The Framework for Index Funds in Kenya

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Abstract

The study set out to assess the institutional and regulatory framework for index funds in Kenya. The study examined the presence of factors that would support the introduction of index funds. The need for the study emanated from the apparent inability of fund managers to outperform the market as represented by an unmanaged index. This study builds on the passive versus active management strategies in the Kenya capital market. The study looked at the importance of index funds to the financial system and how the index funds would benefit the investing public. It also examines the Kenyan investor profile to see whether it matches the investor characteristics associated with Index funds. The structure of the capital market and the characteristics of fund managers were examined to find out whether they support passive or active investment strategies. Focus was also placed on the current state of the legal and regulatory framework and how well investors are protected in the Kenyan market. Finally, the capital market was examined to determine the existence of Index funds' critical success factors. There was sufficient evidence of the existence of factors that form the framework for index funds. However, a number of issues such as inefficiency of the capital markets, lack of adequate regulation and investor protection need to be addressed for the successful introduction of Index funds into the Kenyan Capital market.

Key words: Index funds, passive investment, active investment

Background

Everyone with money to invest is faced with the same problem of forming and managing a portfolio of financial assets (Jacob and Petit, 1988). The science of investment analysis, choice and evaluation is primarily driven by risk and expected return (Sears and Trennepohl, 1993). An important investment management development is the Index fund, which is a special type of mutual fund that seek to increase the value of the portfolio in line with a benchmark index through partial or fully replication. Recent developments have seen the emergence of index funds that reflect personal benchmarks (Moneychimp, 2005), closet indexing where active managers buy stocks that have the largest impact on the index and enhanced indexing where managers add value by over or under weighting particular stocks (Custodio, 2005). Currently there are no index funds in Kenya. In the last few years there has been an emergence of a number of unit trusts including, Old Mutual, African Alliance, British American, Stanbic and Commercial Bank of Africa schemes.

Statement of the Problem

Active management is an attempt to 'beat' the market by taking advantage of certain market irregularities to achieve higher returns. In contrast, passive management or indexing invests in exactly the same securities and in the same proportions as an index on the premise that it is difficult to beat the market (Russell, 2005). Portfolio returns in active management are expected to exceed the return of a passive benchmark portfolio, net of transaction costs on a risk-adjusted basis (Reilly and Brown, 2000). In exchange for management fees, investors expect professional expertise that generates an above-market return. However there have been increasing concerns amongst investors on the inability of fund managers to outperform the market. Jensen (1969) showed that mutual fund managers had no ability to outperform an unmanaged index and under-performed the market by an amount about equal to the amount of their expenses and fees. This study therefore sought to assess the framework for index funds in Kenya.

Hypothesis

The study hypothesized that a framework does not exist for the introduction of index funds in the Kenyan Market.

Objectives of the Study

- To assess the institutional framework for index funds in Kenya.
- To assess the regulatory framework for index funds in Kenya.

Literature Review

Passive Investment Strategies

Passive investment strategies arose in the 1970's (Sears and Trennepohl, 1993) with the first domestic common stock index fund being introduced in 1971 (Sharpe, Alexander and Bailey, 1996). Replication of the targeted stock index is attained through (1) full replication technique where all stocks in the index are bought weighted in accordance to their market values proportion of the index; (2) the sampling approach where purchases of a subset of the index are made which are designed to minimize deviations from the index, and; (3) Partial replication which involves the selection of a subset weighted in accordance with the industries represented in the index.

Active mutual funds spend time and effort selecting individual securities or timing their movements into and out of the market thereby have greater costs compared to index funds (Jacob and Petit, 1988). Kiplinger (2003) attributes the lower costs of index funds to minimal turnover and therefore less taxable capital gains, staying fully invested and lack of stock analyzers and stock pickers to pay. Index fund investing is however not decision-free as the investor needs to select which indexes to track, which particular index funds to track them with, how much to allocate to each and when to rebalance (Newberry, 2000).

Innovation plays an important role in construction of passive portfolios that are not based on a published index. Reilly and Brown (2000) present customized passive portfolios that complement active portfolios, while Mossavar-Rahmani (1988) note passive portfolios constructed to track the performance of customized benchmark for investors with special needs.

Active Investment Strategies

Active investment strategies attempt to 'add value' by profiting from forecasted market movements primarily through the use of three approaches namely: market timing approach, management style and factor model approach (Sears and Trennepohl, 1993). Market timing strategy focuses on capturing gains in a bull market and avoiding losses in a bear market. Reilly and Brown (2000) recognize three generic market timing themes: of shifting funds into and out of stocks; shifting funds among different equity sectors, industries or investment styles; and stock picking.

In management styles, a top-down strategy is concerned with industries that are expected to outperform the market with emphasis being placed on the big picture rather than individual companies (Chand, 2005). In contrast, the bottom-up strategy involves selection of individual stocks that are undervalued and are expected to outperform the market with little or no emphasis on the larger picture (Chand, 2005). Factor model strategies select stocks, based on factors such as book/price ratio, earnings/price ratio and earnings variability, with the help of computers using the Arbitrage Pricing Theory.

Passive Versus Active Investment Strategies

Though a 20-year study in 1989 showed that the S&P Index outperformed more than 80% of the active fund managers, investors continue to hire active managers believing they can spot the manager who will outperform the index (Elton and Gruber, 1995).

Sharpe (1975) reported that the yearly market timer must be correct 75 percent of the time in order to outperform a buy-and-hold portfolio. Droms (1989), extending the study of Sharpe, found out that it was much more important to forecast correctly in a bull market than in a bear market. Jeffrey (1984) concluded that the potential gains from timing do not compensate for the potential underperformance if the investor is wrong. Sy (1990) reported that small investors with no particular skill in market timing would probably lower their portfolio returns by attempting to time the market. Chang and Lewellen (1984) found no evidence that fund managers had market timing and security selection abilities. However, for holding periods beyond a year, expected returns on stocks and long-term bonds have been found to be weakly predictable (Fama and French, 1987; Keim and Stambaugh, 1986; and Poterba and Summers, 1988). Reilly and Brown (2000) found active management strategies dominate indexed portfolio strategies in terms of total funds under management. The findings further revealed that the indexed sector was growing quite rapidly with equity indexing far more popular than fixed income indexing.

Many investors are happy to pass up a chance of outpacing the market by a point or two for the guarantee of matching it – the risk and worry associated with active management outweighs the possible benefits (Kiplinger, 2003).

Contemporary Issues on Index Funds

Ferris (2000) proposes that indexing will lead to self destruction of markets since all investable funds will wind up in stock prices comprising the index leading to insane prices for bankrupt firms with billion-dollar market capitalization. Graff and Dugan (2005) faulted this argument pointing out that only 16% of all new investment dollars in 1998 came into S&P 500 index funds.

Ferris (2000) argues that if everyone were to put his or her money into a market-capitalization index fund, the index would grow ever more and more top-heavy due to the need to buy big-cap stocks until there will be only one stock left. The S&P 500 would become S&P 1! Graff and Dugan (2005) countered this argument noting this is unlikely to happen since 90% of all equity mutual funds are actively managed. Concerns over the contribution of indexing to market inefficiency were raised by Ferris (2000) noting that the prices of stocks in an index have stopped driving the index, but rather the index is now driving the prices of stocks. Graff and Dugan (2005) recommended the use of index funds even in inefficient markets.

Index Fund Success Factors

The success of index funds hinges on the continued inability of active fund managers to outperform an unmanaged index. Richards (2005) notes that though a fund manager might have a phenomenal record the investor is not buying his history but rather his tomorrow and nobody knows what tomorrow's record will be.Increasing market efficiency makes it even harder for active money managers to outperform unmanaged indexes. Lower net transaction costs coupled with reduced commission costs due to low turnover add value to index funds (Browne, 2005).

Empirical research shows that 80% -90% of investment returns have occurred in spurts that amount to 2%-7% of the total length of the time of the holding period. The rest of the time, stocks return has been small. Index funds' success is in part due to staying fully invested with minimum levels of cash (Browne, 2005). Longer holding periods and lower turnover results in greater deferral of taxable gains and higher after-tax returns. Jeffrey and Arnott (1993) showed that active funds trade so much that even when they do beat the index pre-tax they often fail to do so after tax. Since active investment strategies are more expensive than index strategies, the active investor is going to have lower returns than the average index investor (Sharpe, 2002).

Investment Strategies in the Kenyan Market

The Kenyan investment market is dominated by a handful of fund managers with diverse investment management strategies. Old Mutual's investment philosophy is based on an unambiguous search for value through understanding the potential future income stream of an asset and the value to be placed on that income stream (Market Intelligence, 2005). AIG Global Investment Company, the second largest fund manager, focuses on producing consistent and superior investment performance through researching on investment opportunities that add value to clients' portfolio (Market Intelligence, 2005). Genesis Kenya, the oldest fund manager, has adopted a bottom-up approach which examines all traditional measures of value with emphasis on a stock's current price relative to its future earnings potential within a 5-year horizon (Market Intelligence, 2005). At African Alliance Kenya investment management revolves around asset allocation and stock picking guided by an analytical research process (Market Intelligence, 2005). None of the key investment managers adopt a passive investment management strategy.

Legal and Regulatory Framework

The regulatory framework provides guidance on standards of governance and mechanisms for investigating allegations of abuse and mismanagement. It promotes and encourages a greater degree of transparency in the administration and management of Unit trusts (FSA, 2005). Kogi (2003) found investor protection sufficient with disclosure requirements and screening rules limiting institutional risk.Low liquidity, volatility of returns, low levels of activities, lack of credit rating agencies, lack of international integration and mispricing of securities characterize the Kenyan capital market. It is necessary that the capital market should be developed in a structured way, ensuring that both sides of the demand and supply equation develop at similar paces (Market Intelligence, 2005).

The Kenyan market has two indexes; the NSE 20-share Index and the AIG 27-share index. Odera (2000) found the NSE 20-share index unsuitable for measuring long term market performance as it had understated price rises by as much as 12%.

Study Methodology

The population of the study consisted of the Capital Markets Authority (CMA), the Nairobi Stock Exchange (NSE), unit trust companies (2), Central Depository and Settlement Corporation (CDSC), investment banks (11), authorized depositories (6), venture capitalists (2), stockbrokers/investment advisors/fund managers (38) in the Kenyan Capital market. The study used primary data collected using a questionnaire. The completed questionnaires were edited for completeness and consistency. The data was analyzed using Statistical measures to produce descriptive statistics. Comparative analysis was done to identify any differences in views from different capital market players.

Research Findings and Discussion

Importance of index funds to the financial system

Index funds will promote the structured development of the Kenyan Capital Market, spur economic development and attract foreign capital. Granting of tax incentives accelerates the growth and uptake of index funds.

Investor characteristics in the Kenyan financial market

Investors were found to have little tolerance for price fluctuations and volatility in the stock market. Though investors valued liquidity, affordability and lower costs, they had little preference for diversification. Most investors were willing to pay higher fees in return for possibility of higher-than-market returns, expert analysis and investment advice. Most investors believed that they can spot a manager who will outperform the market but surprisingly chose their fund manager by word of mouth rather than by performance or independent analysis.

Capital market framework in Kenya

Inefficiency of the capital market was evidenced by the existence of mispriced securities. The NSE 20 share index was found to be an inaccurate reflector of market performance. The prevalence of low analysts' coverage of small companies increased the number of underpriced small company stocks. Moderate charges and levies on trading transactions enhanced market liquidity. However, high listing fees hindered capital market development.

Fund managers in Kenya

It emerged that Kenyan Fund managers cannot consistently beat the market and neither could their management fees be compensated by the incremental returns accruing from their management skills. The study found that some fund managers depended on technical analysis and the stock picking skills to outperform the market. Market timing, stock selection, bottom-up strategy, growth strategies and value strategies were the most favored investment strategies while passive strategies, sector/industry rotation and top-down strategies were least employed.

Legal, regulatory and political frameworks in Kenya

There was no agreement on the conduciveness of licensing requirements to the ease of entry and exit of market players. The study indicated strongly that the current regulatory practice and market structure does not support the correct pricing of securities. The study found a lack of a standard model for pricing IPO's and secondary market securities. There was low-level support for enforcement of capital market laws byjudicial and political systems.

Investor protection in Kenya

Heavy reliance on formal investment limits was found to be a sustainable approach to delivering high levels of investor protection. Investment safeguards were found to be sufficiently robust to address emerging risks in collective investment schemes management. Reduction of financial crimes was credited to the effectiveness of Kenyan financial services regulators. The findings caution that relaxation of listing rules could worsen investor protection. One interesting finding of the study was that financial crimes such as money laundering were not comprehensively covered under the CMA rules and regulations as compared to the Banking Act which had more elaborate measures to curb financial crime. The Kenyan financial market lacked alternative systems of dispute settlement.

Current state of the regulatory framework in Kenya

The study found high levels of regulatory compliance. However, the Kenyan financial legal framework weakly adhered to international standards. There was inadequate practice of anti-money laundering, professional secrecy, insider dealing and market abuse laws. The regulatory framework included mechanisms for investigating allegations of abuse and mismanagement.

Critical success factors for index funds in Kenya

A significant number of investors were content to receive a return equivalent to the market return and valued surety of achieving a market return over the possibility of above-market returns. The study was inconclusive as to whether or not the increased efficiency in the Nairobi Stock Exchange makes it difficult for managers to outperform stock indexes. Actively managed funds exhibited high turnover with increased commission costs and lower returns. The private sector had adequate capacity to develop and sustain a market index.

Conclusions

Index funds will spur development and increase confidence in the capital market. However, caution needs to be exercised in launching index funds as the market maybe immature and poorly regulated to support such instruments. Index funds are exposed to price fluctuations which does not augur well with investors' low tolerance level. Kenyan investors are willing to pay higher fees and would therefore favour active management of funds over index funds.

Index funds thrive in efficient markets where opportunities for outperforming the market are rare. The inefficiency of the Kenyan market creates mispriced securities that offer opportunities for above-market returns. These portends negatively on the marketability of Index funds. Increasing research work in the Kenyan Capital market will lead to market efficiency by eliminating mispriced securities hence strengthening grounds for index funds. Index funds are tailored on a market representative index. Both the NSE 20 share index and the AIG 27 share index are not seen as being representative of the market. The success of index funds will therefore depend on the development of a more representative market index.Market trading costs remain high favouring index funds which offer higher returns due to their lower trading costs. However, strong sentiments that fund manager's experience and reputation matters more to Kenyan investors than the cost of their services portends negatively on the success of index funds.

Index funds stand a better chance of success by the development of standard models for pricing IPO's and secondary market securities to address mispricings. Judicial and political systems reform will support the enforcement of regulations, create confidence and reduce financial crimes. Alternative systems of dispute settlement should be established and regulatory standards elevated to international standards. The Kenyan government should encourage Collective Investment Schemes to set up index funds by offering lower tax rates and supporting private sector initiatives to develop alternative indexes. Impediments to achieving market efficiency at the Nairobi Stock Exchange should be minimized and the current regulatory structure strengthened. The transactions costs should be lowered to enhance market liquidity and increase returns.

Recommendations

The government should spearhead the use of Capital Market as an avenue for tapping domestic savings and channelling them into profitable investments. All market players should strive to increase the level of awareness and participation of investors in the capital market. The regulators should facilitate removal of impediments to the efficiency of the capital market. Financial analysts should give adequate coverage to all companies to eliminate mispricing of securities. The regulators should introduce proper pricing mechanisms. Market players should lobby for enhancement of tax benefits granted to capital market instruments. The private sector should be encouraged to develop alternative indexes rather than rely on the NSE 20 share index and the AIG 27 share index. Revisions to stock indexes should be carried out frequently to align them to changes in the economy.

Licensing requirements should support the ease of entry and exit of market players. There is a need for the judicial system to support the enforcement of regulations and legislations in the Kenyan capital market. The resource capacity of the Capital Market Authority needs to be improved to ensure effective policing. Listing rules should not be relaxed but alternative systems of dispute resolution need to be put in place. The legal framework needs to be improved to international standards. The regulatory rules should promote innovation and provide more flexibility for the development of new approaches to deliver returns for investors.

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