Vol. 2, No. 03; 2018

ISSN: 2456-7760

INVESTMENT MANAGEMENT STRUCTURES: AN EXPLORATORY REVIEW OF INSTITUTIONAL INVESTORS IN KENYA

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Abstract
This paper explores the investment management structures of institutional investors in Kenya. The investment management approach of three main categories of institutional investors with significant activity in the market, namely, unit trusts, retirement benefits funds and insurance companies is investigated. The choice of the investment management structure is a critical first step in the investment decision making process of an investor. Using desk top analysis of various reports and key informant telephone interviews, the research identifies two main investment management structures being used by these institutional investors. The study uses a random sample from among the entities in each category. In house investment management structure where part or the entire portfolio of assets is managed by internal teams was found to be in use by 20% of insurance companies. No unit trusts used this approach but one retirement benefits scheme was found to manage part of its assets internally. As a means to comply with regulations, virtually all retirement benefits funds used delegated investment management model. Delegation among pension funds took the form of separately managed accounts (SMA) and guaranteed funds. 80% of Insurance companies delegated investment management through SMAs. This paper recommends the relaxation of compliance based rules on investment management to allow fiduciaries exercise greater control and discretion in the selection of investment management approaches.

Keywords: Investment management structure, institutional investor, in house investment management, delegated investment management, Compliance based regulation, broken agency.

Introduction

Investment management is a rapidly evolving field of finance that happens to have major ramifications on the level and growth of the wealth of society. Globally, Assets Under Management (AUM) by various investment management professionals grew to US $ 76 trillion in 2013 from under US $ 60 trillion in 2000 (IMF, 2015). This represents over 100% of global Gross Domestic Product (GDP) and about 40% of global financial assets. Investment management by professional managers, while significant, accounts for less than half of all the available financial assets (IMF, 2015). Table 1.1 shows the distribution of assets under management across the main institutional investors.

Gordon, Sharpe and Bailey (2001) describe investment management or portfolio management as the process of managing money. It may be passive or active, use explicit or implicit procedures

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and have controlled or uncontrolled risk. The investment management process may be summed up as the art and the science of analyzing, selecting, maintaining, protecting and evaluating the performance of a collection of securities with the objective of achieving set investment goals. Hodgson et al. (2000) explain that the investment management structure (IMS) of an investor is the framework that establishes how investment assets should be divided amongst different investment approaches and investment managers. Investment management structures are many and varied but the main dichotomy is between in house or internal management and external or delegated management (Hodgson et al., 2000). Today, professional money managers control nearly half of the investment wealth across the globe. This means that the financial institutions who act as the investment managers control market outcomes. At the same time, there is still a significant share of financial assets that is managed directly by the owners. How institutional investors manage their assets is an important aspect of their market behavior.

Blake et al. (2013) posits that there is a lot of research on mutual funds structure and performance and little research on pension funds, which is attributable to scarcity of data. Blake et al. (2013) then proceeds to investigate the investment behavior of pension funds and finds a move towards decentralization of investment management activities. Insurance companies, despite being similarly large institutional investors, differ from both pension funds and mutual funds. However, their investment behavior in terms of investment management structures as investigated for pension funds by Blake et al. (2013), has attracted very little research.

Clark and Monk (2012) analyses case studies of the largest institutional investors among pension funds and sovereign wealth funds from around the world in order to develop principles and policies for in house investment management. MacIntosh and Scheibelhut (2012) benchmarking study of a sample of 19 large pension schemes drawn from across six members of the G20 countries focuses on prevalence, reasons for adoption and outcomes of different investment management structures.

This research is an exploratory study of institutional investor behavior in Kenya with the following research objectives:

a) To identify and characterize the main institutional investors in the Kenyan capital markets.
b) To find out the investment management structures used by institutional investors in Kenya.

Literature Review

Celik and Isaksson (2014) validly argue that there is no simple definition of an "institutional investor". Institutional investors are best characterized by the fact that they are not natural persons but rather are legal entities that take varied legal forms. The most common institutional investors include sovereign wealth funds, pension funds, mutual funds, private equity firms,

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banks, insurance companies and savings and credit societies. In many cases, institutional investors are “intermediary investors” in that they manage and invest other people’s money.

Sharpe (2011) argues that there are generally two approaches to investment management. First, advisors who make investment recommendations which the investor can accept or reject then make appropriate trades to realize the advice. Second, an investment organization or individual provides both the needed advice and implementation. Both approaches involve some division of labour between the investor and an advisor. This simplified model represents what is viewed as the investment management structure of an investor.

According to Reilly and Brown (2009), traditional investment management was organized in two basic structures, namely, direct delegation structure and mutual fund/investment company structure. Direct delegation obtains where asset owners do not manage their own wealth but instead, they employ an asset manager. The asset owner is the principal, who delegates portfolio management responsibility to the fund manager, who is the agent. Under direct delegation investment management arrangement, individuals as well as institutional investors make contracts directly with a management and advisory firm for its services.

Stracca (2006) argues that in most industrialized countries a substantial part of financial wealth is managed through financial intermediaries. This implies the existence of an agency contract between the investor (the principal) and a portfolio manager (the agent). Stracca (2006) concludes that delegated portfolio management is one of the most important agency relationships intervening in the economy, with a possible impact on financial markets and economic developments at a macro level.

There are two main models that are used in decentralized or delegated investment management. These are the use of a single external manager running balanced portfolios and the use of multiple competing managers. Single manager delegation obtains where one professional manager is hired to manage a balanced portfolio comprising of debt, equities and cash. This arrangement constitutes a transfer of the entire investment decision making to a fund manager. Multi manager delegation is the use of multiple generalist or specialist managers to oversee a portfolio (Blake, Timmermann, Tonks & Wermers, 2010).

Investment management delegation structures can also be distinguished into mutual funds and segregated funds also known as Separately Managed Accounts (SMAs) depending on how client funds are handled (Peterson, Iachini & Lam, 2011). Investment management delegation using the mutual fund structure involves the pooling together (comingling) of investment capital from several clients and managing the funds as a single portfolio of securities. The several investors are issued with new shares representing their proportionate ownership of the mutually held securities portfolio or the fund (Reilly & Brown, 2009). The two arrangements differ in terms of the ownership of the underlying securities in the portfolio. In a mutual fund structure, the securities are owned by the fund which is managed as a single portfolio and its shares are in turn held by the investors. In SMAs, the investor owns the underlying securities in his or her own account and accounts are managed on a client-by-client basis (Peterson, Iachini & Lam, 2011).

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The other approach to investment management is the in house model of investment management. In house investment management structure or "in sourcing" obtains where an investor takes charge of the investment decision making process through a committee of internal executives. Clark and Monk (2012) argue that the main reason behind the preference of in house management is the "broken agency" problem. Broken agency refers to a situation whereby the agents who bear short term risks and receive short term rewards are different from those that bear long term risks and receive long term rewards. In the case of institutional investors who are generally long term investors, it implies that the delegated investment manager's investment decisions, are inclined towards maximizing their own short term utility without much regard for the long term utility of the investors.

In house investment management structure can be organized in a variety of ways or governance frameworks. Gallagher, Gapes and Warren (2016) isolate four main ways of implementing in house investment management. These include dedicated internal manager, hybrid internal and external manager, co investment and partnerships. There is an emerging trend is the use of hybrid structures of investment management which are a blend of in-house and delegated management. Gallagher, Gapes and Warren (2016) explain that under the hybrid (in house/delegated) model, the in-house management team is responsible for a slice of the assets within a multi-manager structure.

Compliance Based Regulation

According to Black (2008), a regulator is any organization(s) that engages in sustained and focused attempts to alter the behaviour of their subjects in accordance with a set of defined standards in order to address a collective problem. They are often state-based regulatory agency although non state actors in some cases act as regulators. May (2007) explains that a regulatory regime is comprised of an institutional structure and assignment of authority. The institutional structure is made up of rules that prescribe expected behaviors or outcomes, standards that are benchmarks against which compliance can be measured, a mechanism for determining the degree of regulatory compliance, and sanctions for failure to comply with the rules.

Compliance based regulation uses a rules based framework which has a set of rules that the regulated entities have to comply with. The regulated entities are expected to undertake compliance actions and report their status on a regular basis. It is involves "ticking of boxes" to indicate compliance or non-compliance (Black, 2008). Under this regime, the regulator also undertakes regular compliance surveillance through inspection visits and management interventions. In many instances, rules based regulation also entails issuance of short term operating licenses.

The regulatory regime prescribes sanctions for non-compliance. These sanctions will almost always have pecuniary implications. Some of the sanctions that are commonly used in rules based approaches include fines and penalties, denial of permits and licenses and in extreme cases of non-compliance, placement under statutory management or statutory winding up May (2007). Risk based regulation where regulated entities are required to develop their own approaches to achieve the objective of regulation is gaining prominence particularly in the financial sector as risk and capital management issues emerge at the forefront of public protection.

Compliance based regulation of financial services market is widespread. In Kenya, most institutional investors who offer various investment services and products are subjected to a rules based regulatory regime. Legislation, regulations and guidelines have been formulated to govern the investment activities of unit trusts and retirement benefits schemes. These market players must evaluate their level of compliance and report to the regulatory authorities. Regulation is a key factor influencing the choice of investment management strucures of these investors.

Principal - Agent Theory and Broken Agency

The basic premise of the principal - agent theory is that there is a principal who delegates a task to the agent, who performs the task on the principal's behalf. Whenever the interests of the two entities are misaligned, the principal - agent problem is observed. This misalignment of interests emanates from two distinct sources: the principal's inability to monitor the agent and the agent's possession of a superior information set (Shah, 2014). It is also recognized that the contracting parties could change their behavior after the contract has been entered into.

Investment management delegation is done on a principal - agent set up. The investor-investment manager relationship is one in which the investor (principal) hires an investment manager (agent) to offer investment management services. The services contracted for include information search, portfolio construction, trading and portfolio maintenance, all of which are unobservable in the portfolio return (output). An additional complication of this arrangement is that it is prohibitively costly for the investor to monitor the investment manager who has no incentive to act in the best interest of the investor unless there is an optimal incentive contract that provides the proper incentives (Golec, 1992).

Investment management delegation necessarily creates a chain of principals and agents. Hodgson et al. (2000) illustrates that for most funds, there are many principal - agent relationships. The providers of funds delegate management to a fiduciary who in turn appoints a professional investment manager to invest the assets. Therefore, the first principal is the provider of funds, and the fiduciary (trustee/executive) is the agent. The fiduciary, acting as new principal then acquires the professional services of an investment manager who is the agent. The beneficiaries of the investment funds may be the same as the providers of the funds or not.

Blake, Timmermann, Tonks & Wermers (2010) explain that under the principal agent theory, a principal hires multiple agents to take advantage of a technology only available to a particular agent, and to provide information to induce incentive effects. The use of multiple agents implies that the principal has multiple tasks to be performed and a single agent is not able to undertake all the tasks because of the need of some specialized knowledge. In investment management, the use of a "growth" manager and a "value" manager within equity asset class is a good example of the use of multiple agents necessitated by multiple specialized tasks

The principal agent theory and the resultant broken agency explains why in the absence of regulation, investors will adopt different approaches to their investment management activities. Investors who wish to avoid the costs of agency will opt to manage their assets internally. External delegation will have considerations of agency costs and the consequences of broken agency. Clark and Monk (2012) contend that in institutional investment management, agency theory and particularly, broken agency, may explain the shift towards in house investment management structure as investors seek to align risk and return through in house teams of professionals.

Methodology

This research follows an exploratory descriptive research design. This design was considered appropriate due to the nature of the problem and the low quantity of previous research output. Desktop analysis of regulatory and other reports was undertaken to identify the main institutional investors who are active in the Kenyan capital markets. Based on this analysis, the main institutional investors who are active in the Kenyan capital markets landscape were identified. These were then investigated further through key informant telephone interviews to identify their investment behavior as far as investment management structures are concerned. Simple random sampling was used to identify the study participants. Being an exploratory study, a small sample was relied on.

Findings

a) Institutional Investors in Kenya

In the Kenyan capital market landscape, the main institutional investors are banks, pension funds/retirement benefits schemes, insurance companies, mutual funds (unit trusts) and savings and credit societies. Private equity firms are present but with limited activity compared to the other groups. This research identifies three main non bank institutional investors whose activity is significant in the capital markets. These are unit trust schemes, retirement funds and insurance companies.

Unit Trust Schemes

A unit trust is a form of collective investment scheme that allows investors with similar investment objectives to pool their funds to be invested in a portfolio of securities. It has a legally defined structure with the underlying portfolio being managed by a professional fund manager. The capital markets in Kenya are still nascent and new investment products are regularly being introduced to the market. Raichura (2008) observes that Kenya has made significant progress towards improving the financial markets, including the dematerialization of securities, automated trading, the introduction of risk rating agencies and the introduction of new performance measurement indices, all of which have improved the investment environment.

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The unit trust regulatory framework was established in 2001 allowing for the introduction of unit trusts as a new investment product in the market. The first unit trust fund was licensed in 2002 and tremendous growth has been observed since then. According to the Capital Markets Authority (CMA), there were 17 unit trust schemes in operation as at 31st March 2017. These unit trust schemes collectively managed assets worth USD 558 million spread across different asset classes based on their sub funds. Money market unit trust funds accounted for 77.6% of all the unit trust assets. The top four unit trust providers controlled 67% of the total assets, making it a highly concentrated market. Most unit trust schemes in operation in Kenya have been promoted by insurance company related fund managers and banks (CMA, 2017). Table 3.1 shows the distribution of unit trusts assets under management across the fund managers while table 3.2 shows the distributions of assets across the unit trust sub funds.

Retirement Benefits Schemes

The retirement benefits schemes sector has expanded greatly since the enactment of the Retirement Benefits Act in 1997 and the establishment of the Retirement Benefits Authority (RBA) to regulate, supervise and promote the retirement benefits sector in Kenya. Raichura (2008) identifies four main types of retirement benefits schemes in Kenya: the National Social Security Fund (NSSF), the Public Service Pension Schemes (PSPS), Occupational retirement benefits schemes and Individual Schemes. The NSSF is a mandatory scheme for all formal sector employees including public servants. NSSF was created by legislation but falls under the supervision of RBA.

The PSPS comprises of a number of retirement schemes created by legislation for civil servants and other government employees such as teachers and disciplined forces other than the military that has its own occupational based scheme. The PSPS is not regulated by the RBA but operates under its own legal framework. Occupational schemes are established under trust by companies for the benefit of their employees. Individual schemes are created under trust by licensed providers and are open for voluntary participation (Raichura, 2008).

As at 30th June 2017, the retirement benefits sector had 942 registered schemes and controlled assets worth USD 9.62 billion accounting for over 10% of the country’s GDP (RBA, 2017). These assets were invested in a diversified way as required by the RBA investment guidelines. Professional fund managers and approved issuers held 84.2% of the assets amounting to USD 8.11 billion, the NSSF held 6.6% of the assets worth USD 632.5 million under internal management and administration while 9.2% equal to USD 886.2 million comprised of property investments that were directly managed by the trustees of the various schemes.

The asset allocation of the sector is heavily skewed to government securities accounting for 36.7% of total assets. Real estate investments take up 21.5% while equities have a share of 18.7%. The equity holding of this investor category accounts for about 8% of the total market capitalization of the Nairobi Securities Exchange (NSE). Guaranteed funds have an allocation of 10.7% with the balance of 12.4% distributed across a range of assets such as cash, bank deposits, corporate bonds and offshore investments (RBA, 2017). Investment in alternative assets such as Private Equity (PE) and Real Estate Investment Trusts (REITs) is still very low mainly as a result of lack of supply and a generally conservative approach to investment by most scheme trustees. The sector asset allocation is shown in table 3.3.

Insurance Companies

Commercial insurance in Kenya emerged in mid-20th century when British settlers, having ventured into farming and other commercial and extractive activities, attracted British insurance companies to open agency offices to service the insurance needs. With time, the agency offices were converted into fully fledged branches (Macharia, 2009). After independence in 1963, the insurance sector that was largely dominated by branch offices of insurance companies based in Britain and India was placed under the Companies' Act of 1960 until 1978 when the Minister for finance issued a directive that all foreign insurance company branches be locally incorporated. In 1987, the Insurance Act, Cap. 487 was enacted and offered a structured basis for the regulation of the sector, under a semi-autonomous office of the Commissioner of insurance. Thereafter in 2006, an amendment of the Insurance Act created the current regulatory body, the Insurance Regulatory Authority (Macharia, 2009).

The insurance industry in Kenya has continued to grow strongly supported by an expanding economy, increased financial literacy and an enabling regulatory framework. As at the end of 2016, there were thirty seven (37) companies operating in the industry; twenty six (26) conducted both life and general insurance business while eleven (11) were in general insurance business only. There were three (3) locally incorporated and regulated reinsurance companies and two (2) multilateral reinsurance companies all operating as composite reinsurers. The industry recorded gross direct premiums of USD 1.96 billion in 2016 up from USD 1.74 billion in 2015. The total assets of the industry stood at USD 5.3 billion (IRA, 2017).

The industry has large investment portfolios under its control. The industry financial securities investment portfolios stood at USD 4.25 billion in 2016 up from USD 3.90 billion in 2015. Those portfolios generated net investment income of USD 53 million in 2016 compared to USD 63 million in 2015 (IRA, 2017). The investment activities of insurance companies are significant in that the asset base is in excess of 5% of Kenya's GDP. The investment portfolios are invested in a diversified way as shown in Table 3.4. As at 31st December 2016, government debt comprised the largest investment class with 49% of the industry investments allocated to the class. Real estate is the other significant asset class taking up 19% of investments while equity investments account for 10% of the portfolio. Insurance companies are also involved in credit intermediation with 3% of their portfolios invested in the loans markets as mortgages and other secured and unsecured loans (IRA, 2017).

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b) Investment Management Structures of Institutional Investors in Kenya

The capital markets (collective investment schemes) regulations, 2001 (GoK, 2001) specifies the legal and governance structure of a unit trust scheme. The scheme should have a promoter, a trustee, a fund manager and a board of directors. In essence, the investment management structure of unit trust schemes is dictated by the legal and regulatory framework in place. The law requires that unit trust management is done on a delegated basis whereby a professional manager oversees investment activities. The decision that is left to the promoter and the board of directors is the appointment of the professional fund manager. Given that most units trust schemes have been promoted by fund management companies, it follows that the fund management company is the professional manager of the scheme.

The retirement benefits act (GoK, 1997) and regulations make it mandatory for NSSF as well as all registered occupational and individual retirement schemes to use delegated investment management structure. The act has prescribed the registration procedure for managers of schemes. Every scheme board of trustees must appoint one or more licensed professional fund managers to undertake the scheme's investment management activities. The choice of the manager is at the discretion of the board of trustees. In the case of this category of institutional investor, the choice of investment management structure is at the second level of choosing the manager to employ from among the licensed retirement benefits managers.

For insurance companies, there is no regulation as to the investment management structure that should be adopted. This makes insurance companies interesting candidates for analysis on how they choose their investment management approaches. Based on telephone interviews of a sample of 10 insurance and reinsurance companies, a variety of investment management approaches were found to be in use as presented in table 4.1 below.

Table 4.1: Investment Management Structures of Insurance Companies

Insurance Company	**Portfolio size (USD million)**	**IMS**
Madison	111.5	Delegated
Heritage	43.8	Delegated
Jubilee	596.3	In house
ICEA	651.7	Delegated
Sanlam	250.0	Delegated

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Kenya Re	325.5	In house
CIC	146.0	Delegated
APA	152.1	Delegated
Old Mutual	130.5	Delegated
Britam	421.7	Delegated
Total Assets	**2,829.1**	

Source: IRA reports, Author's analysis.

Discussion of Results

This exploratory study offers insights into the nature and operations of institutional investors in Kenya. Unit trusts were identified as a significant player in the financial markets owing to their large asset portfolios and availability to a wide cross section of the investing public. The unit trust space though relatively new compared to other parts of the world, has attacted interest from investors. However, the predominance of money market funds could mean that these investment vehicles that are popular with individual investors are primarily being used for short term savings mobilization. The use of equity funds, balanced and bond funds was found to be low suggesting a lack of awareness of the operations of these funds or a risk averse nature of investors. Professional management of unit trusts investment porfolios offers benefits to investors due to the level of skill applied in the management of the portfolios.

Retirement benefits schemes are large institutional investors in Kenya with assets in excess of 10% of the country's GDP. They hold a large portion of both bond and equity market investments. Indeed, retirement assets holdings of shares quoted at the Nairobi Securities Exchange (NSE) account for 8% of the market capitalization which is among the largest holdings by a group of institutional investors. Given that the total market float is about 40%, retirement schemes control about 20% of the float, which is significant. Investment in the safe haven government securities is the largest part of the assets. Professional delegated management of the retirement schemes offers asset diversification benefits based on detailed securities analysis by the fund managers. Some retirement schemes control considerably large portfolios and barring regulations would warrant internal management.

Insurance companies enjoy wide latitude in their investment management activities due to the absence of impending controls. Despite the absence of any prescription on investment management structures, over 80% of insurance companies manage their assets under the delegated investment management model. This means that the firms appreciate the need to focus on core insurance business while delegating their investment management activities to external specialised managers. In house management was observed in a small proportion of companies,

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highlighting the fact that some companies have created the necessary capacity to undertake management of assets internally.

A confounding observation from this research was that most insurance companies had an investment management subsidiary or were part of a group that included a fund management company. Therefore, investment management delegation was done within a group set up. The investment subsidiaries and associates also engaged in the management of third party assets. This arrangement creates scope of professionalism and economies of scale in management. However, the relationship between the parties could impede independence and possible influence decision making of the professional manager.

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APPENDIX

Table 1.1: Distribution of global assets under management by institutional investors

	USD "trillions"						
Institutions	1995	2000	2005	2006	2007	2008	2009
Investment funds	6.3	12.1	18.2	21.5	24.9	20.6	24
Insurance Companies	8	10.4	16.3	18.1	19.9	18.3	20
Autonomous Pension funds	7.2	10.8	14.3	16.5	17.7	13.3	15.9
other institutional investors	0.5	0.5	0.5	0.6	0.7	0.6	0.7
Institutional Investors (Total)	**21.9**	**33.5**	**49**	**56.6**	**62.8**	**52.5**	**60.3**

	% of GDP						
	1995	2000	2005	2006	2007	2008	2009
Investment funds	29.8	53.4	60.3	67.8	72.1	56.3	69.2
Insurance Companies	37.7	45.6	53.9	57.1	57.5	50	57.7
Autonomous Pension funds	33.8	47.4	47.3	51.8	51.2	36.3	45.9
other institutional investors	2.5	2.2	1.6	1.9	1.9	1.6	2
Institutional Investors (Total)	**103**	**147.6**	**162**	**178.1**	**181.7**	**143.3**	**173.7**

Source: Adapted from the Global Financial Stability Report, September 2011. International Monetary Fund

Table 3.1: Distribution of assets across unit trusts schemes

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Intermediary	Amount (USD Mn)	Share
CIC Unit Trust Scheme	135	24%
British American Unit Trust Scheme	104	19%
Old Mutual Unit Trust Scheme	81	14%
ICEA Unit Trust Scheme	53	10%
Stanlib Unit Trust Scheme	33	6%
Sanlam Unit Trust Scheme	32	6%
Commercial Bank of Africa Unit Trust Scheme	30	5%
Equity Investment Bank	24	4%
African Alliance Kenya Unit Trust Scheme	22	4%
Amana Unit Trust Funds	10	2%
Madison Asset Unit Trust Funds	9	2%
Zimele Unit Trust Scheme	8	1%
Nabo Capital Ltd	7	1%
Genghis Unit Trust Funds	7	1%
Dry Associates Unit Trust	3	0%
Apollo Unit Trust Scheme	1	0%
Standard Investment Trust Funds	0	0%
Total	**558**	**100%**

Source: CMA reports

Table 3.2: Distribution of assets across sub funds as at March 2017

Sub fund	Share

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Money market assets	78%
Equities	16%
Bonds	6%
Other	0%
	100%

Source: CMA reports

Table 3.3: Asset allocation of retirement benefits schemes as at June 2017

Asset class	**Asset allocation**
Government Securities	36.7%
Real Estate	21.5%
Equity	18.7%
Guaranteed funds	10.7%
Other assets	12.4%
	100.0%

Source: RBA reports