RESEARCH PAPER

VIABILITY OF PROPERTY INVESTMENTS BY PENSION FUNDS IN KENYA

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Safeguarding your retirement benefits

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1.0 INTRODUCTION

Pension funds in Kenya have primarily invested in the 'big two traditional assets'; government securities and equities. However, over the recent past, the Kenyan financial markets have been greatly affected by market volatility arising from the 2007/2008 Post Election Violence following the disputed presidential elections; the global financial crisis of 2008/2009; the Euro Crisis of 2009 and the steep depreciation of the Kenya shilling in 2011. Pension funds being significant investors in the financial assets have been adversely affected (Mutuku, 2012).

Pension funds therefore are increasingly moving into new asset classes in search for better yield and returns. One such product is real estate, which has been viewed as an important asset for pension funds due to its investment characteristics of high quality, income producing, and its low risk and portfolio diversification benefits (APREA, 2010). Investment in real estate has been shown to reduce risk; enhance returns; act as a hedge for inflation and deliver strong cash flows to the investor (Fabozzi, Gordon and Hudson-Wilson, 2003). Real estate also has been shown to have low correlation to other financial assets and thus implying a good diversifier within a mixed-asset portfolio.

However, barriers to investments in real estate by pension funds still exist. Investments in real estate are illiquid and require large sums of funds for direct investment and therefore locking out many small schemes. Direct real estate is often associated with extended periods of not being traded and every property is more often than rarely, unique (Riddiough et al., 2005). Direct real estate investment also require special management skills and worst still, there is low information transparency (Hoesli and Lekander, 2006). The Real Estate Investment Trusts (REITS) which is considered as more liquid compared to direct real estate investments are new or non-existent in most developing markets. Investments in real estate by pension funds have also been dogged by controversies and governance issues starting from acquisition to the disposal stage. This has therefore seen most governments limit investment in real estate by pension funds despite its diversification benefits. For instance, in Kenya, investment in immovable and units in property Unit Trust Schemes incorporated

in Kenya and collective investment schemes incorporated in Kenya and approved by the Capital Markets Authority is limited to a maximum percentage of 30 percent of the aggregate market value of the total assets of a scheme or pooled fund. Such restrictive measures may further limit scheme portfolio diversification opportunities.

1.2 Problem Statement

The property market in Kenya unlike the financial sector and other property markets around the world, has exhibited relative stability with gradual upward appreciation of prices (Mutuku, 2012; Kariuki, 2012). In the last ten years, the property market in Kenya has thrived, despite the high interest rates and the weakening shilling in 2011. Since 2002, the Kenyan real estate has experienced a boom; the prices have escalated and remained bullish; it has also exhibited limited volatility (Mutero et al., 2010; Kariuki, 2012). According to the Hass Consult Report, 2013 the property values have increased by 3.46 times since the year 2000 and the average value of property went up from Kshs. 7.1 million in 2000 to Kshs. 24.8 million in June 2013 (Hass Consult, 2013).

However, barriers to investments in real estate by pension funds still exist. Real estate investments are illiquid, and require large sums of funds for direct investment and therefore locking out many small schemes. Until recently, the only option available for pension funds needing to gain exposure to real estate was through direct (physical) real estate investing. This posed copious challenges; the high cost of acquisition coupled with setting up a team to manage the property and illiquidity made it difficult, if not impossible for smaller pension funds to gain exposure to real estate. The Real Estate Investment Trusts (REITS) regulations were recently gazetted, but no REITs have been listed in the market even though firms have shown interest in raising capital through REITs[1]. Similarly, only one real estate firm (Home Afrika Ltd) is listed in the stock market under the Growth and Enterprise Market Segment (GEMS).

[1] Some of the firms which shown interest in raising capital through REITs include NSSF and Home AfriKa Ltd.

Investments in real estate by pension funds also have been dogged by controversies and governance issues; starting from acquisition, management and disposal of real estate investments. Notwithstanding, the requirement for scheme trustees to procure the services of fund managers to manage the scheme funds, in some cases, trustees do not involve fund managers in the procurement and management of real estate investments. Real estate also has been argued to have been in the forefront of the 2007/2008 global financial crisis[2] (Eichholtz, Kok and Yonder, 2009). Equally, the real estate investment by pension funds is also relatively under-researched compared to other financial asset classes despite its big size of the market. There is therefore relatively low understanding in real estate investment as an asset class.

Nonetheless, infrastructure and housing has remained a key priority in Kenya's development plans since independence. But, to date, it is still an outstanding agenda. Kenya still suffers from inadequate, unaffordable and indecent housing particularly for the low income earners. The level of urban home ownership is also low and stands at 16 percent of the population (GoK, 2011). In 2003, the government estimated that the country required a delivery of at least 150,000 housing units annually in order to meet the growing demand (GoK, 2003)[3]. The country only manages to produce about approximately 35,000 houses per annum (GoK, 2011). It is estimated that 20 percent of the houses constructed cater for the low income earners. The rate of urbanization has also increased from 15 percent in 1979 to 19 percent in 1999 (GoK, 2011). Similarly, the urban population has also increased from 5.4 million in 1999 to 12.5 million in 2009.

The acute shortage of housing in the country coupled with the ongoing infrastructure development projects such as the Konza Technology City; Lamu

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[2] Investors bullish perspectives regarding the residential and commercial property markets not only allowed borrowers access cheap and almost unlimited credit, but also offered the possibility to raise large amounts of equity on the public capital markets (Eichholtz, Kok and Yonder, 2009).

[3] See the Economic Recovery Strategy for Wealth and Employment Creation (ERS) 2003-2007: the government targeted to facilitate the construction of 150,000 housing units during the period of recovery (2003-2007). The Government aimed to achieve this through the enactment of appropriate land and housing legislation to facilitate private sector development of affordable houses.

Port – South Sudan – Ethiopia Transport corridor (LAPSSET project) geared towards the attainment of the Kenya Vision 2030 aspirations offers a viable and lucrative investment opportunity for pension schemes in Kenya. This paper therefore examines the viability of property investment by pension funds in Kenya.

1.3 Research Objectives:

a) To examine the opportunities, constraints and viability of property investments by pension funds.
b) To analyze the factors considered in the assets allocation by pension funds.
c) To examine the challenges faced by pension funds in asset allocation and propose remedial actions.
d) To make policy recommendations based on the research findings.

1.3 Significance of the Study

The findings of this study would be useful in policy development and formulation of appropriate legislation and guidelines in the management of property investment by pension schemes. More so in the wake of the financial crisis and the recurrent market volatility, pension funds are redefining their investment and risk allocation strategies. This therefore may call for development of new regulations/investments guidelines and introduction of new innovative products. The study will also help enhance the greater understanding of real estate investment as an asset class by pension schemes.

2.0 LITERATURE REVIEW

For several decades, real estate has been the most significant alternative asset class in the portfolio of institutional investors primarily due to its steady and predictable appreciation overtime; it's low correlation with other assets classes, it's strong risk adjusted performance in comparison to equities and bonds and its inflation hedging capabilities (Hoesli et al., 2002; Hudson-Wilson et al, 2003; Andonov, Eichholtz and Kok, 2012). Property investments have been seen as low risk, long term and illiquid assets (Reddy, 2001). Property therefore plays a significant role in investment portfolios as it is considered a secure income generating good capital growth investment. It is also regarded as less volatile

investment than shares, providing a reliable hedge against inflation and offering diversification benefits. Real estate investment therefore is viewed as an important asset class for pension funds with attractive investment characteristics that match long term liabilities (APREA, 2010).

Literature investigating characteristics of real estate usually offer the following arguments for real estate investments: Real estate investments are useful because of their diversifications potential. Their returns are less dependent on the returns of bonds and shares (Vančura, 2012). The price of properties apart from economic factors depends on non economic factors like population expansion or development of technology. Investment in real estate also offers other considerable advantages: it is a tangible asset with low volatility; and it generates an attractive income stream and long term capital appreciation and strong diversification benefits compared to stocks and bonds (Leo, undated).

However, investment in real estate suffers some shortfalls; they are illiquid, needs expert management and require significant capital to build a diversified portfolio (Leo, undated). Real estate is also characterized by large lot size, heterogeneity (partly as function of the importance of location), high management costs and high transaction costs which lead to longer holding periods than would be the norm in financial asset markets which, in turn, means that the real estate markets tend to be thinly traded (Hoesli and Lizieri, 2007). Similarly, there is not any organized market focused on real estate direct trading, so finding a buyer or a seller may be difficult (Vančura, 2012). Investors therefore have sought alternatives, such as the publicly traded real estate securities (REITs) to invest in so as to gain the advantages of real estate investment without its disadvantages (Ciochetti, et al, 2002).

Investing in listed property stocks and REITs provides attractive opportunities for portfolio diversification. Equally, there are no potential problems that are frequently associated with directly held real estate such as low liquidity, high transactions and monitoring costs as well as high information asymmetry that arises due to lack of market knowledge (Eichholtz 1996; 1997). However, debate as to whether REITs are real estate, stocks or bonds, or a combination of all three is still unresolved.

McMahan (1994) argues that REITs returns have not behaved in the same way as private real estate despite the fact that the REIT cash flows are derived from real estate and its performance ought to be influenced by factors affecting the physical assets, such as general demand and supply and demographic changes. As financial securities, REITs follow a different return generating process than the underlying real estate market. This has been attributed to the ownership and operating construct wrapped around the properties that might otherwise be privately owned (Peyton eta al., 2007). The REIT structure therefore brings with it pricing mechanisms, liquidity features and leverage characteristics that are different from privately owned real estate (Connor and Falzon, 2006).

Questions have also been raised whether REITs or securitized real estate returns reflect direct real estate returns or the stock market returns. Hoesli and Oikarinen (2012) using data for the U.S., U.K. and Australia estimated a vector error correction model and the results showed that both variance decomposition and impulse responses suggested that the long run REITs market performance was more closely related to the direct real estate market than the general stock market. They opine that since REITs behave much like direct real estate investments in the long horizon, REITs and real estate therefore should be relatively good substitutes in a long-horizon investment portfolio.

In terms of real estate returns and performance; empirical literature show that the performance of real estate investment by pension funds depends on the economic factors, size and location. Andonov, Eichholtz and Kok, (2012) used defined benefit data collected by CEM Benchmarking Inc. which covered 884 U.S., Canadian, European, and Australian/New Zealand pension funds which invest in direct real estate and real estate investment trusts (REITs) over the period 1990-2009. The pension funds had combined assets under management of $4.6trillion in 2009. The study observed that the costs and performance of pension funds' real investments were driven three main variables: size, the choice to invest internally or externally, and geography. They found out that larger pension funds were more likely to invest in real estate internally have lower costs and higher net returns. The small funds on other hand were more likely to invest in direct real estate through external managers and funds-of-

funds, but largely ignored REITs. However, the additional investment layers significantly increased their costs and disproportionately reduced their returns.

Myer et al (1997) used appraised-based (direct) real estate wealth indices (proxied by NACRIEF index) for United States, Canada, and the United Kingdom and for several property types found a cointegrating relationship among real estate indices across the three countries and concluded that there was a common factor that creates a link among the indices. Tarbert (1998) used publicly traded indices applied cointegrating techniques to investigate diversification opportunities available to UK investors and found evidence of cointegration among sectors across regions concluding that sectoral and geographical diversification benefits within property portfolios were more limited. However, Wilson and Okunev (1996) found absence of cointegration among real estate and equity markets and among the securitized property markets in the US, UK and Australia.

Yunus (2007) on the other hand employed time series techniques to evaluate the degree of long run integration and short run dynamics among the major public property markets (in terms of market capitalization) in the US over the period 2000-2006. The study also examined the long run and the short run interactions among the corresponding major international equity markets to compare and contrast diversification benefits from exploitation of international property markets. The results showed that US investors could attain substantial diversification benefits from investing in many of the international property markets in the long-run as well as in the short-run. The short run results showed that there were relatively fewer lead-lag relationships between the US and the international property markets indicating that due to the underdeveloped state of the securitized property sector (relative to equity markets) and due to the real estate nature of these markets, the securitized property sector is less impacted by the US property market in the short run than the corresponding equity markets.

However, Yunus (2007) notes that correlation of returns are unstable over time, therefore developing portfolios solely on the correlations of returns is fraught with problems and is not appropriate for investors in real estate who are typically more interested in the long term diversification attributes of their

portfolio. He also notes that even though some of the earlier research have shown that there were evidence of segmentation between the property markets and other capital markets, and among the property market themselves, recent work shows increasing tendency of the markets to commove with each other, implying that the potential benefits of adding real estate to a mixed-asset or real-estate only portfolio may be decreasing.

Studies in the East Africa region indicate that there is limited investment in the real estate market. Mutero et al (2010) observes that although pension assets in East Africa constitute a large pool of funds which forms a significant part of its GDP, pension funds have seen limited use in the housing sector. This has been attributed to a number of reasons: trustees and fund managers have inadequate knowledge of housing markets, especially low income sub-markets, and are unfamiliar with the associated investment risks; the capital markets in the region are underdeveloped, limiting the investment options open to pension schemes; some pension funds are too small to set aside funds for lumpy investments required to acquire housing and property assets; and low coverage of pension schemes.

2.1 Investment in REITs in Kenya

A Real Estate Investment Trust (REIT) is a listed company that owns and actively manages a portfolio of high quality income producing commercial real estate. REITs are listed on their respective stock markets and their shares are publicly traded via active trading as per other stocks (Newell, 2012). Property trusts investment is an indirect form of property investment; it operates with the idea of combining a large number of small sums of capital belonging to different investors into a viable investment pool which is professionally managed. Property trust can provide a worthwhile spread of returns that is not achievable with investors acting individually. It also allows investors to trade with property with a fair deal of liquidity. Most investors view direct property investment as illiquid, long term, immobile and low risk investment.

REITs have become an important asset class in pension fund portfolios as a type of indirect property investment. It plays an important role as a diversifier in mixed-asset portfolio, more so, given that direct real estate investment can be too

large and illiquid for small investors and can be difficult and time costly to be disposed of. REITs aid investors to get real estate exposure in their portfolios without encountering these challenges. An investor can therefore hold small amount of shares in a REIT and can acquire a well diversified real estate exposure by combining stakes in different REITs (Yonder, 2013). There are three types of Real Estate Investment Trusts (REITS); equity REITs which purchase, own and manage real estate properties (they may also develop properties); mortgage REITs, which invest in loans secured by real estate; Hybrid REITs, which generate income from rent and capital gains, like equity REIT, as well as interest like a mortgage REIT.

In Kenya, the REITs regulations were gazetted on 18th June 2013 through the legal notice No. 116. Unlike the traditional REITs which invest predominantly on income producing real estates, the Kenya REITs is tailor made to suit the country's development agenda and aspiration of the Kenya Vision 2030. The Capital Markets (Real Estate Investment Trusts) (Collective Investment Schemes) regulations, 2013 categorizes REITs into two; D-REIT and I-REIT. The D-REIT was designed to target development and construction, mainly housing development while the I-REIT which targets income producing real estate is based on the traditional REIT structure with flexibility. According to the regulations, the D-REIT may be structured as an open ended or a closed ended fund[4] and may be converted from one status to the other. An I-REIT on the other hand may be structured as an open ended or closed ended depending whether they are restricted or unrestricted. An I-REIT which is the subject of unrestricted offer may only be structured as a closed ended fund and the REIT securities shall

[4] The regulations defines open ended fund as a fund in which a person may invest from time to time by acquiring REIT securities and may dispose of the investment by having the REIT securities redeemed by the trustee and where the value of the investment and redemption price per unit is determined by the net asset value per unit is calculated from time to time in accordance with the scheme documents and where the size of the fund may expand or contract as investors acquire or dispose REIT securities. The closed ended fund is defined as a fund or trust in which a person invests by subscribing for an issue of REIT securities or by acquiring REIT securities in a secondary market; the value of the investment fluctuates over time as determined by market price for the REIT securities; the number of the REIT securities issued remains constant over time except where a new issue of REIT securities is made or there is a reduction in the capital of the fund initiated by the trustee or a consequence of termination or winding up of the trust; and the REIT securities holder, except where there is a reduction in the capital of the fund initiated by the trustee or a consequence of termination or winding up of the trust – (i) is not entitled to require the trustee to redeem the REIT securities; and (ii) may only exit the investment in the REIT securities by selling the units in a secondary market.

be listed. An I-REIT on the other hand which is the subject of a restricted offer may be structured as either an open ended or a closed ended fund and may be converted from one status to the other. So far no REITs has been listed in the market even though firms have shown interest in raising capital through REITs. The Capital Market Authority has licensed five Real Estate Investment Trust (REITs) managers: these include; Centum Assets Managers Ltd, UAP Investment Ltd, Stanlib Kenya Ltd, Fusion Management Ltd and CIC Asset Management Ltd. Currently, only one real estate firm (Home Afrika Ltd) is listed in the stock market under the Growth and Enterprise Market Segment (GEMS).

3.0 METHODOLOGY AND SOURCE OF DATA

This section provides the description of the research methodology employed in the study. The research design, the population and sampling design, and the data sources are discussed in the section.

3.1 Research Design

The study used a mixed research design. The study utilized both qualitative and quantitative data. A qualitative study involving trustees of retirement benefits schemes and pension administrators was undertaken. An in-depth interview with trustees of retirement benefits schemes which had invested in real estate in the year 2011 was carried out. Similarly, an in-depth interview with the pension fund managers were also undertaken to get the insights on how, and what considerations are made in regards schemes investments more so real estate investment. The quantitative data was drawn from secondary sources including the RBA database.

3.2 Population and Sampling Design

The population of the study consisted of schemes which had invested in property in the year 2011 as indicated in the audited accounts. During the period 50 retirement benefits schemes had invested in property. Purposive sampling was done given the uniqueness of the schemes and the fact that property investments and its characteristics are unique and differs from one asset to another and the geographical location. This was done also in order to focus on the trustees/administrators with appropriate experience, background and

insights in property investment. Trustees of six retirement benefits schemes were interviewed. The schemes were geographically dispersed and from different sectors of the economy. This was so to capture the various unique factors and characteristics considered by the trustees in investing in property. The schemes visited were distributed geographically as follows: Nairobi -2; Mombasa-1; Eldoret -1; Nakuru -1; and Kakamega -1.

The population also consisted of the registered pension fund managers given their role and expertise in scheme funds investment. During the period there were 19 registered fund managers[5]. Three fund managers were interviewed.

3.3 Data Sources

The study utilized both primary and secondary data. The secondary data was sourced from RBA documents and database. Various documents such as economic surveys and Medium Term Plans (MTP) were also utilized.

The primary data was collected through in-depth interviews with selected fund managers and trustees. The samples were drawn from trustees of selected schemes which had invested in property in 2011. The trustees of the selected schemes were conducted through letters and follow up telephone calls. The consent of the respondents was sought and were informed on the objects and the dates of the study.

The study used semi–structured questionnaires. The questionnaire was designed to elicit information/views from the respondent pertaining scheme investment and more so property investment. The in-depth interviews preferred because they provide much more detailed information than what would be available through other data collection methods such as surveys. In-depth interviews also provide a relaxed atmosphere in which to collect information where the respondents may feel more comfortable having a conversation with the interviewer about a subject as opposed to filling a questionnaire (Boyce and Neale, 2006). In-depth interviews were also used to explore the respondents' point of views and perspectives given the uniqueness and complexity of real

[5] http://www.rba.go.ke/media/docs/service-providers/fund_managers_2014.pdf

estate investment. The information collected through the interviews was supplemented with secondary data collected from RBA database in order to enrich the findings. Considering that most data was qualitative, multiple sources of data was used to facilitate triangulation of results so as to improve validity and reliability.

4.0 DATA ANALYSIS, FINDINGS AND DISCUSSION

This section looks at the investment in property by pension schemes in Kenya. It also examines the trend in investment in property over the years and its contribution to the pension schemes portfolio. The section also provides a detailed discussion of the findings from the secondary data and the in-depth interviews.

4.1 Investment of Pension Funds in Kenya

Pension funds in Kenya are separate legal entities and are governed by a board of trustees, which is appointed by the sponsors and contributors. The pension funds have to comply with the Retirement Benefits Act and its regulations in the management and investment of pension funds. Section 37 of the Retirement Benefits Act requires that every scheme should have a prudent investment policy on the investment of the funds of the scheme so as to maintain the capital funds and generally to secure market rates of return on such investment. However, section 38 of the Act spells out the restriction on the use of the scheme funds.

Regulation 37 and 38 of the Retirement Benefits (Occupational Retirement Benefits Schemes regulations) 2000 and regulation 30 and 31 of the Retirement Benefits (Individual Retirement Benefit Schemes) regulations 2000 also requires that the investment policy needs to be reviewed every three years. It also details what the policy should cover, which include: the kind of investments to be held, the risks, the realization of investments, assets liability matching and such matters as may be prescribed by the Authority from time to time. The following components therefore need to be defined in a statement of investment policy: rate of return objective; the acceptable risk parameters; liquidity requirements; and, allocation of assets. It also requires that the policy take consideration the latest actuarial report.

4.1.1 Pension Assets Growth in Kenya

The retirement benefits sector in Kenya has grown tremendously both in membership and assets since the Authority came into full operation in 2000. Currently, there are about 1,243 registered schemes with over 1.7 million members. The retirement benefits assets have increased, both in absolute terms and as a ratio of GDP. The Pension assets grew from Kshs. 117.4 billion in 2002 to Kshs. 548.8 billion in 2012. As a share of GDP, the ratio improved over the period from a ratio of 11.5 percent in 2002 to approximately 16 percent in 2012.

Pension funds in Kenya have largely invested in the traditional asset classes, mainly government securities and quoted equities. In 2012, both assets combined constituted 59 percent of the total assets. There has been limited investment in property by most schemes and has been mainly attributed to the fact that most of the pension schemes are too small to set aside funds for the lumpy investments required to acquire or erect property.

The government securities constitutes the largest share of industry assets and as at December 2012 it stood at 35 percent of total assets, followed by Quoted Equities, property and guaranteed funds at 24 percent, 19 percent and 9 percent respectively as shown in table 1 below.

Table 1: Overall Industry Investment Portfolio (2010-2012)

	Asset Class	December 2010		December 2011		December 2012[6]	
		Kshs (Bn)	%	Kshs (Bn)	%	Kshs (Bn)	%
1	Government Securities	143.6	32%	145.7	34%	190.3	35%
2	Quoted Equities	130.4	29%	93.0	21%	130.4	24%
3	Immovable Property	80.0	18%	87.8	20%	101.6	19%
4	Guaranteed Funds	33.3	7%	48.0	11%	48.1	9%
5	Fixed Income	21.1	5%	20.7	5%	26.7	5%
6	Fixed Deposit	17.2	4%	21.9	5%	27.1	5%
7	Offshore	15.3	3%	5.2	1%	8.5	2%

[6] Excludes data for schemes under Zimele Asset Managers and Guaranteed funds from CFC Insurance.

	Asset Class	December 2010		December 2011		December 2012[6]	
		Kshs (Bn)	%	Kshs (Bn)	%	Kshs (Bn)	%
8	Cash	7.3	2%	6.8	2%	12.9	2%
9	Unquoted Equities	2.5	2%	3.7	1%	3.1	1%
	TOTAL	**450.7**	**100%**	**432.8**	**100%**	**548.8**	**100%**

4.1.2 Investment in Property

A cursory analysis of pension schemes which have invested in property shows that most of the schemes are either schemes of quasi-government institutions or big multi-national companies and banking institutions. This can mainly be attributed to their large membership and thus bigger asset portfolio to undertake the lumpy investment in property. In 2011, out of 1027 schemes which submitted the audited accounts to the Authority, only 50 schemes had invested in immovable property translating to a paltry 4.86 percent. Similarly, most of the quasi government schemes also inherited most of the property investments from their sponsor as part of funding the deficits following the treasury directive to convert from defined benefits scheme to defined contributions in 2010.

Table 2: Property Investment by Schemes by Institution Category in 2011

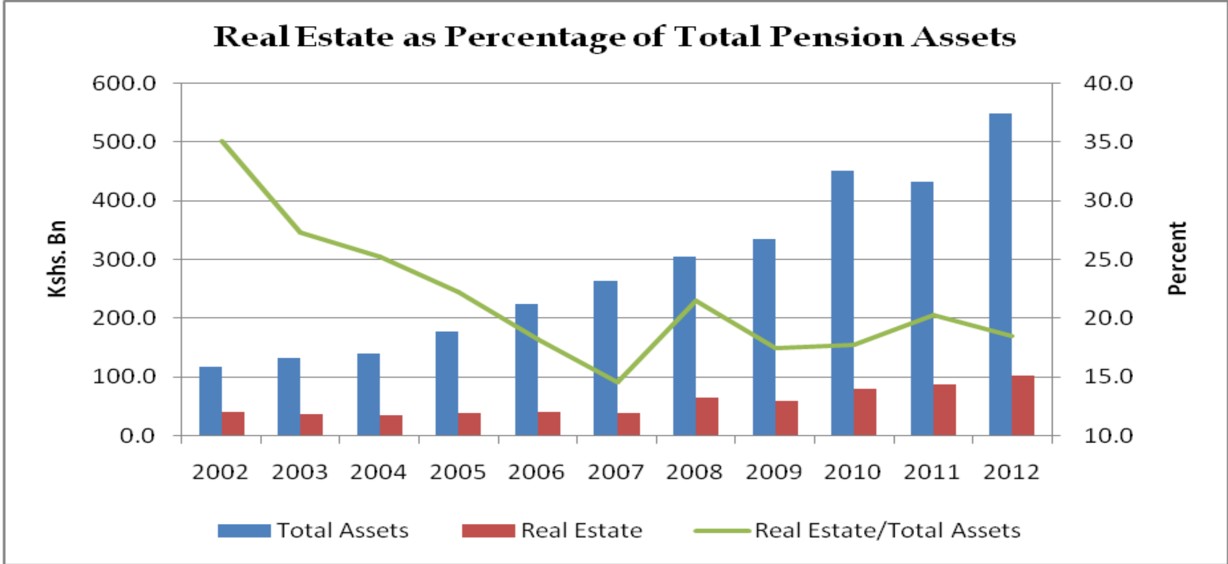
Institutions	No. of Schemes	Property Investment (Kshs. Billions)	Total Assets (Kshs. Billions)	Proportion (%)
Quasi Government	31	93.7	264	35.4%
Banking	7	7.4	25.6	28.9%
Multi Nationals & Others	12	3.3	8.2	40.2%
Total	**50**	**104.4**	**297.8**	**35%**

Source: RBA Database

Over the years, investment in property by pension funds has decreased as a percentage of total pension assets; it decreased from 35 percent in 2002 to 14.6 percent in 2007, but went up to 21.5 percent in 2008 as shown in figure 2 below. The decrease in the proportion of real estate investment during last decade can largely be attributed to the enforcement actions undertaken by the Authority

upon coming into full operation in 2000 in order to ensure that schemes fund investments were within the allowable investment limits. The increase in the proportion of property assets in 2008 and 2011 can be attributed to the fall in the value of the stocks in 2008 and 2011 due to the global financial crisis and the euro zone crisis which affected the stock market.

Figure 2: Real Estate as a Percentage of Total Pension Assets



The government securities as a percentage of total assets, on the other hand, increased over the last decade except in 2005, 2006, 2007 and 2008. This can be partly attributed to the high interest rates and post election violence. Compared to real estate as a percentage of total assets, they tend to move in opposite directions as shown in figure 3 below, suggesting that real estate investment and government securities could be uncorrelated. It has also been argued that prices of real estate follow different cycles than prices of shares and bonds and therefore their returns are considered to have little correlation. This implies therefore that real estate investment could be a good diversifier.

Figure 3: Real Estate and Government Securities as a Percentage of Total Assets

4.2 Findings and Discussion of the In-depth Interviews

This section presents the findings of the in-depth interviews carried out with selected pension fund managers and trustees of schemes which had invested in property. A semi structure questionnaire was used in the interview in order to capture the pertinent issues in property investments and to address the objectives of the study. Some of the issues discussed in the interviews included but not limited to: the general investment in Kenya; the scheme's assets allocation; investment in property and REITs and the opportunities and challenges in property investment.

4.2.1 In-depth Interviews with Trustees of Schemes

An in-depth interview with trustees of schemes which had invested in property in 2011 was carried out. Trustees/Administrators of six pension funds which had invested in property were interviewed. A range of questions touching on the general investment of pension funds in Kenya and specific questions on property investments were asked. The interviews were semi structured and an interview guide was used to ensure that the objectives of the study are covered and capture the relevant respondents' views, opinions and perspectives in regards to property investments by pension funds. The areas covered in the interview include: the general investment in Kenya; the scheme assets allocation;

investments in property and REITs; and, the opportunities and challenges in property investment. The following findings and observations were made:

On the general investment climate, the respondents were asked to provide their opinions on the general investment climate in Kenya and the available investment classes. According to most trustees who were interviewed the general investment environment was conducive and the available investment asset classes were adequate. They also noted that the quantitative restrictions were not hindering portfolio diversification and the 30 percent ceiling on property investment was alright. However, some of the trustees were of the view that schemes should invest according to their investments policies rather than being subject to investment guidelines which prescribe the quantitative limits. In this case, they noted that schemes should frequently file returns with the Authority. The trustees advocating for the removal of the guidelines are of the opinion that the quantitative restrictions limited creativity and innovation and hence they were of the opinion that self regulations should be encouraged.

On property investment, most trustees who were interviewed noted that they had invested in property in order to diversify their portfolio and cushion the schemes funds against market volatility, more so, following the global financial crisis and the euro crisis which adversely affected the stock market. The property investments ranged from commercial buildings, housing, to fallow land. In terms of investment in new property, most trustees noted that they consulted with the fund managers and property managers including other property specialist. The schemes also employed other innovative ways to developed new property in an efficient and cost effective manner. Some schemes enter into joint ventures/turnkey projects with developers in order to realize the value and maximize their returns, in cases where schemes have land. The schemes also in some cases formed special committees or "*special purpose vehicles* (SPV)" which incorporate the developers and the trustees to oversee the development of property. Some schemes have also implemented the tenant purchase projects and others are considering Public Private Partnerships (PPP) in regards to property development. In order to ensure prudent and systematic investment in property, some of the schemes have developed property investment specific plans/strategies.

On real estate returns, the findings were mixed and varied from one scheme to another and the nature of the property investment. It was observed that majority of the schemes of quasi-government institutions had inherited most of the property from the sponsors as part of funding the scheme deficits which existed during the conversion to defined contribution scheme following the government directive via the treasury circular No. 18/2010 which required all Public Service Retirement Benefits Schemes to convert from defined benefits schemes to defined contribution schemes. It was also noted that most schemes which had inherited property from the sponsors had a huge exposure to property with some exceeding the investment guidelines limits of 30 percent. The returns on such properties were low, more so, where the tenants are employees of the sponsor (members). Revision of rents or disposal of such properties is always an uphill task given that it involves the workers union. Likewise, the rents are either subsidized or negotiated and hence making the returns low. On the other hand, it was noted that where schemes had investment in property with a clear plan or strategy, the returns were likely to be high.

On REITS, the respondents were asked their opinions in regards to REITs. The trustees who were interviewed welcomed the introduction REITs in the Kenyan market. However, they noted that an investment in REITS was still new and they required more sensitization and training in order to invest in it. Trustees were still "*fearful*" to invest in REITs. The concept was still new. They noted that REITs had not been adequately understood. The trustees also raised questions whether REITs was property investments, bond or a stock? Similarly, the issue of management of REITs was noted as a concern. The trustees interviewed were unison that REITs should be treated as a separate asset class.

On management of property, a number of the trustees who were interviewed noted that where they had commercial premises they employed the services of property managers. However, due to lack of standardized reporting structure, the returns have been low or below the expectation due to uncollected rent. The schemes have therefore had to employ in-house property managers. The trustees therefore felt that the property managers need to be somewhat regulated. The trustees also noted that there was need for an industry property index in order to assess and benchmark the performance of the property market by pension funds.

On investment policy, most trustees who were interviewed acknowledged they had investment policies to guide their investments. However, majority of the schemes had not reviewed their investment policies as required.

4.2.2 In-depth Interviews with Fund Managers

An in-depth with selected fund managers was carried out. Three selected fund managers were interviewed. The objective of the interviews was to get the insights of in regards to property investments by pension funds. The following findings and observations were made:

On the general investment environment, most fund managers who were interviewed noted that the investment environment was conducive and the investment limits were adequate.

On property investment, the fund managers who were interviewed noted that property investment was an excellent investment if done well due to its income generating, inflation protection and long term nature. However, they noted that some of the Board of Trustees were hesitant relinquishing property management and where they are involved, they were involved partially, and not in major decision making in terms of property investment. They therefore played minimal role in property investment. Fund Managers also noted that property investment was an emotive issue and trustees had close interests in it. They therefore called for a clear regulation or guidelines to address the ambiguity.

Fund Managers were of the view that schemes would be better of undertaking direct investment in property rather than purchasing an already existing building. Fund Managers also noted that schemes which had invested in property were big schemes with fund value over Kshs. 1 billion. Most Pension Fund Managers also noted that pension funds need to be encouraged to undertake infrastructural projects e.g. housing and other social amenities as this would go along in meeting the vision 2030 aspirations of development of affordable housing.

On management of property, fund managers who were interviewed noted that they played majorly the advisory role on investment in property investment but not day to day management of property. In some cases the fund managers

guides the trustees in developing “Special Property Investment Strategy”. In cases where they managed property investment for pension funds, they noted that they did it based on a benchmark e.g. non volatile inflation (CPI) plus a margin of ±2% or ±3%.

In terms of the investment limit of 30 percent in property, the fund managers who were interviewed noted that it was adequate and serves well for liquidity purpose. They also noted that the current investment guidelines were not restrictive and the Kenyan market was not yet mature. However, it was also noted that there was need for a separate asset class for REITs, since as it is currently; it was difficult to classify REITs investments. It is not clear whether REITs was equity or a real estate investment? It was also noted that the schemes need to invest in innovative products including private equity and joint ventures in order to unlock the property value. Fund manager also noted that pension schemes need to be encouraged to diversify its portfolio into new products like mining and oil exploration. This can be done through Public-Private Partnership (PPP).

Fund Managers noted that there was a challenge in the management of the scheme assets when a scheme had more than one fund manager. The respective fund managers therefore have to only manage their respective portfolios under them and hence making monitoring and tactical asset allocation difficult. The fund Managers also lacked the internal capacity in terms of property management.

4.2.3 Challenges Faced by Schemes in Property Investment

The findings from the secondary data and the in-depth interviews reveals that most of the quasi-government schemes inherited property from the sponsor and most of it was land and residential houses of which the tenants were staff of the sponsor and in effect are members of the scheme. In most cases, the rent was subsidized or was negotiated with their trade unions. This complicates the revision of the rent charged by the scheme and the disposal of such property even more difficult. The trustees also are not willing to put in more money to improve such properties. The return on property in such cases therefore is low compared to other assets.

The schemes also face a challenge in managing of property given that there were no standardized regulations governing the property managers. The scheme therefore has to resort to hiring different property managers to manage different properties and in order to minimize risks. In some cases schemes have also hired/recruited property managers internally to analyze reports from property managers and advise trustees in regards to property investments. Similarly, there is lack of adequate data to calculate a reliable property index since there is no central registry to collect and analyze such data. The true performance of the property market may not be known due to the fact that the available statistics may be skewed. Similarly the mortgage accounts held by banks are low and therefore its reliability and scope may be debatable. Different and specific property characteristics also underpin the movement of property prices.

The schemes also face a challenge in complying with the investment guidelines in that the value of property usually increases without new investments due revaluations. The scheme trustees therefore have to furnish the Authority with a remedial plan. Some of the schemes also which have huge exposure to property faces challenges in disposing them and hence have a difficulty in paying benefits to retirees. There are also no clear guidelines on the valuation of property investments and different property managers use different valuation methodologies. Issues of performance measurement was still a challenge given different managers apply different methodologies to measure performance hence leading to differing results which are non-comparable.

There is also lack of capacity amongst the fund managers to manage property investments. They have to rely on property managers and other property specialist for information. Some of the fund managers have tried to address this gap by hiring in –house property managers.

5.0 CONCLUSION AND RECOMMENDATIONS

5.1 Conclusion

Real investment has increasingly being viewed, not as an alternative, but an essential portfolio component. This is more so given the volatility of the equity and the bond markets. Real estate investment offers considerable advantages; it

is a tangible asset with low volatility; and it generates an attractive income and long term capital appreciation and particularly strong diversification benefits to stocks and bonds. However, real estate investment is plagued with myriad drawbacks: it is illiquid, needs expert management and is “lumpy” requiring significant capital to build a diversified portfolio. Currently, schemes can only invest in real estate directly, either internally or through external managers. Although REITs regulations have gazetted, no REITs have been traded in the market. Real estate investment is therefore only realistic for big schemes, with sizeable investible funds.

Property investment by pension funds in Kenya has increased in absolute terms over the years. However, as a percentage of total pension assets it has decreased over the period. It decreased from 35 percent in 2002 to 14.6 in 2007, but went up to 21.5 percent in 2008. The decrease in the proportion of real estate investment during last decade can largely be attributed to the enforcement actions undertaken by the Authority upon coming into full operation in 2000 in order to ensure that schemes fund investments were within the allowable investment limits. The increase in the proportion of property investment in 2008 and 2011 can be attributed to the fall in the value of the stocks in 2008 and 2011 due to the global financial crisis and the euro zone crisis which affected the stock market. This implies that property investment could be a good diversifier.

The findings also showed that majority of the schemes which have invested in property are schemes of quasi-government institutions of which most of them inherited most of the property from the sponsors as part of funding the scheme deficits which existed during the conversion to defined contribution scheme following the government directive via the treasury circular No. 18/2010 . The circular required all Public Service Retirement Benefits Schemes to convert from defined benefits schemes to defined contribution schemes. It was also noted that most schemes which had inherited property from the sponsors had a huge exposure to property with some exceeding the investment guidelines limits of 30 percent. The returns on such properties are also low, more so, where the tenants are employees of the sponsor (members). Revision of rents or disposal of such

properties is always an uphill task given that it involves the workers union. The rents are either subsidized or negotiated.

From the in-depth interviews with selected scheme trustees and fund managers, direct real estate investment seemed to be the preferred choice. However, the investments in property need to be aligned to the members profile and take into consideration the interests of members. The funds ought to work for members. Albeit, there is always the delicate balance between the interest of members for example in the case of low cost housing and generating optimal/best returns for the members. Questions arise whether members should subsidized fellow members to enjoy affordable or low cost housing which they would otherwise not have afforded in the market? These are some of the delicate issues the trustees and the regulator have to deal with in trying to make pension funds work for members.

Correspondingly, there should be a clear strategy and guidelines to be followed by the trustees in the investment of the property in order to avoid conflict of interests and promote good governance and prudent investment. The trustees also need to involve the fund managers or services of a property specialist in order for them to benefit from expert and independent opinion. This is necessary given that property investment in Kenya is an emotive and contentious issue.

5.2 Recommendations

The study makes the following recommendations based on the study findings:

- **Use of pension funds in financing housing and other infrastructural projects**: Infrastructure assets has been argued to be a good diversifier of pension assets due to a number of factors; Infrastructure projects are usually long term investments and therefore provide duration hedging. Infrastructure assets are also usually linked to inflation and could also hedge pension fund liability sensitivity to inflation. Infrastructure assets also have low correlation with the traditional class assets especially if they are unlisted. Equally, the government has also identified infrastructural development and housing as some of its key priority areas in the Kenya Vision 2030. In the same vein, the second Medium Term Plan (MTP II), the government has committed itself to

develop affordable and quality houses in order to address the shortage and high cost housing challenges currently being faced in the country.

There is therefore need to encourage schemes to invest in infrastructural project geared towards the attainment of Kenya Vision 2030 and also investment in innovative products in the property market which would enhance the scheme returns without putting into jeopardy the scheme funds. Pension funds need to be provided with incentives to invest in infrastructural projects e.g. waiver on import duties. There is therefore need for a legal framework to facilitate pension funds in the investment in infrastructural projects geared towards the attainment of Vision 2030 e.g. joint ventures in housing, roads, rails etc.

- **REITs as a separate asset class**: the Real Estate Investment Trusts (REITS) regulations were recently gazetted and there need to encourage schemes to invest in REITs. This will enable big scheme with huge property exposure to unlock the property investment value and hence ensuring liquidity. REITs will also make trading in property less cumbersome and transparent. Similarly, small schemes will also have an avenue to investment in property. In order to eliminate ambiguities as to whether REITs are equities, bond or property, it would desirous to treat REITs as a separate asset class.

- **Property Guidelines/Practice Notes:** Property investment by pension funds is complex and contentious. The trustees have a duty to act prudently and with due diligence with respect to the management of pension funds. The trustees have also a duty to act in the best interest of the scheme members. The trustees are also expected to exercise the principle of diversification and as well as ensure that unwarranted risks are avoided. However, property management is a specialized field and most Pension Fund Managers may not have the necessary expertise and skills and therefore have to depend on property managers. Also big schemes have to hire/ recruit property managers internally in order to assist them analyze the property reports. Similarly, there are no regulations or standards governing the property managers currently. There is therefore need for the Authority to ensure uniformity in terms of management, valuation, reporting and other

requirements of property investment, including corporate governance. The Authority therefore needs to issue guidelines/practice notes to guide investment in property by pension funds.

- **Sensitization of Trustees on available new products:** there is need to empower trustees on the availability and how they can invest in new and innovative products. It was noted that the trustees were "*fearful*" to invest in product which were not expressly provided for in the investment guidelines. Investment in alternative assets is still not clearly understood. There is therefore need to sensitize trustees on the available new products so as to enable them make informed decisions and diversification of the scheme portfolio.

- **Encourage the development innovative products:** there is need for the Authority to encourage pension funds to develop innovative pension products which enable members' access tangible benefits e.g. housing, medical etc. There is therefore the need to make pension funds work for the members.

- **Further Research:** there is need for the Authority in collaboration with the industry stakeholders to undertake a real estate study to find out the opportunities and challenges in real estate investment and come out with an industry real estate index or benchmark in terms of returns and document best practices. This will also inform real estate investment guidelines or practice notes.

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