PROPERTY PORTFOLIO CONSTRUCTION AND PERFORMANCE ANALYSIS IN KENYA
(A Case Study of Registered Pension Schemes)

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A Research Project Submitted in Partial Fulfillment of the Requirements for the Degree of Master of Arts in Valuation and Property Management

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DECLARATION BY RESEARCHER

I, Joyce Makena Kaaria, hereby declare that this research project is my original work and has not been presented for a degree in any other university.

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28th June 2004
Date

DECLARATION BY SUPERVISOR

This research paper has been submitted for examination with my approval as University Supervisor.

Dr Tom Konyimbih

7th July 2004
Date
DEDICATION

To my family for their support at all times
ACKNOWLEDGEMENTS

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"The role of the property professional in property investment market lies in providing right and timely advice to institutional investors on asset selection, portfolio construction and revision."

(Geho, 2001)
ABSTRACT

This study was prompted by a need to look into the management of property portfolio investments as alternative long-term investments. The issues of concern were the factors considered during the construction of property portfolios and after portfolio construction, the presence or absence of procedures for the assessment of the performance of these portfolios in order to obtain a rational basis for portfolio revision. Property as an investment involves an immense capital outlay which should give optimal returns either individually or as part of a portfolio. To this end it was recognized that unlike securities and equity, the property investment market was uniquely inflexible and its assessment is limited by insufficient information.

Bearing in mind the foregoing, this study looks at the current practice in the construction of property portfolios and the analysis of their performance. It also looks into the role of the players in portfolio construction and performance analysis with particular reference to pension schemes. These are investment managers hired by registered pension schemes trustees to construct their investment portfolios in a manner that ensures that they obtain market returns on the investments. The study further looks into the challenges faced in the construction and the assessment of the performance of property portfolios. Finally, the researcher makes recommendations that will enable the performance of property portfolios to be continually assessed and analyzed in a similar manner as is done for other long-term investments such as securities or equities.

The outlook of many investment managers is that property investment analysis is property valuation. This research has sought to bring out the difference between property valuation and property appraisal. While property valuation is the estimation of worth to the owner, assessment/appraisal or analysis is the process through which its performance is compared either against set benchmarks or against alternative investments within the existing economic environment.

Investment policies and targets for returns within a specified level of risk are a prerequisite for successful portfolio construction. Investment policies are required to guide investment in various media while investment targets are necessary to ensure that market returns are achieved and if they cannot be achieved then the portfolio is revised. The study also looks are the Retirement Benefits Authority regulations and investment guidelines in a view to determining if they are practicable. In the study, a brief comparison is made between actual proportions of fund values invested in immovable property by local pension schemes against investment levels by a sample of European Pension Schemes and Retirement Benefits Authority Guidelines.
Data for this study was collected through interviews and administration of questionnaires to registered investment managers and to a randomly selected sample of in-house fund managers. The findings revealed that contrary to the common belief that many pension schemes have over invested in immovable property, this is not the case in practice. Over investment in immovable property was only experienced where the schemes were run as public corporations or parastatals and were therefore susceptible to political influence. In this case, immovable property constituted up to 60% of the pension scheme fund value. For the rest of the pension schemes, the average level of investment in immovable property ranged from 0-8% of total fund value.

The study also determined that investment managers had procedures which they followed when assessing alternative investments prior to portfolio construction. The managers also had procedures for assessing the performance of long-term investments although this was not usually applied to property. Also determined was that the major challenge faced during property portfolio performance analysis is the lack of adequate, up to date information on the current state of the various property sub-sectors.

The study revealed that while there are procedures for the assessment of long term investments, these were not applied to property on a continuous basis like in securities or equities but only during acquisitions or disposals. The study established that property portfolio performance assessment could be out-sourced to property management firms since they are in constant touch with the property market.
CHAPTER ONE
1.0.0 Introduction

Global research indicates that corporate real estate accounts for approximately 25% of most corporations' assets value (Veale, 1989). In Kenya, a corporation's real estate assets may comprise between 40-80% of its total asset value (Knight Frank, 2000).

The major institutional investors in Kenya include banks, pension schemes, insurance companies and public institutions. Institutional investors act as financial intermediaries by transferring funds from persons or organizations with surplus resources to organizations requiring to undertake investment or expenditure. Institutional investors have at their disposal substantial fund reserves that they are obliged to invest judiciously on behalf of their beneficiaries so as to provide the beneficiaries with sufficiently high returns on capital invested (Geho, 2001).

By December 2002, there were one thousand four hundred (1400) Retirement Benefit Schemes regulated by the Retirement Benefits Authority and holding assets estimated at Ksh.117 billion or approximately 21% of the Kenya's Gross Domestic Product (GDP). The National Social Security Fund (NSSF) which is Kenya's largest pension scheme is believed to have a fund value of Ksh.50 billion of which 36 billion is invested in immovable property (RBA News, March 2003).

Similarly the Kenya Reinsurance Corporation (KenyaRe) which was established in 1970 under the State Reinsurance Corporation Act to transact re-insurance and insurance business has Ksh.4.2 billion of its Ksh.6.3 billion of its portfolio invested in rental properties and land (KenyaRe Brochure, 2003). According to media reports, some of the investments in land and property holdings are made because of the quick gains accruing to sellers of the properties rather than the economic value of the investments. As a result some schemes have found themselves saddled with property and other investments that do not yield meaningful returns.

Theoretically, the optimal selection of investment assets in a portfolio should be done in a manner that gives a reasonable rate of return, spreads risks and enables an investor to tap from newly discovered resources. Optimal asset allocation is defined as the process of mixing asset weights of a portfolio within the constraints of an investor's capital resources to yield the most favorable risk-return tradeoff (Sing & Ong, 2000). To achieve optimal asset allocation, careful selection and performance analysis of a corporation's investment portfolio must be carried out.
Investment by pension schemes is guided by the Retirement Benefits Authority (RBA) created under the Retirement Benefits Act, Act No. 3 of 1997 and through the Retirement Benefits Regulations 2000. These laws aim to protect the benefits of scheme members, develop the retirement benefits industry and mobilize domestic savings in the economy (Section 5, Retirement Benefits Act). Investments of scheme funds are managed through registered investment managers and custodians. Pension Scheme trustees are required to appoint a registered manager and custodian under a written instrument which should be filed with RBA.

There are currently eleven (11) registered investment managers who are charged with the responsibility of “investing pension funds prudently so as to maintain the capital funds of the schemes and to generally secure market rates of return on such investments” (Section 37, Retirement Benefits Act). By end of the year 2002, registered investment managers controlled Ksh.67.4 billion belonging to 778 pension schemes which excluded the over Ksh.50 billion held by the National Social Security Fund which is yet to comply with Retirement Authority Benefits guidelines and appoint an investment manager. The statistics on the registered investment Managers and the investment portfolios under their care are given in the Table 1.1 below.

Table 1.1: Registered Investment Manager, Number of Schemes Managed and Fund Values

<table>
<thead>
<tr>
<th>Registered Manager</th>
<th>No. of Schemes Managed</th>
<th>Total Fund Value (Ksh. M)</th>
</tr>
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<tbody>
<tr>
<td>African Alliance Kenya Limited</td>
<td>Not Available</td>
<td>-</td>
</tr>
<tr>
<td>AIG Global Investment Company (East Africa)</td>
<td>98</td>
<td>14,175.2</td>
</tr>
<tr>
<td>CFC Financial Services Limited</td>
<td>32</td>
<td>760.9</td>
</tr>
<tr>
<td>Co-op Trust Investment Services Limited</td>
<td>66</td>
<td>2,344.7</td>
</tr>
<tr>
<td>Genesis Kenya Investment Management Limited</td>
<td>39</td>
<td>6,444.2</td>
</tr>
<tr>
<td>ICEA Investment Services Limited</td>
<td>211</td>
<td>7,409</td>
</tr>
<tr>
<td>Jubilee Financial Services Limited</td>
<td>62</td>
<td>1,257.2</td>
</tr>
<tr>
<td>Kenindia Asset Management Company Limited</td>
<td>82</td>
<td>1,105.1</td>
</tr>
<tr>
<td>Madison Asset Management Services Limited</td>
<td>Not Available</td>
<td>-</td>
</tr>
<tr>
<td>Old Mutual Asset Managers (E.A) Limited</td>
<td>6</td>
<td>9,816.9</td>
</tr>
<tr>
<td>Old Mutual Asset Managers (Kenya) Limited</td>
<td>129</td>
<td>20,540.2</td>
</tr>
<tr>
<td>Stanbic Investment Management Services (East)</td>
<td>53</td>
<td>3,535.2</td>
</tr>
</tbody>
</table>

The RBA gives investment guidelines regarding the proportion of a scheme's assets that can be invested in a particular asset class. Currently, the permitted limit for real estate assets is 30% of the schemes assets. In administration of pension schemes, trustees are required to amend their scheme rules to the extent that they are not in compliance with the regulations. In addition, they are required to invest in prescribed investment vehicles which meet the capital requirements and technical capacity of the scheme.

The RBA investment guidelines provide limits only and do not require schemes to invest in a given asset class. Schemes may temporarily violate maximum limits in cases of asset revaluation and appreciation. Schemes that do not comply with the outlined requirements are required to state to the RBA how they intend to come into compliance. The deadline for compliance with regard to development of investment policies and compliance with investment guidelines or submission of a plan of compliance was set at 30th June 2006 in this year's Finance Bill.

A rational investor, such as a pension scheme, wishes to make good investment decisions, however, in the real world the investor is faced with a shortage of reliable information, inadequate appraisal methodology and inefficient decision criteria (Hargitay & Yu, 1993). This is especially true of investments in the property market due to the characteristics of property as an investment and lack of information.

Many challenges exist in the planning, selection and appraisal of investments, some of which are related to the availability of information from various investment markets on which to base sound investment policies. This results in confusion on what to invest in order to obtain maximum return and consequently the portfolio problem of selecting a collection of individual investments or bundles of investments that taken together will have the most desirable characteristics with respect to risk and expected return.
To maximize investment returns and minimize risks, an investment portfolio strategy must be developed which enables selection of the most appropriate investments which achieve the investors objective, that is, allocation of an appropriate level of capital to the investment at the most appropriate time. The investment portfolio then has to be actively managed by continuously seeking ways in which to improve the performance of the individual assets as well as their role in the entire portfolio (Timm, 1995).

1.1.0 Statement of the Problem

Investment management involves analysis of the investment performance of individual components of a portfolio and the revision of the portfolio based on the findings of the analysis. **Portfolio management can only be effective if there exists a sound and rational basis, first for the selection of an efficient set of investments and secondly for the revision of the portfolio** (Hargitay & Yu, 1993).

The problem is that a review of Annual Reports from the Retirement Benefits Authority indicates that property investment by pensions schemes in Kenya has been very prone to irregular investment, often politically instigated, without due regard to the need for contributors to achieve market returns on the investments. Also there does not exist a sound and rational basis of measuring the performance of property investments either against macro-economic indicators such as inflation or against the performance of well run benchmark portfolios. In addition, the investment managers registered under the Retirement Benefits Act are mainly trained as Financial Analysts and do not have daily interaction with the property investment market.

Investment portfolio analysis and harmonizing in Pension Schemes is a pre-requisite for optimal asset allocation to ensure maximum returns at minimum risk levels. To ensure optimal asset allocation for any investment a basis for determination of return and risk levels is required in addition to a performance benchmark against which to rate performance. The lack of a rational basis of property investment performance analysis is seen as the main cause of poor selection of property investments and ineffective revision of property portfolios.

Data from the Retirement Benefits Authority indicates that as at 31\textsuperscript{st} December 2002, 36% of investment funds of pension schemes regulated by the Authority (including the National Social Security Fund) was held in immovable property. The total amount invested in immovable property is only comparable to the amount invested in low risk government securities the specific allocation to various investments is indicated in the Figure 1.1 below.
Property investment selection and analysis is made particularly difficult by the imperfect nature of the property market. The unique characteristics of property as an investment and lack of information on transactions make it difficult to compare returns and rate performance among investors. As a result most acquired property investments are not compared and ranked against market benchmarks. In most instances, the benchmarks for property performance are either unavailable or unknown.

For a corporate investor faced with numerous investment options, a means of conducting an analysis of the portfolio has to be established to determine investment performance against market benchmarks and to determine the optimal investment vehicle in the market at any particular time. Performance analysis must be based on accurate, up to date and relevant data from each investment market. In addition to the lack of property performance benchmarks, other challenges exist that inhibit the informed selection, performance analysis and subsequent revision of property investments by pension schemes.

Investment managers of pension funds are charged with the responsibility of assisting their clients formulate investment policies, and select appropriate investment vehicles that suit the investment policies and attitude of the trustees towards risk. Investment managers are also required to conduct
regular analysis of such investments. In carrying out these duties, they require information and expertise on all the investment sectors.

Research by the Property Investment Committee of the Real Estate Institute of Zimbabwe seeking to find out the perceptions of institutional investors and fund managers regarding property investment found that most distinct weakness of the property market when compared against the money and equity market was the limited depth of knowledge and analysis available. In comparison to the property investment market, other investment sectors are considered well researched with easily available information on which to base an analysis.

In Kenya, values of stocks are listed at the Nairobi Stock Exchange and their performance trends are easily available from the Nairobi Stock Exchange NSE or the Capital Markets Authority. In addition, the Nairobi Stock Exchange Index gives daily turnovers in the stock market. Similarly, for Treasury Bonds, the information on available bonds and their coupon rates is readily available from the Central Bank of Kenya. The Central Bank of Kenya also gives monthly reviews on the trends in Treasury Bill and Bond rates. On the contrary, there does not exist a formal collection of data on the property investment market on which to base an analysis of property performance.

According to Geho (2001), little is known on how institutional investors invest in Tanzania, especially how they select investment vehicles, estimate returns and deal with the elusive function of measuring and minimizing property portfolio risk. The same can be said for Kenya.

1.2.0 Study Objectives:

The main aim of this research study is to examine the current practice in the construction of investment property portfolios and the analysis of their performance. To achieve this, the study will seek to do the following.

1. To compare the proportion of registered pension scheme funds allocated to real estate with the proportion allocated to other long-term investment media.
2. To find out the factors considered by pension scheme trustees during property portfolio construction.
3. To find out the procedures and techniques currently used to analyse the performance of property portfolios.
4. To find out the roles of registered investment managers in property portfolio construction and performance analysis for registered pension schemes.

5. To find out the challenges faced in conducting property portfolio construction and performance analysis.

6. Based on the findings, to give recommendations on how the challenges can be mitigated in order to improve property portfolio construction and performance analysis.

1.3.0 Study Hypothesis:

Inadequate information on the property market is the leading cause of non-application of a rational basis of performance analysis of property portfolios.

1.4.0 Scope of the Study

In Kenya, the major investors include pension funds, banks, public corporations and parastatals, and insurance companies. This study will be limited to registered pension schemes with asset values exceeding Ksh.100 million. The scope is limited to this fund size because the Pension Schemes with large fund sizes have access to numerous investment options and are likely to have an investment property portfolio. The study will also include the National Social Security Fund which is the largest pension scheme although not yet compliant with RBA guidelines.

1.5.0 Significance of the Study

Little research has been undertaken in the area of property portfolio construction, performance measurement and analysis in Kenya. The results of the study will be of use to in-house fund managers, investors and investment management firms as they plan for, construct and appraise property portfolios.

1.6.0 Assumptions

This study assumes that registered investment managers have pension schemes with investment property portfolios under their management.
1.7.0 Research Methodology

This research is an exploratory survey. This research design was selected because it enables the researcher to collect data from members of a population in order to determine the current status of that population with respect to one or more variables. According to Mugenda O.M & Mugenda A.G, (1999) a survey is used to seek information that describes the existing phenomena or to explore the existing status of a variable. Under this research design, a representative sample is selected from the population for study.

The population under study in this research is registered pension schemes with funds values of more than one hundred million Kenya Shillings (Ksh.100 million). There are currently One thousand Four Hundred (1400) pension schemes regulated by the Registered Benefits Authority of which ninety nine (99) have fund values exceeding One Hundred Million shillings (Ksh.100,000,000) (Retirement Benefits Authority, May 2003).

Primary data collection for this research study was through interviews and questionnaires to all the eleven (11) investment managers registered under the Retirement Benefits Act (1997) as at March 2003 and listed in Table 1.1. Questionnaires were also distributed to in-house investment managers of ten (10) randomly selected Pension Schemes which have not yet appointed an Investment Manager and therefore conduct property investment selection and analysis through an in-house team. Secondary data collection was from the review of relevant literature from books, journals, the internet, published and unpublished research work, and papers presented at conferences and seminars. Descriptive and where inferential statistics were used to analyze data.

1.8.0 Organization of the Study

This study is organized into five chapters. Chapter One gives an insight into the area of study and a statement of the problem that has necessitated the study. It also contains the study objectives, hypothesis, scope, significance, limitations and the research methodology.

Chapter Two consists of a review of the literature related to investment planning, portfolio construction and performance analysis. Literature on available long-term investment media, property investment alternatives, and performance measures for various media was reviewed. From this literature, a
theoretical framework was formed for investment selection, performance measurement and analysis for application to property portfolios.

Chapter Three consists of a commentary on the Retirement Benefits Act, Retirement Benefits Authority, and the roles of the pension scheme trustees, registered investment managers and in-house investment managers. It also contains a commentary on the other statutory bodies that regulate investments in long-term assets being the Central Bank of Kenya and the Capital Markets Authority.

Chapter Four contains an analysis of data collected through interviews and administration of questionnaires. The results of this data were used to examine the current practice in property portfolio construction and performance analysis by Pension Schemes.

Chapter Five gives the conclusions derived from analysis of the data and recommendations for improvement of the practice of property portfolio construction and performance analysis in corporations.

1.9.0 Working Definitions

1. Investment: The commitment of funds made in the expectation of a positive rate of return by generating a flow of income, generating a return on capital invested or by producing a psychic income.

2. Investment Performance Measurement: The quantification of the degree of achievement of investment against set objectives and targets.

3. Property Portfolio Analysis, assessment or appraisal will be used interchangeably in this study to mean an assessment of the performance of investment in a portfolio against market values of similar investments during decision making for property portfolio construction or disposal.

4. Portfolio: A combination of several investments assembled for the purpose of the management of investment risk and for the enhancement of investment returns.

5. Valuation: Estimation of the most likely selling price or worth to an investor.
1.10.0 Abbreviations

RBA                Retirement Benefits Authority.
AFR                African Alliance Kenya Limited
OM (K)             Old Mutual Asset Managers
CFC                CFC Financial Services
COOP               Co-op Trust Investment Services
GEN                Genesis Kenya Investment Management Limited
ICEA               ICEA Investment Services Limited
JUBI               Jubilee Financial Services Limited
KENI               Kenindia Asset Management Company Limited
SIMS               Stanbic Investment Management Services Limited
NSSF               National Social Security Fund
CBK                Central Bank of Kenya
CMA                Capital Markets Authority
CDA                Central Depositories Act
CHAPTER TWO

LITERATURE REVIEW
An investment is a commitment of funds made in the expectation of a positive rate of return (*Fischer & Jordan, 1996*). The positive return may be by generating a flow of income, by generating a return of capital or by producing a psychic income (a positive feeling induced by investment ownership) (*Baum & Cosby, 2002*). If the investment is properly undertaken, the return will be commensurate with the risk the investor assumes. A true investor is interested in a good rate of return earned on a consistent basis over a relatively long period of time. The entire process of estimating return and risk for individual portfolios is known as Portfolio Analysis.

Different investments differ in their characteristics. The major qualities that a rational investor will seek in an investment are:

- Security of capital,
- Security of income,
- Regularity of income,
- Liquidity,
- Low cost of purchase and re-sale,
- Ease of purchase and sale,
- Divisibility of the investment,
- Security of the investment in real terms, which is its growth in value in line with inflation (*Isaac, 1998*)

Investment decisions are made by investors in an environment, which contains a number of factors influencing the attitudes of decision-makers. As shown in *Figure 2.1* below, making an investment decision is a rational activity that requires consideration of macroeconomic indicators and market factors. The major considerations include the objectives of the investor, source of investment finance, risk exposure and returns obtainable from the investment media.
2.1.0 Portfolio Approach to Investment

A portfolio is a combination of several assets. A portfolio is assembled for the purpose of managing the investment risk and for the enhancement of investment returns. The rationale for investing in a portfolio arises from the need to manage investment risk through diversification of investments. The elements of a portfolio are liquidity, fixed-interest holdings and equity content. These three areas provide accessibility, a guaranteed income and monetary capital growth from the fixed-interest element, and scope of growth of both income and capital from the equity content (Wanjala, 1999:28). It also gives instant funds to pay for recurrent expenditure without having to sell any of the investments.
2.1.1 Modern Portfolio Theory

The Modern Portfolio Theory (MPT) was first developed by Harry Markowitz in the 1950's and provides the rationale to selecting a combination of assets which meet the investors goals and objectives. Modern Portfolio Theory is a set of quantitative techniques that identifies portfolios offering the lowest risk for a given expected return (Wilson & Wilkerson, 2000). By defining a portfolio of assets in terms of their risk, return and covariance, Markowitz developed a model that could identify the optimal proportion of funds to hold in each asset.

The basic concept underlying the Modern Portfolio Theory is that while portfolio returns are merely the weighted average returns from the portfolio constituent investments, portfolio risk on the other hand is quite unique. For a portfolio of assets, risk aggregation is not merely an additive process, rather it must take into account the covariance of returns. Low or negative covariance of asset returns is desirable as it is responsible for reducing portfolio risk (Geho, 2001). Research by the Investment Property Databank (IPD) indicates that it is only possible in large funds to diversify property investments effectively so that portfolio performance patterns do not deviate markedly from market norms.

An efficient investment portfolio is one that maximizes the return at a given level of risk or alternatively minimizes risk at a given level of return. Traditionally, individual investments, mostly equities were treated as independent projects by fund managers when evaluating their performance. However, recently fund sizes have become significantly larger and more sophisticated and formal models such as the Modern Portfolio Theory (MPT) and the Capital Asset Pricing Model (CAPM) have been developed to aid investment analysis.

2.1.2 The Capital Asset Pricing Model

The Capital Asset Pricing Model is an important economic model which relates the expected returns on an asset to the portfolio. It relates the expected returns of an asset to the risk-free interest rate plus a premium for bearing risk. The result of the model is an upward sloping line known as Security Market Line (SLM) which uses the following Equation $E(r_p) = r_f + B_p [E(r_m) - r_f]$ where:

$E(r_p)$ = Expected rate of return for the project

$r_f$ = risk free rate of return

$B_p$ = market risk
\[ E(r_m) = \text{risk premium} \]
\[ r_f - \text{risk free rate of return} \]

The Capital Asset Pricing Model can be used to identify those projects that are under or over valued. The projects that lie above the Security Market Line are underpriced while those lying below it are overpriced since an investor will expect to be compensated with higher returns by taking on higher levels of risk. The Capital Asset Pricing Model holds for all assets both financial and real.

2.2.0 LONG TERM INVESTMENT OPTIONS IN KENYA

Investments generally involve real assets or financial assets, the difference being the extent of liquidity. Real assets are more heterogeneous, often peculiarly adapted for a specific use and yield benefits only in co-operation with other productive factors. In addition, returns on real assets are frequently more difficult to measure accurately owing to the absence of broad, ready and active markets. Nevertheless, many of the concepts, techniques and decision rules applicable to financial assets are applicable to real assets (Fischer & Jordan, 1996).

According to Enever & Isaac (1994), there are two forms of financial investment: first where money is lent and a debt created such as the granting of a mortgage or corporate bond and secondly, where a proprietary interest is acquired such as the acquisition of an interest in property or a share in a company. There are three major areas of traditional investments: fixed interest securities, company stocks and shares and real property. Under the Retirement Benefits Regulations (2000), Pension Schemes may invest in the following areas:

1. Cash and Demand Deposits
2. Fixed Deposits, Time Deposits and Certificates of Deposits
3. Commercial Paper, Corporate Bonds, Mortgage Bonds and Loan stocks
4. Kenya Government Securities
5. Equity - Preference Shares and Ordinary Shares of Quoted Companies
6. Unquoted shares
7. Offshore Investments
8. Guaranteed Funds
9. Other – works of art,
10. Property in Kenya

Property Portfolio Construction and Performance Analysis in Kenya
J.M. Kaaria, 2003
The principal forms of investments available locally to pension schemes are discussed below.

2.2.1 Cash and Demand Deposits

According to Wanjala (1999), a liquid reserve of up to 10% of the value of the portfolio should be provided for in an investment portfolio. This reserve should be easily accessible and carry the best after-tax rate of interest from available high-interest bank or building society accounts. Liquid investments enable unexpected bills to be paid and any new investment opportunities that may arise to be taken advantage of.

However, cash deposits have two main problems, first the interest rate moves in line with the general level of interest rates and if the rate falls then the investor loses out on income. Secondly, the capital value remains static, thus inflation erodes the purchasing power of the capital.

The fixed interest element is also affected because prices rise and fall inversely to interest rate movements. Once a fixed interest rate stock has been purchased, it is not possible to benefit from higher interest rates in the future. Conversely, the investor is protected if future interest rates fall. To minimize the interest rate and inflation risks, investment in shares is utilized. However, even with shares, sufficient diversification is required.

According to Wanjala (1999), the factors that drive investor demand for investing in products offered by financial institutions include: the predictable rate of interest, low risk of capital loss, convenience, adequate liquidity, simplicity, and tax efficiency.

2.2.2 Bonds

A bond is a debt obligation where the lender promises and is bonded by a detailed contract, to repay back the borrowed funds by or on an agreed date. The life of a bond may vary from one year to ten years. According to the Kenya Institute of Bankers, the Kenyan colonial economy had an active debt market in Corporate, Municipal and Government Bonds. However, in the last decade, heavy reliance on external funding coupled with a run-away inflation, has resulted in high interest rates impacting adversely on the cost of capital (The Kenyan Banker, April – June 1997).
How the repayment is structured differentiates from one bond to another. The traditional bonds are the fixed interest semi-annual debt issued both by the corporate bodies and the government. A fixed interest bond will pay a fixed amount of interest per period of time during the life of the bond and then the principal in one lump sum at maturity. Interest periods could be every one year, six months (semi-annually) or three months (quarterly). A floating rate bond has an interest rate that varies from period to period depending on the benchmark against which the rate is determined.

Conventionally, government bonds are classified as riskless investment and therefore command a higher credit rating than corporate bonds. Data from Suntra Stocks Limited published in the Business Week segment of the Daily Nation Newspaper on 11th August 2003, indicates that the Corporate bonds listed at the Nairobi Stock Exchange as at this date were as follows:

Table 2.1: Listed Corporate Bonds

<table>
<thead>
<tr>
<th>Bond Issuer</th>
<th>Date of Issue</th>
<th>Maturity Date</th>
<th>Interest Payment Terms</th>
<th>Coupon Determination</th>
<th>Current Coupon</th>
<th>Bond Value Ksh. (M)</th>
</tr>
</thead>
<tbody>
<tr>
<td>East African Development Bank</td>
<td>15/10/01</td>
<td>25/04/06</td>
<td>6 months</td>
<td>T.B + 0.75%</td>
<td>7.086</td>
<td>1,600</td>
</tr>
<tr>
<td>Shelter Afrique</td>
<td>09/07/01</td>
<td>09/07/04</td>
<td>6 months</td>
<td>T.B + 0.75%</td>
<td>2.297</td>
<td>100</td>
</tr>
<tr>
<td>Shelter Afrique</td>
<td>22/10/01</td>
<td>09/07/04</td>
<td>6 months</td>
<td>T.B + 0.75%</td>
<td>2.297</td>
<td>100</td>
</tr>
<tr>
<td>Safaricom Limited</td>
<td>11/06/01</td>
<td>31/03/06</td>
<td>3 months</td>
<td>T.B + 1%</td>
<td>3.027</td>
<td>4,000</td>
</tr>
</tbody>
</table>


The coupon rate on these bonds was set at the Treasury Bill interest rate plus 0.75% (T.B+0.75%) for East African Development Bank and Shelter Afrique and Treasury Bill interest rate plus 1% (T.B+1%) for Safaricom Limited. The rate of return obtained from these bonds therefore varies with the Treasury Bill rate. The main disadvantage of fixed rate bonds is that the investor does not enjoy the benefits from higher interest rates in the future.

As indicated in the table below, in the last eight months since January 2003, there has been substantial decline in Treasury Bill interest rates from 11% in January to 1.48% for the 91-day Treasury Bill and 2.6% for the 182-day Bills as at 5th August 2003. Increased investment has been directed to blue-chip stock pushing their price to over 20 times their earnings in many instances (Daily Nation, Business Property Portfolio Construction and Performance Analysis in Kenya
J.M. Kaaria, 2003

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At the peak of the Treasury Bill Boom in 1997, their interest rate was set at 27% (www.centralbank.go.ke)

Figure 2.2   Trends in Interest Rates January – August 2003

According to the Retirement Benefits Authority, in the year 2002, investment managers showed a strong preference for investment in Government Securities especially Treasury Bonds. As a result pension schemes held Kenya Shillings 25.4 billion (or 19.1%) of the Ksh.133 billion government bonds portfolio (Retirement Benefits Authority, Annual Report June 2002)

2.2.3 Equities

Shares are of two types, preference or ordinary shares (equity), each of which represents part ownership of a company and the right to participate in its profits in the form of dividends. Preference shares provide a fixed return on capital paid out of profits while ordinary shares provide a variable return. Gilts are stocks that are 100% secure in money terms, the only risk run is that of inflation eroding the purchasing power of the interest and capital.

As profits for equities vary, there is no stability of income and yield is calculated on the current dividend. Yields vary enormously and in deciding which companies to invest in and the yield that would be acceptable, the investors and their advisors must have regard to a number of factors. According to Enever & Isaac (1994), they must try to forecast future profitability, and consider the company’s policies regarding distribution of profits and gearing (amount ploughed back into the business).
The market value of equities in a company is determined by the price to earnings ratio (P/E) which is the market value divided by the annual earnings of the company. In order to assess the "true value" of a share, an investment analyst may undertake a fundamental or technical analysis. A fundamental analysis involves a detailed study of a company's accounts over a number of years. S/He must then examine the prospects of the industry and the economy in general, and against this background study the corporate investment plan. The end result of this detailed study will be a prediction of future profit levels and possibly also future dividends. If profits and dividends can be predicted, then a projected P/E ratio can be calculated based on current share price and adjusted for risk (Wanjala, 1999).

A technical analysis of the investment potential of equity involves an examination of the shares demand and supply. A chart is used to predict future share price movements by plotting share price movements over a period of time.

According to the Retirement Benefits Authority, at the end of year 2002, registered Pension Schemes had Ksh.6.2 billion of their fund values invested in equities. A portfolio's equity content needs careful management. To have a well diversified direct equity holding there should be at least 15 shares, each in a different sector of the market (Wanjala, 1999).

### 2.2.4 Guaranteed Funds

Guaranteed funds are investment options usually offered to pension schemes by insurance companies. Table 2.1 below obtained from the Retirement Benefits Authority indicates various insurance company's declared rates of return on Pension Scheme funds for 2002.

<table>
<thead>
<tr>
<th>Rank</th>
<th>Insurance Company</th>
<th>Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>American Life Insurance Company (ALICO)</td>
<td>9.00%</td>
</tr>
<tr>
<td>2.</td>
<td>British American</td>
<td>8.60%</td>
</tr>
<tr>
<td>3.</td>
<td>Corporate Insurance</td>
<td>5.00%</td>
</tr>
<tr>
<td>4.</td>
<td>Fidelity Insurance</td>
<td>10.50%</td>
</tr>
<tr>
<td>5.</td>
<td>Heritage Insurance</td>
<td>8.50%</td>
</tr>
<tr>
<td>6.</td>
<td>Insurance Company of East Africa (ICEA)</td>
<td>8.50%</td>
</tr>
<tr>
<td></td>
<td>Insurance Company</td>
<td>%</td>
</tr>
<tr>
<td>---</td>
<td>---------------------------------</td>
<td>-----</td>
</tr>
<tr>
<td>7</td>
<td>Jubilee Insurance Company</td>
<td>10.75</td>
</tr>
<tr>
<td>8</td>
<td>Kenindia Insurance Company</td>
<td>10.50</td>
</tr>
<tr>
<td>9</td>
<td>Kenya Alliance</td>
<td>8.90%</td>
</tr>
<tr>
<td>10</td>
<td>Madison Insurance Company</td>
<td>6.00%</td>
</tr>
<tr>
<td>11</td>
<td>Mornarch Insurance Company</td>
<td>10.00%</td>
</tr>
<tr>
<td>12</td>
<td>Old Mutual Insurance Company</td>
<td>6.00%</td>
</tr>
<tr>
<td>13</td>
<td>UAP</td>
<td>8.00%</td>
</tr>
</tbody>
</table>


From the table above, the highest yield offered by insurance firms controlling a pension scheme funds stood at 10.75 (%) per cent well above the underlying annual average inflation rate of 4%. But as interest rates fall, financial analysts predict that yields will also come down (*Business Week, Daily Nation Newspaper, August 12 2003*).

### 2.2.5 Immovable Property

The term property refers to freehold and leasehold interests in land and buildings. The property sector is divided into sub-sectors according to size, type and location and ranges from a small house to multi-million shilling investments. Financial investment in immovable property may be through the transfer of existing capital assets or through asset formation by property development. Property may be acquired by auction, by tender, by private treaty or by take-over bid.

The rate of return on an investment in property is calculated from the income generated or the capital gain achieved. The return is calculated as annual income as a percentage of capital outlay. The initial yield is the current net income as a percentage of capital outlay. The capital value of an investment therefore depends on the yield which investors are prepared to accept. Capital gain is described in terms of an annual discount rate by calculating the rate of compound interest required to achieve a certain capital gain over a given period of time (*Enever & Isaac, 1994:7*).

The application of investment funds has to reflect competition from other forms of investment. Unlike other investment markets, the property market is fragmented and dispersed whilst that of shares and
securities is highly centralized. A decentralized market, such as exists for property, will have high costs of transfer of investments and imperfect knowledge of transactions in the market (Isaac, 1998).

Property as an investment option has distinguishing features which limit the analysis of its performance. These include:

**Heterogeneity:** Property is infinitely more heterogeneous than other investment media as every property is unique in location, design, condition and size.

**Inelasticity of Supply:** This is a fundamental economic feature of property as its physical overall supply is fixed and the mix of various land uses is difficult to alter due to planning controls. It is therefore difficult for supply of property to instantly react to a change in demand.

**High costs of transfer:** The incidental costs of dealing in property are high relative to those of other investments as various professionals have to be engaged at its transfer. Property agents and lawyers are required to investigate the title, draw up a formal contract, report on the physical condition of the property and, advertise and negotiate on behalf of the seller.

**Special Risks:** Property is subject to special risks such as physical risks of fire, earthquake, flooding and wear and tear. It also subject to the economic risk of obsolescence.

**Imperfect Knowledge:** Transactions involving certain types of property are infrequent and the details concerning them are kept secret.

### 2.3.0 PROPERTY INVESTMENT ALTERNATIVES

There are various options for an investor interested in investing funds in the real estate market in Kenya. These options vary in type, size, locality and returns. Options for investment are found in the residential, commercial, industrial, agricultural and recreational sectors. Investments may also be made in special properties.
2.3.1 **Commercial Properties**

Commercial properties include offices, shops and car parks. Traditionally, offices offered the premier type of property investment due to their rental growth and flexibility of use. In Nairobi, yields on commercial property were estimated in the region of 10-14% throughout the 1990's, which coupled with an 8 – 10% annual capital growth, provided a safe hedge against inflation (*Knight Frank Research, 2000*). However, returns from commercial property investments have been on the decline since the year 200 due to declining rental values.

Factors that affect investment in commercial office property include location, design and lettable area. Of these, the location of a building is of utmost importance. Other factors include the availability of complementary services, type of the neighborhood and availability of utilities. In Nairobi, sale transactions for commercial properties are rare and there exist prime properties that have been on the market for several years such as Stanbank House, Bank House and Chester House. This brings out the illiquid nature of real property as a major disadvantage. With the current over supply of office space in the CBD, office blocks put up by institutional investors have proved difficult to let and resulted in declining rents. The I&M Building on Kenyatta Avenue, the newest building in the CBD completed in 2001, has achieved an all inclusive ground floor rent of Ksh. 100 per square foot and Ksh. 53 for the upper floors.

2.3.2 **Residential Properties**

Residential properties available for investment include single apartments, multi-unit complexes, bungalows and maisonettes. Various factors will influence an investors choice to invest in this sector including: the supply of and demand for the properties, expected rate of return, investors tastes and preferences, price of the property and prices of available alternatives. Investors in residential properties are particular about the location of the property, nature and extent of the accommodation offered, neighbourhood characteristics, design style and finishes.

Rents for multi-unit complex of flats command high rents due to the improved facilities which include swimming pool, satellite television and gym facilities thus giving high yields. Rents range from Ksh.30,000 – 40,000 for three and four bed roomed middle market apartments and Ksh.100,000 – 150,000 for highly serviced apartments like Riverside Park in Westlands belonging to the Insurance Company of East Africa. However, rents for detached houses in up market areas such as Muthaiga have
fallen in the recent past. Single houses on individual plots suffer from high outgoings resulting in investment returns of as little as 5% (Knight Frank Annual Report, 2000). Sale prices for residential houses vary from four million in middle income areas to forty million in up market areas. Yields are influenced by outgoings and vacancy rates.

2.3.3 Industrial Properties

Industrial properties available for investment purposes include warehouses, manufacturing plants and convertible plants. Factors that influence an investor’s decision to invest in this sector include: location, government policies for example on environmental degradation, imminent risks such as fire, respiratory illnesses, water pollution etc. According to Syagga & Aligula (1999), many developers prefer warehousing to factories because of the greater flexibility of use, the wider range of first class tenants such as airlines, import and export companies and the slower rate of physical deterioration. Warehouses located in Nairobi have large volumes of business from storage of goods in transit. On the other hand, most factories are purpose built rather than for rental.

The performance of industrial real estate assets is influenced by their location. Properties with access to good roads and the railway line will let for more than those further away giving a higher return to the investor. Also depending on the nature of the industry, access to a water course into which effluent is disposed adds value to it although this has to be weighed against environmental pollution considerations. Investors in industrial real estate also benefit from industrial estates enjoying tax relief such as the Export Processing Zone (EPZ) in Athi River. Economies gained from common infrastructure and complementary services by industries could increase the value of the investment. The yield obtainable from industrial investments varies with the nature of the property and its level of outgoings.

2.3.4 Agricultural Properties

Agricultural properties available for investment include properties used for the production of food crops, cash crops, animal products and horticulture. Factors that will influence an investor’s decision to invest in this sector will include: the climate, availability of water, soil fertility, availability of transport, and marketing, credit and pricing policies. Agricultural properties are predominant in the peri-urban and rural areas.
Most investors will prefer to invest in other forms of real estate rather than agriculture because of its dependence on prevailing climatic conditions. The performance of an investment in agricultural real estate will depend on the particular sector. Horticulture is considered to have the highest returns presently. However, the outgoings associated with this sector in form of farm inputs, personnel and transport are high.

2.3.5 **Recreational Properties**

Leisure properties offer recreation and enjoyment to an individual and include hotels, lodges, restaurants, casinos, golf courses, stadiums and parks. Factors that would influence an investor’s decision to invest in this sector include: location of the property, design, age, the range of facilities available, government tax policies and security.

Like in other properties, the performance of recreational properties depends on their location. However, there are factors that are specific to recreation properties such as customer tastes and preferences, nature of accommodation facilities, availability of adequate parking, quality of catering services and level of outgoings. These factors will influence the performance of the investment.

New recreational facilities such as restaurants gain a large number of clients who are out to experiment. An investor has to be innovative or to employ relevant creative personnel to keep such clientele interested. In Nairobi, some restaurants have such as Carnivore have managed to do this while others such as City Cabanas have failed to keep the clientele.

2.3.6 **Special Purpose Properties**

Special properties include hospitals, cemeteries, schools, cinema halls, theatres, petrol stations, nursing homes, forests, game park and reserves. Factors that will influence an investor’s decision to invest in these properties include demand for them and government regulation and policies.

The factors that affect the performance of special purpose properties will depend on the nature of the property. Cinemas and theatres have their values affected by availability of wide clear space, support of balconies and galleries, and modern equipment (*Syagga & Aligula, 1999*). In the past, a lofty auditorium influenced the value but the trend recently is to have several small auditoriums such as are
offered by Nu Metro and Fox cinemas. On the other hand, the value of a petrol station is enhanced by its design, accessibility, the volume of traffic along its frontage and the size of the total station.

### 2.4.0 Unit Trusts

Unit trusts are commonly referred to as mutual funds. The principal behind mutual funds is that by several investors purchasing a single holding, an investor acquires an interest in a large number of companies. The investor also gets the benefit of the expert management of the fund portfolios. In addition, the investor is safeguarded against disastrous loss arising from the misfortunes of one or two companies.

A trustee usually a bank or an insurance company holds the securities and cash but the funds are ran by expert management companies which sell units to the public as well as look for the right investment media. In America, mutual funds have outstripped funds held in commercial banks. In Kenya, the establishment and operation of mutual funds is hindered by the lack of a regulatory framework, a limited market depth that does not allow for a variety of investment media, the lack of a coordinated policy on mutual fund growth and the limited knowledge on the operation of mutual funds (*The Kenyan Banker, April – June, 1997*).

Like Unit Trusts, Real Estate Investment Trusts (REIT’s) are quoted companies that have an underlying portfolio of property. Currently, there is no listed Real Estate Investment Trust in Kenya mainly due to the lack of a legislation under which they can be established and operated. Three kinds of constraints influence Real Estate Investment Trusts: constraints on what can be sold, constraints on how much capital can be invested and constraints on what assets the company is willing to hold. The risk levels of individual properties in a REIT’s portfolio may be very different. In addition, there may be tremendous difference in expected returns.

Each REIT’s portfolio is distinct and the differences may be more dramatic than are generally reflected in stock prices (*Wilson & Wilkerson, 2000*). In selecting a Real Estate Investment Trust (REIT), attention has to be paid to the management team, its strategies, balance sheet issues and asset allocation decisions. The long-term driver of the performance of a Real Estate Investment Trust (REIT) is the underlying property and the market in which it is located. The advantages to Trusts are that the investor can achieve a well diversified portfolio which would be impractical with a small amount of money. In addition the Trusts take care of burdensome administration and management and Trust managers ensure
that the price of the units is very close to the underlying net asset value. Usually there are legal restrictions on the maximum deviation allowed from the net asset value (Institute of Bankers, 1979).

Like equity or securities, property investments need re-balancing to keep abreast with shifts in the markets. This means that an analytical framework must become part of the portfolio management process in order to assess investment performance prior to decision making on revision or re-balancing of the portfolio.

2.5.0 PORTFOLIO CONSTRUCTION AND PERFORMANCE ANALYSIS PROCESS

2.5.1 Portfolio Planning

Traditional portfolio planning called for the selection of those assets that best fitted the personal needs and desires of the investor. However, Modern Portfolio Theory follows a more scientific approach based on estimates of risk and return of the portfolio and attitudes of the investor toward a risk-return trade off stemming from the analysis of individual assets. Planning is an essential ingredient for investment decision making which includes three important considerations; specification of the investors position, specification of the portfolio managers position and establishment of the investment criteria that will guide the managers actions on behalf of the investor (Smith, 1970).

Specification of the investors position includes establishment of an investment horizon, identification of the investors objectives and recognition of his capital needs during the investment horizon which will influence the investment managers decisions. The investors capital profile is concerned with the size of the total capital entrusted to the portfolio manager and also with the extent that the investor will add capital or withdraw capital from the portfolio over time. Specification of the portfolio managers position involves recognition of the value his services will add in optimizing asset allocation and increasing returns.

The setting of realistic objectives and the recognition of the constraints must precede the acquisition of assets and the assembly of the investment portfolio. The needs of the investor must be recognized before realistic targets and objectives can be set (Hargitay & Yu, 1993). For corporate investors such as pension schemes, constraints by various statutes and regulations must also be recognized.
Portfolio analysis considers the determination of future risk and return in holding various combinations of individual assets. It takes the ingredients of risk and return for individual investments and considers the blending or interactive effects of combining investment assets.

2.5.2 Investment Performance Measurement and Analysis

The objective of investment performance measurement and analysis is to assess the value of investments on offer or acquired against the market values of similar investments. Performance is measured by comparing the degree of achievement against a set of objectives and expressing it in quantitative terms. Performance measurement therefore looks at the quantified evidence of past performance and a reasoned assessment of future performance.

Comparison of investment is not so simple as the alternatives being considered have varying costs and incomes generated over different periods of time. The discounting technique is used to overcome this difficulty by bringing all future revenues and expenditures to present day values using a given rate of interest known as a discount rate. The resulting cash flow is referred to as the Discounted Cash Flow (DCF) (Isaac, 1998).

To produce a Discounted Cash Flow, an appraiser will use either the borrowing rate, the opportunity cost rate or the target rate or return. The borrowing rate is the rate, which has to be paid for borrowing capital. The opportunity cost rate is the rate which could be earned if the capital was invested elsewhere while the target rate is the rate of return which the investor required to compensate for the risk involved, the loss of immediate consumption and inflation. Usually the target rate of return is used as it can be related to government bond coupon rates.

The risk element in the performance of a property investment implies that the actual rate of return may diverge from the expected rate of return. Risk may therefore, be defined as the amount of potential variability or divergence of the future rate of return about its mean or expected value.

The performance of a property portfolio is the aggregate of the performances of its components, that is, the performance of individual property assets. The appraisal of the performance of individual properties enables the identification of the contribution of the component assets to the overall performance characteristics of the portfolio so that appropriate action may be taken to remedy shortcomings or to improve overall performance.
2.5.3 Components of Property Investment Performance

Since property is regarded as a long-term investment media in which transactions are few and take a long time to conclude, performance measurement can be undertaken annually and not quarterly as is the case of equities. For effective analysis, data requirements include:

1. The capital value of each property at the beginning and at the end of the period of analysis.
2. The incomes and outgoings including additional capital expenditure during the period of analysis,
3. Rental values and trends over the period of analysis,
4. Rental income projections,
5. Details of the lease structure of each property in the portfolio,
6. Details of occupancy costs.

The components of property investment performance are summarized in Figure 2.3 below as follows:

- Portfolio Total Return
  - Sectors Total Return
  - Individual Properties Total Return
    - Income
    - Capital
      - From rental growth
      - From capitalization changes

Source: Hargitay & Yu, 1993 Pg.195
2.5.3.1 Capital Value Estimates

To assess the rate of return, the capital value of individual property investments must be determined. Capital values are determined through valuation which involves the estimation of worth to an individual and can be expressed either as the Net Present Value (NPV) of the cash flow over the holding period of the property or as an internal rate of return (Baum & Cosby, 2002). The Net Present Value is the present value of all cash inflows less the sum of the present value of all cash outflows. Calculation of the Net Present Value requires the estimation of the correct discount rate or required return. On the other hand, the internal rate of return is the discount rate which equates the present value of all inflow and the present value of all outflows. Property valuation methods take into account the concept of discounting income and costs in the future which illustrates the time value of money.

The Net Present Value may also be expressed as the Open Market Value which is defined as: “the best price at which an interest in a property might reasonably be expected to be sold by private treaty at the date of valuation assuming:

a) a willing seller,
b) a reasonable period within which to negotiate the sale has already taken place prior to the valuation date,
c) the nature of the property and the state of the market are as at the valuation date,
d) the property will be freely exposed to the market,
e) no account is to be taken of an additional bid by a special purchaser.”

(Practice Statement 5, Royal Institution of Chartered Surveyors Statement of Asset Valuation Practice and Guidance Notes - The Red Book)

The common valuation approaches are: the Comparison Method, the Profits Method, the Investment Method and the Contractors Method. The Comparison method compares the capital values and rents of properties which have recently been sold or let with the subject property. The Profits method is based on the assumption that the value of a property is based on the profit produced and is used to value properties such as hotels. The Contractors approach is based on the cost of construction and is used when the property has no open market value. The Investment method is used to value capital investments and is obtained by multiplying the net income by the Years Purchase.
Hargitay & Yu (1993) observe that the problem of subjectivity of valuations used for the assessment of capital values continues to be the main source of suspicion for non-property people who are used to the efficient provision of market values in the stock market environment. With the adoption of the International Valuation Standards and the International Accounting Standards, it is hoped that a more standardized approach will be achieved.

2.5.3.2 Rate of Return Estimates

The ultimate decisions to be made in investments are what assets should be held and how much should be allocated to each. These decisions are normally made in two steps.

a) Estimates are prepared of the return and risk associated with available investment vehicles over a forward holding period.

b) The risk-return estimates are then compared in order to decide how to allocate available funds among these investments over a continuing basis. This step comprises portfolio selection, analysis and management.

The required rate of return has three components as follows.

- \( l \) A return for loss of liquidity - non-availability of money, non-consumption.
- \( i \) A return for anticipated inflation
- \( p \) A risk premium - certain investments are more risky than others.

\[ R = l + i + p \]

A good indication of the market requirement of loss of liquidity and anticipated inflation is long term government securities as there is no risk premium because such investments are guaranteed by the government. Therefore, the redemption yield on government securities is used as a measure of the risk free rate of return. Every investment class will have a different risk premium.

The return of an investment is seen as a reward for committing and exposing to risk some capital in investment projects. Total return has two components: the income earned and the increase in the value of the asset acquired (Hargitay & Yu, 1993). Returns across time or from different investments can be measured and compared using the total return of a portfolio. Total return is an acceptable measure of returns for a specified period of time although statistics are required to describe a series of returns.

According to the Markowitz Modern Portfolio Theory, a simple decision rule can be developed for selecting an optimal portfolio for an investor that can take both risk and return into account. This is
called a risk-adjusted return and is the expected return of the portfolio minus the risk penalty. The risk penalty depends on total portfolio risk and the investors risk tolerance (Fischer & Jordan, 1996).

Investment returns are usually regarded as gross potential returns although most prudent investors will be more interested in the real returns after allowances for the inflation and taxes. Since investment means the purchase of future earnings, it is necessary to formulate future return expectations through examination of historical returns and consideration of trends. In order to identify the total return expectation, an appropriate yardstick which is usually a close alternative investment is used. The net return of an investment after costs and other deductions is its profitability which is central to investment decision-making.

The rate of return on a particular investment is determined by the forces of supply and demand within the market, and is evaluated by investors and their advisers by comparing returns from various investments. In the case of equities, there is no knowing in advance precisely when the dividend will be varied and therefore in theory, there is no stability of income. Property investments on the other hand, usually provide for rent reviews at regular intervals and thus the timing of future variations of income is known precisely.

2.5.3.3 Risk Estimates

Fischer & Jordan (1996), define risk as the standard deviation around expected return. The more the variability, the greater the risk. Investors perceive investment risk in terms of: security of capital invested; security of expected incomes; liquidity and problems of asset management. Risk may be systematic or unsystematic where systematic risk refers to the portion of total variability in return caused by factors affecting the values of all investments and unsystematic risk is the portion of total risk that is unique to a firm or industry.

Systematic risk includes market risk, inflation risk and interest rate risk. Unsystmeatic risks surround the ability of the investor to achieve the target rate of return either due to the operating conditions of the firm or the way in which the firms operations are financed, that is business risk or financial risk respectively. Business risk may be internal or external. Internal business risk is largely associated with the efficiency with which a firm conducts its operations within the broader operating environment imposed upon it. On the other hand, external business risk is a result of operating conditions imposed upon the firm by circumstances beyond its control (Fischer & Jordan, 1996).
Financial risk is associated with the way a company finances its activities. It is usually gauged by looking at the capital structure of a firm. The presence of borrowed money or debt in the capital structure creates fixed payments in the form of interest that must be sustained by the firm. The presence of these interest commitments causes the amount of residual earnings available to be more variable than if no interest payments were required.

**Assigning Risk Allowances**

According to *Fischer & Jordan (1996)*, one way of quantifying risk and building a required rate of return would be to express the required rate as comprising the risk free rate plus compensation for individual risk factors previously enunciated. The quantification of risk is necessary to ensure uniform interpretation and comparison between assets. Investment managers must strive to provide not only careful and reasonable estimate of return but also some measure of the degree of uncertainty associated with these estimates of return.

Extracts from the Property Appraisal Study Guide of the School of Architecture and Construction, University of Greenwich, the traditional view of risk in property assets was as follows.

i) Tenant/Default Risk – The perceived risk occurs in a situation where the investor receives no rent or a reduced income. This could be due to none payment because the tenant is experiencing financial difficulties. Also due to non-compliance with repairing obligations which mean that the landlord has to pay the cost of repairs.

ii) Structural Risk – This relates to a situation where the physical property asset suffers from construction defects. These may produce an abnormally high maintenance cost. Moreover, the landlord may have to pay for significant cost of refurbishment. In extreme circumstances the building may suffer from structural failure. Also functional obsolescence may occur when changing technology renders the property unsuitable for the needs of modern occupiers.

iii) Legislation – Changes to legislation can have a significant impact on the income producing ability of a property asset. Changes in case law can impose new burdens on landlords or give tenants extra rights. The listing of a property or its inclusion in a conservation area such as under the
Antiques and Monuments Act, will reduce the landlord’s ability to physically change a property and may reduce its income generating ability.

iv) Taxation - Property has been subject to numerous different types of taxes in the past such as the tax on commercial properties introduced by the Kenya Revenue Authority in 2000 and later withdrawn. The introduction of new taxes or the abolition of existing taxes can have repercussions for property investment performance.

v) Planning - The policies of the local and national planning authorities will affect the investment performance of property assets. In general a restrictive policy favours existing investors, whilst a *laissez-faire* approach can have dramatic effects on the investment potential of a property asset.

vi) Liquidity – Property is a lumpy investment and there is a limited number of potential buyers for a large development. It is difficult to assess the extent to which values can be realized and the certainty of disposing a property asset at a reasonable price.

An analysis of investment risk can be summarized as follows:

**Figure 2.4 Summary of Investment Risk**

![Diagram of Investment Risk]

The capitalization rate of a property investment depends on interest rates, inflation expectations and market conditions. The prospective Net Operating Income will depend on the Gross Income obtained and the extent of operating expenses that is \( \text{NOI} = \text{GI} - \text{OE} \). The gross income is obtained from rent and its level depends on the lease arrangements, level of investment exposure to the market and the efficiency of management. On the other hand, the level of operating expenses will also depend on the lease structures, provisions of service contract, vacancy levels and efficiency of management.
Risk Diversification

Total risk has two components; diversifiable and non diversifiable risk (Fischer & Jordan, 1996). Diversifiable risk represents the portion of an investments risk that can be eliminated by holding a large enough portfolio of assets. Non diversifiable risk is unavoidable and is therefore the risk of concern. Each asset possesses its own level of non-diversifiable risk. It is possible to diversify away risk by constructing a balanced portfolio.

The key components in the measurement of risk are beta and the Capital Asset Pricing Model. Beta is a statistical measure of non-diversifiable risk which shows how the price of an asset responds to market prices. The more responsive the price, the higher will be the beta. The Capital Asset Pricing Model links beta to the level of required return.

Risk Measurement

Investors must relate the risk perceived in a given asset not only to returns but to their own attitudes toward risk. The risk evaluation process is not one in which we simply calculate risk and compare it to a maximum risk level associated with an investment offering a given return. An investor wants to know if the amount of perceived risk is worth taking in order to get the expected returns, or whether a higher return is possible for the same level of risk. Risk may be assessed by considering the following factors:

1. The variance or standard deviation of the rate of return,
2. Comparing the actual balance of the portfolio achieved through diversification with the target balance,
3. Assessing the capital value growth and its historical variation,
4. Assessing the rate of growth of rental value and its historic variation,

Investors are typically risk averse and would require an increase in the level of return for an increase in risk. Investors evaluate the risk – return behaviour of each alternative investment to ensure that the return expected is reasonable given its level of risk. Investors want to maximize expected return subject to their tolerance for risk.
2.6.0 PROPERTY INVESTMENT ANALYSIS TECHNIQUES

Performance is achievement relative to targets and objectives (Hargitay & Yu, 1993:47). Performance is measured by comparing the degree of achievement against a set of objectives and expressing it in quantitative terms. Performance measurement therefore looks at the quantified evidence of past performance and a reasoned assessment of future performance. The objectives of Performance Analysis can be stated as:

- To monitor the progress of invested capital,
- To monitor relative performance of the investment in comparison to other investments,
- To analyse past performance for decision making,
- To evaluate the performance of the management (Hargitay & Yu, 1993)

Through the monitoring and analysis of portfolio performance, the investor can gain valuable insight into the investment characteristics and behavior of various assets. Techniques applied in the measurement of the performance of investment property include:

2.6.1 Payback Period Method

This method involves the calculation of the number of years that it takes to pay back the original investment in a project. The decision rule in this technique is to accept projects if the pay-back period is less than the agreed cut off period. The shortcomings of this technique are that it does not take into account the timing of the cash inflows and outflows during the investments holding period. Thus the discounting effect is completely ignored and it does not recognize cash flows occurring after the payback cut-off point and ignores overall profitability. In addition, the technique treats all projects in the same way irrespective of their risk, thus a riskier project with a shorter pay-back period may be accepted in error.

The discounted payback period method may be used to take into account the time value of money. However, it requires a lot of work to set up the cash flows and calculation of the discounted pay-back is no simpler than calculating net present values (Brown & Matysiak, 2000).
2.6.2 Return on Investment Method

This approach expresses a rate of profit as a percentage of the cost of an investment or capital employed in the project. A target return is set and if the profitability exceeds this figure, then the project is acceptable. However, the capital value in this context is the price paid or the cost and the yield is the initial yield. This appraisal is therefore, a form of a market valuation rather than an analysis of the investment (Isaac, 1998). Since the rate of return is calculated from accounting figures, it may differ from the market determined rates of return. In addition, the yield obtained by use of the pre-determined cut-off rate does not reflect profitability. As a result low risk/low return projects may be rejected even though they may be profitable while high risk/high return projects may be accepted even if they are unprofitable (Brown & Matysiak, 2000).

The advantage with this approach is that it uses the same criteria both for analysis of projects and for overall business profitability. The same target rate can be used for projects and for the business. However, this method ignores the time value of money.

2.6.3 Discounted Cash Flow Techniques

The discounting technique brings all future revenues and expenditures to present day values using a given rate of interest known as a discount rate to form a cash flow referred to as the Discounted Cash Flow. Discounted Cash Flow recognizes that costs and revenues arise at different times and that the future is uncertain and forecasted cash flows may not arise as predicted. The discounted cash flow appears to give a clear indication of the accept/reject decision for investment appraisal through the determination of the Internal Rate of Return (IRR) and the Net Present Value (NPV).

The internal rate of return is the discount rate which equates the present value of all inflows and the present value of all outflows. The decision rule when using this technique is to accept a project if the internal rate of return exceeds the opportunity cost of capital. To produce a Discounted Cash Flow, three forms of discount rate may be used: the borrowing rate of capital, the opportunity cost of capital or the rate of return which the investor requires to compensate for the risk involved – the target rate.

The decision rule when using this technique is to accept the project if the net present value is greater than zero when discounted at the opportunity cost of capital. This technique is attractive as the value additive principle, which implies that if the NPV for one project is known, it can be added to the NPV
for other projects to determine if there will be an overall increase in value, can be applied (Brown & Matysiak, 2000).

2.7.0 PERFORMANCE MEASUREMENT IN PROPERTY INVESTMENTS

2.7.1 Assessment of Capital Values

The determination of capital values of quoted shares at the Stock Exchange does not represent any difficulties, as the price information is available on all assets traded at the stock markets on a daily basis. Capital value assessments are also needed for the appraisal of the performance of property portfolios. In fact, capital values of property assets are regarded as the most important parameters the analysis of investment performance (Hargitay & Yu, 1993).

The investment performance of a property portfolio is assessed in terms of incomes and the realized or unrealized capital gains or losses. Capital gains or losses are reflected in terms of the change in market values. The recommended basis for valuation of property assets is the Open Market Value which is defined as the capital value of a property asset as the reflection of the market at a particular point in time, in the past or in the present. Determination of the Open Market Value implies acceptance of the current market consensus regarding estimated rental values and capitalization rates (Hargitay & Yu, 1993).

The capital value of a property investment is estimated after considering annual net income, estimated rental value, lease structures and discount rate and yields. Increasingly, the Discounted Cash Flow valuation method is being used to estimate capital values and make forecasts for capital gain.

2.7.2 Assessment of Net Returns

Measurement of individual property returns can be done on the basis of a simple measurement of return that is arrived at by taking the gross annual rent receivable, subtracting outgoings and expressing it as a ratio of the initial capital outlay for the property. Returns may be considered in terms of the initial yield obtained from the first years income or the terminal yield obtained from the income level at the end of the holding period.
2.7.3 Use of Property Indices

Indices are a useful way to tracking market changes and trends in a particular sector of the economy. In developed economies, many property measures such as capital growth, rental growth and total return are provided in terms of an index number. An index number is a summary measure provided by a single number which gives the average value of a set of related items. The number is expressed as a percentage of the average value at some base period. For instance, if 1981 is taken to be a base period against which all future periods will be compared, the capital value in 1981 is arbitrarily assigned a value of 100 since the future values will show the percentage change that has occurred since the 1981 base date. In order to arrive at any index number, the capital value in the year in question is divided by the value in the base year and multiplied by 1000. The index numbers are shown to one decimal place rounded up (Brown & Matysiak, 2000).

Indices are categorized into:

1. Capital and capital growth indices,
2. Rental and rental growth indices
3. Total return indices

Capital growth indices are derived from the capital growth trends of properties in the same sub-sector while rental growth indices are derived from determination of the values per square metre of the properties constituting the index, their operating costs and vacancy rates. Total return indices are derived from the total returns for many different types of property, locations, ages and sizes of buildings. To obtain real total return for comparison between various portfolios, the following components are considered: income return, capital growth, initial yield and inflation rates (SAPIX/IPD South Africa Property Digest 2002)

Indices such as the Richard Ellis Index use open market rental values and yields estimated from a representative sample at different rent points rather than specific properties. The measure reflects the best rent obtainable assuming it is available on the open market. On the other hand, other indices such as the Jones Lang Lasalle Index employ a portfolio method where the performance of a representative portfolio with actual properties is measured. The portfolio index reflects factors such as voids, rent-free periods and other tenant inducements. The Investment Property Data bank Annual Index which is the mostly widely used measure of UK property performance had 2,812 properties with a capital value of...
7.86 billion pounds in its database (Brown & Matysiak, 2000). The majority of information relates to properties owned by pension funds and insurance companies.

All investors need to examine the performance of their investments in the context of the investment market. There is a need to establish a suitable yardstick against which the performance of individual investments and portfolios may be judged and to determine whether the investment has achieved an above or below average measure of success. According to Hargitay & Yu (1993), the property investment market has been notoriously ill-equipped with reliable market indices. The main reason for the slow evolution of the property market is cited as the fragmented and localized nature of the property market where all individual investments are unique. Most investment managers are concerned about their own performance and the performance of their portfolios relative to the performance of others through comparison with an appropriate market index.

The construction of property market indices is complicated by the nature, availability and collection of data. The data requirements are such that specialized data banks need to be set up. Without an efficient and well-designed data bank, the provision of a reliable property index is virtually impossible. An immediate and fairly good guide to the reliability of an index is the number of properties included in the survey.

There are a number of indices in general use in investment practice. Most of these indices reflect market movements and the various stock markets and securities market while some like the Consumer Price Index are used as general indicators of the state of the economy. In Kenya, the Nairobi Stock Exchange Index is used to judge the performance of equities.

The fact remains that the property market and property investments are very different from securities and equity markets. Equity markets are centralized markets with a large number of daily transactions whose details are well publicized. On the other hand, the property market is fragmented with relatively few transactions whose details are not usually revealed. Under these conditions, the construction of an overall, comprehensive property market index is a remote possibility. However, the purpose, objective and scope of a property index may be defined within the confines of the property environment in order to be useful and successful (Isaac, 1998).

Since the evidence of property transactions of institutional investors is more readily available and easier to co-ordinate, property indices should be used for analysis of institutional investment activity and if
comparisons are necessary, they should be made with institutions investments and performance in other investment media and not the performance of the markets themselves (Hargitay & Yu, 1993).

2.8.0 PERFORMANCE MEASUREMENT FOR EQUITIES

The following measures of earning and profitability are used in the analysis of equities and securities:

1. Ratios

Ratios are used to determine the prospects of a firm, quality of earnings and the ability of the management. Ratios in common use include:

a) Return on Capital Employed (ROCE) or Return on Investment (ROI)
This is a popular measure of net return which is the ratio of the earnings and the capital committed to an investment. The returns used in this ratio are usually pre-tax operating earnings while capital is the total sum of all long-term funds employed in the enterprise.

b) Earnings per Share (EPS)
This is the simple ratio of the returns on equity divided by the number ordinary shares issued. It gives the earning per share.

c) Price to Earnings Ratio (P/E)
This ratio relates earnings per share to the current price of a share.

2. Beta Coefficients

The beta coefficient purports to measure the risk level of a particular share relative to the stock market as a whole. If a share has a beta coefficient of one the share is considered to be no more or less risky than the stock market as a whole. The higher the beta coefficient, the more risky the share is considered to be. Computer software is used to calculate the beta coefficient and compare the return on a particular share (dividend and capital gain) over a given number of periods with the total return on the stock market as a whole for these periods. Generally, a high-geared share will have a higher beta coefficient than a low-geared share.
3. Management

Management is an intangible factor in the past and potential performance of a company. If a company’s rate of growth consistently exceeds those of similar companies, then the reason could well be due to good management. Likewise if a company’s performance is consistently below similar companies it could as well be due to management or lack of it.

4. Performance of the Industry

Performance of any investment sector can be obtained from government publications, industry watchdogs and the media. Government publications such as the Economic Survey and Leading Economic Indicators will give general trends in macro-economic indicators. Sector performances with past trends and forecasts may be obtained from organizations such as the Capital Markets Authority. Reports from the media will give information such as interim and final results of companies, news of corporate bond issues, take-overs, management changes and industry development, active stocks and major price changes.

According to Wanjala (1999), in analysing the performance of various investment vehicles, the most important information comes from company accounts. Information available from the balance sheet include: the book value of assets, shareholders funds, determination of net asset value per ordinary share, capital cover, gearing ratios, liquidity ratios, earning ratios, earnings yields, income cover and cash flow statements.

There is a need to standardize the measures of profitability in order to facilitate the proper comparison of opportunities in competing investment media.

2.9.0 PORTFOLIO REVISION

Revision of an investment portfolio mostly involves disposal of non-performing assets. The strategy for the disposal of assets is important especially in terms of timing. For equities and securities, the general rule is to sell when prices are high. From the analysis of performance of equities, if the present value of future earnings is much smaller than the current price, then the security should be sold. Disposals during the revision of a portfolio are also carried out if:
1. The asset no longer meets portfolio objectives,
2. the market price of the asset is very high,
3. return and risk ratios are low,
4. other investment opportunities are extremely attractive,
5. there are tax advantages to be realized.

The real estate investment life cycle must be considered during the construction or revision of a property portfolio. According to the concept of a property life-cycle developed by Seldin (1979), there is an upside period of between one and five years during which the risks inherent in the property ownership decrease through four stages: ground floor; loan commitment stage; interim stage; and tenancy. The downside period of between forty and fifty years during which the risks associated with the property increased in four stages: absorption; maturing process; aging process and demise. A developer is associated with the property at the beginning and end phases of the property life-cycle whilst an equity investor is more likely to be involved during the middle phases of the property life-cycle.

According to Wanjala (1999), a basic portfolio should include an emergency cash reserve, gilts for guaranteed income, equities with scope for growth of income and capital and tax free investments. In addition, large portfolios benefit from a property element which should be provided by indirect methods such as property bonds. This structure spreads the risk across a range of different types of investment thus increasing diversification. The need for careful selection and revision of an investment portfolio cannot be over emphasized as portfolio construction can make or break the performance of a pool of assets.

2.10.0 INFORMATION REQUIREMENTS FOR INVESTMENT PORTFOLIO CONSTRUCTION AND PERFORMANCE ANALYSIS

2.10.1 Information on the Economy

Information on the economy is in form of macro-economic information from statistics published by the government or official bodies. Macro-economic information enables the investment sector under review to be seen in the context of the economy. The leading macro-economic indicators are the Gross Domestic Product (GDP), inflation rate, treasury bill rates, commercial bank interest rates and foreign exchange rate and consumer and investment indices. This information is essential for understanding the state of the economy.
2.10.2 Information on the Property Market

Unlike the stock market, there is no central market for generating information on the property market. Property investment analysis therefore has to rely on the gathering of up-to-date market information from all available sources. Information required includes:

Activity Indicators: This information is found in transactions of land and buildings, investment in new construction and institutional investment in property. Transaction data comes in form the plot area, type of development, sale price and the date of sale.

Building rents and occupancy costs: Levels and trends of rental values provide the basic information for the determination of income and possible growth. Net annual rentals are used to compute the return on capital invested.

Property Investment Performance Indicators: Market indices and reports provide information on investment yields, returns and capital values. Different property indices present their data in different forms of yield and capital values. Data is normally subdivided into different property categories and geographical coverage. Each index derives its data from different primary sources and the frequency of production and periods covered differ.

Property Finance: Property has traditionally been regarded as a secure form of collateral for banks and other lending institutions. Information on banks lending against property can be used to assess the current state of the property market as well as future prospects.

2.10.3 Information on Individual Property

For individual property performance measurement and analysis information is required on the property’s physical, legal and financial attributes. Information on planning, land use and development controls is important for investment analysis of properties which are subject to changes in land use or with potential for change of use.

Information requirements for Property Investment Analysis are summarized in Figure 2.5 below:
Figure 2.5  Information Requirements for Property Investment Analysis

INFORMATION ON INTERNATIONAL EVENTS AND THE WORLD ECONOMY

INFORMATION ON THE PROPERTY MARKET:
- Economic Growth
- Inflation Rate
- Interest Rates
- Activity Levels
- Consumption and Investment

INFORMATION ON THE INDIVIDUAL PROPERTY:
- Geographical Location
- Physical Attributes
- Legal Attributes
- Rental Income
- Capital Value
- Occupancy Costs
- Lease Structures

Source: Hargitay & Yu, 1993: 249

Information on property is obtained from different kinds of sources which include property indices, reports and journals, newspaper reports, handbooks, company accounts, and other agencies such as banks and real estate agents. Before an advisor can advise an investor on suitable investments s/he must elicit information from the investor that will aid the correct choice of investments. The portfolio of investments recommended to a client will be based upon the accurate usage of all the information provided by the client. In general the information to be sought will include: the clients marginal rate of tax, attitude to risk, required income and capital growth.

2.11.0 GLOBAL TRENDS IN PROPERTY INVESTMENT ANALYSIS

Historically, UK institutions held about 5% (per cent) of assets in property but are now looking to boost this figure to about 15% due to changing perceptions of property investing. According to the Financial Times Mandate, 14th August 2003, the priorities of investors have changed and diversification, yield and...
long-term stability are now considered more important. Whereas the investment in commercial property by pension schemes had fallen from an average of 14% of total fund value in 1971 to 4% in 2001, property returns outperformed returns from bonds and glits but were less than returns from equities.

According to Enever (1994), there are three categories of research into property investment that are being developed globally:

i. The development of measures of property performance at an individual property or portfolio level and in terms of benchmark market indicators, and hence the development of commercial property indices,

ii. The forecasting of activity at a variety of levels from macro-economic forecasts, through national property market trends to detailed analysis at sector, region and town level,

iii. The combination of performance measurement and the forecasting of results to establish portfolio strategies; that is the diversification of the portfolio, the management of property as a financial asset and the buy/sell decision.

A report prepared by the Director of Resources for the Devon County Council in the United Kingdom advised against direct investment in property as it is expensive to deal in and to manage, it is illiquid and it can depreciate in value if it does not meet present day standards, or tenant requirements. Investment through Property Investment Trusts or Unit Trusts was recommended as it avoids the property management responsibilities and allows the pension scheme access to a broader spread of individual properties (including very large ones) than it could otherwise afford. This reduces risk and can improve performance (www.devon.gov.uk/dcc/committee/reports).

In the developed countries such as USA and UK, the selection of an investment manager to manage pension funds is a competitive exercise based on the manager’s products and team. The investment manager has to be able to clearly explain the firm’s investment process and products to the pension fund trustees. Appointment of an investment manager is made mainly to monitor and balance the asset allocation of the pension scheme.

Globally, there are various property indices which offer a comprehensive reference guide to the performance of property investments. These indices include the Investment Property Databank (IPD), Jones Lang Wootton (JLW) Property Index, Richard Ellis Property Market Indicators and the
Weatherall Green and Smith (WGS) Quarterly Property Index (Isaac, 1998). In Africa, the only property index worth noting is the Investment Property Databank (SA) which was established in 1997.

In collaboration with the South African Property Information Exchange (SAPIX) the IPD SA, provides market information for “portfolio analysis on property investment, to give fund managers and investors fair benchmarks for total returns plus a full evaluation of investment strategy and portfolio quality” (IPD SA Handout, March 2003). The results of the index are outcomes for real properties and are based on a Databank covering 17 institutional and property company portfolios which at the end of 2001 had a total value of R47.7 billion (Kshs.477 billion at 10Ksh: Rand) (SAPIX/IPD Property Digest 2002).

2.12.0 Investment Managers

According to the Financial Times Mandate 14th July 2003, in the year 2003, 85% of European institutional investors used external investment managers compared 62% the previous year. A survey by the Invesco European Institutional Asset management in 2003, indicated that the trend was to manager diversify with 30% of the institutions using more than five managers to avoid over exposure to one market. The advantage with multi-managers is that assets are held with a single custodian and changing a manager only means changing the adviser on a particular sub-portfolio rather than physically moving the assets.

There are many local independent firms that act as investment advisors. Their main functions are; advise on the best rates of return currently available, best shares at the stock exchange and tax planning. Investment advisors charge a fee for the advice and will remit commission received on, for example, unit trust deals, against the fee. Other investment advisors will provide the best advice on a range of products from different companies and earn their remuneration form the commission received and do not charge the investor fees (Wanjala, 1999).

Good investment environment has to be created by the government, the business community and professionals. The government has to set up rules and regulations to govern and protect investors such as the Banking Act and the Retirement Benefits Act.
To value or appraise means either to fix a price for or to estimate the worth of something to an individual. Valuation gives the best price at which an interest in property might reasonably be expected to be sold. On the other hand, the estimation of worth does not necessarily give the market value as it considers subjective estimates of other factors that are important to the individual for whom the appraisal is carried out. According to Baum & Cosby (2002), market valuations should be accurate, that is they should closely predict selling price. Valuations of worth on the other hand should be rational in order to facilitate decision making.

In the appraisal of property investments, the concern is with the prediction of the most likely selling price of a real property investment in the market or with the estimation of the worth of such an investment to a prospective purchaser. Property investors are looking for more analysis in valuations because situations have occurred where the returns on property investments have not reflected target returns set out in accordance with the price paid. According to Baum & Cosby (2002) appraisal should be clearly divided into property valuation to determine the market price and subsequent analysis of performance. The former ought to be referred to as valuation and the later as analysis. The overall process is termed ‘property appraisal’.

Therefore, the valuation of the property, that is the calculation of the exchange value for the property, is different from the subsequent analysis of the performance of the investment which is the appraisal of its actual worth. The calculations before and after purchase will not agree because of the lack of perfect
knowledge in the market at the time of the transaction and the inability to predict the future changes in cash flow and the risk profile of the investment accurately (Isaac, 1998).

To anticipate market value or to record and analyse the progress of an investment after purchase, the Discounted Cash Flow technique is used. Property investment performance is considered too complex and specialized to be analysed side by side with other investment assets. Rational decision-making on property investments is virtually impossible without the quantified evidence of past performance and a reasoned assessment of likely future performance. A performance appraisal report should quantify historical performance, provide explanations for good or bad performance, assess expected future performance and assist in re-assessing investment strategies.
FIGURE 2.7: CONCEPTUAL MODEL FOR PORTFOLIO CONSTRUCTION AND PERFORMANCE ANALYSIS

INFORMATION BASE
- Review of the General Economic, Social and Political Situation
- Review of the General State of the Investment Market
- Historical Performance and Forecasts for Different Investment Media
- Historical Performance and Forecasts for Specific Sectors
- Tax structure
- Inflation Trends

1. Establish investor's investment goals and objectives
2. Available Funds for Investment
3. Statutory Constraints
4. Investors' Attitude to Risk

- Identify Alternative Investment Scenarios
- Select the Optimal Investment Strategy
- Appraise Different Investment Media
- Select Preferred Sectors for Investment
- Allocate Funds and Set Time Horizons
- Construct Portfolio by Acquiring Preferred Investments
- Periodically Appraise Different Sectors in the Portfolio
- Periodically Appraise Individual Investments
- Forecast Future Performance of Investments
- Formulate Guidelines for Action for the next Portfolio Period
- Revision of the Portfolio

Complied from Author’s Literature Review, 2003.
CHAPTER THREE

STATUTORY BODIES REGULATING LONG TERM INVESTMENTS
3.0 STATUTORY BODIES REGULATING LONG-TERM INVESTMENTS IN KENYA

3.1.0 The Retirement Benefits Authority (RBA)

The Retirement Benefits Authority (RBA) was established through an act of parliament and came into operation in January 1999. The Authority was formed as part of the reform process in the financial sector aimed at bringing the retirement benefits industry under a harmonized legislation. The Act’s dual broad objectives are to protect the interests of members and sponsors of retirement schemes so as to ensure that members receive a reasonable retirement income and, to spur Kenya’s economic growth through enhancing the mobilization of domestic savings and capital formation.

The objectives and functions of the Authority as outlined in Section 5 of the Retirement Benefits Act No. 3 of 1997 are to:

a) Regulate and supervise the establishment and management of retirement benefit schemes,
b) Protect the interests of members and sponsors of retirement benefits sector,
c) Promote the development of the retirement benefits sector,
d) Advise the Minister on the national policy to be followed with regard to retirement benefits schemes and to implement all government policies relating thereto.
e) Perform such other functions as are conferred on it by the Act or any other written law.

3.1.1 Retirement Benefit Schemes

All retirement benefit schemes in Kenya must be established under an irrevocable trust, that is, an arrangement under which property is held by persons (trustees) who are bound by law to use the property for the benefit of other persons. The schemes are constituted under irrevocable trusts so as to maintain a legal separation between the scheme and the business of the founder. The assets of the scheme should be completely segregated from those of the founder and therefore the scheme should not be prejudiced if the founder experiences financial difficulties.

The usual practice is to prepare a Trust Deed and Rules which should be approved by both the Commissioner of Income Tax and the Retirement Benefits Authority. The Trust Deed sets out the powers of the Trustees and forms a contract between the Trustees and the Founder of the Scheme.
Trust Deed also indicates the number of trustees required to run the scheme, the method of their appointment and removal, and basic guidelines for investment. The Rules are a contract between the Trustees and the Members of the Scheme and set out the nature of the benefits payable and the manner in which these benefits will be paid.

The Retirement Benefits Act seeks to protect the interests of members through limiting the Trustees powers of investments. It provides that every scheme should have a prudent investment policy on the investment of funds of the scheme so as to maintain the capital funds of the scheme and to secure market rates of return on the investment of the funds.

3.1.2 The Role of Pension Fund Trustees

The RBA adopts a liberalized free market approach where private sector professionals compete equally to provide administration, management and custody services for retirement benefit funds. Under the Retirement Benefits Act, every scheme is required to have a scheme fund separately maintained from any other funds under the control of the trustees or fund manager. This provision intends to protect the interest of the members of the scheme by preventing access to the scheme funds by the employer or other parties. The provision of separation of scheme funds also reinforces the essence of the trust, that is, the scheme fund being trust property should be maintained entirely separate from any other legal entity (East African Standard, September 14, 2001).

Section 32 of the Retirement Benefits Act provides that every scheme other than those funded out of the Consolidated Fund should establish a scheme fund into which investment earnings, income and all other moneys payable under the scheme rules or the Act shall be paid. Section 37 further provides that each scheme shall have an investment policy. Regulation 37 of the Retirement Benefits (Occupational Retirement Schemes) Regulations 2000 requires that each scheme prepares an investment policy under the advise of a professional investment advisor. Such investment policy should be revised and up-dated every three years.

To maintain professionalism and accountability in the operations of schemes, the RBA Act mandates for distinct separation of roles of the different players in retirement benefits business. There is now a clear distinction between the trustees, managers and custodians of the schemes. The Trustees of schemes are the ultimate guardians and legal owners of the scheme fund and are directly accountable to members to ensure that their benefits are safeguarded while Fund Managers are hired by the trustees to advice on
investment of scheme funds in a manner that balances the need for optimizing returns, reducing inherent risks and maintaining sufficient liquidity for the scheme to meet its obligations. Schemes custodians are charged with the responsibility of safe custody of scheme assets and title documents. The benefits arising from this separation is in terms of higher investment returns and increased transparency and accountability in scheme affairs.

Further the Retirement Benefits Authority has barred loaning of scheme funds to any person and prohibited the use of scheme funds as collateral for borrowing by any person.

3.1.3 The Role of Investment Managers or Fund Managers

Most Trustees are not investment analysts and therefore, it is crucial for them to engage the services of a capable professional team comprising of asset managers and actuaries. Fund managers are hired to advice on the investments of scheme funds. Under Section 25 of the Retirement Benefits Act, an applicant can only be registered as a manager if the applicant is:

1. Is a limited liability company incorporated under the Companies Act whose liability is limited by shares and whose main object is to manage scheme funds,
2. Has such minimum paid up share capital as may be prescribed,
3. Is capable of meeting the obligations to members and sponsors specified in the scheme rules,
4. Has the professional capacity to manage scheme funds,
5. Had never been involved in the management of any scheme which was deregistered due to any failure on the part of the management.
6. Meets such additional requirements as may be prescribed.

To optimize returns in every investment sector, the investment managers must have access to sufficient, up to date information on the sectors performance during construction, performance appraisal and revision of the portfolio. Currently, there are 11 (eleven) registered managers. Figure 3.1 indicates the investment portfolio of Retirement Benefits Schemes held they these managers as at December 2002 was as follows.
<table>
<thead>
<tr>
<th>Manager</th>
<th>No of Schemes</th>
<th>Cash</th>
<th>Fixed Deposits</th>
<th>Fixed Income</th>
<th>Government Securities</th>
<th>Quoted Equity</th>
<th>Unquoted Equity</th>
<th>Offshore</th>
<th>Immovable Property</th>
<th>Guaranteed Funds</th>
<th>Other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFR</td>
<td>98</td>
<td>415</td>
<td>919.7</td>
<td>862.3</td>
<td>8,379.8</td>
<td>1,281.4</td>
<td>48.2</td>
<td>127.5</td>
<td>1,077.9</td>
<td>1,060.7</td>
<td>3.0</td>
<td>14,175.2</td>
</tr>
<tr>
<td>AIG</td>
<td>129</td>
<td>289.5</td>
<td>1,063.5</td>
<td>1,237.3</td>
<td>12,968.6</td>
<td>2,642.8</td>
<td>152.4</td>
<td>2,178.7</td>
<td>7.4</td>
<td>0.0</td>
<td>0.0</td>
<td>20,540.2</td>
</tr>
<tr>
<td>CFC</td>
<td>32</td>
<td>808.1</td>
<td>2.5</td>
<td>20.9</td>
<td>82.6</td>
<td>7.4</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>760.9</td>
</tr>
<tr>
<td>COOP</td>
<td>66</td>
<td>123.9</td>
<td>59.1</td>
<td>381.6</td>
<td>972.4</td>
<td>187.4</td>
<td>379.4</td>
<td>0.0</td>
<td>241.0</td>
<td>0.0</td>
<td>0.0</td>
<td>2,344.7</td>
</tr>
<tr>
<td>GEN</td>
<td>39</td>
<td>62.1</td>
<td>742.7</td>
<td>785.7</td>
<td>4,462</td>
<td>332.7</td>
<td>2.4</td>
<td>145.7</td>
<td>179.4</td>
<td>30.2</td>
<td>1.3</td>
<td>6,444.2</td>
</tr>
<tr>
<td>ICEA</td>
<td>211</td>
<td>7.1</td>
<td>211.2</td>
<td>33.5</td>
<td>800.9</td>
<td>165.3</td>
<td>4.0</td>
<td>0.0</td>
<td>1,361.5</td>
<td>4,825.7</td>
<td>0.0</td>
<td>7,409.0</td>
</tr>
<tr>
<td>JUBI</td>
<td>62</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>2.3</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>4,254.9</td>
<td>0.0</td>
<td>1,257.2</td>
</tr>
<tr>
<td>KENI</td>
<td>82</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>1,105.1</td>
<td>0.0</td>
<td>1,105.1</td>
</tr>
<tr>
<td>OM (EA)</td>
<td>6</td>
<td>1,438.1</td>
<td>608.2</td>
<td>121.9</td>
<td>3,411</td>
<td>1,348</td>
<td>101.6</td>
<td>197.9</td>
<td>2,294.9</td>
<td>0.0</td>
<td>0.3</td>
<td>9,816.9</td>
</tr>
<tr>
<td>SIMS</td>
<td>53</td>
<td>176.1</td>
<td>204.3</td>
<td>283.9</td>
<td>2,038.5</td>
<td>266.8</td>
<td>1,184.8</td>
<td>225.3</td>
<td>109.5</td>
<td>229.6</td>
<td>0.0</td>
<td>3,535.2</td>
</tr>
<tr>
<td>TOTAL</td>
<td>778</td>
<td>2,512.6</td>
<td>3,811.1</td>
<td>4,030</td>
<td>32,815.9</td>
<td>6,225.4</td>
<td>689.2</td>
<td>2,875.3</td>
<td>5,271.6</td>
<td>9,152.9</td>
<td>4.6</td>
<td>67,388.6</td>
</tr>
<tr>
<td>NSSF</td>
<td>1</td>
<td>3,482.8</td>
<td>0.0</td>
<td>2,943.8</td>
<td>2,422.8</td>
<td>4,634.6</td>
<td>587.3</td>
<td>0.0</td>
<td>36,021.3</td>
<td>0.0</td>
<td>0.0</td>
<td>50,092.3</td>
</tr>
</tbody>
</table>

Source: (RBA News, March 2003)
In relation to investment funds, Section 37 (1) of the Act provides that

'every scheme shall have a prudent investment policy on the investment of funds of the scheme so as to maintain the capital funds of the scheme and generally to secure market rates of return on such investment'.

Although the Act does not set a benchmark for the return that a Trustee should secure from the investments, it does state that the Trustees should not loose the capital in the process of investing the funds. In order to evaluate whether the investment has secured market rates of return, an objective standard must be set. Whereas it may be easy to gauge what the market rate or return is with regard to fixed income securities, it may not be that easy to judge the position with regard to equities or property. Clearly, a performance index that charts the average of market rates should be developed in order to set the benchmark against which Trustees may gauge their performance (Wanjala, 1999).

The Trustees must have an investment policy which is a set of rules that guides their investment decisions. These rules are documented as the Retirement Benefits Authority can require the Trustees to explain the rationale behind an investment or otherwise defend their investment policy. When preparing an investment policy, for a retirement benefits scheme, the Trustees will usually take into account the long nature of the scheme. According to Wanjala (1999), the suitable horizon for policy making is between 35 – 60 years. In addition, ideally policy decisions on the change of the policy should only be taken at intervals of over several years.

3.1.4 Retirement Benefits Authority Investment Guidelines

The long term nature of retirement benefits schemes are an advantage to Trustees who can invest in large scale developments or in equities and hold the investment over several years. However, long-term investments have special challenges such as changes in the rate of inflation and devaluation of the currency, therefore, detailed strategies have to be formulated to hedge against the risk of loss. The schemes investment policy must ensure the spread of risks through diversification and also maintain a suitable asset allocation over the various investment sectors available.

In line with this provision, the RBA has published guidelines on the proportion of a scheme’s assets that can be invested in a particular asset class as given below. The permitted limit for real estate assets is 30% of the schemes assets.
Table 3.2: Maximum Percentage of Aggregate Fund Value by Asset Class

<table>
<thead>
<tr>
<th>Item</th>
<th>Categories of Assets</th>
<th>Maximum Percentage of Aggregate Market Value of Total Assets of Scheme or Pooled Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Cash and Demand Deposits in institutions licensed under the Banking Act of the Republic of Kenya</td>
<td>5%</td>
</tr>
<tr>
<td>2</td>
<td>Fixed Deposits, Time Deposits and Certificates of Deposits in institutions licensed under the Banking Act of the Republic of Kenya</td>
<td>30%</td>
</tr>
<tr>
<td>3</td>
<td>Commercial Paper, Corporate Bonds, Mortgage Bonds and loan stocks approved by the Capital Markets Authority and collective investment schemes incorporated in Kenya and approved by the Capital Markets Authority reflecting this category.</td>
<td>30%</td>
</tr>
<tr>
<td>4</td>
<td>Kenya Government Securities and collective investment schemes incorporated in Kenya and approved by the Capital Markets Authority reflecting this category.</td>
<td>70%</td>
</tr>
<tr>
<td>5</td>
<td>Preference shares and ordinary shares of companies quoted in a stock exchange in Kenya, Uganda or Tanzania and collective investment schemes incorporated in Kenya and approved by the Capital Market Authority reflecting this category.</td>
<td>70%</td>
</tr>
<tr>
<td>6</td>
<td>Unquoted shares of companies incorporated in Kenya and collective investment schemes incorporated in Kenya and approved by the Capital Markets Authority reflecting this category.</td>
<td>5%</td>
</tr>
<tr>
<td>7</td>
<td>Offshore investments in bank deposits, government securities, quoted equities and rated Corporate Bonds and offshore collective investment schemes reflecting these assets.</td>
<td>15%</td>
</tr>
<tr>
<td>8</td>
<td><strong>Immovable property in Kenya and units in property Unit Trust Schemes incorporated in Kenya and collective investment schemes incorporated in Kenya and approved by the Capital Markets Authority reflecting this category.</strong></td>
<td>30%</td>
</tr>
<tr>
<td>9</td>
<td>Guaranteed Funds</td>
<td>100%</td>
</tr>
<tr>
<td>10</td>
<td>Any other assets</td>
<td>5%</td>
</tr>
</tbody>
</table>

Data obtained from the *Financial Times Mandate of July 14th 2003*, indicates that European Pension Schemes invest approximately 10-15% of their funds in immovable property. In comparison to the limit set by the Retirement Benefits Authority, local Pension Schemes are permitted to invest twice as much in immovable property, probably to enable the Pension Schemes with disproportionate investments in property come into compliance with Retirement Benefits Authority regulations as soon as possible. According to *Wanjala (1999)*, it is likely that investments in bank accounts, fixed income government securities, listed public companies and property are likely to form the backbone of the investment options open to trustees.
3.2.0 The Central Bank of Kenya (CBK)

The Central Bank of Kenya was established in 1966 through the enactment of the Central Bank of Kenya Act of 1966. According to the Central Bank of Kenya (Amendment) Act, 1996, its principal objectives are to formulate and implement monetary policy directed to achieving and maintaining stability in the general levels of prices and, to foster the liquidity, solvency and proper functioning of a stable market based financial system. The responsibility for determining the policy of the Central Bank is given by a Board of Directors whose members are all appointed by the President of the Republic.

One of the Central Bank’s secondary objectives is to act as a banker and adviser to, and fiscal agent of the Government. The Central Bank accepts deposits and effects payments on behalf of the Government. It also maintains and operates special accounts for the Government.

The Central Bank of Kenya Gives monthly reviews on the state of the economy, leading economic indicators and performance trends in key investment markets.

3.3.0 The Capital Markets Authority (CMA)

The Capital Markets Authority was established in 1989 through the enactment of the Capital Markets Authority Act Cap 485A. The mission of the Authority is

"to promote the development of orderly, fair, efficient, secure, transparent and dynamic capital markets in Kenya within a framework which facilitates innovation through an effective but flexible system of regulation for the maintenance of investor confidence and safeguards the interest of all market participants".

Since its enactment, the Act has been amended twice, first in 1994 through the Kenya Gazette Supplement No. 4 of January 1995 to deal with the restructuring of the Nairobi Stock Exchange from a company limited by shares to a company limited by guarantee and secondly, in August 2000 to make the Capital Markets Act. In the new Act, the powers of the Capital Markets Authority have been enhanced to enable it license, approve or accredit new institutional players in the market including investment banks, authorized securities dealers, credit rating agencies and registered venture capital funds.
The Capital Market Authority oversees the operations of the stocks and securities markets. The Capital Markets Authority in collaboration with the Nairobi Stock Exchange has reorganized the structure of the stock market into four independent segments in which investors may invest. They are categorized as the Main Investments Market Segment (MIMS), the Alternative Investment Markets Segment (AIMS), the Fixed Income Market Segment (FIMS) and the Futures and Options Market Segment (FOMS) (Capital Market Authority, Annual Report 2000). Property investments are categorized under the Alternative Investment Markets Segment. However, currently there are no property companies listed in this segment after the public issue by Anglo African Properties in the year 2000 failed to attract the minimum subscription required to have it listed.

The Capital Markets Act provides the legislative framework for the establishment of Collective Investment Schemes (CIS) in form of Unit Trusts, Mutual Funds or Investment companies which are institutions developed to mobilize domestic savings (Capital Markets Authority, Annual Report, 2000).

The Act also provides the framework for the formation of the Central Depositories Act (CDA), which allows the securities of a company to be held through an electronic medium within a common repository in the same way that a bank provides a common repository for cash for different account holders through book entries. The provision of the CDA recognizes the concept of immobilization and dematerialization of share certificates. Immobilization means a security where the underlying physical certificates have been deposited with and are held by a central depository while dematerialisation means a book entry security which the underlying physical certificate is no longer recognized as prima facie evidence of ownership under the Companies Act.

The Capital Markets Authority has formulated “Guidelines on Corporate Governance for Public Listed Companies in Kenya”. These have been developed for good corporate governance practices by public listed companies in Kenya in order to promote domestic and regional capital markets growth.
CHAPTER FOUR

DATA COLLECTION AND ANALYSIS
4.0.0 DATA COLLECTION

Data was collected through questionnaires and interviews. Questionnaires were distributed to the eleven (11) registered investment managers and to Thirty (30) randomly selected Pension Schemes with fund values exceeding Ksh.100,000,000 including the National Social Security Fund. Responses were obtained from seven of the eleven investment managers. Of the remaining three, Stanbic Investment Management Services (SIMS) did not undertake management of Pension Schemes with property portfolios while two investment managers being Kenindia Asset Management Company Limited, Madison Asset Management Services Limited become exceedingly difficult to follow up. The fourth investment manager, Old Mutual Asset Managers (Kenya) Limited, was reluctant to give any information as their considered investment information confidential.

Ten (10) responses were obtained from the in-house managers of the randomly selected registered Pension Schemes with fund values exceeding Ksh.100,000,000 including the National Social Security Fund. Of the remaining Twenty (20), thirteen (13) had out-sourced investment management to a registered investment manager and therefore referred the researcher to their respective investment managers, five (5) did not respond while the remaining two (2) pension schemes had no investment property portfolios.

Data was sought on ten (10) major issues:

1. The roles of an investment manager with regard to pension funds.
2. The main long-term investment media preferred by pension schemes.
3. The main factors considered during portfolio construction.
4. The current practice of property portfolio construction.
5. The current practice in property portfolio performance measurement and analysis.
6. Estimation of target rates of return on investment property and estimation of acceptable risk levels.
8. Information requirements and sources for property portfolio construction and performance analysis.
9. The challenges faced by investment managers in conducting property portfolio construction and performance analysis.
10. Recommendations to mitigate these challenges.

Property Portfolio Construction and Performance Analysis in Kenya
J.M. Kaaria, 2003
Data collection turned out to be a time consuming and somewhat frustrating exercise. The major difficulty was in having the investment managers think of property portfolio analysis in the same way as analysis of the performance of any other capital investment and not as property valuation. Without getting it clear, the required information would not have been obtained. Further, most investment managers only dealt with property portfolio performance analysis when computing annual accounts for the client, at which time they required a valuation carried out to determine capital appreciation and current yield. Also decisions to off load property assets were rarely made after assessment of performance but rather after a decision by the pension scheme trustees to free money for alternative investment purposes.

Since data collected was from Investment Managers of pension scheme funds, some managers felt that the information required for the research was confidential although only average figures were required. In some instances, it was not possible to convince the respondents that the data required was for academic purposes only and the results would be made available to them. They reasoned information in writing could be used against them as evidence! In such instances, a brief interview with the respondent on their opinion of property portfolio performance analysis sufficed.

Given the bureaucratic nature of the organizational structure of most pension schemes and the limited time available to complete this research work, it was not possible to obtain the views of other practicing investment managers who are not registered under the Retirement Benefits Act.

Data was also collected from brochures and annual reports of the pension schemes under study.

The data collected was analysed as follows.

4.1.0 DATA ANALYSIS

Data collected from the field was analysed in accordance to the objectives of the study as follows.

4.1.1 The Practice of Property Portfolio Construction and Analysis in Registered Pension Schemes.

To fulfill the main objective, which was to examine the practice of property portfolio construction, performance analysis in registered pension schemes, data was collected on the main long-term
investment media in which pension schemes invest; the average proportion of the fund value that is allocated to various property sub-sectors, the main considerations of pension scheme trustees when constructing property portfolios; the basis of measurement of return and risk levels for property portfolios and implication of investment guidelines by the Retirement Benefits Authority on allocation of Pension Scheme funds.

The data collected was analysed as follows.

4.1.1.1 Long-term Investment by Registered Pension Schemes

From the data collected from Investment Managers, it was observed that the main long term investment media in which pension schemes invest are Kenya Government Securities, Quoted Shares, Corporate Bonds, Guaranteed Funds and immovable property. Only one investment manager reported an off shore investment in Futures and Options. For most pension schemes, investment in property did not constitute a large proportion of the fund value except in the case of the National Social Security Fund where the investment in real estate constituted approximately 66% of the total fund value.

Investment managers noted that the declining interest rates on 91-day and 182-day Treasury Bills had resulted in over investment in blue-chip equities resulting in inflated prices of equities. Most investment managers said they were now faced with dilemma of investing in low interest Treasury Bills or paying high prices for stocks. Investment managers interviewed recognized that there was high liquidity in the investment market but preferred to invest in corporate bonds rather than property. Exceptions were noted in pension schemes such as the Kenya Re-insurance Corporation Staff Pension Fund which did not invest at all in equity and whose property investment was entirely in the up-market residential sector.

The average proportion of fund values invested in different investment media is summarized in the Figure 4.1 below.
A comparison of the allocation of funds to different investments indicates that on average investment trends in immovable property by local Pension Schemes are comparable to global trends. Figure 4.2 below gives a comparison between the asset allocation shown in by local pension funds in Figure 4.1 with asset allocation by the Belgian Pension Fund Association which represents 7.5 billion Euros (75b) worth of assets. The analysis indicates that current average level of investment in real estate is in line with global trends at approximately 6.4% of total fund value although for specific public schemes and corporations such as the National Social Security Fund and the Kenya Reinsurance Corporation, the case is different.

Also apparent from the data collected was the low level of investment in equities despite the stipulated limit under the Retirement Benefits Regulations 2000 being 70% for shares of company's quoted at the stock exchange in Kenya and 5% for unquoted companies incorporated in Kenya and collective investment schemes incorporated in Kenya and approved by the Capital Markets Authority.
From this analysis, it is evident that the permissible limit for investment in immovable property given by the Retirement Benefits Authority is much higher than what is held in practice by various registered pension schemes. The possible reason for the generous limits could be to accommodate pension schemes such as the National Social Security Fund which have immense investments in real estate and assist them to come into compliance as fast as possible.

4.1.1.2 Preferred Property Sub-sectors for Investment

From the data provided by registered investment managers, it was noted that registered pension schemes with large fund values preferred the commercial and residential up-market property sub-sectors for investment. Commercial property constituted approximately fifty one (51%) per cent of the total fund value allocated to investment in property. The proportion of fund value invested in different property investment sectors as a percentage of the total property portfolio is summarized in the Figure 4.3 below.
Only two pension schemes had investments in retail, industrial and recreational properties while no scheme had investments in agricultural real estate. Retail property investments were mainly shopping centers.

### 4.1.1.3 Priority Factors Considered during Portfolio Construction

Data collected indicated that the main consideration of registered investment managers when giving investment advise to pension scheme trustees are two fold: real growth of returns and regularity of income. Secondary considerations included security of capital and security of income which are common to any investment decision. The investment managers were of the opinion that the ease of purchase and sale and the cost of purchase and sale were not of much significance to fund trustees when making investment decisions.

The investment manager interviewed differed in their view of the attitude of trustees towards investment in property. Most managers felt that the trustees have a special attachment to land and held the traditional belief that immovable property only appreciates and rarely depreciates hence creating a continuous increase in wealth. In contrast, other managers were of the opinion that trustees attitude to property investments was negative due to the low property values experienced since 1998 within
Nairobi. There was general consensus that the attitude of the trustees would depend on their exposure to the investment market and their awareness of existing investment options and the expected returns.

4.1.1.4 Property Portfolio Performance Analysis in Practice

According to majority of the respondents, the property portfolio performance analysis process was commenced by instructions from the pension scheme trustees or after the lapse of the investment planning period, says annually. Also, Portfolio performance analysis is prompted either due to changes in investment strategies and policies or, due to drastic changes in the property market that necessitated immediate review of the property portfolio. In most instances, property portfolios are assessed when acquisition or disposal of a property asset is required.

Figure 4.4 below indicates the theoretical procedure for property portfolio performance analysis adapted from Hargity & Yu, 1993 and illustrated below was discussed with the investment managers.

![Diagram of property portfolio performance analysis]

All the managers indicated that the procedure they used for property portfolio analysis was similar to the theoretical procedure above. In particular, the summary of steps from the responses obtained was as follows.
(a) Assessment of the Scheme’s Investment Portfolio

Investment managers indicated that they constantly researched on the state of the various investment markets to keep in touch with their state and new opportunities. They noted that while information was easily obtained for the securities and equities markets, it was difficult to know the state of the property market and therefore, difficult to make accurate trend analysis and forecasts.

Most investment managers interviewed said that they sub-contracted the assessment of the property market to valuation or property management firms from whom they obtained a general guide on the trend in expected yields in the various property sub-sectors. Performance analysis of the individual properties and the property portfolio as a whole was undertaken by assessing rates of return, assessing risk levels and assessing capital values. The results of this assessment were then compared to target returns established during the last planning period.

(b) Assessment of Anticipated Income over the Holding Period

From the responses from investment managers, individual investments are then assessed by analysing the historical trend in incomes and forecasts of anticipated income over the holding period. Once achievable income was determined, it forms the basis of decision making on retention or disposal of the property investment or property portfolio.

(c) Assessment of Actual Rates of Return against Target Rates of Return

The investment managers then compare the actual rate of return achieved during the last planning period with the target rate of return. The rate of return of individual properties is compared with returns from similar properties in the portfolio to determine relative performance and with the returns from other capital investments. The average target rate of return on investments in various property sub-sectors was given as follows.
Table 4.1 Expected versus Actual Market Returns

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial (offices)</td>
<td>12%</td>
<td>10%</td>
</tr>
<tr>
<td>Residential (up-market)</td>
<td>10%</td>
<td>7%</td>
</tr>
<tr>
<td>Residential (complexes)</td>
<td>11%</td>
<td>10%</td>
</tr>
<tr>
<td>Residential (middle income)</td>
<td>9%</td>
<td>9%</td>
</tr>
<tr>
<td>Retail (shopping centres)</td>
<td>12%</td>
<td>12%</td>
</tr>
<tr>
<td>Industrial properties</td>
<td>-</td>
<td>10%</td>
</tr>
<tr>
<td>Agricultural properties</td>
<td>-</td>
<td>7%</td>
</tr>
<tr>
<td>Recreational properties</td>
<td>-</td>
<td>7%</td>
</tr>
<tr>
<td>Special purpose properties</td>
<td>-</td>
<td>10%</td>
</tr>
</tbody>
</table>

A comparison of the average expected rate of return with the actual market rates of return indicates that investment managers expect higher returns than what is available in the market. The National Social Security Fund for instance, anticipates returns of 15% on its investment in commercial property. This is 50% more than what is achievable.

Most investment managers interviewed used returns from alternative investment markets to set their performance targets. The most commonly used indicator from the alternative market was the Nairobi Stock Exchange index. The returns from listed blue chip equities are used to compare income and capital appreciation. Other basis for setting performance targets in use included:

- Target return indicated by pension fund trustees
- Market returns in the specific property sub-sector
- Performance of rival property portfolios
- Macro-economic indicators such as inflation rate and government borrowing rates.

The popularity of the above basis of determining a target rate of return among investment managers was ranked as follows.
It was observed that the performance of rival portfolios is rarely used as a basis for determining the target rate of return on property investments since such information is rarely publicized and also as different pension schemes invested differing amounts in different property sub-sectors. 60% of the investment managers were of the view that the current performance of property investments by pension schemes was quite low when compared to alternative investments such as government securities which have had high interest rates since 1993. They however, noted that with the continual fall in Treasury Bill interest rates in the last eight months, investment in property may gain popularity.

(d) Assessment of Capital Values

When historical and anticipated income trends have been established, the investment managers then assess net present values or capital values. Investment managers indicated that they relied to a great extent on market values returned by valuers for book purposes or annual accounting purposes. These market values/capital values were used as the basis of estimation of the return on a property and to determine capital appreciation. The historical trend in capital appreciation is analysed by comparing the standard deviation over a period of years to determine if there is capital growth is positive, constant or negative.
(e) Assessment of Acceptable Levels of Risk

When the first to components of performance analysis, return and capital value, have been assessed, then risk levels are analysed. The respondents indicated that they considered the following factors when estimating the risk levels in property investments.

1. Level of Vacancies: Before investing in a property sub-sector especially office blocks, the investment managers conduct an analysis of occupancy levels to determine if there is sufficient demand to warrant such an investment. If the level of vacancies is high, then the risk level rises proportionately.

2. Rate of lease renewals: Rate of lease renewals was also considered an important indication of risk levels. Investment managers were of the view that in the recent past, occupiers have been surrendering offices in favour of occupying smaller spaces to cut on overhead costs. A decision to invest in an office block would need to be well thought out in order to tailor spaces and facilities to suit the demands of potential investors and therefore guarantee lease renewals.

3. Location: A history of the development of the proposed location in which a property is to be developed or purchased is considered very important. Investment managers at ICEA cited the immense losses that were incurred during and after the Likoni clashes in Mombasa in 1997 due to tenants choice to relocate from rented properties to safer areas. Risk levels increase when a property is not suitably located, for instance, Mobil Plaza on Muthaiga Road. In contrast, well located properties have low risk levels as tenancy and hence income is guaranteed.

4. Bad Debt Levels: Investment managers argued that investment is best carried out in properties that are affordable to most middle income citizens as such properties have a higher target market with regular incomes and default rates are low.

5. Rent Escalation: Also considered in determining the level of risk prior to investment in property is the growth in rental income to beat inflation. Most managers were happy with a margin of 4—5% rate of return above the inflation rate. However, where the rate of return is lower than the inflation rate, the net income is eroded.
6. Services: Highly serviced buildings are difficult and expensive to maintain and therefore, have higher risk levels.

Some investment managers recommended that the risk factor in long term investments such as property and corporate bonds be countered through underwriting.

(f) Determination of an Objective Rate of Return

Once risk and return is analysed, an objective rate of return is established. Investment analysis techniques are used to determine an objective rate of return at a specified level of risk by assessing anticipated income against capital invested. From the data collected, ratios such as the Return on Capital Invested were in common use to obtain an objective rate of return on an investment. The extent of use of the various performance measurements to determine an appropriate rate of return by investment managers is summarised in the pie chart below.

Figure 4.6 Preferred Property Portfolio Analysis Techniques

Some investment managers said they also carried out detailed analysis of Discounted Cash Flows to determine expected initial and terminal yields at varying rental incomes on property investments prior to recommending acquisitions.
Compare objective Rate of Return with other Economic Indicators

The respondents indicated that the pre-determine objective rate of return on an existing or proposed property investment is then compared with returns from alternative long term investment such as Treasury Bond coupon rates.

Revision of Portfolio to meet revised Pension Scheme Objectives

Finally, the investments manager instruct the pension scheme custodians to acquire or dispose of specific individual properties and revise the portfolio to achieve market returns.

75% of the investment managers said they did not assess property portfolios using this procedure unless when there was a proposed acquisition. Further, the investment managers noted that while this was the ideal procedure for property portfolio analysis, the depth and extent of analysis differed with the economic value of the investment, the geographical spread, the information available and the time horizon for the assessment.

In addition, the procedure was not followed systematically, the steps followed depended on the nature and size of the proposed investment and the availability of information. It was noted that sometimes investments were done following “a gut feeling” on their possible outcome.

Furthermore, investment managers in public corporations and parastatals noted that the procedure was often ignored when carrying out acquisitions or disposals of property under political duress. If the procedure was eventually conducted, it was to determine how best to develop or use the new addition to the portfolio to attain profitability even if below of market returns.

4.1.1.5 Implication of Retirement Benefits Authority Investment Guidelines

Most investment managers were of the view that in the past pension schemes with large fund values over-invested in property and the present investment guidelines by the Retirement Benefits Authority would result in divestment in property with new member contributions being put into other asset classes. As a result of the new investment guidelines, some pension scheme investment managers have
recommended measures which will enable the schemes come into compliance with the investment guidelines. Such measures include:

a) Disposal of land held for speculative purposes,
b) Introduction of Tenant Purchase Schemes to dispose of large investments in residential properties,
c) Freezing of all additional investment in immovable property,

Some investment managers were of the view that there was no rational basis on which the limit of 30% was set. They argued that the application of the same limits for registered pension schemes with different fund values was not realistic.

A large proportion of investment managers agreed that the guidelines would result in a more rational approach towards property investment selection and appraisal by scheme trustees therefore leading to improved returns on pension fund investments. Other managers were of the opinion that the rate of return may not improve but there would be better capital security and better diversified portfolios.

4.2.0 The Role of Registered Investment Managers in Property Portfolio Construction and Performance Analysis

From the data collected, the investment managers considered their main role to be to prudently advise pension scheme trustees on the best investment options available in accordance to the provisions of the Retirement Benefits Act. This role requires the investment managers to propose and recommend to the Board of trustees the available investment opportunities and their expected return and risks rates. Other roles include monitoring investment income, identifying new investment opportunities and managing the existing investment portfolios in accordance with client requirements and existing statutory regulations.

On a day to day basis, investment managers carry out the following duties:
a) Advise the pension schemes trustees on asset classes available for investment

Investment managers advise pension scheme trustees on the alternative investment assets available in the market. To effectively do this, investment managers must keep up to date with the rates of return in different investment sectors as well as arising opportunities for investment.

An Investment Manager assist the Trustees of the Pension Scheme by offering a view of what would be the ideal investment vehicle at any particular time. This calls for the establishment and maintenance of an accurate, up to date database of various investment vehicles, their income and return trends over a number of years. The Investment Managers advise on the major macro economic indicators that influence returns on investment, their past trends and anticipated performance in the future. Most investment managers interviewed noted that whereas information on market performance in equities and securities market was readily available, the case was different for the property market.

b) Formulating prudent investment policies for the schemes.

Investment managers assist pension scheme trustees to formulate prudent investment policies. Investment policies are broad guidelines aimed at ensuring that a scheme's investment portfolio is adequately diversified and that a scheme has a well defined investment policy. Investment guidelines are prepared to provide a maximum limit for the asset classes that a scheme can invest in, in order to ensure diversification.

According to Investment Analysts at the Old Mutual Asset Managers Limited, investment policy is client-driven. In order to carry out this function, the pension scheme trustees must clearly state their investment objectives. Such investment objectives are not limited to the achievement of the highest possible return but also include social goals.

Investment policy is driven by the pension fund trustees depending on their preference of investment vehicles and their attitude to risk. The basic steps in the formulation of an investment policy were identified as follows
1. Determination of the Return Objective

With the aid of pension scheme trustees, investment managers determine the return objectives of a pension scheme based on the income expected on their funds. The return objective is also pegged to the investment horizon, that is, the holding period within which the investors would expect to recoup the invested capital. For most risk averse investors, an investment horizon of 10 to 15 years justifies an investment in real estate or long term treasury bonds.

2. Determination of the Risk Objective

The investors ability and willingness to take risk is used to determine their risk objective. Ability to take risk relates to how important the risk is to the investor in view of the total assets while willingness relates to the investors personal attitude to risk that is, is the investor risk averse or conserve. A risk averse investor will be willing to invest in low return, low risk investments such as fixed deposits.

3. Identification of Constraints to Investment

Investment managers advise pension scheme trustees on the constraints to investments. Generally, most investment vehicles are constrained by liquidity needs which relates to the ability to convert an asset into cash in the future in order to exploit opportunities for investment as they arise. Other constraints relate to tax, statutory guidelines and investor preferences. The level of tax will limit the number of investments that an investor can consider. According to investment managers, generally, the tax on dividends is less than the tax on interest earning vehicles. Statutory guidelines and regulations of government bodies such as the Retirement Benefits Authority limit the amount of funds that can be put into a particular asset class.

Also a client’s unique circumstances will determine the preferred asset classes.

4. Identification of Appropriate Benchmarks

Investment managers noted that while benchmarks for the performance of investment options in the financial and securities market were easily available and adaptable, this was not the case for
the property market. The main difficulty identified was in obtaining an appropriate standard against which to gauge the performance of a property in a specific sub-sector.

The benchmark for equity is the Nairobi Stock Exchange Index (NSE Index) while the benchmark for interest earning papers is the Treasury Bill rate.

5. Research into the Investment Environment

The investment managers research and maintain detailed databases on macro-economic indicators, investment trends in various sectors and the associated risks and returns. The data is used to determine the relative attractiveness of various portfolios by evaluating different portfolio mixes to come up with what is most suitable for an investor.

Having followed the above procedure, the investment managers then formulate an investment policy for approval by the pension scheme trustees.

c) Invest Scheme Funds subject to the outlined Investment Policy

Investment managers' role extends to investment of pension scheme funds subject to the schemes investment policy. Prior to investment, they research into the various investment media, which meet the investment goals of the scheme. Where an investment portfolio already exists, the investment managers are charged with the responsibility of revising and reconstructing the portfolio so that it meets investment objectives.

d) Appraise the Performance of Investment Assets

Investment managers conduct investment analyses by assessing the investments capital value and risk and return rates, and monitoring investment income. Investment analysis also involves the comparison of the investment portfolio performance against target returns. According to the interviewees, where an investment has been made in equities or interest earning vehicles, the objective is the outperform inflation in terms of real return.

The returns from the selected property investments are also compared against the rates obtained from commercial paper bonds such as Treasury Bills and Bonds during analysis.

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e) Submit quarterly reports to the schemes trustees.

As required under Section 34 of the Retirement Benefits Act, the investment managers submit annual audited accounts for each scheme. Most investment managers felt that this was a good method of maintaining accountability and transparency in the use of scheme funds. This was recognised to be in line with the requirements under the Banking Act for financial institutions to submit bi-annual audited accounts.

f) Attend pension scheme trustees meetings.

Investment managers have regular meetings with Pension Scheme trustees to review the performance of investment assets and to recommend new investment areas to be pursued.

g) Invest funds on behalf of pension scheme trustees

Investment managers issue instructions to registered custodians (on behalf of pension scheme trustees) to transfer, exchange or deliver assets held by the custodians and to effect payment in respect of purchased securities or assets,

h) Maintain records

Investment managers keep books, records and statements giving a complete record of the investment portfolio and investment transactions carried out by the custodians. An investment manager will require the trustees of a registered pension scheme to explain how they will evaluate the performance of the fund manager. There are no set benchmarks for comparison between investors as the objectives of investors differ, although the primary objective remains to make the best return on the investment.

4.3.0 Challenges faced in Property Portfolio Construction and Performance Analysis

According to most investment managers most challenges to property investment performance analysis related to the availability and extent of information on which to base decisions. Other challenges related to the narrow market which did not give provision for establishment and operation of Property or unit trusts. With regard to this, the investment managers lauded the establishment of an Alternative

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Investments Segment at the Nairobi Stock Exchange as an initial step towards the formation of property trusts. The challenges were detailed as follows.

4.3.1 Limited Information

Investment managers were of the view that there exists a very low level of disclosure in the investment market especially with regard to construction costs, sale prices, and returns obtained. Information is especially difficult to obtain from the property market due to the lack of a collective database of accurate, relevant and up to date market information on the various property sectors. Attempts to collect and collate data by investment managers have been defeated by the reluctance of property managers and owners to disclose information.

The main information required to form a sound and rational basis of investment performance analysis and to facilitate decision making were said to be:

- Transaction costs on land and buildings
- Rents and rental reviews
- Capital values of investment properties
- Research on comparable property markets in the East African region.

Most managers relied on journals from the United Kingdom such as the Estates Gazette, the Journal of Corporate Real Estate Management and the Financial Times for views on investment and global trends in the management of investment assets. In addition to newspapers, periodicals and journals, most investment management firms indicated that they carried out their own research into the investment market. It was noted that information from the property investment market was difficult to come by and sources were limited to publicized transactions by institutions, newspaper articles and property reports by property management firms. However, the extent of data available from the above sources was said to be limited, as it did not deal sufficiently with trends and forecasts of returns and the critical aspect of investment risk.

Investment managers indicated that they required information on properties to carry out a trend analysis of income, returns and risks in alternative property investments to aid decision making. Investment managers noted that information from investments by financial institutions had however, become easier to obtain due to the current requirement that they disclose their quarterly performance. The estimation
of risk levels is made difficult by the lack of accurate estimates of the net present values of property investments, the historical variation of capital values, occupancy rates and tenant default rates.

Further, the investment managers said that capital values returned Valuers during annual valuations were not reliable as no basis was given for the appreciation or depreciation of net present values. In addition, the application of values returned by Valuers was difficult, as the required conditions under the International Accounting Standards were not meet. Also, the valuation reports did not have sufficient information to assist in decision making.

4.3.2 Limited Basis for Benchmarking

The lack of an appropriate benchmark against which to compare the performance of properties in various investment sectors was seen a major challenge to investment performance analysis. Unlike in Bonds and Guaranteed funds where the benchmark is the Treasury bill rate or in the case of equities where there exists an up to date Stock Exchange Index, the performance of investment property portfolios cannot be compared with market performance with certainty.

4.3.3 Ignorance of trustees

Investment managers noted that trustees are ignorant of the concept of risk and return. The trustees prefer investments of low risk such as vacant land without realizing that it also results in low returns. Also establishing the expectations of trustees on returns is difficult since they are not aware of alternative investment media and their performance.

4.3.4 Narrow Market

Investment managers explained that the options for a well diversified portfolio were restricted by the narrow investment market for a large capital sums. There are currently no property trusts listed at the Nairobi Stock Exchange. As a result pension schemes seeking to diversify end up investing in commercial or residential units whose returns are subjective depending on the chosen location, target market and set rentals.
4.3.5 Subjectivity of performance in different sub-sectors

Investment managers noted that different property investment sectors have different levels of occupancy costs. Occupancy levels fluctuate even in a specific market making it difficult to compare performance.

4.3.6 Subjectivity of Capital Values returned by Valuers

Many investment managers were of the view that the differences in capital values returned by Valuers affected the yield reported thus causing uncertainty in performance analysis. The lack of a standardized basis for reporting also made it difficult to compare capital appreciation trends.

4.3.7 Lack Relevant knowledge and training

Most investment managers lack the expertise to carry out performance analysis of property investments. Investment managers have their background training in Finance and will tend to apply models relating to the securities and equity market whose operations and characteristics are much different from those of the property investment market.

4.3.8 Political Influence

This challenge was specifically faced by investment managers working in public corporations such as the National Social Security Fund where the Board of Trustees are political appointees and tended to carry through investment decisions without consulting investment managers. This has a negative effect on the ability to construct a well diversified portfolio.

The respondents recommended that the actors in the property market especially property valuers and managers should increase availability of information. They also recommended that the property investment market be diversified by formulation of legislation and regulations to govern the establishment and operation of unit trust or real estate investment trusts.
5.1.0 STUDY CONCLUSIONS

5.1.1 Investment in Real Estate

An analysis of the data collected indicates that the perceived notion that most pension schemes have a substantial amount of their funds invested in property is not true. On average only 8% of the total fund value of registered pension scheme is invested in immovable property. This is comparable to global trends in investments by European pension schemes. From the responses obtained, only public pension schemes run as parastatals had immense investment in landed property, presumably due to political influence.

With the declining rates of return of Treasury Bills and Treasury Bonds, investment in immovable property should be seriously considered. Since real estate is an edge against inflation, it ensures that capital appreciation is achieved and at the same time has residual value at the end of the holding period.

To improve and widen the property investment market, the government needs to formulate legislation that will guide investment in Real Estate Investment Trust through the Capital Market Authority. In turn, the Capital Markets Authority needs to play a more proactive role in encouraging the establishment of Collective Investment Schemes (CIS) in form of Unit Trusts, Mutual Funds and Investment Companies.

5.1.2 Considerations during Property Portfolio Construction and Revision

In the construction of property portfolios by pension schemes, the major considerations are real growth of returns, security of capital and regularity of income. For this reason, 52% of investments by registered pension schemes are in commercial property and 34% in residential property with little investment in retail, industrial and recreational properties where security and regularity of income is not certain.

Pension scheme trustees rely on the advice of investment managers on where to invest while investment managers are guided by market information on the performance of investments. However, due to limited information on the state of the property investment market, it is difficult to form a rational basis for selection of investment property or for the revision of a property portfolio.
5.1.3 Procedures and Techniques used in the Analysis of Property Portfolios

From the data collected, it was ascertained that although elaborate procedures for investment analysis exist, most investment managers did not carry out analysis of the performance of their property portfolios on a regular basis. Property analysis is usually conducted prior to acquisition of new property and where there is political influence, the process is often ignored.

None of the respondents used models to aid the analysis of property investments for decision making when constructing or revising portfolios. While many investment managers are aware of the capital market theory pioneered by Harry Markowitz to diversify portfolio risk, its application was limited by the extent of information required to apply it.

Another notable element was the lack of differentiation between valuation and property performance appraisal. Most investment managers viewed performance appraisal as valuation and in many instances the difference had to be explained. The tragedy in this is that the investment managers considered the annual valuation of landed property for book purposes adequate to make decisions on portfolio construction and revision. Whereas capital values obtained from valuation can be used to establish a trend in capital appreciation, they are not sufficient for an analysis of property performance either individually or as part of a portfolio.

It is recommended that the general procedure for Investment Analysis in Property Portfolios should be regular applied. From the result of the study, this procedure would be recommended as follows.
Review of the general economic outlook
Review of the state of the property investment market
Assess the current property investment portfolio
Assess historical and anticipated rental income and capital growth
Assessment of Actual and Target Rates of Return
Assessment of Risk Levels
Determine an objective rate of return
Compare the objective rate of return and income with market benchmarks
Revision of portfolio to suit investor strategies or objectives

(a) Review of the General Economy

The already established databases on leading economic indicators such as inflation, government borrowing rates and commercial bank lending rates can be used in property performance analysis. The determined target rate of return may be set at the same level as nine or ten year Treasury Bond or pegged at a percentage higher than the inflation rate.

(b) Review of state the Investment Markets

Property investment must compete with the alternative markets in order to be managed successfully. The rate of return expected from the selected property investment must be realistic and should be comparable to the return obtainable from an alternative long-term investment market such as the Securities market.
(c) Assessment of the Current Property Investment Portfolio of the Pension Scheme

Assessment of the property portfolio held by a pension scheme needs to be a continuous process, which is not prompted by a decision to divest or make new acquisitions.

(d) Assessment of Anticipated Income over the Planning Period

Investment managers need to continuously monitor income over the planning period to keep in touch with market trends. Property trends such as decentralization of business districts can then be anticipated and the process of acquisition of property in the suburbs or disposal of property in the central business district can be commenced in good time. Further historical trends in net rental income and capital expenditure will enable capital expenditure be anticipated and planned for.

Acquired development property must be suitably located and subsequently suitably planned and serviced in a manner that ensures tenants are attracted and maintained. As a result rental income can be maximized at minimal risk of lease surrenders and high tenant default rates.

(e) Assessment of Actual Rates of Return against Target Rates of Return

The set target rates of return need to be constantly monitored against actual rates of return for individual property and for the entire portfolio. Where possible, performance should be compared with the performance of rival portfolios. This ensures that target rates of return remain realistic and that realistic decisions are made regarding investment or divestment in a particular property subsector.

(f) Assessment of Capital Values

Capital appreciation trends are commonly used to assess investment performance. However capital appreciation trends must be viewed in conjunction with inflation rate trends in order to establish actual increases in value.
(g) Assessment of Acceptable Levels of Risk

Risk levels can be almost accurately determined by use of models such as the Capital Asset Pricing Model. However, this is not practiced in assessing property investment portfolios due to limited information. The investment managers should constantly monitor vacancy levels, the rate of lease renewals, suitability of proposed property development sites, tenant default levels, levels of outgoings and capital expenditure on maintenance in order to adequately assess property risks.

To be almost completely safe the risk factor in long term investments including property can be countered through underwriting.

(h) Determination of an Objective Rate of Return

The determination of a target rate of return needs to be more objectively carried out. While the use of ratios or the pay back period method is quick and easy, they do not take into account property investment risks and the timing of cash flows. In this case, the use of explicit methods such as the Discounted Cash Flow is recommended as all future cash flows and expenditures are discounted to present day values.

(i) Compare objective Rate of Return with Market Benchmarks

Comparison of performance may be in absolute or in absolute or relative terms, that is relative to the market or relative to funds of a similar type. To facilitate relative comparison during property portfolio analysis, property indices need to be developed for the local market.

Once comparisons have been made, the shortfall or excess relative to performance targets and benchmarks can be analysed and useful conclusions and explanations drawn for strategic and operational decision making.
Revision of Portfolio to meet revised Pension Scheme Objectives

Finally, portfolios must be revised and non-performing immovable assets replaced with those that will give market returns. Performance analysis should be used as a tool to improve future performance of property portfolios either by helping the investor allocate available funds effectively or by giving useful guidance to individual portfolio managers to help them improve their future performance.

5.1.4 The Roles of Investment Managers in Property Portfolio Construction and Performance Analysis

From the data collected, the most important role of investment managers in property portfolio construction and performance analysis is to guide property investment in a manner that ensures optimal returns. To adequately perform this role, market information on all property sectors must be readily and easily available on a day to day basis. To effectively perform their roles investment managers must be aware of the returns from different sectors of the property market.

Once the decision to invest is made, investment managers monitor the levels of income from the investment and identify new investment opportunities. The investment managers also have to manage the existing investment portfolios in accordance with Retirement Benefit Authority regulations.

It is felt that the role of the investment manager in property portfolio construction and performance analysis would be more effectively played if the managers have background knowledge of the property market obtained either through academic qualification or from experience. Further, property investment models need to be developed which can indicate how to sufficiently diversify a property portfolio and obtain maximum returns from it.

5.1.5 Challenges of Property Performance Analysis

According to data obtained from the field study, the main challenge in property performance analysis relates to the adequacy of information. The ability to conduct adequate performance analysis was hindered by the lack of information and suitable local benchmarks against which to rank performance, making investment decisions in the property market very difficult to make.
Information requirements include:

- Macro-economic indicators
- Transaction costs on land and buildings
- Proposed investments and new constructions in the property sub-sectors
- Market rents in various property sub-sectors
- Occupancy costs
- Anticipated capital expenditure during the life of a building
- Lease structures
- Capital Values of immovable properties in the portfolio
- Trends in commercial bank lending rates for property transactions

This information can be collected by professional bodies such as the Institution of Surveyors of Kenya, from their members or through statutory bodies such as the Retirement Benefits Authority and the Capital Markets Authority. Information so collected can be made available through on website in the Internet, through journals or periodic articles in the media.

5.2.0 STUDY RECOMMENDATIONS

From the literature reviewed and data collected from the field study, the researcher would recommend the following in relation to property portfolio construction and performance analysis.

5.2.1 Research for Increased Property Information

Real estate agents and managers should invest more in detailed research on various sectors of the property market and produce market reports on a regular basis. Availability of information is a major challenge to estimating investment returns and risks related to property. The participation of real estate practitioners in information exchange is recommended. This Information Exchange could be a company along the lines of the South African Property Information Exchange (SAPIX) or a database established and maintained by the Institution of Surveyors of Kenya or a private company.

As noted earlier, the property market is fragmented with relatively few transactions whose details are not usually revealed. As a result, the construction of an overall, comprehensive property market database is a difficult task. However, the purpose and scope to the property database and resulting
property index may be defined within the existing property market context in order to be useful and successful.

Research on transaction costs on land and buildings, occupancy costs and new investments in real estate should be conducted on a national scale by the Central Bureau of Statistics. In addition, research by the Retirement Benefits Authority should extend to the specific property sub-sectors and not only real estate as an option for long term investment. The Retirement Benefits Authority would then be in a better position to guide pension schemes investments and to review investment guidelines.

While market prices of equities are available instantaneously on an objective and consistent basis, the market price of property assets are subjectively estimated by using an appropriate valuation method. In light of this, there is a great need for a reliable property index to guide performance analysis of investment property portfolios.

5.2.2 Move of Professional Practice from Valuation to Property Investment Appraisal

Valuations reports need to be more informative. More explicit methods of appraisal such as the Discounted Cash Flow are recommended. Valuation reports should indicate the general outlook of the economy, present trends and future forecasts in the performance of the relevant property sub-sector. Shallow unstandardised reports which do not indicate justification for the capital values arrived at have made performance measurement difficult as properties cannot be assessed by the same standards.

5.2.3 Increased Levels of Computerisation

The computerisation of property firms is the first step towards enabling the exchange of property information. Collection and collation of property information would be more efficiently and effectively carried out if records are easily retrievable from a computerised system. In addition, government records which hold a lot of information in form of transaction costs, new constructions, building and occupancy costs need to be computerised and made more accessible to the public.
5.2.4 Expansion of the Investment Alternatives within the Property Market

The Capital Markets Authority needs to promote the establishment of a listed Real Estate Investment Trust which invests in various types of properties from which investors can buy shares into the trust from the Stock Exchange thus expanding the options for investment in the property market. The establishment of property trusts would enable investors enjoy the benefits of expert management of fund portfolios while being safeguarded against disastrous loss arising from the misfortunes of one or two companies. The Capital Markets Authority and the Nairobi Stock Exchange should encourage property companies to be quoted to widen investment opportunities.

5.2.5 Outsourcing of Property Performance Analysis to Real Estate Firms.

Property Portfolio assessment could be sub-contracted to valuation or property management firms as they are in constant touch with the property investment market. However, guidelines need to be given on the level of analysis so that the outcome is a relevant, useful report. In addition, property valuers must begin to use explicit methods such as the Discounted Cash Flow which allow better performance assessment traditional analysis techniques such as the Return on Capital Employed and the Pay Back Period method.

Property management firms interact with the property investment market on a day to day basis. They would therefore be better placed to conduct property investment selection and performance analysis. The success of an asset manager would then be rated from the increased investment returns and a balanced investment policy.

With the Retirement Benefits Act now requiring every scheme to appoint a professional fund manager to manage scheme funds, it is expected that in the next few years there will be marked improvement in the quality of scheme investments in Kenya. Major changes are also expected in the country’s financial markets since the retirement benefit schemes are the largest players in the mutual fund and unit trust markets in the developed countries and it is expected that these investment vehicles will quickly develop in the local market once the schemes begin to apply modern investment models.
5.3.0 **Hypothesis Testing**

The hypothesis of this research was that *inadequate information on the property market is the leading cause of non-application of a rational basis of performance analysis for property portfolios*. This hypothesis was accepted based on the proof that there is a lot of information required to effectively use any procedure and technique of investment performance analysis and this information is not readily available.

The study found out that procedures and property analysis techniques and models do exist which can be used for performance analysis. However, their effective application is hindered by lack of information and to a limited extent by political influence as this relates to public pension schemes.

5.4.0 **AREAS OF FURTHER STUDY**

Property investment is a very wide area. Within the context of our local institutional investors, I would recommend further studies in the following areas.

1. The practicability of compliance with RBA guidelines on property investments.

2. Establishment of a model for appraising performance measurement of real estate investments in Kenya.

3. A feasibility study for the practicality of establishment of a comprehensive property index.
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Central Bank of Kenya www.centralbank.go.ke
www.devon.gov.uk  Local Direct Property Investment.

www.bakertilly.co.uk  Property Purchase via Pension Funds.

www.primepitch.com  Pension Funds find a Property Solution.
Appendix I  Investment Portfolios of the 100 largest schemes

INVESTMENT PORTFOLIO OF 100 LARGEST SCHEMES, %

- Real Estate: 30%
- Quoted Equity: 5%
- Unquoted Equity: 15%
- Government Paper: 20%
- Cash & Deposits: 20%
- Offshore: 0%
- Other: 0%

Source: www.rba.co.ke
APPENDIX II

QUESTIONNAIRE FOR REGISTERED INVESTMENT MANAGERS/ FUND MANAGERS

NAME OF ORGANISATION:

PERSON INTERVIEWED (Optional):

DATE OF INTERVIEW:

PREAMBLE

Institutional investors such as banks, pension schemes, insurance companies and public institutions have at their disposal substantial fund reserves which they are obliged to invest judiciously on behalf of their beneficiaries so as to provide the beneficiaries with sufficiently high returns on capital invested.

To obtain optimal returns, the selection of investment assets has to be done in a manner that gives a reasonable rate of return, spreads risks and enables an investor to tap from newly discovered resources. To achieve this, careful selection and analysis of an institution's investment portfolio must be carried out. Investment management can only be effective if there exists a sound and rational basis, first for the selection of an efficient set of investments and secondly for the revision of the portfolio (Hargitay & Yu, 1993).

It is, however, recognized that the most distinct weakness of the property investment market when compared against the money and equity markets is the limited depth of knowledge and analysis available. In comparison to property, other investment sectors are considered well researched with frequent and recorded transactions from which information is easily available on which to base a performance analysis. In contrast, property investments lack a central market from which data can be collected and analyzed to establish performance benchmarks.

Like in other investment media, the process of investment in property involves the commitment of capital and in turn the property assets are expected to produce a continuous income flow in form of rent, and at the end of the holding period, the market value of the assets can be converted into liquid cash.

According to Geho (2001), little is known on how institutional investors invest in Tanzania, especially how they select investment vehicles, estimate returns and deal with the elusive function of measuring and minimizing property portfolio risk. The same can be said for Kenya's institutional investors. This research study aims to find out how property investment selection, performance measurement and analysis is carried out in registered pension schemes, who the players are and their roles, what challenges they face and how these challenges can be mitigated.
SCHEDULE OF QUESTIONS

A) Investment Management

1. What is your main business activity as an investment manager?

2. How long has your firm been in operation as Investment Managers?

3. How many registered Pension Schemes have appointed your firm as their investment manager?

4. What is your role as a registered investment manager under the Retirement Benefits Act?

B) Investment Media

5. What are the main long-term investment media in which Pension Schemes invest?

- [ ] Kenya Government Securities
- [ ] Equity - Preference Shares and Ordinary Shares of Quoted Companies
- [ ] Unquoted shares
- [ ] Property in Kenya
- [ ] Other (please specify)

6. On average, what is the proportion of fund value allocated to property investment as a percentage of all long-term investments by Pension Schemes?

<table>
<thead>
<tr>
<th>Long-term Investments</th>
<th>Property as a proportion of the total investment portfolio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government Securities</td>
<td></td>
</tr>
<tr>
<td>Quoted Equity</td>
<td></td>
</tr>
<tr>
<td>Unquoted Equity</td>
<td></td>
</tr>
<tr>
<td>Property in Kenya</td>
<td></td>
</tr>
<tr>
<td>Offshore Investments</td>
<td></td>
</tr>
<tr>
<td>Guaranteed Funds</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>100%</td>
</tr>
</tbody>
</table>

Property Portfolio Construction and Performance Analysis in Kenya
J.M. Kaaria, 2003
7. For Pension Schemes with large fund values, what are the preferred property sub-sectors for investment as a percentage of the total property portfolio?

<table>
<thead>
<tr>
<th>Property Sub-sector</th>
<th>Proportion of total property portfolio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial (offices)</td>
<td></td>
</tr>
<tr>
<td>Residential (up market)</td>
<td></td>
</tr>
<tr>
<td>Residential (middle income)</td>
<td></td>
</tr>
<tr>
<td>Retail (shopping centers)</td>
<td></td>
</tr>
<tr>
<td>Industrial</td>
<td></td>
</tr>
<tr>
<td>Agricultural</td>
<td></td>
</tr>
<tr>
<td>Recreational properties</td>
<td></td>
</tr>
<tr>
<td>Special Purpose properties</td>
<td></td>
</tr>
</tbody>
</table>

C) Investment Selection

8. What is the main consideration of Pension Scheme trustees in investing in property?

- [ ] Real growth of returns
- [ ] Security of capital
- [ ] Security of income
- [ ] Regularity of income
- [ ] Ease of purchase and sale
- [ ] Cost of purchase and sale
- [ ] Divisibility
- [ ] Other (please specify)

9. How would you describe the attitude of Pension fund trustees towards investment in property? (Edge against inflation, Good for diversification, Special interest in property etc)

D) Investment Performance Measurement and Analysis

10. How do you measure the performance of property investment when reviewing property portfolios?

- [ ] Property Indices
- [ ] Audited Accounts for Capital Values
- [ ] Ratios
- [ ] Other (please specify)
11. The theoretical procedure for analysis of property performance is outlined in the steps below adapted from Hargitay & Yu, 1993.

Assess the structure of the fund portfolio
Assess geographical spread by capital value
Assess anticipated income over the holding period
Assess historical rental income growth
Access historical capital value growth
Determine objective rate of return
Compare rental growth with market benchmarks
Comparison with other economic indicators.
Portfolio revision

How does your procedure for analysis differ from this?


Returns on Property Investments

12. What are your performance targets (ideal rate of returns) for investment in property based on?

- Target return indicated by pension fund trustees
- Market returns in the specific property sub-sector
- Returns on alternative investment media
- Performance of rival property portfolios
- Macro-economic indicators
- Other (please specify)  

Property Portfolio Construction and Performance Analysis in Kenya
J.M. Kiaria, 2003
13. What are your current return targets (or rate of return objectives) on investment for the following property sub-sectors?

<table>
<thead>
<tr>
<th>Property Sub-sector in Nairobi</th>
<th>Estimated Market Rate of Return (%)</th>
<th>Your Current Target Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial (offices)</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>Residential (up market)</td>
<td>7%</td>
<td></td>
</tr>
<tr>
<td>Residential (middle income)</td>
<td>9%</td>
<td></td>
</tr>
<tr>
<td>Retail (shopping centers)</td>
<td>12%</td>
<td></td>
</tr>
<tr>
<td>Industrial</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>Agricultural</td>
<td>7%</td>
<td></td>
</tr>
<tr>
<td>Recreational properties</td>
<td>7%</td>
<td></td>
</tr>
<tr>
<td>Special Purpose properties</td>
<td>10%</td>
<td></td>
</tr>
</tbody>
</table>

14. What is your view of the performance in terms of returns on property investments by Pension Schemes?

Risk Levels

15. What factors do you consider when estimating risk levels in property investments?

E) Retirement Benefits Authority Guidelines

16. How has allocation of pension funds to various investment media changed with the introduction of investment guidelines for Pension Schemes by the Retirement Benefits Authority?

17. Will this effectively improve investment selection and appraisal by registered Pension Schemes and consequently lead to improved returns?
F) Information Sources and Requirements

18. From the options below, what kind of information do you require to conduct performance measurement and analysis for property investments?

- Macro-economic indicators (economic growth rate, inflation rate, interest rates)
- Transactions costs on land and buildings
- Investments in new construction and improvements
- Building rents
- Occupancy costs
- Additional Capital Expenditure during the life of the investment.
- Lease structures
- Open Market Values of land and buildings
- Trends on banks lending for property transactions
- Other (please specify) _____________________________

19. From which of these sources do you obtain your information on the state of the property investment market and its performance?

- Statistical Publications such as the Statistical Abstract
- Government Publications
- Economic Forecasts
- Periodicals and Journals
- Newspapers
- On-line services
- Property Databases
- Own research
- Other (please specify) _____________________________

20. a) Is the information obtained from the above sources sufficiently adequate and reliable to conduct an analysis of a property investment portfolio? Yes/No

b) If not, how would you suggest that the situation be rectified?

-------------------------------------------
G) Main Challenges

21. What challenges do you encounter in carrying out advisory services for property investment selection?

22. What constraints do you face in measuring and analysing the performance of property portfolios?

H) Recommendations for Mitigation

23. What recommendations would you make to the actors in the property market (being real estate agents, valuers and investors) to ease decision-making during property portfolio construction and performance analysis, in view of the imperfect nature of the property market?

24. Are there opportunities for outsourcing the selection and analysis of property investments to real estate firms?