ An upper income employed person.
   10 ☐ An upper income businessman.
   59 ☐ Middle income person.
   65 ☐ Lower income person.

   Upper Income:  KShs.50,000/= per month and above.
   Middle Income:  KShs.20,000/= - 50,000/= per month.
   Lower Income:  Up to KShs.20,000/= per month.

20. My educational level is (tick highest attained).
   4 ☐ Up to Primary level  51 ☐ High School
   104 ☐ University

21. My age is
   97 ☐ 20-30 years  44 ☐ 31-40 years  13 ☐ 41-50 years
   5 ☐ 51-60 years  1 ☐ Over 60 years
BIBLIOGRAPHY


