“PROSPECTS FOR THE ESTABLISHMENT OF MUTUAL FUNDS IN KENYA'S FINANCIAL SECTOR”

BY

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DECLARATION

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

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

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ABSTRACT

This study examines the prospects for the establishment of mutual funds in Kenya's financial sector. This is accomplished by investigating the reasons for their absence and reviewing measures towards their establishment that are planned or being implemented by their most likely promoters. Extensive interviews were conducted with persons from the industry possessing expert knowledge and their views, along with consideration of practical measures being taken towards establishment of mutual funds, inform the conclusions of the study. Owing to lack of education about the mutual funds concept, perception among the likely promoters that existing legislation is inadequate, their overall lack of interest in mutual funds, as well as negative market sentiment, the near-term prospects of mutual funds do not appear bright.

Chapter 1 contains the introduction, problem statement, and the objectives and significance of the study. Chapter 2 contains the literature review. The chapter includes a detailed presentation of this type of investment instrument, a review of its historical development in the United States, where it is most developed, as well as a review of some of the topical issues relating to the run-away development of the mutual fund industry in that country. The chapter includes an examination of Kenya's experience with collective investment schemes, seen as important precursors to the establishment of mutual funds in the country. Chapter 3 details the research methodology employed in determining the prospects for mutual funds in Kenya, while Chapter 4 presents the findings. Chapter 5 draws conclusions, recognizes the limitations of the study and makes recommendations for further research.
CHAPTER 1: INTRODUCTION

1.1 BACKGROUND

This study reviews the prospects for the establishment of mutual funds in Kenya’s financial sector. Mutual funds are “pooled” financial institutions or collective investment vehicles (CIVs), the resources of which are invested in the capital and money markets, through purchase of such instruments as stocks, corporate bonds and treasury bills and bonds. Through mutual funds, a large number of relatively small investors are able to “pool” their resources and thereby access certain advantages that would not otherwise be available to them individually, as they are ordinarily only available to large and institutional investors. Such advantages include access to professional financial management, portfolio diversification, low transaction costs, ease of portfolio re-alignment and other economies of scale.

But beyond these benefits that accrue to the investors, mutual funds play a crucial role in mobilizing savings and availing these to the productive sectors of the economy through capital markets. They also provide to the ‘man on the street’ a meaningful and convenient way to participate in the growth of his country’s economy and thereby share ‘a piece of the action.’ From humble beginnings late in the nineteenth century, mutual funds now command immense and growing financial clout, especially in the developed capital markets. In the USA, for example, mutual funds control assets in excess of US$ 5 trillion (Investment Company Institute 1998). Total assets in mutual funds world-wide were projected to increase from US$ 7 trillion as at the end of 1997 to US$ 30 trillion in 2007, with the amount in assets outside the US growing seven fold from US$ 2 trillion to US$ 15 trillion over the same period (Cresswell 1998).
Mutual funds in the US are now worth more than either its pension funds or its insurers, and are poised to overtake banks as the biggest repository of the nation's wealth (Economist 1997, I).

Given these advantages and the great potential that mutual funds hold for individuals and the economy as a whole, and given the ever-increasing role that mutual funds are set to play in the global financial markets, one would expect to find fairly active mutual funds in our country's financial sector. In recognition of their important role in the development of the country's economy, legislation to facilitate unit trusts, a variant of mutual funds, was passed in 1965 through the Unit Trusts Act, CAP 521 of the Laws of Kenya. The Act was revised in 1990 in a bid to make unit trusts more attractive. To date, however, there are no unit trusts or mutual funds in operation in the country, except for the Zimele Multi-purpose Cooperative Society founded in 1999. Although structured to operate as a mutual fund, Zimele has had to seek registration under the Cooperatives Act revised in 1997. The Kenya Funds Management Company (KENFUND), which was affiliated to the collapsed Kenya Finance Bank and enjoined to the International Finance Corporation (IFC), is the only institution known to have actively sought registration (in 1993) under the Unit Trusts Act from the industry regulator, the Capital Markets Authority (CMA). The application was denied owing to the financial difficulties that engulfed the initiating company, the Kenya Finance Trust.
1.2 Statement of the Problem

This absence of mutual funds in Kenya’s financial sector is curious, particularly in light of the fact that Kenyans are no strangers to pooling of resources. The appeal of “pooled” or collective investment schemes locally is manifested through such flourishing examples as the co-operative movement, land buying groups, women’s groups and, more recently, informal investment clubs. The rational extension of such collective initiatives would seem to be the introduction of formal, professionally managed mutual funds or unit trusts. But with the exception of Zimele Cooperative, as noted above, this has not happened. There are no mutual funds in operation in the country. This study, therefore, seeks to provide an explanation for the absence of mutual funds in Kenya and to review the prospects for their establishment.

Mutual funds provide an ideal mechanism for dis-intermediation between banks and savers, and would be expected to appeal to our relatively unsophisticated investing public. This is particularly so in view of the fact that the number of investment opportunities for the average Kenyan investor has tended to be limited to the traditional asset classes such as real estate and fixed deposits. With the on-going liberalization of the economy and development of our capital markets, however, a significant increase in investment opportunities can be expected. Diversification into non-traditional classes, including domestic, regional and offshore equities, fixed income and money market instruments and venture capital funds, would represent new avenues for channeling of investible funds. To date, these non-traditional classes have tended to be limited to well-informed, large institutional investors. Professionally managed mutual funds represent a viable means for individual investors to access
these new asset classes, thereby injecting additional, probably considerable, resources into the capital markets, and developing the investors’ financial capacity to purchase housing, fund the higher education of their children, and provide for retirement, among other objectives.

1.3 Objectives of the Study

i) To investigate the obstacles which, according to industry experts, have contributed substantially to the absence of mutual funds in the country.

ii) To examine the prospects for the establishment of mutual funds in Kenya.

iii) To explore measures that are either being implemented or that are planned by the major players in Kenya’s financial sector, who represent the most likely promoters of mutual funds, and the likelihood of success of those measures in the present economic environment.

1.4 Significance of the Study

Research in this area is important because as experience in the developed capital markets of the world demonstrates, mutual funds have considerable potential to harness investible funds from both individuals and institutions. In an environment such as ours, where interest rates tend to be prohibitively high, the role of capital markets in dis-intermediating between the banks and savers is critical in spurring economic activity. This study should, therefore, prove important to the following:

i) Individual investors looking for alternatives to the traditional asset classes.
ii) Institutions such as banks and asset management companies, which are the most likely promoters of mutual funds.

iii) The Nairobi Stock Exchange, which would have to create absorption capacity for investible funds, harnessed through mutual funds.

iv) The Government of Kenya, specifically, the Capital Markets Authority which is the industry’s sole regulator, and, generally, departments within the Treasury that are charged with formulation of financial policy.
CHAPTER 2: LITERATURE REVIEW

2.1 Structure of mutual funds

Mutual funds are investment companies or investment trusts that raise or “pool” funds from a large number of investors by selling shares. The funds so raised are placed under professional management for purchase of financial assets for the benefit of shareholders. Rose and Kolari (1995) point out that although investments in the fund may be by either large or small savers, the investment company exists primarily to offer the small saver a means to diversify asset portfolios in a manner unattainable except with a very large portfolio.

Investment companies are of two types, open-end and close-end. Open-end investment companies are the ones known as mutual funds. These are obligated to redeem shares at the request of the shareholder. When a shareholder redeems shares, he or she receives their net asset value (NAV), which equals the value of the fund’s net assets divided by the number of shares outstanding. An investment manager determines the composition of the fund’s investment portfolio in accordance with the fund’s return objectives and risk criteria. A closed-end investment company operates like any other public company in that it issues a fixed number of shares and its stock trades on a secondary market. The market price of the shares is determined by supply and demand, which means that a closed-end fund can sell at a premium or
discount to its NAV. Reilly (1994) informs us that the U.S. market price of these shares has historically been at a discount to the NAV of 5 to 20%. The Kenyan Unit Trusts Act of 1965 establishes in Section 12 the obligation of the unit trust manager to buy back the interest of a unit holder on request, thereby conferring upon the unit trust the distinguishing characteristic of a mutual fund – that of being open-ended. For the purposes of this project, the terms mutual funds and unit trusts are, therefore, used interchangeably. Mutual funds that charge a sales commission for sale of shares are referred to as 'load funds' while a 'no-load fund' imposes no initial sales charge so it sells shares at their NAV, with a charge of a small redemption fee. The desire to spread the cost of the load over time may make a shareholder reluctant to sell in the short run. For example, Ippolito (1992) finds that poor performance leads to half as many withdrawals from load funds as from no-load funds. Chordia (1996) also provides evidence that such fees discourage redemptions.

The Investment Company Institute (1989) of the USA categorizes mutual funds into 21 groups categorized by investment objectives. These include 'Common stock funds' that invest almost solely in common stocks their primary objective being to provide long-term capital growth. 'Bond funds' emphasize current income by investing in corporate, municipal or government debt obligation, or some combination of these. 'Balanced funds' combine some of the traits of stock and bond funds in a single portfolio. 'Money market funds' seek income, liquidity and a stable share price by investing in high-quality, short-term investments, including certificates of deposits and Treasury Bills. Remolona and Kleiman (1997) point out that it is important to gauge a fund's performance
relative to its objective because the different objectives represent trade-offs between risk and return. Some objectives aim for high returns at high risk, others for more modest returns but at less risk.

It should also be noted that in addition to the advantages that mutual funds possess, as outlined above, they do entail disadvantages as well. For one, they offer no guarantees. Unlike bank deposits, investments in the fund can fall in value. There is also the element of diversification "penalty": While diversification can help eliminate risk of loss from holding a single security, it limits potential for a "big score" if a single security increases dramatically in value. Potentially high costs are another disadvantage. Further, while mutual funds can be a cost-effective way to buy a variety of securities, in some cases, the efficiencies of fund ownership can be offset by a combination of steep sales commissions, redemption and other fees, and high operating expenses.

Sharma (1990) observes that Collective Investment Vehicles (CIVs) are important institutional participants in the capital markets of the developed countries and their importance in countries with relatively less developed financial markets is increasing. The study presents a general background of these financial institutions and reviews such operational issues as the various legal forms that they take, organizational structuring, the principal types of costs associated with investment companies, profit distribution, investment policies, underwriting and retailing of share issues, as well as various criteria for assessing performance of investment funds. An important fact highlighted is that mutual funds are passive investors in that they do not usually exercise
control over their investee companies and in this sense are quite different from holding companies. Included in the study is a review of regulations governing collective investment vehicles in nine selected countries in Europe (France, Germany, Ireland, Italy, Spain, United Kingdom), the United States and Canada, as well as Bermuda. The study observed that at the time, CIVs were more predominant in the capital markets of Europe than in the US markets owing in part to their use as vehicles for investing retirement savings. However, the study also notes that the use of investment funds for this purpose was also becoming more common in the US as evidenced by the increase in assets of Individual Retirement Account mutual funds.

According to Greenhalgh (1996), the term ‘unit trusts’ is used in the UK in reference to closed-end investment trusts, which were the ones in existence until the publication in 1996 of new Treasury Regulations on open-ended investment companies (OEICS) or ‘investment companies with variable capital.’ These, in effect, would become the UK equivalent of mutual funds. Greenhalgh (1996) outlines the background to the development of OEICS, discusses their structure and the procedure for their establishment, reviews the regulatory regime under which they were to operate and the key players and documents involved. In contrasting OEICS with unit trusts, Greenhalgh points out that they have a similar relationship between price and the underlying securities, and similar tax treatment. However, the legal structure of a unit trust and an OEIC is different, principally because OEICs have a corporate structure, while unit trusts are governed by trust law. This offers OEICs greater flexibility than unit trusts in terms of investment options. While observing that unit trusts
have served the UK well, Greenhalgh predicts that within the UK retail domestic market, OEICs may become the accepted collective investment vehicle of the future.

2.2 Empirical studies

Remolona and Kleiman (1997) note that although mutual funds have existed in the United States since 1924, truly significant amounts of money did not start flowing into the funds until the mid-1980s. A decline in deposit rates in the early 1990s marked the beginning of explosive growth in the funds. Household investment in mutual funds increased more than fivefold in the ten years preceding the study, making mutual funds the fastest growing item on the balance sheet of most American households. Most of the growth came at the expense of more traditional forms of savings, particularly bank deposits. Remarkably on this unprecedented growth, they observed that with the increase in the popularity of mutual funds came increased concerns – namely, whether a sharp drop in stock or bond prices could set off a cascade of redemptions by fund investors and whether the redemptions could exert further pressure on asset markets. Research on this issue has already confirmed high correlations between market returns and aggregate mutual fund flows (Warther 1995). In the same vein, commentators such as Kaufman (1994) have raised the specter of widespread financial distress should rising American interest rates scare investors into redeeming their funds in a panic, creating a vicious spiral of falling prices.
In their detailed investigation of these concerns, Remolona and Kleiman (1997) observe that in recent years, flows into funds have generally tended to accompany market upturns and outflows have tended to accompany downturns. This correlation raises the question whether a positive-feedback process is at work, in which market returns cause the flows at the same time that the flows cause the returns, with consequent fears that such a process could turn a decline in the stock or bond market into a downward spiral in asset prices. The study uses historical evidence to explore the effect of short-term market returns on mutual fund flows. The effect of market-wide returns on aggregate mutual fund flows is examined within a period of a month, as opposed to a year, a level of aggregation and time horizon that the authors feel is more consistent with the dynamics of a downward spiral in asset prices. The study concludes that despite observers’ fears of a downward spiral, the short-term effect of market returns on mutual fund flows typically has been too weak to sustain a spiral. The study finds that during unusually severe market declines, stock and bond movements have prompted proportionately greater outflows than under normal conditions, but even at these times, the effect has not seemed strong enough to perpetuate a sharp fall in asset prices.

The Economist (1995) further explores the question of whether the explosive growth of the mutual fund industry makes the US financial system potentially vulnerable to panic withdrawals, thereby undermining its stability. Observing that the extra-ordinary growth of the industry has changed American financial topography more dramatically than any other trend, the Economist nonetheless maintains that the likelihood of a swift mutual fund meltdown still seems
remote. The study notes that fears of a meltdown hinge on the observation
that, unlike bank loans, for example, mutual fund investments are largely
discretionary and can be withdrawn as quickly as it takes to make a telephone
call. Thus the more clout mutual funds acquire, the more financial markets are
exposed to the possibility of sudden lurches as nervous investors take fright.
The study observes that there is little hard evidence to support such fears. For
one thing, an increasing amount of mutual fund money is tied up in
individual's retirement accounts which, by their nature, tend to have a long-
term outlook. The study also cites research by the Investment Company
Institute, which found that, over the long term, flows of new money into equity
mutual funds show little correlation with the total return on the big stock
market indices. This would mean that investors do not necessarily rush to sell
when markets fall, nor do they necessarily jump in to rising markets.
Moreover, 40% of mutual funds are held by institutions such as pension funds,
a fact that belies the image of an industry dominated by nervous retail
investors. The study also points to several precedents, such as the American
bond market collapse of 1994, which show that fears about the likely behavior
of mutual fund investors can be exaggerated. Although such events led to some
redemptions, there was no capital flight on anything like the scale that would
have been caused by an 'old-style run on a tottering bank.'

The rapid growth of the mutual fund industry in the US has prompted Hale
(1994) to suggest that the rise of mutual funds is creating a whole new financial
system. So much so that policy makers who once worried about the impact of
failing banks on the economy now fret instead about mutual funds. In
reviewing the effects of the remarkable growth of mutual funds on the American Economy, Hale notes that first, it has provided a new channel for monetary policy to buoy the economy by broadening the number of households able to benefit from rising bond and equity prices. Second, the mutual fund boom has helped facilitate a dramatic expansion of securitized forms of credit at a time when commercial banks have been focusing on ‘reconstruction of their balance sheets and pursuing moro-conservative lending policies.’ Hale further observes that the improved access to equity and debt finance from small- and medium-sized companies is important for job creation because practically all of America’s employment growth since 1980 has been concentrated in that sector. But Hale goes on to caution that although the mutual fund boom has had positive side effects for the most part, the sheer household changes now occurring in flows of American household savings raise a number of provocative questions about both financial regulatory policy and the future stability of the financial markets. Concern revolves around anxiety that the household sector will be potentially vulnerable to wealth losses from declining financial asset prices if interest rates rise sharply in the future. Concern is also expressed that the government (American) is pursuing asymmetrical financial regulatory policies, by imposing numerous rules and guidelines on the investment policies of the commercial banking sector, in order to both insure capital adequacy and promote various social objectives – such as increased lending to poor neighborhoods and minority groups, while its primary objective in mutual fund regulation has been to promote adequate disclosure of information. This has lead to complaints from the banks that the government is imposing new social costs on them, despite shrinkage occurring in their share of the financial
intermediation industry. Hale also observes that a third economic side effect of the mutual fund boom has been a large expansion of capital outflows from the United States through purchase of foreign securities by international and country funds.

Fredman (1996) focuses on the concept of investment risk in mutual funds and examines the various types of risks that mutual fund investors need to be educated about. The study reviews such classifications as inflation risk or loss of asset value due to inflation; market risk; interest-rate risk – loss of asset value due to fluctuations in interest rates, currency risk – loss of asset value due to fluctuations in value of currencies, and asset class risk, these being the most common, and emphasizes that those who understand the various elements of risk are better equipped to enjoy a profitable long-term investment journey. Other pitfalls highlighted are management risk – the risk of ending up with poor portfolio managers; sector risk – faced by those who invest in narrowly focused sector portfolios; country risk – such dangers as economic and political instability associated with single-country funds, especially those targeting developing countries; as well as credit risk and tax-rate risk. Among the suggestions recommended to handle risk better include allocating assets among diverse fund categories, adopting a long term perspective – riding out market lows and highs over the long term and not jumping in and out of shareholding with every twist in market price, continually weeding out ‘laggards’ – funds that have lagged their peers over the past 18 to 24 months, avoiding hardcore market timing – the tendency to always seek to buy low and sell high, as well as being disciplined and using dollar cost averaging – investing
a specific amount in a specific stock fund every month, regardless of market ups and downs.

Emerging markets, defined by the World Bank as countries with a gross national product of less than $9,385 per person, are commanding increasing attention from the mutual fund industry in developed capital markets. Kantrow (1998) points out that while the emerging markets can be extremely volatile and fraught with political and economic risk, there is a strong case for investing in them. Among the most compelling arguments is the belief that the world's developed nations are overextended and growing slowly. The economies of the world's 24 developed nations are expected to grow 2% to 3% annually between 1996 and 2005, while the world's 71 developing nations will log an economic growth rate of 6% to 8%. Similarly, the emerging markets were expected to account 20% to 25% of the world's market capitalization in the year 2000, up from 11.3% in 1996 (ibid.) Among the countries touted as good emerging market prospects are Russia and South Africa. But not all emerging markets are bright, and the meteoric rise and rapid demise of the domestic mutual fund industry in Indonesia is used as a precautionary tale of how the outlook for an emerging market can change dramatically overnight. While initially designed to attract retail investors, many of the country's funds were buoyed by banks, which, by August 1997, had put 3.1 trillion rupiahs into the Indonesian fund market. That turned into a huge problem when an economic crisis hit the country that summer and caused the rupiah's value to plunge. Investors in Indonesian mutual funds rushed to redeem their shares (ibid.)
Fairley (1996) provides an assessment of some specific emerging market funds, such as the Calvert New Africa Fund, a $9 million pan-African fund that focuses on Southern Africa. Other regions considered important include Latin America, Asia and Eastern Europe. But the study cautions that foreign funds are no short-term story, and advises prospective investors to "prepare to park your money through thick and thin for at least a decade." The study distinguishes foreign funds into two categories, global and international. The difference is that international funds hold securities exclusively outside the U.S. with no American exposure, while global funds hold U.S. as well as foreign securities. According to Morningstar, the Chicago-based firm cited in the study that tracks mutual funds, in 1995 the return on U.S. general equity mutual funds was 31.2% compared with 15.8% for global funds and 6.6% for international mutual funds. But analysts expected this trend to change dramatically, with Fairley (1996) recommending that in order to expose investment to a high-growth market, foreign funds are the best bet. Quinn and Ehrenfeld (1993) observe that of all the world's markets, Asia remains the most popular, fueled by booming intra-regional trade and China's dynamic growth. They point out that the success of these markets rests on privatization and growth. The Economist (1997, II), however, cautions about the barriers to competition and outright protectionism in many emerging-market countries, where fund management companies are either forbidden to sell to locals, or are forced to go through local intermediaries to do so.

Turning to Kenya's experience with collective investment vehicles, there were no such schemes to invest in the capital markets prior to the inception of Zimele
Multipurpose Cooperative Society in 1999. As noted above, there were unsuccessful attempts made in 1993 to register the KENFUND. However, demand for other types of collective investment vehicles in Kenya has been substantial. For the most part, such demand has been channeled through land buying companies, co-operative societies of various types, women's groups and more recently, investment companies, clubs and groups among the urban professionals with disposable income especially in Nairobi (Institute of Economic Affairs, IEA, 1998). Official statistics on the numbers and assets of these groups—with the exception of cooperative societies—are scarce. Some examples are available, though: For example, between 1963 and 1983, 24,000 land buying companies were formed in Kenya, pooling the funds of investors to buy farms after independence especially in the former white highlands (Leonard 1994). As another example, there were 4,576,000 members of co-operative societies at the end of 1995, of whom 3,284,000 were members of savings and credit societies (Statistical Abstract 1996). If one makes the assumption that 50% of Kenya's estimated 27.5 million population are over the age of 18, the figures indicate that slightly over one in three Kenyan adults belongs to a co-operative society and about one in five belongs to a savings and credit society (IEA 1998). Membership in registered women's groups tripled recently from 1,072,149 members in 1995 to 3,096,102 members in 1997 (Economic Survey 1998). This experience suggests widespread appreciation in Kenya of the power of pooling resources for purposes of investment, and is relevant to the prospects of mutual funds in the country's financial sector.
At the behest of the Capital Markets Authority (CMA) Deloitte and Touche (1994) examined why unit trusts had failed to take off in Kenya and concluded, among other issues, that regulation was not the cause of non-start up of unit trusts. Rather, it was perceptions of the market that this form of investment was not as interesting as other available forms of investment. They also concluded that the Kenyan investor is, in many ways, still ‘traditional’ preferring established investment avenues. The preference was for security but there were emerging patterns that suggested disenchantment with land and buildings as forms of investment. From their survey, most Kenyans did not know much about unit trusts, with only 14% of a sample of 400 having working familiarity with unit trusts.

These findings on the familiarity of Kenyan investors with unit trusts are an interesting comparison to those of Karau (1996) who sought to determine whether the Kenyan market was ready for mutual funds by analyzing the familiarity of existing and potential investors with the concept of these vehicles. Out of 165 respondents in the survey, 33% and 38% indicated familiarity with mutual funds and unit trusts respectively, with 28% indicating familiarity with both. However, only 1.7% had invested in any. Those claiming to be ‘fully aware’ of these instruments were 46% of the total, while 45% had only ‘vague knowledge’ of what they were. The study concluded that there was an investment gap in Kenya’s financial sector that could be filled by “pooled” investment vehicles such as mutual funds.
Other commentators have made reference to factors that have enabled the development of mutual funds in diverse settings. In their review of open-end investment funds in the European Economic Community, Corner and Stafford (1977) refer to legislative frameworks, selling methods and innovation, as well the size of domestic capital markets as having played an important role. Lambrechts (1994), in reviewing the historical development of the unit trust industry in South Africa, observes that the significant success of the industry owes much to the fact that unit trusts were launched in a period of rapid economic growth. "The appeal of unit trust investments grew rapidly as the unique combination of the industry's potential became more widely understood. The combination of professional management, spread of risk, liquidity on demand, simplicity of investment, tax effectiveness and relatively low entry costs were indeed hard to resist amid a general mood of confidence and an early record of performance that was better than forecast, or generally expected."

Hopkins (1990) details the impressive gains made by the Botswana government through an investment trust in enhancing public participation in government-sponsored investments and in promoting the concept of share ownership as an acceptable method of holding and enhancing wealth for Botswana citizens.

The research methodology for this study depends upon detailed interviews and opinions of experts in the industry. For this reason, it is important to point out that there are many other studies that apply the same methodology and depend upon interviews and expert opinions. For example, in their study of the differing perceptions and the fate of executives involved in foreign versus domestic acquisitions in the United States, Krug and Nigh (2001) interviewed
284 chief executives involved in such acquisitions. A better understanding of such perceptions was considered important given the increasing number of foreign acquisitions in that country, and the tendency of the popular press to focus on the negatives aspects of foreign acquisitions of U.S. companies and landmarks. Similarly, Johannisson and Huse (2000) rely on in-depth interviews and surveys of 12 family businesses in their study of how contrasting ideologies influence the selection process of outside directors in the small family business. As a further example, Feitelson and Lindsey (2001) rely upon in-depth interviews with county authorities in their study of factors that have affected local use of economic instruments in determining land use policies in the Chesapeake Bay Critical Area. (Their study arises out of recognition of the fact that in many countries and regions, there is a general devolution of authority to the lowest level of government, and local jurisdictions find themselves increasingly encumbered with responsibility for environmental programmes.)
CHAPTER 3: RESEARCH METHODOLOGY

3.1 Selection of subjects

In examining the prospects of mutual funds in Kenya, it is first necessary to gain an appreciation of some possible reasons why these institutions have failed to take off despite facilitating legislation having existed since 1965. Research in this area depends upon interviews with industry practitioners whose opinions are considered to be expert knowledge. This consideration arises from their formal training and years of experience, as well as their current professional responsibilities as chief stewards of some of the leading institutions in the financial sector. The same interviews are also used to determine, in a general sense, what the financial sector is doing, if anything at all, to overcome the obstacles identified. For it is to the extent that such measures are focused and determined that possibilities of establishing mutual funds exist. As justification for adopting this approach, studies that employ interviews and expert opinions in their methodology are cited in the previous chapter.

Although the population for this study is, potentially, all the firms and key individuals in the financial sector, the experts chosen for this study, comprising the sample, were from those institutions that have traditionally been the key promoters of mutual funds in developed countries. Justification for this approach can also be found in the studies cited in the previous chapter. These institutions in the sample were divided into four categories:
i) Banks and investment companies related to banking institutions,
ii) Independent investment and asset management firms,
iii) Insurance companies and investment companies related to insurance firms, and
iv) Stock brokers.

In each of these categories, firms that are market leaders in the local industry were sought, many of which are affiliates of multinational concerns. Particular effort was made to incorporate those firms whose international operations include mutual funds. A total of five interviewees from different institutions in each category were selected, with seven interviewees from the stock brokerage fraternity, resulting in a total of 22 principal respondents. The views of senior executives at the Capital Markets Authority, the sole regulating authority of capital markets in the country, and at the Nairobi Stock Exchange, the country's only bourse, were also incorporated into the research for a total of 24 respondents.

Through networking and direct contact, the researcher managed to obtain interviews with the chief executive officers of most of these institutions, or investment managers very close to the top. Thus, for example, the managing director of the country's largest investment services firm was among the respondents, along with the managing director of another leading banking institution, and two managing directors of asset management firms. The total
sample of 24 respondents included two expatriates affiliated to multinational concerns, as well as three female executives.

3.2 Data Collection

A questionnaire outlining the basic format of the interview (Appendix I) was sent in advance to each of the respondents and formal appointments made to meet in their offices. Containing a total of 16 open-ended questions, the questionnaire was designed as an aid to structure discussions around the key issues relating to the research problem. It was necessary to restrict the number of respondents to a manageable size because of the level of detail that discussion on each question entailed. The interviews turned out to be quite extensive and informative, with each lasting over an hour on average. With the permission of the respondents, a portable audio tape recorder was used to record the discussions, which upon playback proved useful in supplementing the notes taken at the interviews. The questionnaires used at the CMA and at the Nairobi Stock Exchange were close adaptations of the initial questionnaire.

3.3 Data Processing and Analysis

The interviews conducted were fully transcribed upon playback of the audiotapes. These transcriptions were then carefully reviewed for the essence of the respondents' views on each question. With the aid of notes taken at the interviews, the responses were then summarized onto a worksheet that enabled the researcher to determine the incidence of factors cited, as well as the extent
to which the respective institutions of the respondents were actively pursuing establishment of mutual funds.

Validation of the views of the individual respondents is achieved, essentially, by comparison with the results from the entire sample. This means that whereas every response is noted, it is those responses that are cited most frequently that are used in arriving at a conclusion. Where applicable, comparisons are also made with the findings of the Deloitte and Touche survey. This helps identify factors cited in that report that remain relevant.
The views expressed in the interviews by the industry experts are presented in this chapter. In the first instance, the interview sought to know from the experts what they considered to be the factors that impede the growth and development of mutual funds. These are summarized in Table 4.1 below. The table indicates the number of respondents who cited each factor from among the total of 24 in the sample.

Table 4.1  
Factors that impede Growth and Development of Mutual Funds

<table>
<thead>
<tr>
<th>Factor</th>
<th>Number of citations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lack of understanding of the mutual fund concept among the investing public</td>
<td>21</td>
</tr>
<tr>
<td>Inadequate legislation</td>
<td>17</td>
</tr>
<tr>
<td>Lack of interest on the part of potential promoters</td>
<td>14</td>
</tr>
<tr>
<td>Lack of qualified professionals to manage such institutions</td>
<td>9</td>
</tr>
<tr>
<td>Capital market not developed</td>
<td>7</td>
</tr>
<tr>
<td>Competition from high Treasury Bill rates</td>
<td>4</td>
</tr>
<tr>
<td>No one has ever tried to launch</td>
<td>1</td>
</tr>
</tbody>
</table>

When asked to rank these factors in order of importance, 9 of the respondents cited lack of understanding as most important, 7 ranked inadequate legislation highest, 5 assigned the highest rank to lack of interest on the part of promoters,
while another 3 ranked the undeveloped nature of the local capital market highest. Among those that rated lack of understanding highest, 3 described it as a 'chicken and egg' situation - no understanding, so no mutual funds, while this absence of mutual funds contributed to the lack of understanding. Interestingly, a key respondent (head of one of the most significant players in the investment management services sector) felt strongly that legislation was NOT an issue. The respondent was convinced that the issue was that mutual funds were just not worthwhile in this environment relative to the level of effort required, expected returns and competing investment alternatives.

Another discussion question asked the respondents to comment on the local experience with collective investment vehicles, such as cooperatives and land buying companies, and what relevance they thought these had for the prospects of mutual funds in the country. The majority of the respondents, 17 in all, felt that the experience was relevant. Interestingly, most of them attributed both positive and negative aspects to the experience and its relevance to mutual funds. On the positive side, the unanimous opinion was that this experience has amply demonstrated the power and potential of collective investment vehicles. But a number of issues were cited on the negative side - mismanagement, corruption and greed; limited managerial capacity; limited products and investment opportunities; limited opportunities for risk diversification; and complications arising from the structure of these organizations. These were felt to be problems that have been largely characteristic of our experience with pooled investments, and which would have to be adequately addressed in any successful marketing strategies for mutual
funds. Opinion was also expressed that there was, perhaps, a silver lining in these dark clouds in that the Kenyan investor is now better informed about potential abuses of these kinds of initiatives, which would make him a more enlightened mutual fund investor.

The opinions of the experts, when asked to name the key players who should be taking a leading role in the establishment of mutual funds, are summarized in Table 4.2 below.

**Table 4.2 Key Players in the Establishment of Mutual Funds**

<table>
<thead>
<tr>
<th>Key player identified</th>
<th>Number of citations</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Banks</td>
<td>22</td>
</tr>
<tr>
<td>2. Insurance companies</td>
<td>19</td>
</tr>
<tr>
<td>3. Fund management institutions</td>
<td>16</td>
</tr>
<tr>
<td>4. Stock brokerage institutions</td>
<td>9</td>
</tr>
<tr>
<td>5. The Capital Markets Authority</td>
<td>5</td>
</tr>
<tr>
<td>6. Large Co-operatives</td>
<td>1</td>
</tr>
<tr>
<td>7. The Nairobi Stock Exchange</td>
<td>1</td>
</tr>
<tr>
<td>8. The Central Bank</td>
<td>1</td>
</tr>
</tbody>
</table>

Several of the experts cautioned, however, that banks and insurance companies should not venture into mutual funds unless they had a specialized division with the requisite human and infrastructural resources. In the absence of such
a division, they warned, mutual funds might suffer from a lack of investment focus and possibly end up being a disappointment.

In response to the question of what these key players ought to be doing in support of the growth and development of mutual funds, the following opinions were given.

**Table 4.3 Actions Key Players should be taking**

<table>
<thead>
<tr>
<th>Action</th>
<th>Number of Citations</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Lobbying on matters pertaining to legislation</td>
<td>16</td>
</tr>
<tr>
<td>2. Education of the public</td>
<td>15</td>
</tr>
<tr>
<td>3. Training</td>
<td>5</td>
</tr>
<tr>
<td>4. Finding interested capital investment partners</td>
<td>3</td>
</tr>
<tr>
<td>5. Nothing at all</td>
<td>5</td>
</tr>
</tbody>
</table>

The last response is interesting. This came from those respondents who identified potential promoters of mutual funds, but who at the same time felt strongly that there was no business case for them at the present time, and so the promoters should not bother.

A follow up question sought to determine what practical measures were being taken to advance prospects for the establishment of mutual funds. Various responses to this question are presented below.
Table 4.4  Actions being taken

<table>
<thead>
<tr>
<th>Action</th>
<th>Number of Citations</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Not much. Awaiting the right time and enactment of appropriate legislation</td>
<td>12</td>
</tr>
<tr>
<td>2. Discussions being held between Kenya Bankers Association and CMA</td>
<td>3</td>
</tr>
<tr>
<td>3. Seeking audience with Attorney General’s office</td>
<td>2</td>
</tr>
<tr>
<td>4. Encouraging brokers to take initiative</td>
<td>1</td>
</tr>
<tr>
<td>5. Looking for investment partners</td>
<td>1</td>
</tr>
<tr>
<td>6. Targeted mailing of educational/marketing material in preparation for launch</td>
<td>1</td>
</tr>
</tbody>
</table>

The experts were also asked to attribute levels of sophistication, as well as potential receptiveness to mutual funds, amongst the various categories of investors, these being retail investors, high-net-worth individuals, institutional investors and foreign investors. The predominant pattern that emerged is classified in Table 4.5 below.

Table 4.5  Sophistication and Receptiveness of various categories of investors

<table>
<thead>
<tr>
<th>Investor category</th>
<th>Sophistication level</th>
<th>Receptiveness to mutual funds concept</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail investors</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>High-net-worth individuals</td>
<td>Medium</td>
<td>Medium</td>
</tr>
<tr>
<td>Institutional investors</td>
<td>High</td>
<td>Marginal</td>
</tr>
<tr>
<td>Foreign investors</td>
<td>High</td>
<td>Marginal</td>
</tr>
</tbody>
</table>

Some additional common trends that also emerged were that:
i) A lot of educational effort would be needed for the first three categories of investors.

ii) The retail market presented great potential but the burden of educating the public, coupled with the burden of administering many small accounts, might dampen enthusiasm among potential promoters.

iii) Returns from mutual fund investment, in comparison to yields from other competing instruments such as treasury bills, would be an important consideration, particularly for the categories of investors of medium to high sophistication.

The experts were also asked about how easily the investing public could be reached once mutual funds were established, and what were considered the best means to reach it. Most identified the necessity for massive marketing and educational campaigns as a prerequisite to successful establishment. The importance of a countrywide distribution system, to ensure that all interested unit shareholders had access to an outlet, was also underscored.

An additional question requested the experts to give their opinions on how important they considered the volume of trade as well as variety of tradable instruments on the Nairobi Stock Exchange to be in determining the success of mutual funds. The great majority, 17 of the 24 respondents, considered these issues to be important. But other factors also considered important emerged:

i) Illiquidity of the Exchange, as characterized by lack of active churning of shares, was cited as an important impediment. This was further
attributed to existing ownership structures where some strong shareholders deliberately work to amass shares in specific companies without selling them in order to gain tax benefits or controlling interests.

ii) The timely implementation of the Central Depository System (CDS) was considered important as another step towards enhancing liquidity of those shares that are traded at the Exchange.

iii) A need for market makers, or players that would take upon themselves a primary buying and selling role, was identified.

iv) A campaign aimed at encouraging and facilitating the listing of successful private companies was also considered important.

For the most part, the experts turned out not to be familiar with cases detailing the experience of mutual funds in economic settings similar to ours.

The experts were also requested to give their impressions on the ability of players in Kenya’s financial sector to formalize an association, similar to the US Investment Company Institute, dedicated to liaison with the authorities on legislation issues, investor education and self-regulation within the industry. Of the 24 respondents, 15 felt such prospects were poor given an overly protective nature of the players, while the rest felt there were moderate to good prospects for such an association.

When the 22 principal respondents (excluding the CMA and NSE) were asked whether their respective institutions would consider setting up mutual funds, 14 responded in the affirmative while eight indicated that they would not. Of
the 14 only one was actively seeking to register a mutual fund. The other 13 felt the time was not right. It should also be stated that most of these envisioned operations that would be targeted at institutional investors, rather than the retail investor. Only one respondent was actively working towards setting up a mutual fund specifically targeted at the retail market. Of the eight who responded in the negative, five considered them to be not worthwhile, one felt a consortium of promoters was needed and hence could not go it alone, while the last (a leading international bank group) is not in the consumer business in Kenya.

The 14 respondents who indicated that their firms would consider setting up mutual funds were asked what they considered their prospects would be in three important areas: i) selling the mutual fund concept, ii) finding managerial expertise to run the fund, and iii) adequacy of infrastructural capacity to facilitate operations. Nine of the 14 expressed confidence about selling the concept, while the remaining 10 were apprehensive about what they considered a massive effort required. On the second issue, all except two indicated that they would have to import the managerial expertise, which they felt was readily accessible. On the last point, all felt that the infrastructural capacity was inadequate and help would have to be sought overseas. When these 14 were asked about the problems they anticipated they would run into, most cited the requirements of the heavy education burden, a few indicated that frequent withdrawals would be a problem, while one was apprehensive about excessive demand for the product among retail investors, thereby raising administrative
costs, a condition that would be exacerbated by limited absorption capacity for new investment inflows at the Nairobi Stock Exchange.

The main findings of the study can thus be summarized as follows:

i) Among the factors considered most significant as impeding the growth and development of mutual funds in Kenya’s financial sector are lack of understanding of the mutual funds concept among the investing public, an inadequate legislative environment, and lack of sufficient interest on the part of the most likely promoters of mutual funds. Other factors worth noting are lack of qualified professionals to manage such institutions, as well as the undeveloped nature of the country’s capital market.

ii) Kenya’s experience with other forms of collective investment schemes, such as land-buying and co-operative societies, provides useful lessons and a good background against which mutual funds can be launched.

iii) Banks, insurance companies and fund management institutions are largely considered as the key players that should be taking a leading role in the establishment of mutual funds.

iv) A further perception is that among the areas that these institutions should be devoting their attention to is lobbying on matters pertaining to legislation as well as education of the public.
vi) Most of the potential promoters of mutual funds do not appear to be taking practical steps towards their establishment. There is a widespread sense that the time is not yet right and developments in the financial sector that will be seen to create an enabling environment are awaited before such steps are taken.

vi) There is widespread acceptance and recognition of the fact that a massive educational effort is a prerequisite to the successful launching of mutual funds.
CHAPTER 5: SUMMARY AND CONCLUSIONS

5.1 Conclusions

This study set out to examine the prospects for the establishment of mutual funds in Kenya’s financial sector. From interviews conducted with key persons in the industry, whose training, experience and leadership positions qualify them as possessing expert knowledge, a number of conclusions can be drawn.

Ignorance on the part of the general public about the concept of mutual funds is an important impediment that is preventing potential promoters from introducing this form of pooled investment instrument. The costs associated with educating the public are deemed to be significant and most potential promoters appear wary of the educational burden entailed in the “first mover” position. Compounding the situation is lack of effective, formal organization amongst the diverse players in the sector that could coordinate lobbying and educational initiatives. Presently, there is no practical demonstration that the financial sector is addressing itself to these issues.

Perception that existing legislation is inadequate to facilitate the successful operation of mutual funds is strong among potential promoters. This contrasts markedly with the findings of the 1994 Deloitte and Touche study in which legislation barely featured as an impediment. Whether or not legislation is
actually inadequate, perception is strong among potential promoters, who are ultimately responsible for the establishment of mutual funds, that it is inadequate. It can be concluded that this perception is among the elements preventing some parties that might otherwise be interested from forging ahead. However, except for some reported consultations, of a tentative and exploratory nature, between the CMA and some players in the industry, it does not appear that there are concerted efforts to address the issue.

Considerable inertia is observable from a review of the practical steps that are being taken by the financial sector towards introduction and establishment of mutual funds. This must lead to the ultimate conclusion that there is significant lack of interest among potential promoters in establishing mutual funds. Though the majority of firms interviewed for the study stated that they would readily consider establishing mutual funds, except for one firm, there was hardly any practical demonstration of such. In any event, the expressed intent, for the most part, pertained to mutual funds targeting institutional investors, thereby negating an important aspect of the raison d'être of these institutions - pooling the resources of many small investors. Those institutions that have ready access to the resources necessary to surmount some of the obstacles identified in this report have shown little inclination towards doing so. Some potential promoters stated outright that they see no business case for mutual funds. The expected returns are not seen as justifiable in relation to the massive effort required in setting up these instruments. Therefore, it can be surmised that these institutions are comfortable with their present activities, and as some of the respondents put it, introducing mutual funds would merely
amount to shifting funds from one pocket to the other, an unappealing proposition given the high risks and doubtful returns.

Indirectly, the views expressed confirm existence of widespread negative sentiment about the performance and prospects of the economy in general. At the time of the Deloitte and Touche study in 1993, political and social uncertainties, along with economic hardship, were said to have depressed market sentiment and dampened enthusiasm for mutual funds. The socio-economic and political climate today is perhaps significantly worse, with Kenya, as recently reported in the local press, being described in some diplomatic quarters as the fastest collapsing African economy after Zimbabwe.

Taking all these matters into consideration, the inevitable conclusion to be drawn is that the near-term prospects of mutual funds in Kenya's financial sector are not at all bright.

5.2 Recommendations

Nonetheless, there are measures that can be taken to prepare ground for a time when these prospects will be brighter. Arguably, the legislative environment could be improved and the CMA, in consultation with industry representatives, could explore plans for replacement of the Unit Trusts Act CAP 521 of 1965 by rules and regulations under the CMA Act that would be specific to the operation of mutual funds. Among other advantages, this would enable legislation to work in tandem with and to respond more effectively to developments in the
sector. Although described as overly protective, players in investment management services need to work towards establishment of an industry association that would be dedicated to such important issues as liaison with the regulatory and legislative authorities on legislation covering the industry, investor education and self-regulation, among others. The Investment Company Institute of the United States is probably an excellent model to learn from. Resolute implementation of the provisions of the Retirement Benefits Act, timely enactment of the central depository system at the Nairobi Stock Exchange, along with other measures that could enhance trading volume, liquidity and over-all capitalization, would improve absorption capacity of new investment inflows and expand investment space for Kenyan mutual funds.

5.3 Limitations of the study

A number of factors can be identified as having posed limitations to this study:

i) Because the questions used in the interviews necessitated detailed and exhaustive discussions on each point, the sample size was kept to a manageable size. While the size selected was adequately representative of the financial sector, a larger sample would have added to such representativeness.

ii) Of necessity, the study reviews prospects of mutual funds prior to their establishment. It is quite possible that upon actual establishment of mutual funds, the findings herein might turn out differently.
iii) The nature of the problem under review limits extensive use of statistical tools.

iv) While the mutual funds industry is highly evolved in the developed capital markets, mutual funds are still an emerging phenomena in most of the developing world. Thus, there is a sense in which experience with mutual funds in economic settings similar to ours can be said to be limited.

5.4 Recommendations for further research

Further research is recommended on the following areas:

i) A study to examine factors influencing the development of capital markets and recommend strategies through which the Nairobi Stock Exchange could expand its listings and encourage active churning of stocks.

ii) A study to track, over time, the experience of the newly launched Zimele Multipurpose Cooperative Society, as well as similar institutions that might come into being in the near future, with regard to issues raised in this study. As noted previously, Zimele is essentially a mutual fund registered in 1999 under the revised Co-operatives Act for legislative and operational expediency.

iii) A study to review Kenya's financial policy and legislative provisions with regard to the financial sector and recommend actions that would
create incentives and an enabling environment for the operation of mutual funds.
APPENDIX I

INTERVIEW GUIDE FOR KEY PERSONS IN BANKING AND INSURANCE RELATED INVESTMENT COMPANIES, STOCKBROKERS AND ASSET MANAGEMENT FIRMS

A Research interview for MBA Thesis

Prospects for the Establishment of Mutual Funds in Kenya’s Financial Sector

NJURU NG’ANG’A
United States International University – Africa (USIU-A)

1. What, in your opinion, are the factors that impede the growth and development of mutual funds in the country?

2. Can you rank these factors in order of importance?

3. How would you characterize the local experience with pooled or collective investments, such as the co-operative movement, land buying companies, women’s groups and the like? Do you think these bear any relevance to the prospects of mutual funds in our financial sector?

4. What factors would you cite as being particularly enabling or debilitating to the operations of these collective investment movements?

5. Who are the key players that you think should be taking a leading role in the process of establishing mutual funds and other collective investment vehicles (CIVs) in the country?

6. Since mutual funds do not exist here, what is it that each of these key players should be doing to see to their growth and development?

7. What, to your knowledge, is being done at a practical level?

8. What is your perception of the education/sophistication levels of the various broad categories of investors, viz: retail investors, high-net-worth individuals, institutional investors and foreign investors, and to what extent do you expect they would find mutual funds in the Kenyan setting particularly appealing, again by category?

9. If/when mutual funds do finally take off in this country, to what extent do you feel the non-investing public will be reachable? What do you think would be the best way to reach it?

10. How important do you expect variety of tradable instruments, as well as the number of listed companies, in the Nairobi Stock Exchange to be in determining the success of mutual funds?

11. Are you familiar with any cases detailing the experience of mutual funds in economic settings similar to ours? If so, kindly share your impressions.

12. In the US, the mutual funds industry has set up an elaborate and highly effective association called the Investment Company Institute that attends to
such important issues as liaison with the Securities and Exchange Commission on legislation covering the industry, investor education, self-regulation of the industry and the like. Given what you know of our local players, what would be the prospects for the formation and operational success of a Kenyan institution similar to the US institute?

13. Would you or your firm consider setting up a mutual fund? Why or why not?

14. If you would consider setting up a mutual fund, what do you think would be your prospects in the following areas?
   - Your ability to sell the mutual fund concept to prospective share holders
   - Finding the managerial expertise to run the fund
   - Adequacy of infrastructural capacity to facilitate your operations

15. What problems do you anticipate you would run into?

16. Finally, I hope you do not mind if I ask you to provide some biographical details. I expect that this information will be useful in contextualizing responses I obtain through these interviews:
   - Age
   - Years of experience in your present field
   - Educational background and formal training in your field
   - Years of service with your present firm
   - Position held
BIBLIOGRAPHY


