

**A SURVEY OF THE FACTORS THAT INVESTMENT  
MANAGEMENT COMPANIES CONSIDER WHEN  
MAKING INVESTMENT DECISIONS**

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**REG NO.**

**D61/ 7018 /02**

**THIS MANAGEMENT RESEARCH PROJECT  
IS PRESENTED AS PARTIAL FULFILLMENT  
OF THE MBA COURSE IN THE  
UNIVERSITY OF NAIROBI  
FACULTY OF COMMERCE  
2004**

# DECLARATION

This management research project is my original and has not been presented for a degree award in any other University.

Signed..........

Date.....14/01/05.....

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This management research project has been submitted with my approval as a University supervisor.

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# DEDICATION

To my dad Mr. Gerishon Mwobobia and mum Mrs. Ruth Mwobobia

## ACKNOWLEDGMENT

It has been a long and tasking journey but successful for which I feel greatly indebted to various people who made it possible for me to come this far.

First to my supervisor Mrs. Kithinji, Lecturer in the department of Accounting, My sincere thanks to her for her tireless effort, commitment and ideas that were very important and valuable.

I am forever grateful to my parents for their love, support and much sacrifice all through my studies. 'Thank you for allowing me to know that I would always count on you.' To my brothers Boniface, Martin and Nicholas, ' Thank you for believing in me'.

To my friend and fiancé Mathew Mugambi for your love, patience, encouragement and for a helping hand through out the studies having gone the same way before me. 'Thank you for being there and always supportive'.

Thanks to my classmates for providing a good learning atmosphere. Especially to Jacinta Mumbua, Eve Akoth, Alex Muriithi, Ken Gachoki, Rebecca Atiti, Job Omagwa, Wainaina Githii, Faith Muhoro, Amina Swaleh, Ann Gachengo, Juliana Namada and Elias kamoyo among many others. ' You all were a great and constant source of inspiration'.

To my pastor Michael Muturi for your prayers and encouragement.

Many thanks to all the investment managers who responded to the questionnaires and made the study possible. Thanks to the CMA staff especially the receptionist and the library staff.

Above all I thank the almighty God for strength and a sound mind and live to this far.

To you all and others not mentioned here, accept my thanks and appreciation. God bless you all

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## **ABSTRACT**

Given the investment decision process that denotes the choice of assets acquired, the amount invested in each asset and the timing of the investment to maximize returns, investors can invest in single assets or in a number of assets. By their very nature the assets invested in bear different characteristics. In order to secure good and productive investments, investors should properly analyze the characteristics surrounding the investment assets.

The study was carried out to identify the factors that influence investment in various investment instruments and rank the identified factors in order of importance as viewed by the eleven investment management companies licensed by the Capital Markets Authority. A survey was carried out in which case primary data was collected using a semi- structured questionnaire. The data collected was analyzed using descriptive statistics like mean scores, standard deviation and percentages. It was presented by the use of tables and graphs.

The results indicate that numerous factors influence investment in different investment instruments. These factors range from economic factors, company factors, social factors and geographical factors. On the hand even where similar factors are involved, they influence investment differently in different instruments hence they are rated on varying mean scores. For example an economic factor like inflation influences investment in Government bonds more than it does influence investment in corporate bonds and stocks.

# CHAPTER ONE: INTRODUCTION

## 1.1 BACKGROUND

### 1.1.1 Financial markets and their role

Financial markets comprise of institutions and procedures for bringing buyers and sellers of financial instruments together (Van horne and wachowicz 2000). The economic function of financial markets is to provide channels for transferring the excess funds from surplus units to deficit units. Financial markets provide the mechanism that links surplus and deficit units by providing the means for surplus units to finance deficit units with additional options. This link is provided where surplus units purchase primary or indirect securities or reduce their debt by purchasing their own outstanding securities. On the other hand, deficit units may issue securities or dispose off some financial assets previously acquired (Faure, 1987). Financial markets encompass various participants (borrowers, lenders, financial intermediaries, brokers, investment managers, investment advisers) whose dealings in financial claims or groups of claims and the manner in which their demands and requirements interact to set a price for such claims (Faure, 1987).

Capital markets are an essential part of the financial sectors of modern economies and more so for growing economies. They provide an avenue for alternative savings tools to savers and non-bank sources of financing for enterprises. Thus, the markets promote economic growth through enhanced savings mobilization. An efficient financial sector reduces the cost of producing and trading goods and services and thus makes an important contribution to raising the standard of living. It also helps investors to allocate their savings through financial markets and institutions rather than buying non-productive assets as a store of value (Herring and Santomero, 1991).

According to Wagacha (2001) well-developed capital markets promote economic growth through: increased savings mobilization, access to foreign savings, spreading of financial risks, help the governments finance their deficits while reducing the fiscal pressures of debt

redemption by lengthening the maturities of the securities, and a facilitating role in translating savings to investments. With the reorganization of the Nairobi Stock Exchange in 2001 into three independent market segments with separate listings regulations for each market segment, the needs of different categories of investors were addressed. There was also the need to develop efficient participation in the securities markets through development of different investors profiles. The Capital Markets Authority act (2000) recognizes specific investment vehicles, especially investment companies. With this development in the recent past, more opportunities for diversification by both institutional and individual investors should emerge (Wagacha, 2000). Capital markets are essential for economic development of any country. This kind of economic growth can be achieved through investment in diverse investment vehicles. Investment in different assets provides an avenue for investors to diversify the risk of investment as well as to maximize their returns. It also provides them with an avenue to tailor their investment to the adequacy of the investable capital that is available. For small and mostly local investors it implies that these investors can take part in the capital market by pooling their resources together. This is important because such investors are able to increase their wealth without relying only on the traditional assets to build wealth. Investors benefit by getting steady returns that improve their current income. At the same time they can grow their capital through capital gains which can be reinvested in the same investment instrument or utilized to diversify in other types of investment.

Investments that Reilly and Brown (1997) define investment as the current commitment of funds for a period of time to derive future payments that will compensate the investor for the time that the funds are committed, the expected rate of inflation and the uncertainty of future payment. The investor can be an individual, a government, a fund or a corporation.

Gitman and Joehnk (2000) define an investment as any vehicle into which funds can be placed with the expectation that they will generate positive income and/or that their value will be preserved or increased. Returns from investments are usually in two forms namely current income and increased value otherwise known as capital gain.

Investments can be classified as; securities or properties, direct or indirect investment represent debt or ownership of a legal right to acquire or sell an ownership interest are

called securities. The most popular types of securities are stocks, bonds and options. The later is not common in the Kenyan stock market. Bonds represent funds lent in exchange for interest income and the promised payment of the bond at a given future date. Stocks represent an on going ownership in a business or property. Options (derivative assets) obtain their value from and have characteristics similar to those of an underlying asset. Property on the other hand comprises of investments in real property or tangible personal property. These may include land, buildings, and artwork among other tangible property. Return being the expected gain from an investment is the sum of income and capital gains generated by an investment (Mayo, 1998).

Return is also described as the level of profit from an investment (Gitman and Joehnk 2001). Return may be in the form of dividend, interest and appreciation in value or gains from selling assets at profitable prices. Return is important in investment decisions because it allows one to compare the actual gain from investments with the levels of return one needs. The level of return will depend on internal factors and characteristics such as type of investment, quality of management and how the investment is financed (Griffith 1990). It will also depend on external factors such as wars, political events, shortages and inflation. Levy and Sernt (1993) argue that a satisfactory return depends on whether the present value of benefits equals or exceeds the present value of its costs hence a high present value of benefits will be acceptable than one with the returns. A viable investment is one in which the return is adequate enough to compensate the investor for taking any extra risk

A direct investment is one in which an investor directly acquires a claim on security or property. An indirect investment is one made in a portfolio, a collection of securities, or properties typically constructed to meet one or more investment goals. Examples of indirect investments include purchase of shares in investment companies or collective investment schemes such as unit trusts, mutual funds and other funds. The investment decision as defined by Copeland (1988) denotes the choice of assets that the firm acquires, the amount invested in each particular asset and the timing of the purchase to ensure maximization of investors wealth. Given the investment decision, investors can invest in single assets or in a number of assets called portfolio.

### **1.1.2 Investment management companies**

An investment company as defined by Madura (1995) is one that invests in a pool of funds belonging to many individuals in a portfolio of individual investments such as stocks and bonds. An investment company invests a pool of funds in a portfolio of individual investments such as stocks and bonds. Portfolio managers in this case called fund managers manage such portfolios. According to Sharpe (1996) individuals enjoy two advantages in investing in investment companies; these advantages arise from economies of scale and from professional management.

The value of the investment company securities depends on what happens to the portfolio of securities. An investment company may also be defined as a firm that holds itself out as being engaged primarily, or proposes to engage in the business of investing, reinvesting or trading in securities. Investment companies provide professionally managed security portfolios which have three potential advantages namely diversification, lower cost of portfolio management and value added professional management. Investors both individual and corporate are often faced with the problem of finding suitable investment vehicles for the available funds till their maturity. Investment companies fill in this gap by providing investment vehicles into which various investors can invest. They also offer advisory services to assist the investors in selecting the best form of investments. Fund management companies according to Fisher and Jordan (1996) are open to the public and they exercise complete discretion over the investments of funds in a very conservative way. The fund managers select which investments to buy, at what prices and quantities, without consulting the resource providers. Their investments have different unique characteristics such as aggressive growth, large capitalization, fixed income and cost structure. The fund management companies assist various pension plan sponsors in the management and administration of the plan assets; they also offer segregated and pooled fund products to suit client's needs. The funds are managed on a discretionary or non-discretionary basis. It is therefore very important for the fund managers to understand the client's investment objectives.

Fund management companies pool resources from various investors and invest on their behalf and they are open to the public. They exercise complete discretion over the

investments of funds in a very conservative way as well as investing other **people's money** (Fisher and Jordan, 1996). Investment management involves a five-step procedure viewed as functions of investment management. The steps are; setting an investment policy, performing security analysis, constructing a portfolio, revising the portfolio and evaluating the performance of the portfolio. A fund manager must perform the above duties efficiently to ensure the growth of the fund. The management company appoints a fund manager to manage the assets of the fund in accordance with the trust deed. This party manages the day-to-day operations of the fund. The fund manager manages the assets/portfolio of the fund in accordance with the fund deed but the fund manager may also provide liquidity for unit holders wanting to sell their investments. Under the fund legislation, the fund manager has to repurchase an investor's units at the ruling market price. If at any time the unit holder wants to sell their units, they simply sell their investment and the money is paid into their bank accounts within stipulated time.

The unit holders are the owners of the fund managed by professional portfolio managers. The owners are entitled to the fund's net income and also share in the cost and expenses of the fund. Each fund has its own investment objective described in the fund's trust deed. Zurich Learning Center (2002), observed that funds have two main objectives; growth, which involves increasing the value of the principal investment amount, and income which involves generating a constant flow of income. The main objective of the fund defines the type of fund. There are many advantages of investing in funds; these include the fact that they are highly liquid and thus are easily convertible into cash; they are professionally managed; involve spreading of risks; have reduced dealing costs; and reduced administration costs. Disadvantages of funds include the fact that they report relatively low performance compared to winning individual company shares, high administrative costs, lack of choice and loss of owner's rights.

According to the Retirement Benefit Act of 2000, fund managers play various roles that enhance proper running of the funds. They advise the trustees on available investment vehicles and expected risk and return for each investment. At the same time they make asset allocation decisions based on the strategic allocation policy contained in the investment policy. They are also expected to manage the portfolio under them so as to ensure liquidity is available to meet the scheme's needs. Fund managers provide accurate

and timely periodic reports to the trustees and the authority relevant. A final but important role is that of decision making and monitoring. Fund managers are supposed to make investment decisions with the interest of investors in mind. They should monitor the performance of the investment that they are in charge of. Given the different roles that fund managers perform, the US investment advisers Act of 1940 stipulates that a fund manager cannot employ any device or scheme to defraud any client or prospective client of their returns or value. He /she should not engage in any transaction or course of business that may operate as a fraud or deceit upon any client or prospective client. They should also not engage in transactions as principal or as agents in a client's account without first disclosing the transaction to the client(s) and receiving the client's consent. Finally they should not engage in any act or course of business that is fraudulent, deceptive or manipulative

## **1.2 Statement of the problem**

The investment process emphasizes alternative investments and valuation assumptions. Fund managers like other institutional investors can invest in real assets or in financial assets. In financial assets they can invest in; ordinary shares, preferred shares, debentures, government and corporate bonds. Fund managers are expected to undertake analysis of several economic, industrial and company factors as well as any other factors surrounding the investment of interest before making an investment. According to the Employee Retirement Income Security Act (ERISA) issued by the US department of labor, fund managers are required to make investment decisions first based on economic and investment merit. Social factors may be an incidental but not a primary consideration of investments that are equal in economic and financial terms.

For the fund manager to achieve their investment objectives, selection of the investment is by undertaking fundamental analysis on macro-economic and micro-economic factors. This will determine the real worth of a firm both at present and in the future. Mugo (1999) studied the factors that institutional investors consider when making investments in the shares quoted at the Nairobi Stock Exchange and identified these factors as economic factors, industry factors, company factors, return and risk. However fund management companies invest in various assets other than investing only in stocks. Different investment instruments have different characteristics and this means that they are different by their



very nature. As such different variables will be at play in the investment decision process. Further, such factors have different degrees of importance when making investment decisions. For example government bonds are associated with less risk especially when considering the default risk. Bonds are also considered to be more responsive to changes in interest rates than other types of investments.

There are various factors that fund managers must consider in order to make viable investment decisions so as to satisfy the objectives and desires of the various investors. These factors include economic factors, industry trend forecasts and assess the potential impact of the various conditions on companies among others factors. Social, environmental and, geographical factors may also influence investment decisions. These factors impact on the investment in various assets differently.

The aim of this study is to determine the factors that fund management companies consider in making decisions on investments in various investment instruments.

### **1.3 Objectives of the study**

- 1) To identify the factors that fund managers consider when investing in various investment instruments.
- 2) To rate in order of importance the factors considered in investing in different investment instruments.

### **1.5 Importance of the study**

**Fund managers:** The factors identified are essential to fund managers and investors in understanding the environment within which funds are invested and allocated. This will further help in dealing with any constraining factors, factors that constrain the growth and development and full embracement of investment companies as a vehicle for development in Kenya.

**Capital Market Authority** as the regulatory body of the capital markets in Kenya may use the results of this study to formulate policies and regulate the capital market. One of its functions is to mobilize resources. This research should highlight issues in achieving this objective.

**Investment advisors:** The information from the study will help investment advisors advise their clients on the factors to consider when making investment decisions, the risk exposure of the various investment vehicles available and the fund companies that meet investor's objectives.

**Corporate managers:** The study will also be useful in to corporate managers in understanding the expectations of institutional investors. This will help corporate managers to make decisions that are in line with the preferences of this group of investors.

**Academicians:** The findings will add to the body of existing knowledge in finance. The results will give an indication of the factors surrounding investment issues.

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## CHAPTER TWO: LITERATURE REVIEW

### 2.1 INVESTMENT DECISIONS

The basic question facing all investors is which securities to invest in. According to Bruno (2000) the answer to this depends on various factors such as; economic factors, financial factors of the investor, the industry where investment interest lies among other factors. Lofthouse (2001) suggests that all investors must consider investment objectives; assets classes to include in the portfolio, weights assigned to various assets classes, the selection strategies to use with each asset class and evaluation of the other four steps.

A portfolio mix simply means the approach to diversify ones or to hold various assets at once (Markowitz, 1956). The author observed that investors should not only care about the expected returns of their wealth but also about the risk. This led him to seek to find the portfolio with maximum expected return for a given level of risk. The goal is to diversify or invest in various assets in order to avoid total failure. On the other hand the basic principle in investment is to compare investment proposals with alternative investments. Investments should be evaluated from a risk return perspective and this presents a difficult task in identifying risk. Whereas returns are in the future this future is highly uncertain.

Diversification existed in past centuries where one held several assets without practical reasons to explain it. Diversification helps to spread the portfolio and reduce risk. It also helps in selecting individual investments that are solid enough to withstand the deterioration in the risk rating recognizing that the market often anticipates changes and risk. This is reflected in the form of risk premium. Reducing total risk will increase expected cash flow thereby increasing the value of the firm. Gitman and Joehnk (2001), argue that the emphasis of the traditional approach was inter-industry diversification. Traditional approach invested in large successful companies because they were liquid and more acceptable by the public. There are various sources of risk but two main categories of risk identifiable are diversifiable risk (unsystematic risk) and undiversifiable risk (systematic risk) (Mayo, 1998).

Diversifiable risk represents that portion of risk that is associated with random factors that can be eliminated away through diversification. It is attributable to a firm's specific events

such as strikes, legal issues, poor management, and poor work force, among others. Undiversifiable risk is attributed to market factors that affect all firms. It cannot be eliminated away through diversification, for instance war, inflation, international events, political events, exchange risk and market risk. Market risk is associated with fluctuation in security prices and in particular securities held in the fund. According to Clarke (1999), risk is measured by use of standard deviation, which measures the dispersion around an average value of returns. An investment manager should consider the factors associated with the assets available.

Return being the expected gain from an investment is the sum of income and capital gains generated by an investment (Mayo, 1998). Return is also described as the level of profit from an investment (Gitman and Joehnk 2001). Return may be in the form of dividend, interest and appreciation in value or gains from selling assets at profitable prices. Return is important in investment decisions because it allows one to compare the actual gain from investments with the levels of return one needs. The level of return will depend on internal factors and characteristics such as type of investment, quality of management and how the investment is financed (Griffith 1990). It will also depend on external factors such as wars, political events, shortages and inflation. Levy and Sernt (1993) argue that a satisfactory return depends on whether the present value of benefits equals or exceeds the present value of its costs hence a high present value of benefits will be acceptable than one with the returns. A viable investment is one in which the return is adequate enough to compensate the investor for taking any extra risk.

## **2.2 PORTFOLIO SELECTION**

The basic problem facing investors is to determine which particular risky securities to invest in. A portfolio is a group of assets held together for the purposes of diversifying risk. It is a collection of securities held together. For this purpose to be achieved one must not only invest in or hold unique assets but must also hold assets that are negatively related in which case their returns move in different directions. According to Eugene and Gapenski (1996), the ability to group assets into portfolios has important implications for financial management. A firm's cost of capital is determined by the riskness of the securities held, and the size of a security and required rates of return depend on risk, hence portfolio effects

influence a firm's cost of capital. The author argues that a firm can itself be thought of as a portfolio of operating assets or projects. So the relevant risk of a given project is its contribution to the riskness of a portfolio of assets.

According to Markowitz (1952), in general risk can be reduced by combining assets into portfolios rather than holding them individually. Portfolio theory implies that investors should combine assets into portfolios to minimize risk and the riskness of each individual asset should not be measured as if it were held in isolation, but rather by its contribution to the riskness of a well-diversified portfolio. In developing the portfolio theory, Markowitz assumes that an investor has a given sum of money to invest at the present time which will be invested for a particular length of time known as the investor's holding period. It is also assumed that investors when given a choice between two otherwise identical portfolios will always choose the one with a higher level of expected return. The assumption of nonsatiation is made in the development of the portfolio theory; that is investors are assumed to always prefer higher levels of terminal wealth to lower levels of terminal wealth. The reason is that higher levels of terminal wealth allow the investor to spend more on consumption in the future. Thus given two portfolios with the same standard deviation, the investor will choose the portfolio with the higher expected return. It is also assumed that investors are risk averse in which case investors will choose the portfolio with the smaller standard deviation.

In portfolio selection different assets must be analyzed for specific returns and their stand-alone risk determined. This is based on the assumption that each asset is held in isolation. The expected rate of return on a portfolio is simply the weighted average of the expected returns of the individual securities in the portfolio. The expected return of a portfolio is given by;

$$K_p = \sum x_i k_i$$

Where;

$K_p$  is the expected rate of return on the portfolio

$X_i$  is the fraction of portfolio invested in asset  $i$

$K_i$  is the expected rate of return on the  $i$ th asset

The riskiness of a portfolio is measured by the standard deviation of its return distribution. It is generally not a weighted average of the standard deviations of the individual assets in the portfolio. It depends on the colleration of the assets making up the portfolio. Correlation is the tendency of the returns of the two assets to move together measured by the correlation of coefficient. In a two-asset portfolio the standard deviation is given by;

$$\delta p = [X^2 \delta_A^2 + (1-X)^2 \delta_B^2 + 2X(1-X) \gamma_{AB} \delta_A \delta_B]^{1/2}$$

Where

X = weight of asset A

1-x = weight of asset B

$\delta p$  = standard deviation of the portfolio

$\delta_A^2$  = Variance of asset A

$\delta_B^2$  = Variance of asset B

$\gamma_{AB} \delta_A \delta_B$  = correlation coefficient of the assets making the portfolio in this case A and B

However for maximum benefits an efficient portfolio must be selected and this will provide the highest expected rate of return for any degree of risk, or the lowest degree of risk for any expected rate of return. The efficient frontier is obtained from the set of attainable portfolio. The extent to which adding assets in a portfolio reduces portfolio risk depends on the degree of correlation among the assets: the smaller the correlation coefficient the lower the remaining risk in a large portfolio.

## 2.3 INVESTMENT MANAGEMENT

The central task of investment management is to construct a portfolio, which ensures that liquidity is maintained as required. Investment management is the process by which money is managed (Sharpe 1996). It may be active or passive management, use explicit or implicit procedures, be relatively controlled or uncontrolled. It also refers to the analysis and selection of a portfolio. In a capital market that is relatively efficient the process takes the

trend towards management in constructing a portfolio. In this case six broad issues should be considered; the investment objectives, the asset classes to include in the portfolio, the strategic weights to assign to those classes over the long term, the short-term tactical weights to assign, the selection strategies to use within each asset class and to evaluate how well the decisions made in other steps have met the objectives.

The portfolio theory assumes that investors are basically risk averse, meaning that given a choice between two assets with equal rates of return, they will select the asset with the lower level of risk (Reily and Brown 1997). It is also assumed that an investor would want to maximize the returns from a given level of risk. An optimum investment portfolio is not simply a matter of combining a lot of unique individual securities that have desirable risk-return characteristics. It has been shown that it is necessary to consider the relationship among the investments if an investor is going to build an optimum portfolio to meet the investment objectives. Investment management is more than good security analysis. Stocks cannot be considered in isolation and constructing an investment portfolio involves a great deal more than just collecting a long list of good stocks and bonds. What is required is the selection of a balanced portfolio that meets the investor's objectives and also provides adequate protection and opportunities with respect to a wide range of risks and other contingencies.

According to Ahearn (1964), the goal in every stage of the investment management process, is to produce better results than the market technician, security analyst or economist could have achieved on his own. Investment decision is almost always an economic decision; the purchase or sale of future economic performance. The stream of potential income, which the investor buys or sells, will fluctuate, grow or decline depending on how the economic environment affects it. Investment policy is naturally influenced by the description and analysis of the economic and political environment in which investment decisions are made. The investment program is affected by economic evaluation of changing trends in the economy and their impact on specific industries and companies. Different investors have different objectives for any investment that they make. An investor's investment policy comprises of his/her investment objectives. According to modern portfolio theory these objectives are reflected in the clients' attitude towards risk and expected return (Sharpe, 1996). By understanding an investor's trade-off between

expected return and risk, the investment manager can embark on constructing an optimal portfolio for the investor(s). Usually specific investors objectives fall in the different categories of; capital preservation, capital appreciation, current (steady) income and total return.

According to Sharpe (1996), the investment management process comprises of five steps. The steps are; setting the investment policy, security analysis, constructing a portfolio, revising the portfolio, and evaluating the performance of the portfolio. The steps outline the general functions of any investment manager. The objectives of investors change with time, probably because the investor's attitude toward risk and return has changed or more likely the managers forecasts have changed. In response, the manager identifies a new optimal portfolio to hold. After establishing the objectives of investors to the fund, fund managers should consider any investment constraints such as liquidity needs, investment time horizon, legal and regulatory constraints, unique needs and preferences (Invest it Magazine, summer 2002). In constructing an optimal portfolio, fund managers make such decisions as: the specific securities to invest in, the proportions of investable wealth to put in each security, the allowable allocation ranges based on policy weight and what specific securities to purchase for the fund. In setting the investment policy, the fund manager identifies the client's investment objective as regards his or her attitude towards the trade off between risk and expected return. The client's level of risk tolerance must be estimated. Individual securities or groups of securities are analyzed in order to identify mispriced securities. In constructing a portfolio, specific securities in which to invest are identified along with the proportion of investable wealth to be put in each security. Revision of the portfolio is necessary as the objectives of investors keep changing from time to time. The actual performance of a portfolio in terms of risk and return is also determined and compared with that of an appropriate benchmark portfolio.

## **2.4 APPROACHES TO PORTFOLIO MANAGEMENT**

Traditionally investment management involved making projections concerning the economy, the money market and capital market by economists, technicians, fundamentalists, and other market experts within or outside an organization. Security analysts or managers use such projections to make predictions about the securities that they



are in change of. Other investment styles have evolved over time within the investment community. According to Gallo and Larry (1996), many institutional investors employ multiple domestic equity managers each representing a particular equity style where each style is characterized by a unique risk return pattern, and experiences unpredictable cycles in which the style is either penalized or rewarded by the market.

Passive management involves holding securities for relatively long periods of time with small and infrequent changes (Elton, 1995). This implies a well-diversified portfolio with infrequent trading and market level risk and return expectation. Passive management will concentrate on less risky assets. Passive management tends to hold securities with small and infrequent changes unlike active management where any risky opportunity will be utilized to increase returns. Passive portfolio managers act as if the security market is relatively efficient and for this reason the price of securities shows their intrinsic value, therefore there are no mispriced securities. However, their decisions are consistent with the acceptance of consensus estimates of risk and return. The portfolios they hold may be surrogates for the market portfolio known as index fund, or they may be portfolios tailored to suit clients with preferences and circumstances that differ from those of the average investor. Passive portfolio managers do not try to outperform their designated benchmark. For example a passive portfolio manager might only have to choose the appropriate mixture of treasury bills and an index fund that is a surrogate for the market portfolio like the S&P 500 or the NSE 20 share index (Sharpe, 1996). When the management is passive, the overall portfolio mix is altered only when (1) the client's preferences change; or (2) the risk free rate changes or (3) the consensus forecast about the risk and return of the benchmark portfolio changes.

According to Elton (1995), active management is based on a forecast about the future and that security markets are efficient. Active managers believe that from time to time there are mispriced securities or groups of securities. Active management involves a systematic effort to exceed the performance of a selected target according to Sharpe (2000); all active management entails the search for mispriced groups of securities. Accurately identifying and adroitly purchasing or selling these mispriced securities provides the active investor with the potential to outperform the passive investor.

Sector rotation is a frequently used method of portfolio management that involves security selection but within a sector or an industry (Lofthouse, 2001). This type of analysis involves selecting one or more of these classifications; industrial, financial, consumer goods, growth among others, Managers who practice this style will rotate their portfolio overweighing or under weighing sectors or industries over time as they change forecasts of what sector is undervalued or overvalued. Specialized managers on the contrary, choose always to select securities within one sector or groups of industries. For example, growth stock managers, utility stock managers, and technology managers. Managers specialize for two reasons. The first is the belief that the sector is permanently undervalued and the second is the belief that ones staff members are able to select undervalued stocks in that sector or industry other than in any other.

## **2.5 ASSET ALLOCATION**

Asset allocation is generally accepted as the investment decision (Brinson et al., 1991). This is the process by which a client's funds are divided into different asset classes. According to Reilly and Brown (1997), asset allocation is the process of deciding how to distribute an investor's wealth among different countries and asset classes for purposes of investment. Asset allocation is based on the investor's policy statement (Gary, 1991). The asset allocation policy overwhelmingly contributes to the performance of an investment. The investment policy explains on average 91.5% of the variation in quarterly returns. This policy refers to the specification of the plan, sponsor's objectives, constraints and requirements including identification of the normal asset allocation mix.

Rather than present strict percentages, asset allocation ranges are provided which allow the investment manager some freedom based on his reading of capital market trends to invest towards the upper lower end of the ranges. The allocation of financial resources for investment in any economy primarily occurs on the basis of expected return and risk. Different financial instruments have different levels of risk and in order for them to compete for funds these instruments must provide different yields. If all securities had exactly the same characteristics, they would provide returns if the market was in balance. However, there are differences in the default risk, marketability, taxability and embedded options, which account for the different risk levels and hence the different expected returns

for the investors (Van Horne, 2000; Van Horne and Wachowicz 2002). The process of asset allocation allows for the formation of an efficient set and this allows the investment manager to invest in those securities that form the optimal portfolio.

There are two types of asset allocation. The first type is the strategic asset allocation that refers to how portfolio funds will be divided given the portfolio managers long-term forecasts of expected returns, variance and covariance (Sharpe 1999). According to Lofthouse (2001), the strategic weights can be set based on the use of the proportions of assets in the world portfolio as the benchmark, do what other funds are doing, use risk and return optimization or relate asset distribution to liabilities. The first approach is based on the argument that all investors should hold the same risky portfolio-the market portfolio and should vary their holding of a risk-free asset to obtain the risk-return tradeoff they desire. The most widely used method however, is doing what other firms are doing. This maximizes the manager's utility rather the clients. The third approach, the efficient frontier should be calculated and an efficient portfolio chosen. This is essentially a one period approach and no attention is paid to the liabilities of the investor. The final approach looks at the projected assets and liabilities of an institution. This long-term asset mix decisions depend not only on accurate estimates of capital market behavior, but also on a clear understanding of the needs and limitations of the investment client. Kritzman and Ryan (1980) observed that a broad investment posture rather than a specific asset mix is more reasonable because capital markets performance is so volatile and investment objectives may shift over time.

The second type is the tactical asset allocation that refers to how the funds are to be divided at any particular moment given the investors short time forecasts. This reflects what the portfolio managers would do under current market conditions. According to Lofthouse (1997), tactical asset allocation determines what deviation, based on current market valuation should be made from the strategic asset allocation projections. Tactical asset allocation therefore takes place within ranges around the strategic weights determined over the long term.

## **2.6 FACTORS CONSIDERED BY INVESTORS**

As discussed earlier the key issues in any investment decision revolve around risk and return of the investment. However there are other issues and factors that have a direct or indirect impact on the risk and return of an investment. Fund management companies must undertake an analysis of macro and micro factors so as to select investments that are valuable currently and in the future since investments have huge current and future financial implications.

### **2.6.1 Returns**

Investors compare expected returns from investment to overall market return and the cost of capital before deciding to invest or not. If expected returns are lower than the market returns, then investment will not be made. If the return is lower than the cost of capital the investment will not be made. Investments with higher return will be preferred.

### **2.6.2 Risk**

Investors consider the risk associated with every investment before making a choice. Some investments are more risky than others. For example government bonds are associated with less risk especially when considering the default risk. In managing risk, portfolio diversification is done. The portfolio is constituted from a number of investments whose returns are negatively correlated. Due to contrast of risk and return always a trade-off between risk and return.

### **2.6.3 Current and future potential of the economy**

The stage of national economy, priorities and probable direction of the economy has implications for investment decisions. Changes in interest rates will have stimulating impact on certain types of companies and depressing effect on others. On the other hand interest rates will affect some investments more as compared to others in which case bonds are more responsive to changes in interest rates than other types of investments.

#### **2.6.4 Monetary and fiscal policies of the government**

Taxation and government expenditure as well as monetary policies of the government and other economic time series provide the present and future investors with information of the investment environment and the direction the economy is likely to take. There exists a close relationship between economic conditions and the value of investments. When the economy is growing, corporate earnings and in turn returns and capital gains increase (Bhalla, 1997).

#### **2.6.5 Industrial factors**

Growing industries provide an avenue for ideal investments because demand of the firm's output is anticipated to grow and profitability will be maintained in the event of increased competition with other industries. The stage of industry growth, the stability of the growth, the stability of the sales in the industry, and the rate at which the industry is growing are important factors to consider especially in times of economic recession. The innovation in the industry gives the overall direction of the industry (Bhalla, 1997).

#### **2.6.6 Nature of the company**

Company analysis must be well done as the value of the company has a direct effect on the return of the investment. Specific market and economic environment impacts positively or negatively on a company's performance for some time. However, a firm's own managerial capabilities will determine its performance over a long period of time. Ratio analysis highlight into a firm's trend and its financial performance and position. Company analysis should also include issues regarding marketing influences, future company earnings in both quantity and quality. The accounting policies are also important because there exists a risk of faulty interpretation of corporate earnings resulting in poor investment decisions. The value of inventory may change over time due to changes in prices affecting profitability and inventory costs. Change in the provision for depreciation will affect net income and the valuation of assets. High depreciation will reduce and undervalue the firm.

#### **2.6.7 Tax considerations**

Inadequate tax allocations affect profitability as well as total assets and net worth of the company. Corporate tax should also be well analysed. Miller et al (1961) found that in a

world without taxes, transaction costs or other market imperfections, a company's dividend policy would not affect its value. Instead value is determined by choosing the optimal investment and therefore investors will not pay a premium for any particular dividend policy. Miller (1977) observed that investors hold securities for the consumption opportunities they offer and will evaluate them in terms of their yield net of tax. Investors attempt to maximize their tax incomes by choosing to either invest in all equity firms and borrow in order to provide personal leverage or invest in a levered firm (Farrar and Selwyn, 1967). As long as there is preferential treatment of tax on capital gains over dividends, preference for capital gains would continue.

### **2.6.8 Firm's operating characteristics**

These directly influence operating efficiency and earnings of the company. Quality management is important to investment success, in maintaining a competitive position of the company and successfully run its affairs to produce profits. Management should be able to plan, organize, direct, control and, co-ordinate the activities of the company to accomplish stated objectives.

### **2.6.9 Asset liquidity**

This is the ability of assets to be converted into cash immediately at full market value in any quantities. This will attract investors since the firm will be in a position to meet its cash obligations without necessarily rushing into other sources of funds. High value assets are a sign of stability while low value assets are a sign of risk. Assets are also a sign of a firm's future stability

### **2.6.10 Safety of the principal**

In this case the invested capital must be protected against loss under reasonably likely conditions or variations of the principal amount invested. Stability of the income both the dividend and capital gains in order to meet the objectives of the individual investors whether income or capital growth objectives. Purchasing power stability is also an issue because investment is done today while the returns are expected in the future which is uncertain.

**2.6.11 Geographical proximity**

Coval and Moskowitz (1999) argue that asymmetric information between local and non-local investors may drive the preference for geographically proximate investments, and the relation between investment proximity, firm size, and leverage may affect the investment made by investors. Drucker (1996) argues that demographic change precipitate economic changes. There is need for grater productivity of all wealth producing resources. In effect this means that the investment strategies or options should incorporate the expected demographic changes. As a result investors continue to show a preference for domestic investment regardless of the well-documented gains from international diversification. This has been attributed to barriers to international investment such as government restrictions on foreign and domestic capital flows, foreign taxes, and high transactions costs. Other explanations are: explanations associated with the existence of national boundaries perhaps the distinguishing feature of international capital markets, and explanations associated with a preference for geographic proximity. When capital crosses political and monetary borders, it faces exchange rate fluctuation, variation in regulation, culture, taxation, and sovereign risk .On the other hand it may be due to information differences and investors concern about hedging the output of firms that produce goods not traded internationally. Investors may simply feel more comfortable about local investments, or firms they hear a lot about, or they may have a psychological desire to invest in the local community.

# **CHAPTER THREE: RESEARCH METHODOLOGY**

## **3.1 Research Design**

The research design that was used in this study was the survey design.

## **3.2 Population**

The population of the study consisted of the 11 investment companies licensed by the Capital Market Authority as at 30 April 2000 (see appendix 3)

## **3.3 Data Collection**

The study used primary data. The primary data was collected through a semi- structured questionnaire (see appendix 2) administered on a drop and pick basis. The questionnaire had both closed ended and open-ended questions. The target respondents comprised of investment managers of the targeted investment management companies.

## **3.4 Data Analysis**

The study used descriptive statistics in analyzing the data. This involved the use of mean scores to indicate the distribution of the factors. Comparative analysis such as percentages were employed to reveal the differences and proportions of the aspects being studied for purposes of relative comparison. The rating of the various factors pertaining to different investment instruments was ranked on a 5-point likert scale with one taken to mean irrelevant, 2 to represent unimportant, 3 fairly important, 4 important and 5 to indicate a very important factor. As it was not possible to get absolute values of the mean scores on the scale used, the results were further categorized as follows.

>4.6 were rated as 5 to mean very important.

4.5 –3.6 rated as 4 to mean important

3.5-2.6 rated as 3 to mean fairly important

2.5-1.6 rated as 2 to mean unimportant

< 1.5 rated as 1 to mean irrelevant



## CHAPTER FOUR: DATA ANALYSIS AND FINDINGS

This chapter dealt with data analysis and interpretation of the research findings. The data in this study was summarized and presented in the form of tables, graphs, percentages, mean scores and standard deviation. Other factors identified from the open-ended questions and other information provided by the respondents are summarized and ranked in order of importance.

### 4.1 Response rate

Out of the eleven-investment management companies targeted only seven responded through filling of a questionnaire, which was administered through, the drop and pick later method. This represents 64% of the companies targeted. This response rate was considered adequate for data analysis given that this comprised of the main investment companies given the number of funds that they manage. In this analysis  $n=7$  and  $n=6$ . This is indicated where these different variables are used. This is because one of the respondents invests only in stocks and therefore eliminated where other investment instruments are involved.

**Table 1:** Response rate

Factor	Number	Percentage
Responded	7	64
No-response	4	32
Total	11	100

**Source:** Survey questionnaire

### 4.2 Asset value

The total asset value of the companies under survey ranged between kshs 12bn and kshs 58.4bn. However this issue was not fully addressed by most of the companies as they considered this as privileged information. On the other hand the number of funds managed

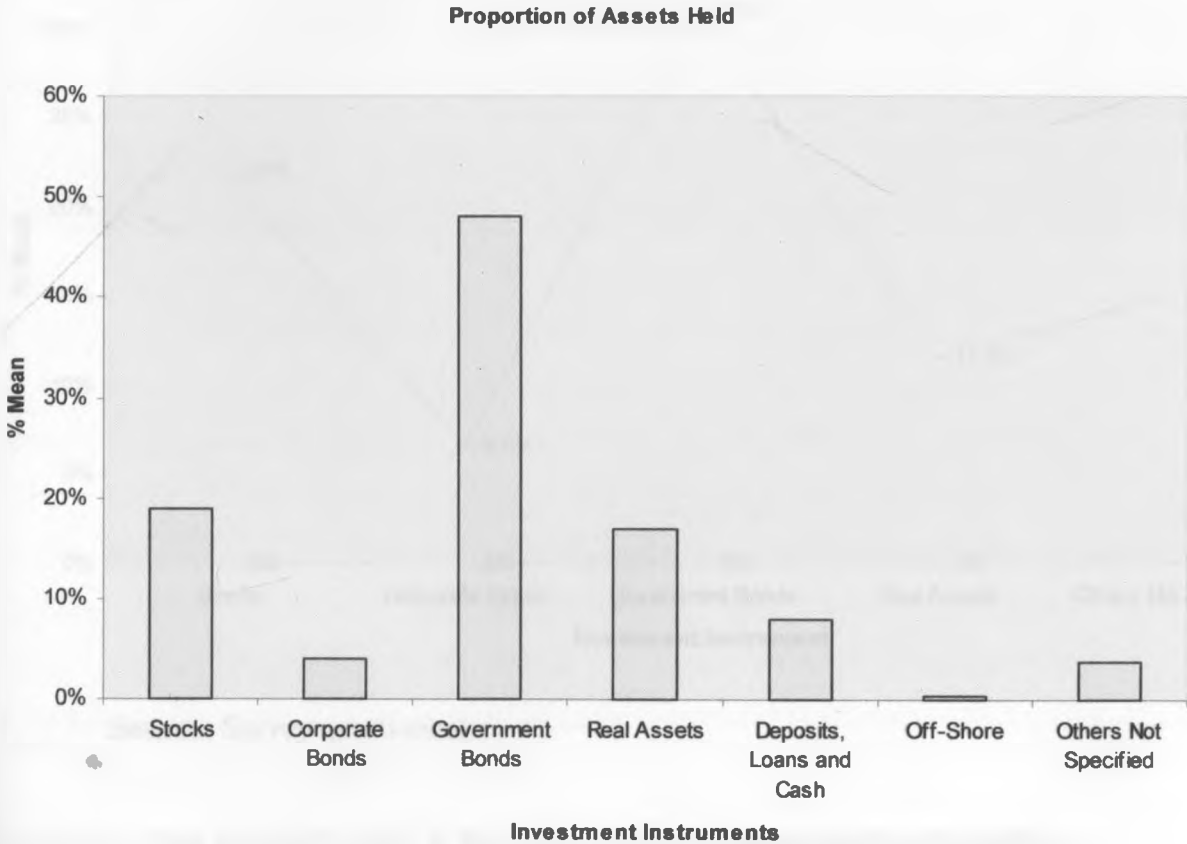
by these investment companies was given as 3, 18 and 49 from only the three investment companies that responded to the question, otherwise all other companies considered this private information that could not be disclosed.

### 4.3 Proportion of assets held

This information was needed so as to be able to categorize and understand the amount of assets generally held by investment companies in the various investment instruments held. Government bonds have the highest percentage of 48%, followed by stocks with 19%, real assets represent 17%, deposits, loans and cash comprise of 8%, corporate bonds is made up of 4% others not specified make up 3.7%, whereas off-shore investments make up 0.3%.

This kind of distribution is clearly seen in the graph below.

**Graph 1: Proportion of assets held**

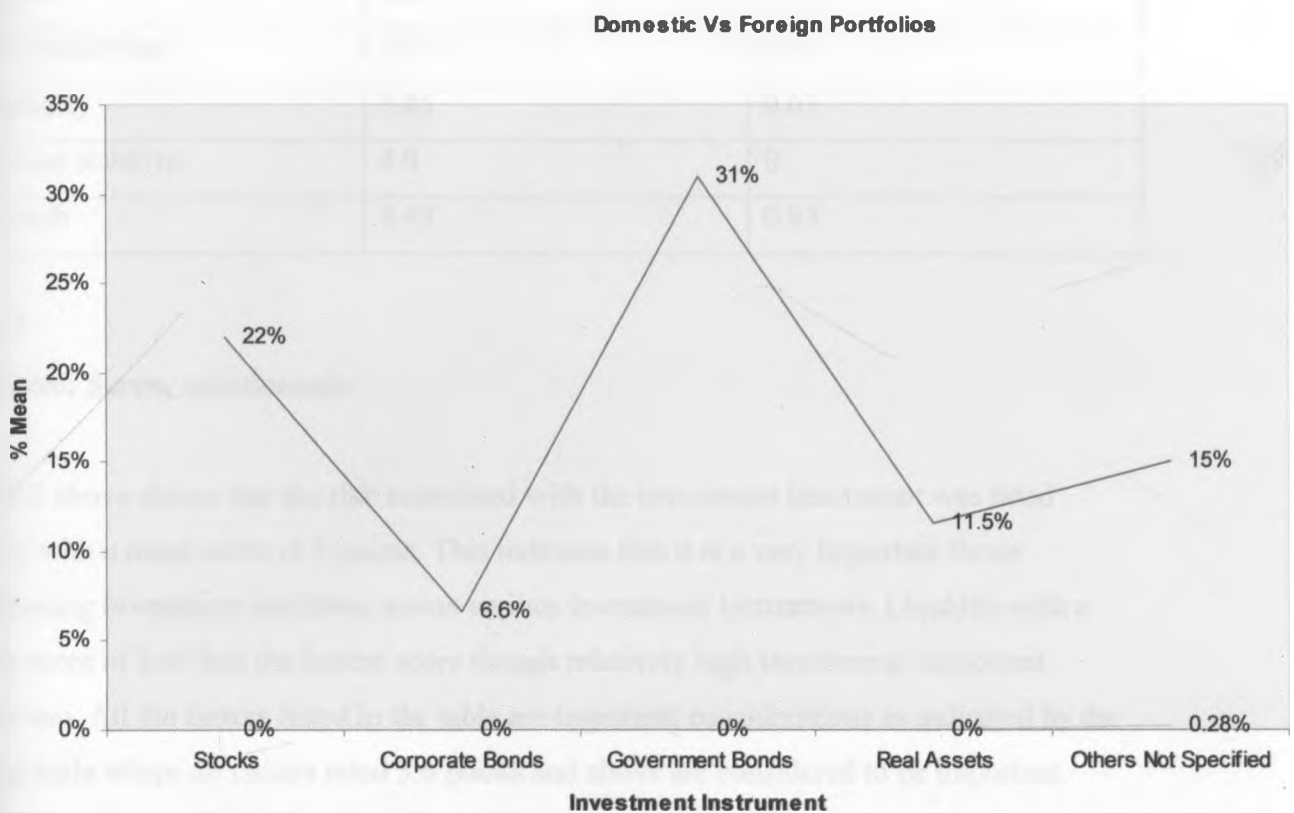


Source: Survey questionnaire

#### 4.4 Percentage of assets held per investment instrument in the domestic and foreign markets.

This information was needed to show the nature of the distribution between the foreign and domestic markets. As seen in the line graph below, most of the investments in the various assets take place in the domestic market. The respondents attributed this kind of bias to market proximity, barriers such as government restrictions on foreign and domestic capital flows, foreign taxes and high transaction costs among other reasons not disclosed.

Graph 2 Domestic versus foreign portfolio



Source: Survey questionnaire

The indication from the above graph is that most investment management companies in Kenya largely invest in the domestic market overlooking the possible opportunities and advantages from the foreign market. This is indicated by the small probably insignificant percentage of 0.28 made in the foreign market.

**4.5 The distribution of the rate of the factors considered by investment companies in making investment decisions of the different investment instruments.**

**4.5.1 General factors**

**Table 2: General factors**

Factors	Mean score	Standard deviation
Risk	5.0	0
Return	4.8	0.35
Diversification	4.14	0.35
Liquidity	3.85	0.63
Income stability	4.0	0
Growth	4.43	0.93

**n=7**

**Source:** Survey questionnaire

Table 2 above shows that the risk associated with the investment instrument was rated highly with a mean score of 5 points. This indicates that it is a very important factor influencing investment decisions across various investment instruments. Liquidity with a mean score of 3.85 had the lowest score though relatively high therefore an important factor too. All the factors listed in the table are important considerations as indicated by the rating scale where all factors rated 3.6 points and above are considered to be important. Apart from those in the table above, other factors specified by the respondents though not rated include management and general outlook of the investment sector in the short run as well as in the medium and long term.

### 4.5.2 Economic factors

**Table 3:** Economic factors as relating to stocks.

Factor	Mean score	Standard deviation
Inflation	4.29	0.88
Tax Rates	3.43	0.73

n=7

**Source:** Survey questionnaire

From table 3 above it can be seen that economic factors influence investment in stocks in an important way with inflation being the more important one than taxes.

**Table 4:** Economic factors as relating to corporate bonds.

Factor	Mean score	Standard deviation
Inflation	4.5	1.56
Interest rates	4.67	0.79
Tax rates	2.38	0.69

n=6

**Source:** Survey questionnaire

As per table 4, interest rates with a mean score of 4.67 on corporate bonds are important economic factors that influence investment. On the other hand tax rates are rated approximately on a mean score of 3, which is judged as fairly important. Inflation is an important factor when it comes to investing in bonds. Probably because inflation affects the future value of the investment.

**Table 5:** Economic factors relating to Government bonds

Factor	Mean score	Standard deviation
Interest rates	4.67	0.75
Inflation	4.67	0.38
Tax rates	3.17	0.89

n=6

**Source:** Survey questionnaire

Table 5 indicates that the surveyed companies equally consider interest rates and inflation when it comes to investing in government bonds. According to the surveyed companies both factors have a mean score of 4.67. However interest rate have a greater variation than inflation as indicated by its higher standard deviation. Tax rates are a fairly important factor.

**Table 6:** Economic factors and real assets

Factor	Mean score	Standard deviation
Interest rate	4.17	0.76
Inflation	3.83	0.83
Taxes	3.0	1.2

n=6

**Source:** Survey questionnaire

From table 6 it can be seen that interest rates are rated as a more important factor with a mean score of 4.17. Interest rates are affected by inflation and as such if inflation rates are high, interest rates are also going to be high at least to capture the high level of inflation and the vice versa is true. Tax rates with a mean score of 3.0 are a fairly important factor.

However the respondents vary a lot on the relevance of the factor as indicated by the relatively high standard deviation on taxes.

**4.5.3 Industry factors**

**Table 7: Industry factors and stocks**

Factor	Mean score	Standard deviation
Industry competition	4.71	0.96
Industry growth	4.29	0.7
Industry rivalry	4.43	0.49
Industry innovation	4.14	0.63

n=7

**Source:** Survey questionnaire

According to table 7 above, factors such as industry competition, growth, rivalry and innovation have a mean score of above 4.0. This rate is considered as indicating the importance of the factors in decision-making. Of the four factors industry competition is highly rated as the most important factor with a mean score of 4.71.

**Table 8: Industry factors and corporate bonds**

Factor	Mean score	Standard deviation
Industry competition	4.83	0.37
Industry growth	4.17	0.68
Industry rivalry	4.17	0.22
Industry innovation	4.33	0.47

n=6

**Source:** Survey questionnaire

Table 8 indicates that most investment companies consider industry competition as an important factor when it comes to investing in corporate bonds. Industry growth and rivalry

are rated the same at a mean score of 4.17, which means that the two factors are important for making investment decisions. However, industry growth has a higher standard deviation than industry rivalry. This explains the fact that different companies would look at this factor differently when it comes to investing in corporate bonds even if the two are rated on the same mean score.

#### 4.5.4 Company factors

**Table 9:** Company factors and stocks

Factor	Mean score	Standard deviation
Profitability	5	0
Growth	4.57	0.49
Dividend policy	4.57	0.73
Size	3.86	0.35
Capital structure	4.14	0.64
Management	4.86	0.35

n=7

**Source:** Survey questionnaire

Of the company factors shown in table 9, profitability is the most important with a mean score of 5 points and standard deviation of zero. On this factor the investment companies do not differ as indicated by the zero standard deviation. Of least importance is size factor indicated by its mean score of 3.86 points. This is categorized as an important factor.

**Table10:** Company factors and corporate bonds

Factor	Mean score	Standard deviation
Profitability	4.5	0.76
Growth	4.5	0.76
Dividend policy	4	0
Size	3.8	0.69
Capital structure	4.0	1.0
Management	4.5	0.76

n=6

**Source:** Survey questionnaire



In table 10 above, the investment companies surveyed rated profitability, growth and management as an important factor influencing investment in corporate bonds. Dividend policy and specifically coupon payment structure was rated at point 4 and standard deviation of 0. This implies that it is an important factor on which the investment companies do not differ.

**Table 11: Social factors and general investment**

Factor	Mean score	Standard deviation
Security	4.9	0.76
Infrastructure	4.57	0.76
Political	4.71	0.76

n=6

**Source:** Survey questionnaire

From table 11, security issues with a mean score of 4.9 approximately 5 is the most important social factor influencing investment. Infrastructure had the lowest mean-Score of 4.57 though this is rated as an important factor. The only major geographic factor cited as influencing investment is location, or proximity especially when considering investment in corporate bonds. It had a mean-score of 4 points, which is ranked as an important factor.

### 4.5.5 Summary of the factors

**Table 12**

Factor	Data	Stocks	Government bonds	Corporate bonds	Real assets
Inflation	Mean	4.29	4.67	4.5	3.83
	Percent	85.8	93.4	90	76.6
Tax rates	Mean	3.43	3.17	2.3	3
	Percent	68.6	63.4	56.6	60
Interest rates	Mean	0	4.67	4.67	4.17
	Percent	0	93.4	93.4	83.4
Industry competition	Mean	4.71	0	4.83	0
	Percent	94.2	0	96.6	0
Industry growth	Mean	4.29	0	4.17	0
	Percent	85.8	0	83.4	0
Industry rivalry	Mean	4.43	0	4.167	0
	Percent	88.6	0	83.34	0
Industry innovation	Mean	4.14	0	4.33	0
	Percent	82.8	0	86.6	0
Profitability	Mean	5	0	4.5	0
	Percent	100	0	90	0
Growth	Mean	4.571	0	4.5	0
	Percent	91.42	0	90	0
Dividend policy	Mean	4.571	0	4	0
	Percent	91.42	0	80	0
Size	Mean	3.857	0	3.8	0
	Percent	77.4	0	76	0
Capital structure	Mean	4.14	0	4	0
	Percent	82.8	0	80	0
Management	Mean	4.867	0	4.5	0
	Percent	97.34	0	90	0

From table 12 above the factors can be easily seen in terms of the extent to which they affect investment in the various investment instruments. In the case of stocks there are three very important factors namely profitability, management, and industry competition. Most of the other factors are considered to be important which include, dividend policy, growth, industry rivalry, inflation, industry growth, capital structure, industry innovation, and size. This describes the order of importance of the factors as influencing stocks from the most important to the least important. Government bonds were found to be only affected by economic factors in which only two of them were rated as very important that is inflation and interest rates. Tax rates were fairly important. The most important factors that influence investment in corporate bonds were industry competition and interest rates. The other factors in order importance were inflation, profitability, growth, management, industry innovation, industry rivalry, industry growth and capital structure. Like government bonds, investment in real assets was found to be influenced by economic factors such as interest rates, inflation and tax rates.

#### **4.6 Other Issues as provided by respondents**

Most of the respondents cited the influence of government policy and regulations as a major factor influencing general investment especially when considering the government policy to encourage economic development with a focus on marginalized areas.

Government policies and regulations also influence investment when considering issues of distribution of economic growth and government programs such as poverty alleviation.

Interest rates were categorized to be a very key consideration when making investment decisions due to the high quality relativity observed and the inverse relationship between interest rates and yields and bond as well as equity prices. This high level of unpredictability due to conflicting signals from both the central bank and the treasury have created uncertainty for investors and thus making the investment efforts very difficult. A unique aspect revolves around private equity funds, which differ from other firms in the

market. This has a main focus on providing risk capital to private companies who require the funds for expenses or change of control transactions.

4.4 Summary of findings, conclusions and recommendations

The study has identified several key findings regarding the current state of the market. It has shown that there is a significant gap between the demand for risk capital and the supply available. This is primarily due to a lack of awareness and understanding of the market among potential investors. The study also found that the current regulatory environment is a major barrier to entry for many potential investors. This is due to the complex and often conflicting nature of the regulations. The study recommends that the government should take steps to simplify the regulatory environment and provide more support for potential investors. This could be done through the creation of a dedicated regulatory body for the market. The study also recommends that industry associations should be encouraged to provide more education and training for potential investors. This could be done through the creation of a dedicated industry association for the market. The study also recommends that the government should provide more support for potential investors through the creation of a dedicated fund for the market. This fund could be used to provide seed capital for start-up companies and to provide support for companies in the early stages of their development. The study also recommends that the government should provide more support for potential investors through the creation of a dedicated network of mentors and advisors. This network could be used to provide support for potential investors in the form of advice, guidance and connections. The study also recommends that the government should provide more support for potential investors through the creation of a dedicated network of investors. This network could be used to provide support for potential investors in the form of advice, guidance and connections.

The study also identified several key findings regarding the current state of the market. It has shown that there is a significant gap between the demand for risk capital and the supply available. This is primarily due to a lack of awareness and understanding of the market among potential investors. The study also found that the current regulatory environment is a major barrier to entry for many potential investors. This is due to the complex and often conflicting nature of the regulations. The study recommends that the government should take steps to simplify the regulatory environment and provide more support for potential investors. This could be done through the creation of a dedicated regulatory body for the market. The study also recommends that industry associations should be encouraged to provide more education and training for potential investors. This could be done through the creation of a dedicated industry association for the market. The study also recommends that the government should provide more support for potential investors through the creation of a dedicated fund for the market. This fund could be used to provide seed capital for start-up companies and to provide support for companies in the early stages of their development. The study also recommends that the government should provide more support for potential investors through the creation of a dedicated network of mentors and advisors. This network could be used to provide support for potential investors in the form of advice, guidance and connections. The study also recommends that the government should provide more support for potential investors through the creation of a dedicated network of investors. This network could be used to provide support for potential investors in the form of advice, guidance and connections.

# **CHAPTER FIVE: SUMMARY OF FINDINGS AND CONCLUSIONS, RECOMMENDATIONS, LIMITATIONS AND SUGGESTIONS FOR FURTHER RESEARCH**

## **5.1 Summary of findings, discussions and conclusion.**

The first objective of the study sought to identify the factors that investment management companies or managers consider when investing in various investment instruments. The results from the study show that several factors are considered when making investment decisions. Whereas some factors cut across the various investment instruments, there are other factors that are unique to specific investment instruments. The factors that investment management companies consider across the board of investment instruments from the most important to the least were risk, return, growth of the capital amount, diversification, income stability and liquidity. However, all these factors were considered to be important to different degrees. There was very small variance observed among the factors with standard deviation ranging from 0 to 0.93. This indicates a common opinion on the various factors by the different investment companies. Social factors such as security, infrastructure and political stability were also considered as very important for investment.

Investment in stocks was influenced by such economic factors as inflation and tax rates. Of the two factors inflation was the more important factor. Among the industry factors influencing investment in stocks, the very important factor was competition in the industry, which was rated as a very important factor by all the respondents. Other factors in this category include industry growth, industry rivalry, and industry innovation. Industry innovation was not considered a crucial factor influencing investment in stocks. The other group of factors influencing investment in stocks was company factors in which case investment companies prefer companies that consistently report high profits, and have good management as this would guarantee continued growth in profits in which case dividends are expected to continually flow to the investors. This is good especially for investors whose main objective is a constant source of income. Growth of the company is also a factor worth considering as this ensures potential profits and capital growth. Other company factors necessary for investment in stocks include capital structure and size of the

company. Capital structure is particularly important because of the agency relationship issues that this factor is likely to breed. From the study, size of the company was the least important factor with most companies rating it as only important.

Investment in corporate bonds was influenced by economic factors such as interest rates, inflation rates and tax rates. The most important of the three was interest rate. Most investment companies considered tax rate as unimportant. In the category of industry factors, industry competition and innovation were important factors. Other factors that were considered were industry growth and industry rivalry. The least important in this case was industry growth. The last category of factors was company factors in which case profitability of the company; growth and management are the most important factors influencing investment in corporate bonds. Other factors included dividend policy, size of the company and capital structure.

Investment in government bonds was influenced by various economic factors. These factors include interest rates and inflation rates, which were very important. Tax rates were considered as fairly important. Industry factors and company factors were not observed to influence investment in government bonds in any significant manner.

The only factors found to influence investment in real assets were economic factors such as interest rates. This factor was considered the most important factor because investment in real assets is mostly financed through debt capital. Interest rates on debt capital can make this source of funds either expensive or cheap. Inflation rates on the other hand influence the rate of interest hence it was also considered an important factor.

The conclusion that can be drawn in addressing this first objective is that several similar factors are at play when it comes to influencing investment in various investment instruments. However the factors influence investment and investment managers to different extents when making an investment decision for one particular asset. For example company factors are more important when it comes to investing in corporate bonds than in

stocks whereas economic factors are the more influencing factors when considering investment in government bonds and real assets.

The second objective of the study sought to rate or rank in order of importance the factors considered in investing in different investment assets. The most important factors to be considered when investing in stocks were found to be competition in the industry.

Profitability of the company as this further determines the amount of dividends distributed to the investors as well as management which largely affects the way the company is run and in the long run the returns. Tax rates were considered to be of the least importance. It can therefore be concluded that investment in stocks is influenced by a host of factors, which relate to the economy, industry or company factors as well as general factors.

The most important factors influencing government bonds are inflation and interest rates. Of least importance are tax rates. It is quite clear that investment in government bonds is largely influenced by economic factors apart from general issues of risk and return. However the risk associated with government bonds is very low especially when one considers default risk.

Corporate bonds are influenced by various factors ranging from economic factors to company factors. Nevertheless competition in the industry and interest rates are the most important. Others in order of importance include profitability, management, growth capital and capital structure. The least important factor is size.

Investment in real assets is influenced by economic factors alone though only two were rated as important. These are interest rates and inflation. It can be concluded that investment in real assets is influenced by other factors other than economic factors. Factors inherent in the real asset of interest may be of more importance than the economic factors highlighted by investment companies.

## **5.2 Limitations of the study**

The major limitation encountered was reluctance to fully address all the questions in the questionnaires by some respondents as they considered some of the information requested for as confidential information, which could not be disclosed.

On the other hand there was a case of one targeted respondent who did not consider it necessary to participate in the study. Another problem was the fact that most respondents did not keep their promise on the time to collect the questionnaires and this led to time wastage and high follow up cost not anticipated by the researcher.

## **5.3 Recommendations to policy makers**

The study reveals that different investment instruments are influenced by different factors in varying degrees. Even where similar factors influence investment decisions across various assets, the degree of influence varies.

Investment management companies require to continuously analyze these factors as they relate to specific investment assets. They also need to pay particular attention to those factors that are very important in influencing investments. For example profitability, management, growth potential, dividend policy and competition among others like risk, return and income stability. These factors translate into maximizing the value of the firm and as such satisfying the specific objectives of the investors like capital growth, stability of income and increasing the level of wealth.

## **5.4 Suggestions for further research**

This study focused on investment management companies only, however a study is necessary to compare these factors with those addressed by other investors like retirement benefit schemes, insurance companies, units trust, mutual funds, among others in making investment decisions on the cited investment instruments. These results can be compared and contrasted to highlight any major similarities or differences in the decision making process.

A study should be carried out to determine the reasons behind the home bias showed by investment management companies in making investment decisions. These companies



were observed to invest in the domestic market despite the returns and other advantages accruing to the foreign market.

A study can be carried out to determine the factors that influence investment in real assets as those covered in this study relating to real assets were found to be of very minimal importance.

The respondents who deal with private equity funds disclosed a unique aspect around these funds. They however did not expose the nature of uniqueness thus this aspect and others surrounding the private equity funds could offer an interesting area of study.

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# APPENDIX 1

## Letter to the respondent

Dear Sir/ Madam,

I am a postgraduate student at the Faculty of Commerce University of Nairobi. In fulfillment of the requirement of the Masters in Business Administration I am currently undertaking A STUDY OF THE FACTORS THAT FUND MANAGEMENT COMPANIES CONSIDER IN MAKING INVESTMENT DECISIONS. I request for your assistance by filling the attached questionnaire to the best of your ability. The information provided will be used solely for academic purpose and at no instance will the name of the company be named in the report. It will be treated with utmost confidence.

Yours faithfully,

MWOBOBIA KINYA HILDA

MRS KITHINJI

MBA STUDENT

RESEARCH SUPERVISOR

SIGNATURE

SIGNATURE

## APPENDIX 2

### SURVEY QUESTIONNAIRE

Name of the fund management company. -----

- 1) How many funds are under the management of the company? -----.
- 2) Indicate the total asset value under the management of the company? -----.
- 3) Please indicate proportion of assets held under the following categories of investment instruments.

<b>Instrument</b>	<b>%</b>
Stocks	
Corporate bonds	
Government bonds	
Real assets	
Others, specify	

- 4) Indicate the percentage of investment held in each category above in the domestic and foreign markets as the case may be.

<b>Instrument</b>	<b>Domestic %</b>	<b>Foreign %</b>
Stocks		
Corporate bonds		
Government bonds		
Real assets		
Others, specify		

- 5) Would you consider the proportion differences above significant.

Yes                    [ ]

No                     [ ]

6) If yes in the question 5 above, what would you attribute this to?

7) Investment decisions are made based on various factors. Please rate the following categories of factors using the key provided below.

### Key

- 1) Very important
- 2) Important
- 3) Fairly important
- 4) Unimportant
- 5) Irrelevant

A) General factors

Rank

1    2    3    4    5

Risk

Return

Diversification

Liquidity

Income stability

Growth

Others (specify)

B) 1. Economic factors as relating to stocks.

Rank

1    2    3    4    5

Inflation

Tax rates

6) If yes in the question 5 above, what would you attribute this to?

7) Investment decisions are made based on various factors. Please rate the following categories of factors using the key provided below.

**Key**

- 1) Very important
- 2) Important
- 3) Fairly important
- 4) Unimportant
- 5) Irrelevant

A) General factors

Rank

1    2    3    4    5

Risk

Return

Diversification

Liquidity

Income stability

Growth

Others (specify)

B) 1. Economic factors as relating to stocks.

Rank

1    2    3    4    5

Inflation

Tax rates

2. Economic factors as relating to

Rank

Corporate bonds

1 2 3 4 5

Interest rates

Inflation

Tax rates

3. Economic factors as relating to

Government bonds

Interest rates

Inflation

Tax rates

4. Economic factors as relating to

Real assets.

Interest rates

Inflation

Tax rates

Others (specify)

C) 1. Industry factors as relating to

Rank

Stocks.

1 2 3 4 5

Competition in the industry

Industry growth

Industry rivalry

Industry innovation

Industry factors as relating to

Rank



Corporate bonds 1 2 3 4 5

Competition in the industry

Industry growth

Industry rivalry

Industry innovation

Others(specify)

D) 1. Company factors as relating to  
Stocks.

Profitability

Growth

Dividend policy

Size

Capital structure

Key management personnel of

The quoted company

Others (specify)

2. Company factors as relating to  
Corporate bonds

Profitability

Growth

Dividend policy

Size

Capital structure

Key management personnel of

The quoted company.

Others (specify)

E Social factors that influence investment

Rank

1 2 3 4 5

Security

Infrastructure

Others (specify)

F Geographic factors that influence investments.

Location

Others (specify)

8) Provide any other information that you think would be useful to this study. -----

-----  
-----  
-----

**Thank you very much for your cooperation.**

## Appendix 3

Fund managers licensed by CMA as at 30 April 2004 Gazette notice No.3271

Fund manager	Address -Nairobi	Number
Stanbic Investment Management services (E.A) Ltd	30550-00100	020/04
Aureos Kenya Managers Ltd	43233-00100	021/04
AIG Global Investment Co (E.A) Ltd	67262-00200	022/04
ICEA Investment Services Ltd	46143-00100	023/04
Co-optrust Investment Services Ltd	48231-00100	024/04
Old mutual asset managers (k) ltd	11589-00400	025/04
Genesis (Kenya) Investment Management Ltd	79217-00200	026/04
Old Mutual Investment Services Ltd	30059-00100	027/04
Old Mutual Asset Managers (EA) LTD	11589-00400	028/04
Royal Investment Services Management Ltd	9480-00100	029/04
African Alliance (k) Management Ltd	27639-00506	030/04