Portfolio Construction and Diversification, & Cytonn Weekly #32/2017

Disclaimer: The views expressed in this publication, are those of the writers where particulars are not warranted. This publication, which is in compliance with Section 2 of the Capital Markets Authority Act Cap 485A, is meant for general information only, and is not a warranty, representation, advice or solicitation of any nature. Readers are advised in all circumstances to seek the advice of a registered investment advisor.

Fixed Income: T-bill subscriptions improved during the week but remained undersubscribed for the 5th week in a row, coming in at 77.5%, compared to 40.5% recorded the previous week. The yields on the 91, 182 and 364-day papers remained unchanged at 8.2%, 10.3% and 10.9%, respectively;

Equities: During the week, the equities market was on an upward trend with NSE 20, NSE 25 and NASI gaining 5.3%, 4.4% and 4.3% taking their YTD performance to 24.8%, 24.7% and 23.7%, respectively. Family Bank released their H1'2017 results, recording a loss of Kshs 0.5 bn from a profit of Kshs 0.7 bn in H1'2016 attributed to a 37.0% decline in operating income, despite a 6.4% decline in operating expenses;

Private Equity: The private equity sector in the region remains robust with continued activity in the acquisitions and the fundraising fronts. During the week, three Danish Pension Funds; Pension Danmark, PKA and Medical Doctors' Pension fund, together with A.P. Moller Holding, a holding company of Danish Based Shipping Company, A.P. Moller-Maersk, have set up a fund that will invest in infrastructure developments in Arica while a South African based Africa Rainbow Capital (ARC), committed to an acquisition of 20% stake in Rain, a South African fixed and mobile network provider, at an undisclosed amount;

Real Estate: Buildings approvals by the Nairobi City County Planning Compliance & Enforcement Department, dropped by 16.3%, between 2016 and 2017, in the period between January and May, as per the Kenya National Bureau of Statistics (KNBS) Leading Economic Indicators Survey, June 2017 issue;

Focus of the Week: This week, we look at the process of portfolio construction and the role of asset allocation and portfolio diversification in investment decision-making.

Company Updates

- Our Managing Partner & C.E.O, Edwin H. Dande was featured on this week's Business Daily Life. See link
- Our Research Analyst, Nancy Murule, discussed the Realities and Opportunities in the Kenyan Real Estate Sector on Capital Markets Africa, August Publication. Read the article here
- We continue to showcase real estate developments by our real estate development affiliate, Cytonn Real Estate, through weekly site visits. Watch progress videos and pictures on The Alma, Amara and Taraji Heights. The site visits target both investors looking to invest in real estate directly, and also those interested in high yield investment

products to familiarize themselves with how we support the high yield returns. To deliver high yield returns, our cost of capital is priced off loan markets where all-in pricing ranges from 16% to 18% and our yield on real estate developments ranges from 23% to 25%, hence our topline gross spread is about 6%. If interested in attending the site visits, kindly register here

- We continue to see very strong interest in our Private Wealth Management training, which is at no cost, and is held bi-weekly, but is open only to pre-screened participants. The training can also be offered to institutions that would like their employees trained on Financial Planning. To get further details contact our Client Services team at clientservice@cytonn.com
- For recent news about the company, see our news section here
- We have 10 investment-ready projects, offering attractive development and buyer targeted returns of around 23% to 25.0% p.a. See further details here: Summary of investment-ready projects
- To invest in any of our current or upcoming real estate projects, please visit Cytonn Real Estate
    - The Alma, which is over 55.0% sold, has delivered an annualized return of 55.0% p.a. for investors who bought off-plan. See The Alma
    - Amara Ridge is currently 100.0% sold and has delivered over 20.0% p.a. returns to investors. See Amara Ridge
    - Situ Village is currently 15.0% sold. See Situ Village
    - The Ridge (Phase One) is currently 31.0% sold. See The Ridge
    - Taraji Heights is currently 10.0% sold. See Taraji Heights
    - RiverRun Estates (Phase One) is currently 8.7% sold after the recent launch. See RiverRun Estates
- We are currently looking for 5-10 acres in Kikuyu, Lower Kabete, Upper Kabete, Loresho or Mountain View, and 7-10 acres of land in Karen, Garden Estate and Langáta for development of villas. Contact us at rdo@cytonn.com if you have any land for sale or joint ventures in the above areas.
- We continue to beef up the team with ongoing hires: Careers at Cytonn

Fixed Income

During the week, T-bills were undersubscribed for the 5th week in a row, despite the overall subscription rate improving to 77.5% from 40.5% recorded the previous week. The subscription rates for the 91, 182 and 364-day papers came in at 29.2%, 95.1% and 79.2% compared to 39.8%, 47.0% and 34.3% the previous week, respectively. Yields on the 91, 182 and 364-day papers remained unchanged at 8.2%, 10.3% and 10.9%, respectively, while the 182-day paper remains the most attractive on a risk-return proposition. The overall acceptance rate came in at 99.6% compared to 94.3% the previous week, with the government accepting a total of Kshs 18.5 bn of the Kshs 18.6 bn worth of bids received, against the Kshs 24.0 bn, which was on offer in this auction.

There was a net liquidity injection of Kshs 24.3 bn this week compared to a net withdrawal of Kshs 1.3 bn the previous week, on account of government payment and T-bill redemptions.

Despite the improved liquidity position in the money market, the average interbank rate rose to 10.5% from 8.2% the previous week, attributable to skewed liquidity position in the market. The average volumes traded in the interbank market rose by 5.8% to Kshs 29.1 bn, from Kshs 27.5 bn the previous week. There was some T-bill rediscounting of Kshs 0.2 bn, which indicates that there are some players that faced significant liquidity challenges since rediscounting is very punitive and is usually done at the prevailing yields plus 3.0% points thus making the value of the discounted T-bills much lower than their market value.

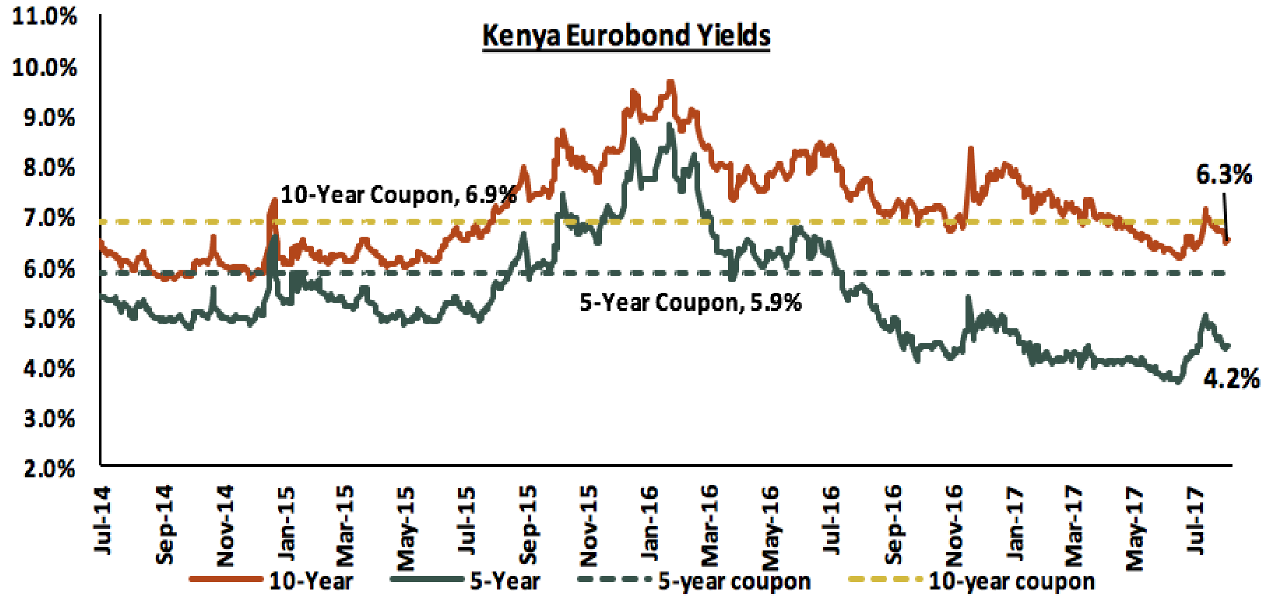
Below is a summary of the money market activity during the week:

all values in Kshs bn, unless stated otherwise

Weekly Liquidity Position – Kenya			
Liquidity Injection		**Liquidity Reduction**	
Government Payments	38.7	Transfer from Banks - Taxes	19.4
T-bill Redemption	26.3	T-bill (Primary issues)	9.2
T-bill Rediscounts	0.2	Reverse Repo Maturities	2.5
Reverse Repo Purchases	2.2	Term Auction Deposit	10
Repos Maturities	5.0	OMO Tap Sales	7.0
Total Liquidity Injection	**72.4**	**Total Liquidity Withdrawal**	**48.1**
		Net Liquidity Injection	**24.3**

For the month of August, the government has issued a 5-year bond (FXD 1/2017/5) and re-opened a 10-year bond (FXD 1/2017/10) in a bid to raise Kshs 30.0 bn for budgetary support. The bonds have effective tenors of 5.0 years and 9.9 years, respectively. The government is behind on its domestic borrowing target for the current fiscal year, having borrowed Kshs 13.6 bn against a target of Kshs 36.7 bn (assuming a pro-rated borrowing target throughout the financial year of Kshs 317.7 bn budgeted for the full financial year). We expect investors to bid at a premium above the secondary market yields, which are at 12.3% and 13.0% for the 5.0-year and 9.9-year bonds, respectively, and we would therefore bid at a range of between 12.3% - 12.5% for the 5.0-year bond, and 13.0%-13.3% for the 9.9-year bond.

According to Bloomberg, yields on the 5-year and 10-year Eurobonds, with 2-years and 7-years to maturity, declined by 10 bps and 20 bps, respectively, to close at 4.2% and 6.3%, from 4.3% and 6.5% the previous week, respectively despite the fact that the country was conducting its general elections this week. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.6% points and 3.3% points for the 5-year and 10-year Eurobonds, respectively, due to stable macroeconomic conditions in the country. The declining Eurobond yields and stable rating (Fitch Ratings having affirmed Kenya’s long-term foreign and local currency issuer default ratings (IDRs) at “B+”), are indications that Kenya’s macro-economic environment remains stable and hence an attractive investment destination.



The Kenya Shilling remained relatively stable during the week to close at Kshs 103.9, despite having hit a low of Kshs 104.0 on the eve of elections, due to last minute dollar demand from oil and retail importers. On a year to date basis, the shilling has depreciated against the dollar by 1.4%. The relative stability is because the dollar has also been depreciating against the other major currencies. Against the Euro, Yen and the Pound, the shilling has lost 13.8%, 8.6% and 6.8% YTD, respectively. The significant depreciation against the Euro, Yen and Pound is mainly because these currencies have appreciated against the Dollar as a result of weakening economic fundamentals in the US compared to the Eurozone, UK and Japan that have pushed further the expected path for the US interest rate hike cycle. In our view, the shilling should remain relatively stable to the dollar in the short term, supported by CBK's activity; with the forex reserve levels currently at USD 7.4 bn (equivalent to 4.9 months of import cover) but we have seen forex reserves decline significantly from USD 8.3 bn at the pick in April this year.

According to the June 2017 Leading Economic Indicators report by the Kenya National Bureau of statistics (KNBS), the economic indicators under review points towards a stable economy given;

- volume of trade rose by 17.4% m/m to Kshs 204.1 bn in May from Kshs 173.9 bn in April, compared to a decline of 3.2% the same period last year,
- the quantity of coffee exported rose by 29.1% m/m to 5,423.7 MT in May, from 4,200.8 MT in April despite the quantity of coffee auctioned at the Nairobi Coffee Exchange (NCE) declining by 64.1% m/m to 1,639.2 MT from 4,562.8 MT over the same period,
- the quantity of tea produced increased by 4.4% m/m to 40,538.0 MT in May, from 38,822.0 MT in April, with the quantity of tea exported rising by 22.6% m/m to 39,328.8 MT, from 32,091.19 MT over the same period,
- total imports increased by 17.3% to Kshs 154.4 bn in May from Kshs 129.1 bn in April, while exports increased by 17.6% to Kshs 52.7 bn, from Kshs 44.8 bn over the same period, indicating a stabilized balance of trade position,

- tourist arrivals remained relatively flat at 67,531 in May compared to 67,084 in April, and
- the Broad Money Supply (M3), a key indicator for monetary policy formulation, increased by 2.2% m/m to Kshs 2,920.5 bn in June, from Kshs 2,857.8 bn in May, which indicated that the money supply is not inflationary as the inflation rate declined from 11.5% to 9.2% over the same period.

We still believe that the economy will remain stable in 2017, bearing in mind that the data released by KNBS points towards a stable outlook. Despite the stable review in the month, we expect to see a slower growth from last year due to a slowdown in agriculture and financial Intermediation, and we have seen the World Bank and IMF revise downwards the projections for this year to 5.5% and 5.3%, respectively. As per our Kenya 2017 GDP Growth and Outlook, we project that the economy will grow by 4.7%-5.2%% this year.

The country held its general election this week, which was relatively peaceful with the Independent Electoral and Boundaries Commission (IEBC) undertaking its mandate with utmost diligence and transparency as per our expectations as highlighted in our focus note on the Post-Election Business Environment. Recently we have seen businesses go about their normal activities with caution and thus there has been subdued activity over the past one week but we expect this to normalise in the coming week as post-election fears and uncertainty dissipates, the president elect gets sworn in, and the government takes charge.

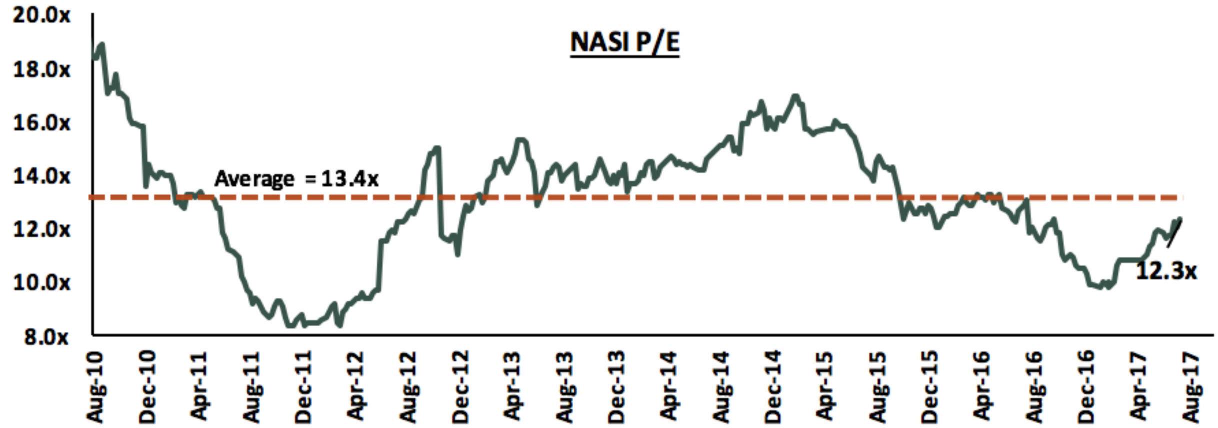
Rates in the fixed income market have remained stable, and we expect this to continue in the short-term. However, a budget deficit that is likely to result from depressed revenue collection creates uncertainty in the interest rates environment as any additional borrowing in the domestic market to plug the deficit could lead to upward pressures on interest rates. Our view is that investors should be biased towards short- to medium term fixed income instruments to reduce duration risk.

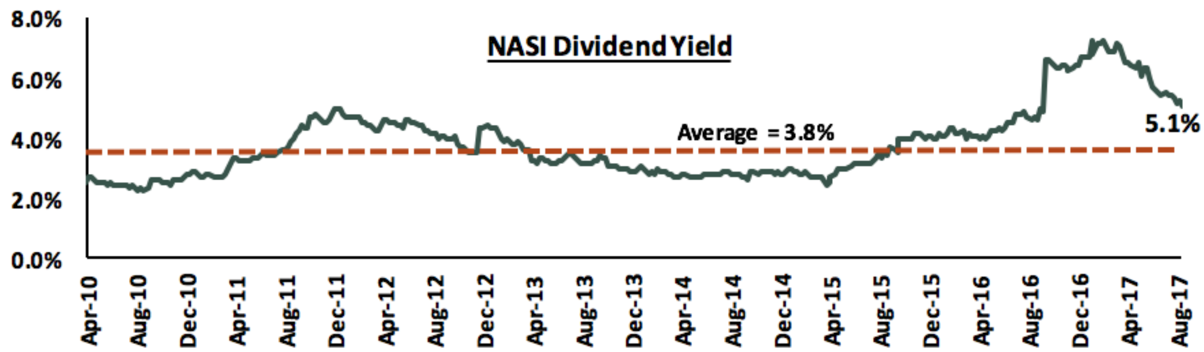
Equities

During the week, the equities market defied the elections and was on an upward trend with NSE 20, NSE 25 and NASI gaining 5.3%, 4.4% and 4.3%, respectively, taking their YTD performance to 24.8%, 24.7% and 23.7%, respectively. This week's performance was driven by gains in select large cap stocks such as Equity Group, KCB Group and Safaricom, which gained 7.5%, 7.4% and 4.3%, respectively. Since the February 2015 peak, the market has lost 7.0% and 27.7% for NASI and NSE 20, respectively.

Equities turnover declined by 45.4% to close the week at USD 26.7 mn from USD 48.9mn the previous week. Foreign investors remained net sellers with a net outflow of USD 0.8 mn compared to a net outflow of USD 10.0 mn recorded the previous week. Foreign investor participation increased to 75.5% from 56.9% recorded the previous week. We expect the market to remain bullish despite the slower corporate earnings growth in 2017 and investor sentiment to be neutral as investors take advantage of the low stock valuations.

The market is currently trading at a price to earnings ratio (P/E) of 12.3x, versus a historical average of 13.4x, and a dividend yield of 5.1%, compared to a historical average of 3.8%. The current P/E valuation of 12.3x is 26.6% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 47.8% above the previous trough valuation of 8.3x experienced in December 2011. The charts below indicate the historical P/E and dividend yields of the market.





Family Bank released H1’2017 results

Family Bank released their H1'2017 results, recording an after tax loss of Kshs 492.5 mn from a profit after tax of Kshs 711.5 mn in H1'2016. This is attributable to a 37.0% decline in total operating revenue to Kshs 3.0 bn from Kshs 4.8 bn in H1'2016, despite a 6.4% decline in total operating expenses to Kshs 3.6 bn from Kshs 3.8 bn in H1'2016. Key highlights for the performance from H1’2016 to H1’2017 include:

- Total operating income declined by 37.0% to Kshs 3.0 bn from Kshs 4.8 bn attributed to 45.2% and 14.6% decline in Net Interest Income (NII) and Non-Funded Income (NFI), respectively,
- Net interest income (NII) declined by 45.2% to Kshs 2.0 bn from Kshs 3.6 bn in H1'2016, on account of a 44.7% decline in interest income to Kshs 3.3 bn from Kshs 6.0 bn in H1'2016, despite a 44.0% decline interest expense to Kshs 1.4 bn from Kshs 2.5 bn

in H1'2016. The Net Interest Margin (NIM) declined to 9.2% from 10.0% in H1'2016. The decline in Interest Income is mainly attributed to a 24.1% decline in the loan book to Kshs 43.8 bn from Kshs 57.8 bn and a reduction in NIM given the current loan pricing framework capped at 4.0% above the Central Bank Rate,

- Non-Funded Income declined by 14.6% to Kshs 1.1 bn from Kshs 1.2 bn. The decline in NFI was as a result of a 45.2% decline in fees and commissions on loans to Kshs 0.2 bn from Kshs 0.3 bn in. The current revenue mix stands at 64:36, Funded to Non-Funded Income from 73:27 in H1'2016, against an industry average of 69:31
- Total operating expenses declined by 6.4% to Kshs 3.6 bn from Kshs 3.8 bn on account of a 24.6% decline in staff costs to Kshs 1.1 bn from Kshs 1.4 bn in H1'2016 bn. Loan Loss Provisions (LLP) however increased by 30.9% to Kshs 0.4 bn from Kshs 0.3 bn,
- Cost to Income ratio (CIR) worsened to 115.9% from 78.0% in H1'2016. Without LLP, the CIR worsened to 103.1% from 71.9%. This is attributable to a 37.0% decline in total operating revenue which outpaced a 6.4% decline in total operating expenses,
- Loss before tax came in at Kshs 0.5 bn from a profit of Kshs 1.1 bn, while loss after tax came in at Kshs 0.5 bn from a profit of Kshs 0.7 bn,
- The balance sheet recorded a contraction, with total assets declining by 13.4% to Kshs 69.5 bn from Kshs 80.2 bn, attributed to a 24.1% decline in the loan book to Kshs 43.8 bn from Kshs 57.8 bn, despite a 61.9% increase in government securities to Kshs 9.2 bn from Kshs 5.7 bn in H1'2016,
- Total Liabilities declined by 15.9% to Kshs 57.2 bn from Kshs 68.1 bn in H1’2016 attributed to a decline in customer deposits by 13.2% to Kshs 47.6 bn from Kshs 54.8 bn in H1’2016, and a 21.2% decline in borrowings to Kshs 8.8 bn from Kshs 11.1 bn in H1'2016,
- The faster decline in loans compared to deposits led to a decline in the Loan to Deposit ratio to 92.1% from 105.4% in H1'2016,
- Family Bank Group is currently sufficiently capitalized with the core capital to risk weighted assets ratio at 17.7%, 7.2% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 6.9% to close the period at 21.4%,

Family Bank has been experiencing a decline in interest income, with the decline in credit growth resulting in lower net margins from lending. In addition, the bank has not seen a pickup in Non Funded Income, with the fees it earns from loans being the hardest hit, declining by 45.2% to Kshs 169.9 mn from Kshs 310.0 mn in H1'2016. The performance of Family Bank could be attributed to the run suffered late last year owing to misleading allegations that the lender would be closed by the Central Bank of Kenya (CBK), and it seems to have not fully recovered from the flight. In our view, banks will still find it difficult to operate in this environment since pricing of risk has been limited to 4.0% above the Central Bank Rate. However, in a bid to reduce operating expenses and improve efficiency, we expect more emphasis on innovation, and agency banking, which will be a key driver for revenue diversification and efficient distribution channels.

Housing Finance Group has raised Kshs 3.0 bn in debt for an undisclosed tenor from international investors. The bank is expected to channel the debt towards general expense financing and in repaying the first tranche of the medium term note it issued in October 2010, worth Kshs 7.0 bn maturing on 2nd October 2017, which was used to fund business growth. Prior to issuing this debt, the bank had struggled with liquidity, which was at 21.4% in Q1'2017, 1.4% above the statutory requirements, and repayment of the bond would have put additional strain on the bank's liquidity position. Given the additional debt funding, and liquid investments in cash and government securities amounting to Kshs 4.2 bn at Q1'2017, we are of the view that the bank will be able to repay the principal to bondholders and still remain sufficiently liquid to fund its operations.

According to the Capital Markets Soundness Report for the second quarter of 2017 by the Capital Markets Authority (CMA), CMA is in the process of developing a framework to ensure that all private offer transactions are made known to the authority. This implies that companies seeking to raise cash through sale of shares or short-term debt through private placements will be required to notify the regulator. CMA indicated in the report that the level of activity from private offerings market has been limited despite its significant potential for funding cash-strapped firms. This framework will see CMA enforce provisions in section 30c of the Act, which require that the Authority is notified through information notices by issuers raising funds through private offers. As such the regulator will be able to track the level of activity in the private space, and monitor trends driving the market. In our view, the impact of this framework will only be clear with time. On one hand, it can boost investor protection, as the regulator will be in a position to warn the public against investing in distressed companies. However, on the other hand, it can just serve to reduce the level of private offerings. Note that in advanced economies, the banks only fund 40% of business financing needs, with the balance, 60% coming from alternative and capital markets sources. In Kenya, the bank funding is at 95%, with alternative and capital markets funding accounting for only 5%, it is therefore imperative that we catalyse the alternative and capital markets funding, and increased regulation in that sector may not necessarily catalyse the alternatives and capital markets funding. Other key highlights that stood out in the report in regards to capital markets include market concentration risk, which as at June 2017, the top 10 listed companies in terms of market capitalization accounted for 80.5 % of the total market capitalization. We concur with the authority that this presents market concentration risk that needs to be addressed; the authority needs to take steps in conjunction with industry players to broaden the market in order to mitigate this risk through more listings of large cap entities or significant numbers of smaller and medium cap companies. In addition to making it easier to list, the timelines for approvals and turn around on engagements needs to be clear and predictable. As highlighted in our Cytonn Weekly #28/2017, the Capital Markets Authority (CMA) has done a fantastic job spearheading the introduction of new products such as Global Depositary Receipts and Global Depositary Notes thus providing faster and more convenient link to the market hence enabling market participants to exercise freedom of choice, which will in turn increase turnover. The market would also like to see more emphasis in expanding existing products.

Below is our Equities Universe of Coverage

all prices in Kshs unless stated otherwise								
No.	**Company**	**Price as at 04/08/17**	**Price as at 11/08/17**	**w/w Change**	**YTD Change**	**Target Price***	**Dividend Yield**	**Upside/ (Downside)****
1.	NIC	32.0	36.5	14.1%	40.4%	51.2	3.9%	44.2%
2.	KCB Group***	40.5	43.5	7.4%	51.3%	54.0	7.4%	31.5%
3.	I&M Holdings	115.0	115.0	0.0%	27.8%	147.5	3.1%	31.4%
4.	DTBK	182.0	189.0	3.8%	60.2%	241.1	1.7%	29.3%
5.	Barclays	9.6	10.6	10.4%	25.0%	12.1	10.4%	24.6%
6.	HF Group	10.5	11.6	10.5%	(17.1%)	13.9	3.5%	23.4%
7.	Co-op Bank	15.6	16.2	3.9%	22.3%	18.5	5.0%	19.5%
8.	Jubilee Insurance	435.0	470.0	8.0%	(4.1%)	490.5	1.8%	6.2%
9.	Stanbic Holdings	80.0	81.0	1.3%	14.9%	77.0	5.9%	0.9%
10.	Kenya Re	21.5	22.0	2.3%	(2.2%)	20.5	4.4%	(2.4%)
11.	Liberty	12.8	13.5	5.9%	2.3%	13.0	0.0%	(3.9%)
12.	StanChart	221.0	230.0	4.1%	21.7%	209.3	4.7%	(4.3%)
13.	Equity Group	39.8	42.8	7.5%	42.5%	38.4	5.0%	(5.1%)
14.	Britam	14.2	14.9	5.3%	49.0%	13.2	1.8%	(9.6%)
15.	Safaricom	23.5	24.5	4.3%	27.9%	19.8	4.7%	(14.6%)
16.	Sanlam Kenya	27.5	27.8	0.9%	0.9%	21.1	0.0%	(24.1%)
17.	CIC Group	5.0	5.6	13.1%	47.4%	3.7	3.2%	(30.6%)
18.	NBK	9.6	11.0	15.2%	52.8%	4.0	0.0%	(63.5%)

**Target Price as per Cytonn Analyst estimates*

***Upside / (Downside) is adjusted for Dividend Yield*

****For full disclosure, Cytonn and/or its affiliates holds a significant stake in KCB Group, ranking as the 5th largest local institutional investor*

We remain "neutral with a bias to positive" for investors with short to medium-term investments horizon and are "positive" for investors with a long-term investment horizon.

Private Equity

On the Fundraising front

Three Danish Pension Funds; Pension Danmark, PKA and Medical Doctors' Pension Fund, together with A.P. Moller Holding, a holding company of Danish Based shipping company, A.P. Moller-Maersk, have set up a fund that will invest in infrastructure development in Africa, focused in the transport and energy sector. The fund has received USD 550.0 mn in commitments from the partners and targets to achieve a total of USD 1.0 bn in commitments in the next 12 months. The fund targets to fund 10-15 infrastructural projects in the next decade and will be managed by former Maersk management members who have had experience in investments across Sub-Saharan African countries such as Nigeria and Ghana. Infrastructure investments remains an attractive venture given that in April 2017, Frontier Investments Management, a Danish private equity firm, raised USD 116.0 mn in the first close of its second fund, Frontier Energy II. The Fund is to finance greenfield renewable energy projects across the Sub-Sahara Africa region.

Acquisitions

Africa Rainbow Capital (ARC), a South African financial services firm, has committed to acquire 20% stake in Rain, a South African fixed and mobile network provider, for an undisclosed amount. The acquisition will (i) expand ARC's presence in the telecommunication sector, having acquired 18.1% of Metrofibre, a South African based telecommunication company, in March 2016, and (ii) assist Rain to implement its expansion strategy to achieve 5,000 base station sites in South Africa in the next 3-years. The telecommunications sector remains robust in Sub- Sahara Africa as we witnessed the acquisition of 60% stake in Telkom Kenya Limited by Helios in June 2016. The growth in the sector is being supported by (i) improved regulatory frameworks by the relevant authorities that support competition hence growth in the sector, and (ii) growth of the middle class population with increasing numbers seeking quality voice and data services.

Private equity investments in Africa remains robust as evidenced by the increased deals. The increasing investor interest is attributed to (i) rapid urbanization, (ii) a resilient and adapting middle class and increased consumerism, (iii) the attractive valuations in Sub-Saharan Africa markets compared to global markets, and (iv) better economic projections in Sub Sahara Africa compared to global markets. We remain bullish on PE as an asset class in Sub-Sahara Africa. Going forward, the increasing investor interest and stable macro-economic environment will continue to boost deal flow into African markets.

Real Estate:

During the week, Kenya National Bureau of Statistics released the leading economic indicators survey for June 2017. As per the report, the value of approved buildings declined significantly to Kshs 105.7 bn in the period January to May 2017, from Kshs 126.3 bn in the same period last year, representing a 16.3% drop. As per our earlier topical, Effects of the Election in the Real Estate Environment in Kenya, investors have a tendency to take a wait-and-see approach during the election period, hence the decline.

As shown below, the value of approved residential buildings experienced a 21.8% drop to Kshs 58.1 bn from Kshs 74.3 bn in 2016. Additionally, the value of non-residential approvals saw a decline of 8.5% to Kshs 47.6 bn from Kshs 52.0 bn in 2016. We attribute this mainly to i) reduced investment from the risk-averse investors due to the elections period, ii) constrained credit advancement from lending institutions and iii) the oversupply in certain themes like commercial office which as per our annual Cytonn Office Report, approximated an oversupply of 3.2 mn sqft of office space in 2017.

Below is a table showing value of approved building:

Year	Residential	Non-Residential	Aggregate	Change
2013	40,006	37,756	**77,762**	24.5%
2014	44,723	32,866	**77,589**	(0.2%)
2015	52,717	28,586	**81,303**	4.8%
2016	74,269	52,040	**126,309**	55.4%
2017	58,063	47,623	**105,686**	(16.3%)

From the table, building approvals for both sectors experienced the highest peak at 2016 and experiencing a sharp drop in 2017. This could be attributed to the prevailing tough macroeconomic conditions such as the interest rates cap law. However, the approvals had the highest increase in 2016 with a 55% growth, attributable to the great demand for affordable housing and availability of corporate tax relief for developers of the same as well as a growing economy and population.

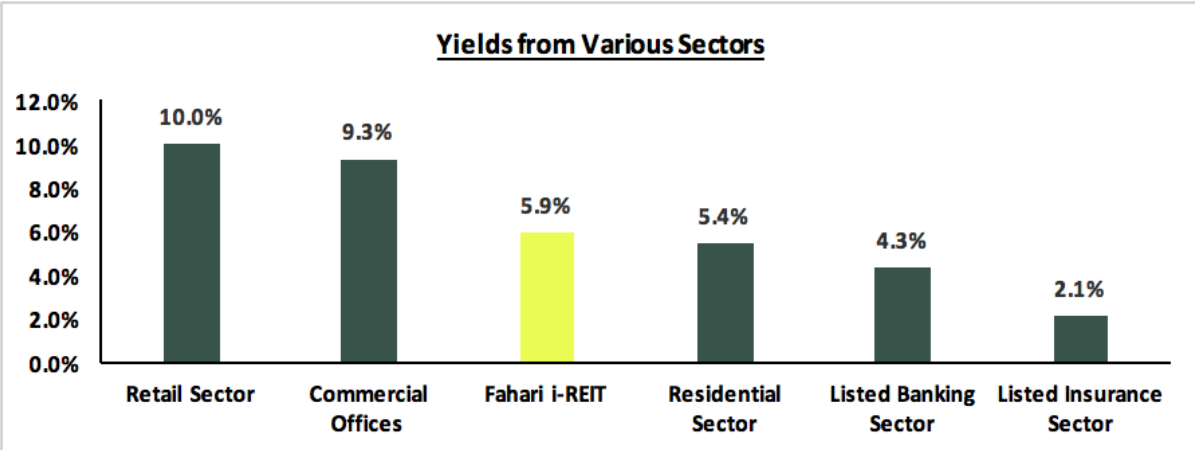
Source: KNBS Data

The decline in activity, however, is only temporary, and we expect it to stabilize in the near-term and increase in the medium-term, supported by the positive prospects of the real estate sector, which include i) large and growing population, ii) expanding middle class, iii) increased foreign investor participation, and iv) demand for institutional grade development properties, all pointing towards increased real estate development. The residential sector should resume its positive growth curve as well due to the increased incentives from the government to encourage developers to provide housing solutions.

Listed Real Estate

Stanlib Fahari I-REIT, on 31st July 2017, released their H1'2017 earnings, posting earnings per unit of Kshs 0.43 for the 6-month period ending June 2017 realizing a 220.8% y/y growth from Kshs 0.13 in H1'2016. This was mainly attributable to a 30.0% decline in operating expenses to Kshs 112.5 mn from Kshs 160.8 mn in H1'2016 and a 14.2% increase in rental income to Kshs 138.0 mn from Kshs 120.9 mn in H1'2016 attributed to the rental income generated by the 3 real estate assets they manage; Greenspan Mall, Bay Holdings and Signature International Properties. The decline in expenses was because of the one-off set up and listing costs such as promotional and marketing expenses incurred in H1'2016, In addition, the REIT has no debt, thus no financing costs compared to the previous period, which had Kshs 23.0 mn in financing costs. The REIT manager did not recommend the distribution of an interim dividend. From our projections, the REIT has a 5.9% dividend yield at market price, assuming a 92% pay-out from its distributable earnings, similar to the 2016 dividend pay-out. This is an improvement from the last year performance, which saw the REIT deliver a yield of 4.3 %. However, this is still low compared to the market average of 10.0% rental yield for retail space and 9.3% yield for office space.

The graph below shows a comparative analysis for pre-tax yields for various sectors against the I-REIT'S.



**Banking and Insurance Sector calculated as dividend yield weighted by Market Capitalization*

**Residential sector calculated excluding a 10% property management fee*

**Retail and Office sector yields calculated from rent excluding service charge*

**Fahari i-REIT dividend yield calculated as 92% pay-out from projected 2017 earnings as a percentage of price as at 11th August 2017*

For a more comprehensive analysis, see our [Stanlib Fahari REIT Earnings' Note here](#).

We expect the real estate sector to stabilize once the government settles down and further supported by continued interest from multinational firms, improvement in the legal environment and the growth of the country's GDP.

Focus of the Week: Portfolio construction and diversification

As investors, we all want our investments to grow and deliver higher risk adjusted returns despite the prevailing economic environment brought about by the cyclical nature of investments markets due to varying macroeconomic factors like politics, inflation, country growth and others. For long-term successful investment, it is important for an investor to have and adhere to an investment plan, and one fundamental pillar of that plan should be an asset allocation that ensures portfolio diversification, and which is aimed at attaining the investors' objectives.

So how do we go about constructing a diversified portfolio? To start off, we first have to consider an analysis of the investor's investment objectives and constraints in order to inform the investment strategy. This planning step involves taking a number of factors into consideration, but primarily the following 7 factors:

i. **Risk:** This is the probability that an investment may not earn its expected rate of return. For investors, it is of paramount importance to figure out your risk tolerance level i.e. your capacity to take on risk, and not just your willingness to bear risk. Generally, the approach is usually to conform to the lower of the investor's ability or willingness to take on risk,
ii. **Return:** This is the expected earnings from an investment; they include dividend, interest, rent, capital appreciation etc. To get return is an investor's 'raison d'etre'; the reason why people invest. Generally, the higher the risk an investor takes on, the higher the expected return, and the lower the risk, the lower the expected return,
iii. **Liquidity:** This refers to how quickly an asset can be converted into cash without a significant loss in value. An investor who requires regular cash flow to fund possible spending needs may require liquid assets to be held in their portfolio,
iv. **Investment Horizon:** This refers to the period that an investor intends to hold an investment and it is dependent on the investors' income needs and risk exposures. In general, the longer an investor's time horizon, the more risk and less liquidity the investor can accept in the portfolio,
v. **Sophistication of the Investor:** This refers to how knowledgeable an investor is in terms of investment products and their capacity to invest. Usually, investment products are classified into retail investment products and institutional investment products, with some investment products being suitable for all classes of investors, while others are tailor made to target a specific class of investors,
vi. **Tax situation:** The tax treatment of various types of investments is also a consideration in portfolio construction. Some investment accounts like pension accounts may be tax exempt, hence investors with such accounts can choose fully taxable securities to hold in their portfolios. For accounts that are fully taxable, investors may opt for investment securities that are taxed at lower rates, e.g. investing in equities for capital gains that are usually tax exempt or taxed at lower rates,
vii. **Unique circumstances:** Each investor may have specific preferences or restrictions on which securities and assets that they can invest. These can range from ethical preferences, religious preferences or restrictions placed on investing in rival companies.

After analyzing an investor's investment constraints, the next step is to construct the investment portfolio, taking into account the need to diversify. Diversification is a risk management technique that aims to minimize risk in a portfolio by spreading investments across a range of securities and asset classes, with the notion that a single negative event will not adversely affect all securities held in the same way and to the same degree. Diversification comes from the time-tested analogy - "don't put all your eggs in one basket". The rationale behind this contends that a portfolio constructed of different kinds of investments will, on average, yield higher returns and pose a lower risk than any individual investment within the portfolio. Where an investor has significant conviction on a certain asset class or security then one can hold a more concentrated portfolio.

In order to diversify your portfolio, you can invest in a variety of asset classes, which include:

1. **Fixed Income:** Fixed income securities are securities that promise to pay a given return to an investor, in the form of coupon payments and repayment of principal on maturity.

These securities include Treasury bonds and bills, corporate bonds, corporate debt issues and fixed deposits in financial intuitions. Fixed income securities constitute the largest investable asset class, with a large number of institutions and investors participating in the loaning out and borrowing of funds in fixed income markets. Key characteristics of fixed income securities that make this asset class appeal to investors under various macroeconomic conditions include:

i. Fixed income securities cover short to medium term investment horizons, and exhibit low volatility, as the payments are defined and periodic, and hence suited to investors who desire stable returns and are risk averse. This makes fixed income securities desirable during periods of uncertain economic performance and more so Treasury instruments,
ii. Interest rate risk- Fixed income securities are highly susceptible to changes in interest rates, due to the value of such securities falling with rising interest rates as the opportunity cost of holding such a security declines. Thus, when interest rates are rising, more investors are attracted to the fixed income market owing to higher yields.

The main thing to get right is to ensure that at all times the investors understands the risk levels of the issuer and ensure their ability to pay is sound.

2. **Equities:** Equities refer to ownership of interest in an entity in form of common or preferred stock. Investors who wish to acquire a stake in a certain company do so by buying shares from the company during an Initial Public Offer or from existing shareholders who wish to offload their investment. Other than capital gains, equity investors also stand to gain from dividends declared by a company if they are in the shareholders' register at the time of book closure. Key characteristics of equities that make this asset class appeal to investors under various macroeconomic conditions include:

i. Liquidity- Listed shares are relatively liquid in that investors can easily convert their investment into cash for immediate use within a short period depending on the trading settlement cycle and investors can easily accumulate and exit their positions without a significant loss in their invested value,
ii. Volatility- Shares are the most volatile asset class as market forces of demand and supply determine the value of a stock. This characteristic makes equities preferable for long-term investors who can hold the stock through the short-term volatility, until the stock price attains its intrinsic value. This characteristic also makes equities appealing when there is positive macroeconomic news as optimism among investors usually results in a rise in stock prices.

As investors buy into companies, they should ensure that they understand the long-term prospect of the company and they buy in at the right valuations. Always good to know that a good company does not automatically translate to a good stock, and conversely, a bad company does not automatically translate to a bad stock, we have to factor in valuations.

3. **Real Estate:** Real estate is an attractive alternative investment, offering investors the chance to get long-term, stable and attractive returns, which also provide a hedge for

inflation. Investment in real estate refers to investment in property for returns, which could either be residential, commercial, retail, hospitality, medical properties, among others. Investment in real estate is in the form of (i) development of real estate to get returns and profits from the development, (ii) investment in completed developments for yield and capital appreciation, and (iii) investment in listed real estate through a Real Estate Investment Trust (REIT) or listed real estate company. Real estate is suitable for long-term investors, with the returns being more attractive as compared to other asset classes. Key characteristics of real estate that make this asset class appeal to investors under various macroeconomic conditions include:

i. Diversification – The inclusion of alternative investments in an investment portfolio tends to result in lower overall volatility of the portfolio, as the portfolio benefits from a greater selection of investment options. In addition, real estate investments do not move in tandem with the public listed markets, hence has low correlation with traditional investments, a factor that further enhances diversification benefits if part of your investment is in real estate.
ii. Superior Returns - Alternative investments have historically outperformed traditional investments. For example, real estate which is an alternative investment asset class, has consistently proven to outperform other asset classes in Kenya, as in the last five years it is projected to have generated returns of 25% p.a., compared to an average of 12.2% p.a. in the traditional asset classes.

4. **Structured products:** Structured products are investments that require one to identify certain market anomalies and within the regulations come up with a product that helps investors attain the best returns. Structured products are supported by the performance of an underlying asset, and the structuring involves adding layers or features to traditional products in a form that meets an investor's needs, which would not be met from the standardized financial products broadly available in the market. Generally, they are traded in the private markets to qualified or sophisticated investors through alternative investment managers such as private equity managers.
5. **Others:** Derivatives and Private equity investments are other types of investments. Though complex, they have the potential of delivering higher than average returns on a risk-adjusted basis.

Diversification has many proven benefits, however, it does not guarantee an investor protection against a loss. In addition, diversification does not reduce the systematic risk of investing in a particular market. This systematic risk is what is referred to as non- diversifiable risk or market risk. It is the risk not associated to a particular company or industry. Non- diversifiable risks include (i) inflation rate risk, (ii) exchange rate risk, (iii) political instability risk, and (iv) interest rate risk. They are the risks investors must accept willingly in order to invest.

In conclusion, the potential complexity associated with considering all these factors in an investment strategy requires a disciplined approach. This can be challenging especially if you are not involved in investment management on a daily basis and hence the need to partner with an investment professional, who will assist in coming up with your own specific investment portfolio. The first step could be the generation of an Investment Policy Statement (IPS). The

IPS serves as a strategic guide to the planning and implementation of an investment program, and is highly customized to meet specific investors' investment constraints. The investment professional should also help with the actual construction of the portfolio and security picking. In addition, the investment professional will periodically review your portfolio to allow for rebalancing back to your target allocation. Investors should take an active role in managing the portfolio to analyze their individual investments and determine if they are worth holding, since a well-diversified portfolio reduces risk without sacrificing returns. At all times investors should have an inquisitive approach to investments to ensure the partner understands where they want to get to and if there are any changes in circumstances, they are captured quite early.

On the run up to the elections we saw many investors taking a wait and see approach to investment, with most of them holding cash and cash equivalent investments, which have lower risk and stable returns. However, some investors saw this as an opportunity to jump in on the perceived riskier assets like equities and real estate at an attractive price. As can been seen from the performance of the equities market, the index has really gone up with NASI increasing by 4.3% during the week, and we expect to see a strong come back in the real estate sector as well.

For investors, getting the right investment partner is key to achieving one's investment goals. Also making the right investment decision at the right time goes a long way alongside diversification in getting the best returns.