

**AN INVESTIGATION INTO FACTORS AFFECTING FOREIGN
PORTFOLIO INVESTMENT INFLOWS TO KENYA**

BY:

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*An investigation into
factors affecting*



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DECLARATION

This project is my original work and has not been presented for a degree in any other university.

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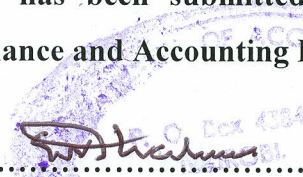
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DEDICATION

To Nduta, Mweru (and your mom) plus Nduta (Mukuru). For your unending love and understanding.

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ABBREVIATIONS

CDS	- Central Depository System
CMA	- Capital markets Authority
FDI	- Foreign Direct Investment
FPI	- Foreign Portfolio Investment
IMF	- International Monetary Fund.
IOSCO	-International Organisation Of Securities Commission
MIGA	- Multilateral Investment Guarantee Agency
NSE	- Nairobi Stock Exchange.
ODA	-Official Development Assistance
UNCTAD	- United Nations Conference and Trade Development.
WB	- World Bank

DEFINITION OF TERMS

Bonds -debt instrument with maturity of longer than one year.

Broker -person who acts as intermediary between buyer and seller for a commission.

Economic policy -a statement of objectives and the methods of achieving these objectives by government. Some of these objectives are maintaining full employment, a high economic growth rate and infrastructure development.

Emerging stock markets -equity markets used to finance private corporations in newly industrialized countries.

Equity- shares or stocks

Equity market- the primary and secondary markets for negotiable equity.

Exchange control -a government policy designed to restrict the outflow of domestic currency.

Exchange rate - the rate at which central banks exchange one country's currency for another.

External debt- the total private and public debt owed by a country.

Gross Domestic Product (GDP)- the total final output of goods and services produced by the country's economy within the country.

Investment managers - persons responsible for supervising an investment portfolio

Portfolio investment -financial investments by private individuals, corporations, pension funds and mutual funds in stocks, bonds etc.

20-share index -indicates the value of the twenty top companies in the stock exchange.

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ABSTRACT

This study examines the factors affecting Foreign Portfolio Investments to Kenya during 2000-2004. The Capital Markets Authority (C.M.A) in Kenya observes that the performance of the capital markets is directly correlated with performance of the economy. The study explored on the various factors perceived to affect FPI to Kenya. Global trends were factored in the background of the study with an objective of finding those institutional factors that affect FPI.

Data was analysed collected and analysed using descriptive statistics. The results indicate that there is a relationship between exchange rate regimes, inflation, and the governance or administration of the various assets listed at the NSE that attract FPI. Those listed companies that had strong corporate earnings and practised good corporate governance continued to attract the highest attention from foreign investors. Further to this, years with high Inflation rates attracted low FPI.

The research concludes that inflation, good corporate governance and Publicity are the fundamental factors affecting foreign portfolio investments to the country on the basis of the data analysed.

The research recommends that further research be carried out on the effects of the **NSE-20-Share Index**, share prices and Initial Public Offerings (IPO) on FPI to Kenya.

CHAPTER ONE

INTRODUCTION

1.0 Background to the Study

Until recently, low-income countries, particularly in sub-Saharan Africa, have been perceived as aid dependent and as receiving virtually no private foreign capital. As noted in the 1997 Fourth Expert Group meeting in Santiago, the structure of external financial flows to developing countries in the 1990s is vastly different from the previous decades (IOSCO 2003). Increased external debt levels and concern of how to obtain continued inflows of foreign capital to offset the shortfalls in domestic saving levels have led many developing countries around the world to place additional emphasis on their local equity market

Governments recognize that a well-organized capital is vital for attracting foreign investments in order to boost economic development. The on-going debt crises are serving to focus attention on equity rather than debt. Foreign funding continues to dwindle from one year to the next making it a necessity to focus on an alternative source of foreign capital (Dailami et al 1990). They, further observe that, the reality of a much reduced supply for foreign funds from previous sources such as exports and tourism compels governments in many developing countries to pay increased attention to capital market development as a way of improving domestic resource mobilization, enhancing the supply of long-term capital and encouraging the efficient use of existing assets.

Foreign Direct Investment (FDI) has the potential to improve the quality of growth. Economic growth tends to lift the incomes of the poor proportionately with overall growth (Dollar et al 2000). Typically, foreign entrants are larger and more productive

than domestic firms in developing countries. Developing countries are overcoming historical objections to foreign investment by increasingly beginning to appreciate the benefits of open markets and private initiatives. Many are recognising that equity markets are integral to economic development and that foreign investment can act as a source of long-term capital.

FDI is a key ingredient for successful economic growth in developing countries and to achieve poverty reduction strategies as it helps improve the management of the social safety particularly service delivery to the poor (Klein et al 2004).

1.1 Portfolio Investments

Portfolio investments include all long-term investments that do not give the investors effective control of the object of investments. Such transactions typically involve the purchase of stocks or bonds of foreign issuers for investments and not control purposes. They also include long-term commercial trade to finance trade (Michie et al. 1995). Since the beginning of 1990, many emerging economies have liberalized their capital markets. At the same time some emerging economies with sound development and reform strategies have in general been growing faster than industrialized economies. Attracted by higher returns and opportunity to diversify risks, portfolio investments have accordingly increased in emerging markets. In 2000, total portfolio flow into emerging markets was of three times that of 1990 and equity inflows went up by nine (IOSCO 2003).

Emerging markets' share of world GDP is 12 percent, but they account for only 5 percent of world market capitalisation. This gap is likely to narrow over time because domestic demand - not foreign demand - traditionally has been the force behind the past performance of developing stock markets. As global investors become aware of the tremendous opportunities in Third World markets, the flow of new equity from capital exporting countries such as Japan should increase (Porter1993).

From a long-term perspective perhaps the most important developments in capital flows to developing countries takes place in the equity markets. In contrast trends in debt flows, equity placements in developing countries have increased sharply over the past two years from US\$ 8.6 billion in 1998 to US\$ 38.4 billion in 2000. Equity flows in 2000 accounted for 15% of all capital market flows to developing countries compared with 5% in 1998 (UNCTAD 2002). Several factors have contributed to this growth. Technological innovations in the information and telecommunications industry caused a run-up in technological stocks in industrial countries. This led some investors to buy technology stocks in developing countries in expectation of similar gains.

Portfolio investments is a way of filling gaps between domestically available supplies of foreign exchange requirements and those derived from net export earnings, foreign aid and tourism (Todaro 1996). The Capital Market Authority observes that the performance of the capital market is directly correlated with the performance of the economy. Portfolio investments are a major source of finance for the development of infrastructure in some countries through the flotation of long-term government bonds to fund road

construction and other development projects. Kenya is today merited as one of the brightest prospect of sub-Saharan Africa having the third largest stock market exchange (Price 1998). He observes that there is strong potential for the growth of the portfolio market facilitating the entry of equitable foreign investment and improving efficiency.

1.2 Statement of the Problem

Despite of these global trends, Kenya remains unattractive destination for inflows of foreign portfolio investments. Its performance lags behind Tanzania and Uganda. With the on-going government's policy on poverty reduction strategy, there is need to attract Foreign Portfolio Investments as an alternative source of the much needed foreign capital (World Investments Report 2004). Portfolio investments act as stabilizers of Foreign Exchange fluctuations and increase the current account balance and foreign reserves. The money and financial markets in Kenya have continued to exhibit the wild swings of the third world market. It has been an extremely volatile market where prices and volumes move up and down unpredictably regardless of any major changes in the fundamentals. In 1995, the NSE 20 Share Index was at 5,000 points. Institutions like the International Finance Corporation (IFC) regarded NSE as one of the best performing bourses in the emerging markets. Come 2002, the bourse hit an all time low of 1090 on the 20 Share Index (Daily Nation April 5 2005).

There has been dismal performance in attracting private international financing since 1993 to date. During 1990 to 1992 Kenya received cumulative capital flow of US\$ 435 million. It then experienced a complete reversal of outflows from 1993 to 2002 amounting to US\$ 728 million attracting small flows of portfolio investments. The ratio

of Foreign Portfolio Investments to Gross Domestic Product (GDP) in Kenya was only 0.4% during the 1990s compared to 1.9% of sub-Saharan Africa. Kenya ranked 117 of 140 countries in 1998 - 2000 from 90 in 1990 (World Bank Report 2005). Foreign Investors Board (FIB) at the Nairobi Stock Exchange the total turnover dropped by 45.7% from Kshs. 699 million in 2000 to Kshs. 449 million in 2001. The foreign investors' participation in the market declined from a level of 36% of the total market turnover in 1997 to a level of 12.5% during 2001(Daily Nation April 5,2005).

This study endeavors to identify those factors that influence FPI and ways to attract investors.

1.3 Objectives

The main objective of this study is to investigate the institutional factors that affect foreign portfolio investments to Kenya. The general objectives being;

- I) To establish the extent at which these institutional factors and policies affect the Foreign Portfolio Investors decisions.
- II) To make policy recommendations on FPI based on the research findings.

1.4 Research Questions

The study sought to answer the following questions:

- I) Which Institutional factors significantly affect foreign portfolio investments to Kenya?
- II) What policies affect the levels of foreign portfolio investments to Kenya?
- III) To what extent do these institutional factors affect the levels of FPI?

1.5 Significance of the Study

Kenya is in a position to be a reservoir of portfolio investments in sub-Saharan Africa. The study endeavored to establish policies that will lead to the growth of portfolio investments in Kenya as an alternative source of foreign currency and establish ways to streamline the existing policies on portfolio investments. This study will be of great importance to corporate bodies like the;

- I) CMA; as it will assist in the formulation of policies conducive for FPIs.
- II) Ministry Of Finance; on the favorable Fiscal policies formulation in order to cater for the FPIs.
- III) The Central Bank of Kenya will also be able to know which monetary policy to follow.

1.6 Scope of the study

The study will focus on a survey of the 17 member firms/stockbrokers of the NSE and 19 Investments Advisors licensed by the CMA within 2000-2004 period. This will be a study of the entire population size of 36. Sampling will be negated due to the small population size. This population is based in Nairobi Kenya.

CHAPTER TWO

LITERATURE REVIEW

2.0 Introduction

According to the Oxford Dictionary of Banking and Finance (2002) investment is the purchase of capital goods such as a factory in order to produce goods for future consumption. It is also the purchase of assets such as securities, works of art, etc, with a primary view to their financial return either as income or capital. It defines portfolio, as the list of holdings in securities owned by an investor or institution. Thus investment is the purchase of stocks and bonds to obtain a return on the funds invested.

Although portfolio investors are not directly concerned with control of a firm they invest amounts in stocks and bonds from other countries (Ball 1996). He further observes that portfolio investments include all-long term, more than, one-year investments that do not give the investors effective control over the object of the investment.

2.1 Theoretical Literature

Foreign Portfolio Investments (FPI) includes a variety of instruments, which are traded, or tradable in organized and other financial markets (UNCTAD 1998). UNCTAD notes that the International Monetary Fund (IMF) even includes derivatives or secondary instruments such as options in the category of FPI. UNCTAD notes that private capital flows are assuming an increasing role as a source of finance for emerging markets. The World Bank Group (2000), states that FPI can be very useful to developing countries. Opening stock markets to foreign participants increases liquidity by deepening the pool of buyers and sellers. As stock market develops and strengthens, it benefits other parts of

the financial sector as well as the wider economy. Previous studies have placed more emphasises on FDI by multinational corporations (MNC) slightly touching on FPI.

2.1.1 Portfolio Specific Factors

Foreign stock and bond markets account for a large proportion of total wealth. There are many impediments to going international which could explain the relatively low amount of FPI. (Jorion and Khoury 1999). These include:

Information Costs.

Processing financial information for foreign investors requires an enormous effort in understanding different cultures, languages and accounting standards besides costs. Information asymmetry affects FPI. Acting on inside information is legal in certain countries, which puts the foreign investor at a disadvantage relative to the locals. In many developing nations, security markets are either lacking entirely or are poorly developed. Further, financial reporting may be unreliable and access to company information highly limited. In such nations, banks and other financial intermediaries take on especially important roles. To secure investment capital from banks, firms often must concede a strong role for the lenders, such as presence on the Board of Directors and access to inside information. In a market in which asymmetric information is especially problematic, the market can break down altogether without some way in which providers of capital can gain access to information and a degree of control (Barry et al 2000). Asymmetric information increases the chance that investors may incorrectly price the risk of making an investment. According to UNCTAD 1998, the asymmetry of information

can also contribute to a hard type behaviour leading to boom–bust cycles of investment and contagious reactions in times crisis.

Accurate information from independent sources makes an emerging market attractive to foreign equity investors and increases the stability of capital flows. Financial markets develop best in the presence of legal codes that stress the rights of shareholders especially minority shareholders and regulatory systems that encourage the disclosure of corporate information (Levine 1999).

Accounting practices

Differences in accounting practices affect investors' decisions and stock markets. Participants in the U.S, U.K, Japan, Switzerland and Germany viewed this as a major inhibiting factor to cross-border capital flows (Voster 1996). In his study of Germany investors, he found out that substantial differences in profit exist when companies use United Kingdom's (UK) Generally Accepted Accounting Principles (GAAP) against the United States GAAP. The regulations and policies of the developing countries to influence the flow of foreign capital can be quite complex (Klein 1990).

2.1.2 Government and Economic factors

Capital Controls

Capital controls also affect international investments. These can take the form of taxes or outright restrictions on amounts that can be invested by foreign investors. According to CMA Foreign Investors Regulations 2002 (Laws of Kenya Capital Markets act cap

485A) foreign equity holding in Kenya is only after 25% domestic issuance of any asset or security. According to Klein, a major obstacle to FPI is the restriction on ownership.

Capital gain taxes also influence FPI levels. When these taxes cannot be compared with other countries or domestic taxes, they influence FPI investors' decision. The question of national taxation policies deserves more careful analysis, not least because capital movements can be influenced by different tax regimes (Fitzgerald 1999).

The way governments regulate and tax firms and transactions both within and out of their borders plays a big role in shaping the investment climate (Shah 1995). The argument for potential growth of emerging markets is further buttressed by the fact that the liberalisation of economies in developing countries and the relaxation of foreign investment barriers (such as tax laws and exchange control regulations) could attract investments, which might trigger the expansion of stock markets in developing countries. For many developing countries, the main focus in attracting private capital is foreign investment. This is evidenced mainly by the relaxation of a number of barriers to foreign investment in countries such as Zambia and Kenya (Nedcor Securities 1996).

Restrictions on the repatriation of profits and capital also involve the access to foreign exchange (Blomstrom 1990). Even if repatriation of profits and capital is granted under the FPI act of country, or by a bilateral treaty, this is not of much use if access to foreign exchange is restricted (Klein 1990). He goes ahead and states that most countries with severe debt and debts financing problems restrict repatriation of profit and capital, and gives Kenya as an example.

Although no country completely prohibits the repatriation of profits, many countries have restrictions that distort optimal financing conditions. Many countries for example, restrict the repatriation of profits to a certain percentage of the registered capital. Multilateral investment guarantee agency (MIGA 2005) of the World Bank Group gives currency inconvertibility and transfer restrictions as a risk factor in offshore portfolio investment.

Exchange risk is stressed as a potential variable impeding international portfolio investment. The instability of the foreign exchange market and the strengthening of the shilling have dampened demand among foreign investors (Daily Nation April 5, 2005). MIGA (2005) recognizes exchange rates as a potential risk factor for FPI and covers it. Closely related to this in the Interest Rate regimes.

2.1.3 Bourse Factors

Unreasonably high costs of transactions will affect market development since investors aim at minimizing costs to increase their returns. FPI is done in the hope of excellent returns. Wild swings in the interest rates have hit the secondary market (Bond market) making the investors give it a wide berth, according to Suntra in Nairobi stocks.

Transactions costs and transitional problems are also a factor that influences the levels of FPI. The introduction of the electronic registration through the Central Depository System (CDS) for shares and the massive demobilization of share certificates are factors that are influencing foreign investors (Daily nation April 5 2005). Transaction costs on the Nigerian stock exchange are high and pose obstacle to the development of a more active secondary market, with minimum transaction costs being 3.2% on the buying side and 3.7% on the selling side meaning that about 7% of an investors capital goes into

transaction fees and charges on a “round-trip” in-and-out basis (Financial times, May 2004).

Emerging markets act as means of diversifying opportunities at relatively attractive valuations. With many developed stock markets setting highs on a daily basis in 1995 and 1996, many investors in U.S. and European stocks wished to shift some of their gains and new cash flows into emerging markets. Japanese institutions, on the other hand, began to more actively invest in emerging markets to improve returns and diversify out of Japanese financial assets under liberalized investment regulations, particularly after the Japan Pension Fund Association sanctioned emerging markets as a distinct asset class in mid-1996. During 1996, 144 additional ADR program were launched by companies from emerging markets, bringing the number of ADR program from emerging markets to 556 from 42 countries. In 1996, such programs raised \$8.9 billion in new capital, according to Citibank's 1996 DR Market Review. The increasing availability of emerging market securities on "approved exchanges" (stock exchanges approved by regulators of pension funds or mutual funds), such as New York or London, allows many investors to own stocks they might otherwise have been prohibited from buying. It also makes such stocks available to the interested retail investor.

2.1.4 Political factors

Generally, the Eastern and Southern African region is politically and economically weak. Civil wars have been going on in Rwanda, Burundi and the Democratic Republic of Congo. Various states in the region are now divided on how to resolve this problem. The

fragmentation in the collective will of states in Eastern and Southern Africa makes the setting up of a formal stock exchange a much more attractive idea than that of having an informal regional stock exchange. Indeed, we are faced with a situation where the social and economic interests of several states are widely divided, and the momentum to galvanise a collective will is almost non-existent (Dickie 1998).

To promote efficient and effective securities regulation in this region, a regulatory system that does not lead to a 'lawless' situation must be put in place. In this context, a more centralised approach to regional financial integration should be adopted. Political risk, expropriation, war and civil disturbances and breach of contracts affect FPI decisions. According to a survey on German firms that have invested in developing countries, the most important individual factor is difficulties in dealing with the state authorities (bureaucracy) in developing countries (Pollack 1994).

2.2 Empirical Study

Most of the studies done have focused on Foreign Direct Investments (FDI). Klein, Aaron and HadjiMichael carried out a study on *FDI and poverty reduction in 2004*. Fitzgerald carried a study on the *Global Capital Volatility and the Developing Countries* in 1999. Klein did a study on factors affecting FDI in developing countries in 1990. UNCTAD has carried out numerous surveys on the role of FPI in developing countries. These studies have also cited the above variables as important factors affecting FPI levels. The World Bank estimates that almost \$177 billion of foreign portfolio capital has moved into emerging markets' stocks over the course of the 1990s. The total amount of

foreign portfolio investment in emerging stock markets (directly and indirectly through depositary receipts and other vehicles) at the end of 1996 is estimated by IFC at around \$230 billion, with dedicated emerging market funds accounting for about two-thirds of the total. The balance comes from global/international equity funds, hedge funds, and institutions and retail investors via direct purchases.

The motivations behind the increased portfolio flows of 1996 can be summarized as:

interest in emerging markets as relatively high-growth economies. Real GDP growth in 1996 for major emerging markets has been estimated by the Institute for International Finance at 4.7%, and forecast for 1997 at 5.7%, double the average for the G-7 countries. Many economists expect this differential in growth rates to persist for years, if not decades.

2.3 Conclusion

The role of stock markets in attracting private capital to Africa is a topic that deserves careful investigation. From the explored theoretical and empirical Literatures, it is quite evident that there exist variables that considerably affect the FPI into the Kenyan stock market.

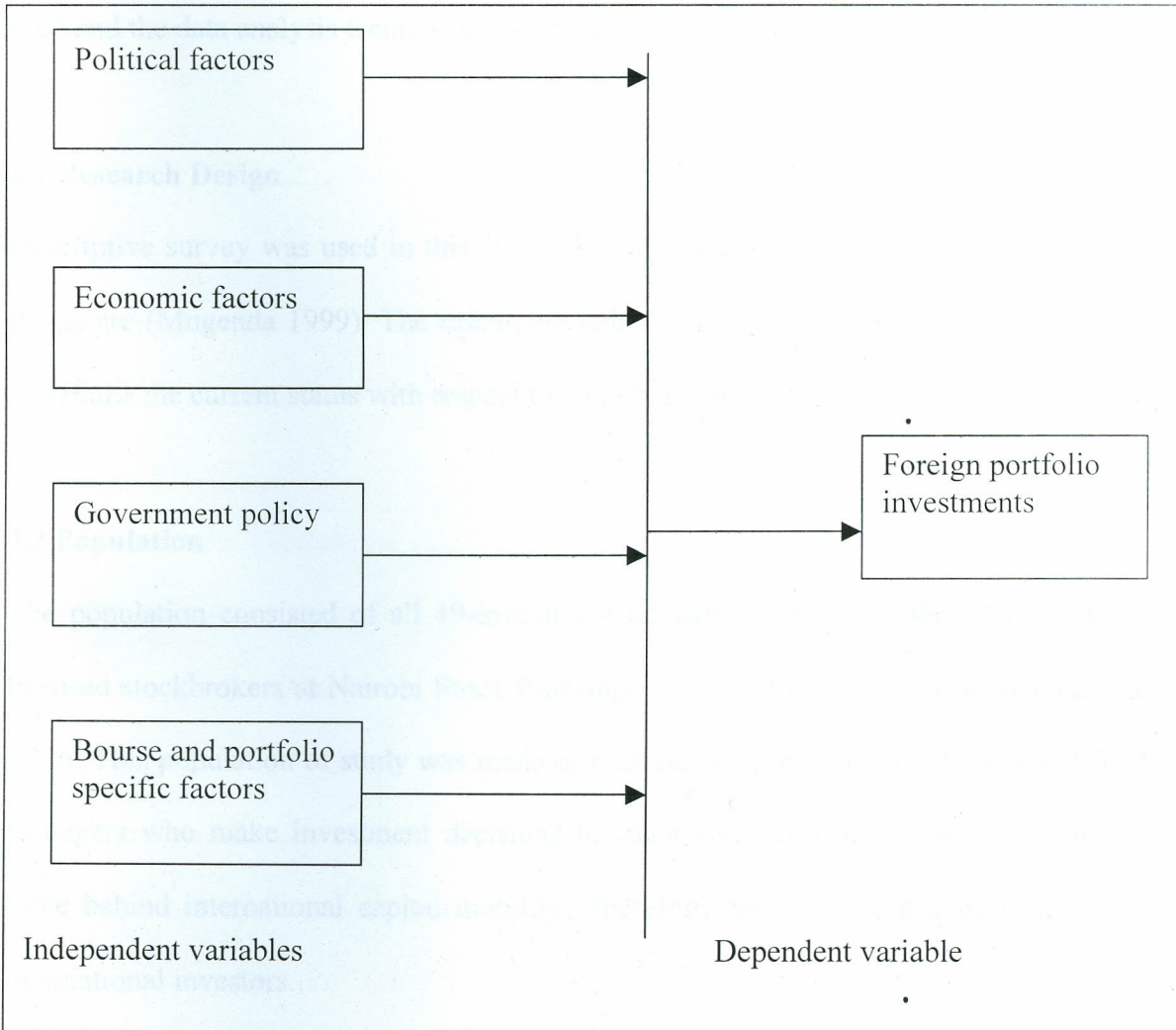
Evidence from studies done previously show that countries such as Kenya and Zimbabwe have failed to attract significant capital inflows despite the fact that they have long established stock markets. Developing countries will have a growing interest in establishing secure and stable regime that protects their overseas investors. They can take action to attract and maximise the benefits of long term FPI by maintaining stable macro-economic, trade and regulatory policies.

It is with this background that this study seeks to further critically examine how the above factors affect or influence FPI to Kenya. It is clear from previous studies that stock markets alone cannot sufficiently contribute to attracting private capital and that other conditions are necessary.

2.4 Conceptual Framework

These factors discussed above can be illustrated further using the following conceptual framework with political, economic, government and portfolio factors as independent variables while FPI being the dependent variable.

Fig 1 Conceptual Framework



Factors affecting foreign portfolio investments.

Source: researcher 2005.

CHAPTER THREE

RESEARCH METHODOLOGY

3.0 Introduction

This chapter elaborates on the research methodology. It starts on the research design, population of study and its size, the sampling procedure the data collection instrument used and the data analysis techniques employed.

3.1 Research Design

Descriptive survey was used in this study. This method determines and reports the way things are (Mugenda 1999). The researcher collected data from a population in order to determine the current status with respect to more than one variable.

3.2 Population

The population consisted of all 19-investment advisors licensed by the CMA and 17-licensed stockbrokers at Nairobi Stock Exchange (NSE). Making a total population size of 36. This population of study was made of multinational investment advisors and fund managers who make investment decisions for their international clients. They are the force behind international capital mobility. Therefore, they represent a true picture of international investors.

3.3 Sampling and Scope of the Study

Due to the low number of licensed stockbrokers and investment advisors, the whole population was considered. This was to ensure that the results were conclusive bearing in mind that some respondents may not have been in business or may fail to respond.

A sample period of five years (i.e. 2000-2004) was viewed as ideal in studying the trends in FPI movements and is the most recent as would give the true picture. Likewise this period spans between two government regimes and thus would indicate the true trends. Likewise Data between these periods is easy to access.

3.4 Instrumentation and Data Collection Procedure

Investment managers and senior officers in the population were interviewed through a questionnaire. A self-administered questionnaire was the main Data collection instrument.

Secondary data were also be used in the study. This came from the NSE library, World Bank's Public Information Centre, UNCTAD reports, Internet, C.M.A and other libraries.

3.5 Data analysis Techniques

Descriptive statistics was used to analyze data collected, as the study was exploratory.

Gupta used similar technique in 1993 in analyzing the trends in portfolio investments in emerging markets. His findings have been proved reliable and published in notable world journals and websites.

Frequencies, percentage mean scores were used in data analysis with the mean score ranging on a 5-point Likert scale (i.e. 1 very important to 5 as least important). This was based on a weighing scale of 5 scores for 1 and one score for 5 in order to arrive at reliable and relevant conclusion.

Tabulations will be done using the Statistical Package for Social Sciences (SPSS).

For non-quantitative data, findings will be analysed qualitative.

CHAPTER 4

DATA COLLECTION, ANALYSIS AND INTERPRETATION

4.0 Data Analysis

This chapter presents the empirical results of the analysis done based on the analytical Likert scale discussed in chapter three. Of the 36 respondents interviewed, 25 of them responded to the questionnaire. This represented a 67% response. Of these respondents, 25% had foreign investors as their clients. The data used covered the period 2000-2004.

92% were of the opinion that corporate earnings affected FPI, 88% gave Inflation as a factor too with foreign publicity and exchange rates being given 84% as factors affecting FPI. After analysing the data the following findings were precipitated.

4.1 Economic Factors

Table 1

Economic Factors * Scale Crosstabulation

		Scale				Total	
		Affect the Most	Average Effect	Minimal Effect	No Effect		
Economic Factors	Exchange Rates	Count	16	5	4	25	
		% within Economic Factors	64.0%	20.0%	16.0%	100.0%	
	Treasury Bills	Count	14	8	3	25	
		% within Economic Factors	56.0%	32.0%	12.0%	100.0%	
	Interest rates	Count	18	7		25	
		% within Economic Factors	72.0%	28.0%		100.0%	
	GDP	Count	11	7	3	4	25
		% within Economic Factors	44.0%	28.0%	12.0%	16.0%	100.0%
	Inflation	Count	20	5		25	
		% within Economic Factors	80.0%	20.0%		100.0%	
Total		Count	79	32	10	4	125
		% within Economic Factors	63.2%	25.6%	8.0%	3.2%	100.0%

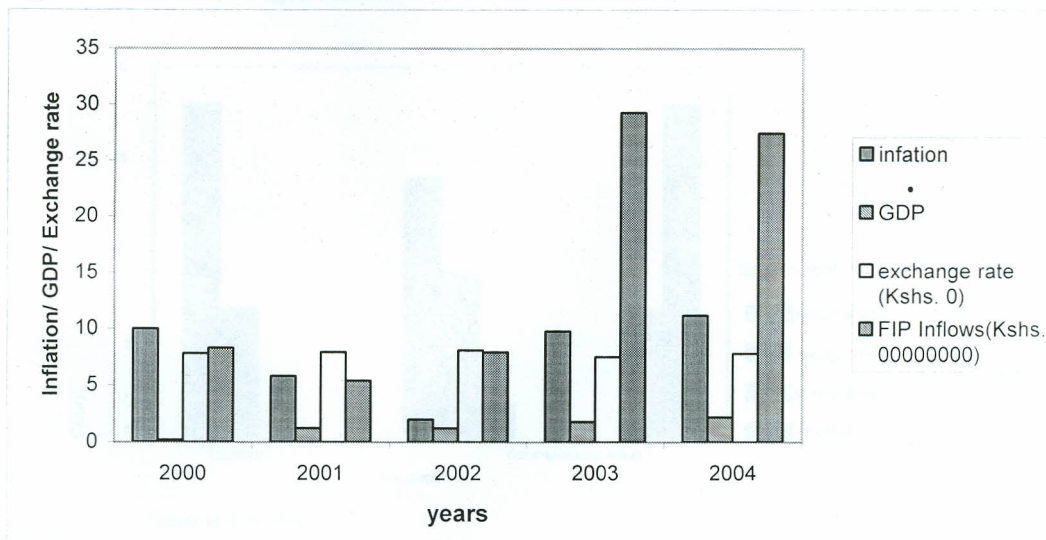
The above analysis shows that 63.2 % of the respondents gave the economic factors as affecting the FPI most, with 25.6% saying it had average effect. 8% gave economic factors as having minimal effect whereas 3.2% had no comment. 80% of the respondents were of the opinion that inflation level affected FPI to the country the most (as a one of the Economic Conditions). However this is when others conditions are held constant. From the graph below, during the General elections year of 2002 despite the low inflation rates FPI inflows went down due to the political uncertainty.

However this can be justified by the downward trends in FPI for the year 2004 when Inflation rates shot from 9.8% to 11.4%. When we plot the Inflationary pressure, Exchange rates, GDP alongside the total cumulative inflows of FPI for the period 2000-2004 we find that we get the following trend.

Table 2: Inflation Trends, exchange rates and volume of FPI

Years	2000	2001	2002	2003	2004
Inflation (%)	10	5.8	2	9.8	11.2
GDP (%)	0.2	1.2	1.2	1.8	2.2
Exchange rate (Kshs. '0')	7.8	7.9	8.1	7.5	7.8
FIP inflows (Kshs. '00,000,000')	8.28	5.41	7.9	29.3	27.5

Fig 2 Inflation Trends, exchange rates and volume of FPI



64% of the respondents gave Exchange rates as having most the effect. This is as a result that with good stable exchange rates investors are somehow assured on the value of investment returns and a sort of guarantee on the value of their returns. It is evident that the years 2000 to 2002 when the exchange rate dipped against the Dollar the FPI went down as compared to 2003 to 2004 when the shilling gained ground against the dollar.

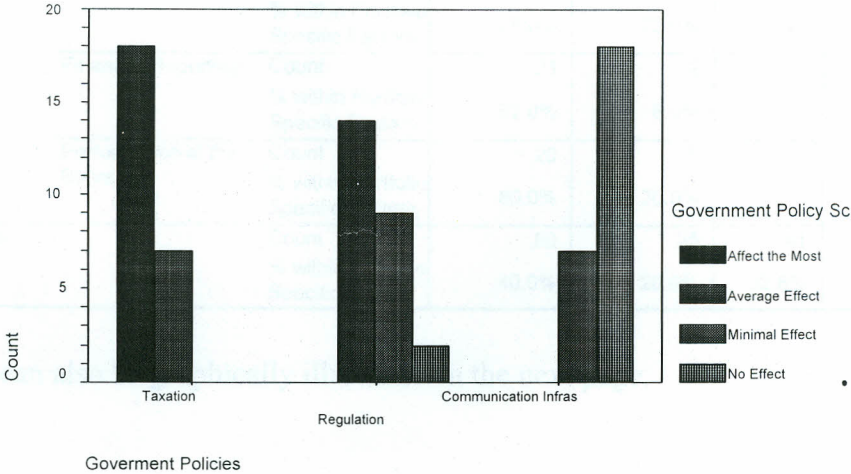
4.2 Government Policies

Table 3

Government Policies * Government Policy Scale Crosstabulation

		Government Policy Scale				Total
		Affect the Most	Average Effect	Minimal Effect	No Effect	
Government Policies	Taxation	Count 18	Count 7			Count 25
		% within 72.0%	% within 28.0%			% within 100.0%
	Regulation	Count 14	Count 9	Count 2		Count 25
	% within 56.0%	% within 36.0%	% within 8.0%		% within 100.0%	
	Communication Infrastructure	Count 7	Count 18			Count 25
	% within 28.0%	% within 72.0%			% within 100.0%	
Total		Count 18	Count 21	Count 16	Count 20	Count 75
		% within 24.0%	% within 28.0%	% within 21.3%	% within 26.7%	% within 100.0%

Fig 3: Taxation, Regulation, and Communication



Another 24% of the respondents were of the opinion that Government policy affected FPI most, 28% as having average effect while 21.3 %gave it as having no effect at all.

The government’s taxation policy on returns on investments takes the centre stage in Government policies on any FPI, as analysed, with 72% of the respondents in strong agreement that taxation is a factor that Foreign Investors consider in any venture to a country’s Portfolio.28% of the respondents believed it had average effect.

This can be attributed to the CMA new act on investment taxation.

Regulation did not matter much to the foreign investor as this was seen to have no much effect. This may be attributed to the fact the time taken to register a new investor takes only five working days which is fast.

4.3 Portfolio Specific Factors

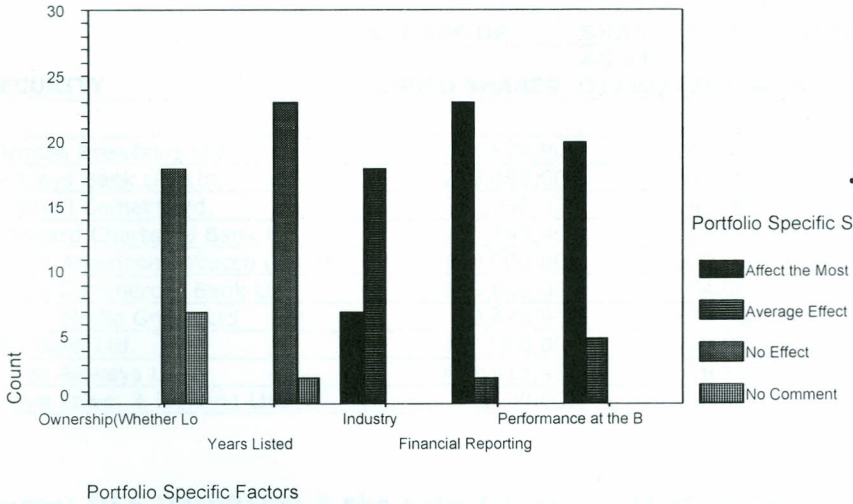
Table 4

Portfolio Specific Factors * Portfolio Specific Scale Crosstabulation

			Portfolio Specific Scale				Total
			Affect the Most	Average Effect	No Effect	No Comment	
Portfolio Specific Factors	Ownership(Whether Local or Foreign shareholding)	Count			18	7	25
		% within Portfolio Specific Factors			72.0%	28.0%	100.0%
	Years Listed	Count			23	2	25
		% within Portfolio Specific Factors			92.0%	8.0%	100.0%
	Industry	Count	7	18			25
		% within Portfolio Specific Factors	28.0%	72.0%			100.0%
	Financial Reporting	Count	23	2			25
		% within Portfolio Specific Factors	92.0%	8.0%			100.0%
	Performance at the Bourse	Count	20	5			25
		% within Portfolio Specific Factors	80.0%	20.0%			100.0%
Total		Count	50	25	41	9	125
		% within Portfolio Specific Factors	40.0%	20.0%	32.8%	7.2%	100.0%

This can also be graphically illustrated in the next page:

Fig 4: Portfolio Specific Factors



From the above cross tabulation it emerges that the respondents agreed that Portfolio factors affected FPI most 40% of the times, whilst 20% of the times it had average effect. 32.98% of the times said it had minimal effect while 7.2% said it had no effect.

Further from the above cross tabulation, financial reporting takes a vital focus of Foreign Investors at 92% of the respondents having it as the most affecting FPI.

80% agreed that portfolio performance in terms of return on the investment affected most FPI to the country. Sound and proper financial disclosures will influence greatly FPI investors. This is important as it indicates the portfolio direction in terms of profitability. Likewise, performance at the Stock Exchange, in terms of Market capitalization and returns on equity, attracts investor confidence.

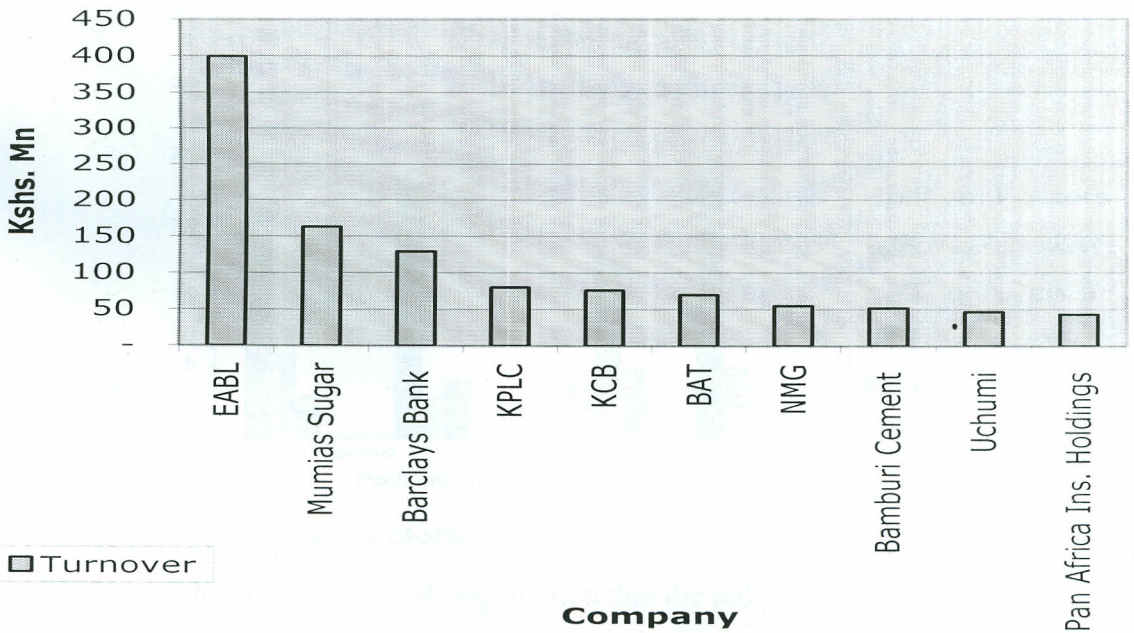
Companies which the highest turnover for Equity continued to attract more Foreign Investors. East African Breweries according to 66% of the respondents attracted the most of FPI followed by Barclays Bank with 52% of the respondents. This can be compared with the respective turnover of their Equities at the NSE.

Table 5: Top ten companies by Market Capitalization (Kshs)

No.	SECURITY	NUMBER OF	SHARE PRICE	MARKET CAPITALIZATION
		ISSUED SHARES	AS AT 31/12/2004	AS AT 31/12/2004
1	African Breweries Ltd.	658,979,900	100.00	65,897,990,000
2	Barclays Bank (K) Ltd.	203,682,600	200.00	40,736,520,000
3	Bamburi Cement Ltd.	362,959,025	95.00	34,481,107,375
4	Standard Chartered Bank Ltd.	271,243,464	122.00	33,091,702,608
5	British American Tobacco (K) Ltd.	100,000,000	200.00	20,000,000,000
6	Kenya Commercial Bank Ltd.	149,600,000	64.00	9,574,400,000
7	Nation Media Group Ltd.	53,478,945	170.00	9,091,420,650
8	CFC Bank Ltd.	144,000,000	58.00	8,352,000,000
9	Kenya Airways Ltd	461,615,484	16.90	7,801,301,680
10	Kenya Power & Lighting Ltd.	79,128,000	94.50	7,477,596,000

Source: NSE Database; * the calculation is based on turnover up to 31ST December 2004

Fig 5: Turnover for Equities and Bonds



Source: NSE Database; * the calculation is based on turnover up to 31ST December 2004

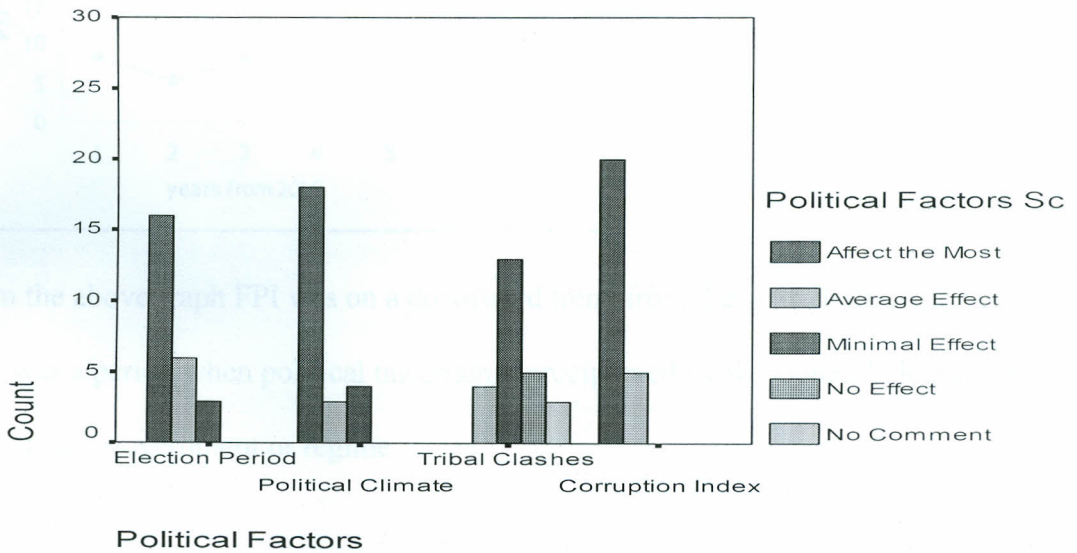
4.4 Political Factors

Table 6

Political Factors * Political Factors Scale Crosstabulation

		Political Factors Scale					Total
		Affect the Most	Average Effect	Minimal Effect	No Effect	No Comment	
Political Election Period	Count	16	6	3			25
	% within Political Factors	64.0%	24.0%	12.0%			100.0%
Political Climate	Count	18	3	4			25
	% within Political Factors	72.0%	12.0%	16.0%			100.0%
Tribal Clashes	Count		4	13	5	3	25
	% within Political Factors		16.0%	52.0%	20.0%	12.0%	100.0%
Corruption Index	Count	20	5				25
	% within Political Factors	80.0%	20.0%				100.0%
Total	Count	54	18	20	5	3	100
	% within Political Factors	54.0%	18.0%	20.0%	5.0%	3.0%	100.0%

Fig 6: Political Factors

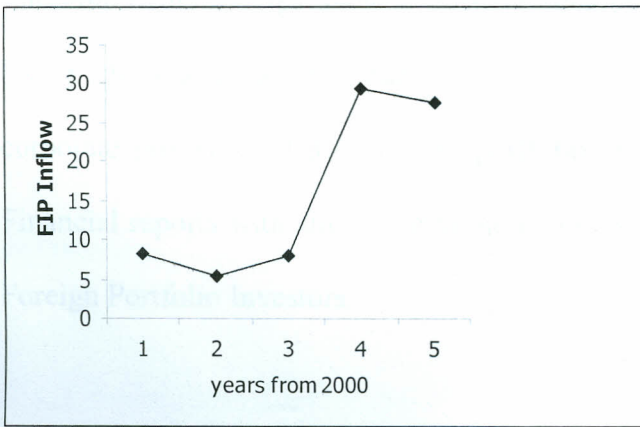


The respondents were of the strong opinion that the political climate affects most FPI 54% of the times, 18% of the times they said it had average effect and 20% of the times it had minimal effect. Foreign Investors are averse to any political turmoil especially if there is no truce in the Government of the day and they shy away from this market.

80percent of the respondents agreed that corruption Index and the general government's policy on corruption affects the FPI.

Compared with the volume of FPI the period preceding the 2002 General elections had low FPI attributed to the foreign investors' jitters on the political environment and regime change. Likewise the dip in 2004 was as a result in the political wrangling in the ruling coalition.

Fig 7 FPI inflows 2000-2004



From the above graph FPI was on a downward trend from the year 2000 to the year 2002. This was a period when political uncertainty precipitated by the General election and the type of new government or regime.

CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

5.0 Summary and conclusion

This study set out to investigate the factors that affect foreign portfolio investments to Kenya. The study analysed data collected from 25 respondents consisting of 16 Fund Manager and 9 stocker brokers. This represented a 67% response.

The empirical findings show a positive relationship between portfolio specific factors (i.e. performance at the bourse and financial reporting that are engrained in Good corporate governance) and foreign portfolio investments. Companies that gave timely financial reports with strong corporate earnings continued to attract the highest level of Foreign Portfolio Investors.

Inflation Rates also had a strong relationship with the volume of FPI to the country.

Firms that had foreign ownership represented the highest value of foreign Investors, whereas 87% of the respondents were of the strong opinion that creating foreign publicity would attract more FPI.

On the basis of the above empirical evidence, the study concludes that strong corporate Earnings, low inflation rates Publicity and low interest rates are fundamental Factors that affect FPI.

5.1 Recommendations

In a nutshell, the following policy recommendations should be adopted to attract more Foreign Portfolio Investors.

5.1.1 Good Corporate Governance

Good corporate governance wins the confidence of investors as it facilitates capital formation, maximises shareholders' wealth and protects investors' rights. The perceived quality of corporate governance will influence the entry of foreign investors. Foreign Investors shy away from markets whose standards of governance are low. Listed companies should comply with all key corporate governance guidelines. Surveillance on all listed companies in order to establish whether they adhere to good corporate governance. Those that do not should be de-listed from the NSE.

5.1.2 Foreign Publicity And Awareness Creation

It would be a great favour to the state creating awareness promoting the opportunities available for Portfolio Investors. Foreign Mission and the CMA should have Investments attaché to sell Kenya as a Potential Destination for Portfolio Investments.

From this study there is minimal investments from the East Asia Countries, which are the new sources of FPI and Japan in particular. Efforts should be made to market these opportunities to these countries in order to raise the FPI.

5.1.3 Policy Support From The Government

The government should take a leading role in providing an enabling environment for the growth of the FPI and especially strengthening the Foreign Investors Board the NSE.

Political bickering and pacification of the various political parties will ensure greater investor confidence.

In order to attract more FPI the necessary fiscal and monetary policies are fundamental in ensuring low inflation rates.

5.2 Limitations Of The Study

The most significant constraint to the study was time. The short time schedule could not allow a comprehensive study from the entire population as desired.

5.3 Suggested Areas For Further Research

A key area that that arose and kept appearing in the course of this study, is the issue of the **NSE-20 Share Index**. This study recommends further research in this area to establish whether this **NSE-20 Share Index** affects the FPI to the country. Also, the issue of share pricing whether overpriced or under priced should be studied to see whether it affects FPI.

Also, there has been no Initial Public Offerings or otherwise new listings at the NSE during the period of study. Further research should be carried out to establish whether Initial Public Offerings or new Listings affect the FPI.

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WWW.miga.org

WWW.nse.co.ke

WWW.unctad.org

APPENDIX 1

INTRODUCTION LETTER

DAVID M. NGAMATE,
KENYATTA UNIVERSITY,
SCHOOL OF BUSINESS
P.O.BOX 43844,
NAIROBI.

.....
.....
.....
.....

Dear Sir/Madam

REF: FOREIGN PORTFOLIO INVESTMENTS

I am a Masters student from Kenyatta University in Kenya carrying out an academic research project on FACTORS AFFECTING FOREIGN PORTFOLIO INVESTMENTS TO KENYA. This project is a requirement for an MBA degree qualification.

With your vast reputation in the investment sector I have identified your organization as one of the several others selected to facilitate the study.

The information you provide is intended for this academic study only and will not be used for any other purpose. Further, the research findings will be made available to you at the end the study.

Your assistance will be of great value.

Yours sincerely

David

RESEARCH QUESTIONNAIRE

Please read and answer as appropriate.

- (1) Name of the firm.....
- (a) Years in business.....
- (b) Position of the respondent.....
- (c) How is your company's share-holding :-(i) local []%
(ii) Foreign []%
- (2) Have you had any Foreign Investors as your clients between 2000-2004?
(i)YES []
(ii)NO []
- (3) How do you categorize your clients in terms of the value of investments or in terms of your Business during this period?
a) Local investors%
b) Foreign investors %

(4) Which countries have these Foreign Investors come from? Rank 5 countries with the highest volume/value of foreign Investors to your organisation?

Country	2000	2001	2002	2003	2004

- (5) How do they get to know about Portfolio Market Information?
.....
.....
.....
- (6) Are there any policy guidelines for Foreign Portfolio Investors? (Tick as appropriate)
YES []
NO []

(7) Which bodies regulate foreign investments?

- i).....
- ii).....
- iii).....
- iv).....

(8) What are the necessary requirements/Licences for Foreign Investor participation at the stock market?

.....

.....

.....

(9) On average how long does it take a new Foreign Investor to be licensed or to participate at the stock market?

[] WORKING DAYS.

(10) On average how long does it take to off load any equity and to settle/close an account for a Foreign Investor?

[] WORKING DAYS.

(11) Which of the present policies do you feel inhibit enhanced Foreign Investor participation in the Kenya's Portfolio Market?

(12) Which Companies listed at the Nairobi Stock Exchange attract the highest foreign investors during this period? Please rank 5 in descending order in terms of volume invested.

- (i).....
- (ii).....
- (iii).....
- (iv).....
- (v).....

(13) How do the following factors affect the levels of Foreign Portfolio Investments to Kenya? Use the key below to comment on each.

5=No Comment, 4=No Effect, 3=minimal effect, 2=average Effect, 1=Affect Most

A. ECONOMIC FACTOR

- EXCHANGE RATES
- TREASURY BILL RATES.....
- INTEREST RATES.....
- GDP.....

B POLITICAL FACTORS

- ELECTION PERIOD.....
- POLITICAL CLIMATE.....
- TRIBAL CLASHES.....
- CORRUPTION INDEX.....

C GOVERNMENT POLICIES

- TAXATION.....
- REGULATION.....
- COMMUNICATION INFRASTRUCTURE.....

D PORTFOLIO SPECIFIC FACTORS

- OWNERSHIP (Whether local or foreign).....
- YEARS LISTED.....
- INDUSTRY.....
- FINANCIAL REPORTING.....
- PERFORMANCE AT THE BOURSE.....

(14)What do you think are the main factors affecting the foreign portfolio investors' decision to invest in a particular country?

.....

.....

.....

.....

APPENDIX 3

POPULATION OF STUDY

STOCK BROKERS

- | | |
|--------------------------------------|-------------------------|
| 1. FRANCIS DRUMMOND & CO. LTD. | P .O. Box 12185 Nairobi |
| 2. NGENYE KARIUKI & CO.LTD. | P .O. Box 41684 Nairobi |
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Investment Advisors/Fund Managers

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<p>AIG Global Investment Co. (EA) Ltd</p> <p>ICEA Building</p> <p>P.O Box 67262</p> <p>NAIROBI</p> <p>Tel: 249444 - 7</p> <p>Fax: 249451</p>	<p>Genesis (K) Ltd Mngnt Ltd</p> <p>Lonhro Hse</p> <p>P.O Box 79212</p> <p>NAIROBI</p> <p>Tel: 251012</p> <p>Fax: 250716</p>	<p>C REATIVE FINANCE & PROVIDENT SERVICES LTD.</p> <p>Kenya Cinema Plaza</p> <p>P.O. BOX 57312</p> <p>NAIROBI</p> <p>TEL. 332299/337233</p> <p>FAX. 212681</p>
<p>Endeavour Securities Ltd</p> <p>NSSF Building, Eastern Wing Block A 12th floor</p> <p>P.O Box 62420</p> <p>NAIROBI</p> <p>Tel: 720848</p> <p>Fax: 721425</p>	<p>Amicable Investment Ltd</p> <p>Embassy Hse</p> <p>P.O Box 44033</p> <p>NAIROBI</p> <p>Tel: 243001</p> <p>Fax: 243055</p>	<p>CBA Capital Ltd</p> <p>Commercial Bank Building, Wabera Street 5th Floor</p> <p>P.O. Box 30437</p> <p>NAIROBI</p> <p>Tel: 228881</p> <p>Fax: 335827</p>
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<p>P.O Box 684 - 00606</p> <p>NAIROBI</p> <p>Tel: 020-4450520-4</p> <p>Email: dryassoc@wananchi.com</p> <p>Website: www.dryassociates.com</p>	<p>university Way</p> <p>P.O Box 39466</p> <p>NAIROBI</p> <p>Tel: 219015/219033</p> <p>Fax: 218992</p>	<p>Upper Hill</p> <p>P.O Box 11589</p> <p>NAIROBI</p> <p>Fax: 243251/246117</p> <p>Fax: 253226</p>
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<p>ICEA INVESTMENT SERVICES LTD</p> <p>ICEA BUILDING</p> <p>P.O. BOX 46143</p> <p>NAIROBI</p> <p>TEL. 340365/6</p> <p>FAX. 338089</p>	<p>Bridges Capital Ltd</p> <p>NO. 209/362 Lenana Road</p> <p>P.O Box 62341</p> <p>NAIROBI</p> <p>Tel: 714372/3</p> <p>Fax: 714657</p>	<p>TRADITION SECURITY (K) LTD.</p> <p>Fedha Towers</p> <p>P.O. BOX 49584</p> <p>NAIROBI</p> <p>TEL. 249634 / 249670</p> <p>FAX. 225694</p>
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