A Presentation on Diversifying Portfolios with Alternative Assets: Strategies and Best Practices

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PRESENTATION OVERVIEW

1. CMA Mandate
2. Alternative Investments
3. Alternative Investments Fund
4. Licensed Players

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CMA's Mandate (Securities and Commodities Market)

1. Licensing and supervising securities and commodities market intermediaries
2. Promoting market development
3. Ensuring proper conduct of all licensed persons and market institutions
4. Promoting investor education and public awareness
5. Regulating the issuance of the securities and/or trading commodities market products/ instruments.

Alternative Investments

Alternative investments are financial assets that fall outside the traditional categories of stocks, bonds, and cash.

These types of investments are often less regulated, can be more or less liquid, and less correlated with traditional markets, making them a useful tool for diversification.

They include: commodities, derivatives, real estate, hedge funds, private equity etc.

Below is an overview of common types of alternative investments.

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Commodities

Commodities are raw materials or primary agricultural products that can be bought and sold. They fall into two main categories:	**Hard commodities**: These include natural resources like oil, gold, silver, copper, and natural gas.
	Soft commodities: These are agricultural products like wheat, corn, coffee, cotton, and livestock
Benefits:	**Hedge Against Inflation:** Commodities, (e.g. gold), are often seen as a store of value when inflation is high. As prices for goods and services rise, the value of commodities may increase.
	Diversification: Commodities typically have a low correlation with traditional stocks and bonds. Thus, they can help reduce overall portfolio risk by providing exposure to a different asset class that may perform well when other investments are struggling.
	Speculation and Profit Potential: Investors can profit from the price changes in commodities due to factors like weather, geopolitical instability, or changes in supply-demand conditions.
Risks:	**Price Volatility:** Commodities can be extremely volatile, influenced by unpredictable events such as weather changes, geopolitical tensions, or shifts in global demand.
	Market Liquidity: Some commodity markets can be illiquid, making it difficult to buy or sell positions at the desired price.
	Storage and Maintenance Costs: For physical commodities, storage and insurance can add significant costs.

Commodities Cont'd

Top global Commodities Exchanges include:

1) Chicago Mercantile Exchange (CME)
2) New York Mercantile Exchange (NYMEX)
3) Intercontinental Exchange (ICE)
4) London Metal Exchange (LME)
5) Tokyo Commodity Exchange

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Private Equity

Investments in private companies or buyouts of public companies to delist them from stock exchanges. Subcategories include:

- **Venture Capital**: Early-stage investments in startups with high growth potential.
- **Growth Equity**: Funding established companies to expand or restructure.
- **Buyouts**: Acquiring control of a company.

Hedge Funds

A hedge fund is a pooled investment fund that holds liquid assets and that makes use of complex trading and risk management techniques to improve investment performance and insulate returns from market risk.

Pooled funds are managed using various strategies to earn active returns for investors. Strategies may include:

Long/Short Equity: Buying undervalued stocks and short-selling overvalued ones.

Event-Driven: Investing based on corporate events like mergers or bankruptcies.

Global Macro: Capitalizing on macroeconomic trends through various asset classes.

Key Features of Hedge Funds:

Flexibility in Investment Strategies: Hedge funds use diverse strategies, including long/short equity, global macro, arbitrage, distressed securities, and more. They can invest in a wide range of assets, such as stocks, bonds, commodities, derivatives, real estate etc.

Leverage: Hedge funds frequently use borrowed money (leverage) to amplify returns, which also increases risk.

Accredited Investors: They are limited to wealthy individuals and institutional investors due to regulatory requirements. This often includes investors with high net worth or significant financial sophistication.

Hedge Funds Cont'd

Benefits of Hedge Funds

Potential for high returns in both rising and falling markets.

Diverse investment opportunities and strategies.

Skilled fund managers with expertise in niche markets

Risks of Hedge Funds

High fees that can erode returns.

Illiquidity, as funds often have lock-up periods preventing withdrawals for months or years.

Greater exposure to loss due to leverage.

Lack of transparency and regulation.

Structured Products and Derivatives

Financial instruments derived from underlying assets like stocks, bonds, or indices. Examples include options, futures, and credit default swaps.

They are complex financial instruments that are used for various purposes, including speculation, hedging and getting access to additional assets or markets.

They include swaps, options, futures, forwards

Swaps

A swap is a contract in which two parties exchange financial instruments or cash flows based on a notional principal amount.

Common Types of Swaps:

- **Interest Rate Swaps**: Exchange fixed interest rate payments for floating rate payments (or vice versa).
- **Currency Swaps**: Exchange principal and interest payments in one currency for those in another.
- **Commodity Swaps**: Exchange cash flows linked to commodity prices.
- **Credit Default Swaps:** Act like insurance against the default of a debt instrument.

Purpose:

- Hedge risks (e.g., interest rate or currency fluctuations).
- Speculate on market movements.
- Reduce borrowing costs.

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Options

An option gives the holder the right, but not the obligation, to buy (call) or sell (put) an underlying asset at a predetermined price (strike price) on or before a specific date.

Key Features:

- Call Option: Right to buy the underlying asset.
- Put Option: Right to sell the underlying asset.
- Premium: The price paid to acquire the option.

Purpose:

- Hedge against potential losses.
- Speculate on asset price movements

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Futures

A futures contract obligates the buyer to purchase, and the seller to deliver, an asset at a predetermined price on a future date.

Key Features:

- Traded on exchanges (e.g., NSE, CME, NYMEX).
- Standardized contracts (quantity, quality, expiration date).
- Both parties are obligated to fulfill the contract.

Purpose:

- Hedge risks (e.g., commodity producers locking in prices).
- Speculate on price movements of the underlying asset.

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Forwards

A forward contract is a private agreement between two parties to buy or sell an asset at a predetermined price on a specified future date.

Key Characteristics:

- Customization: Forward contracts are customizable; terms such as the quantity, price, and delivery date can be tailored to meet the needs of the parties involved.
- Over the Counter (OTC): Forwards are traded over the counter, not on an exchange.
- Settlement: Typically settled on the delivery date but can be cash-settled.
- Counterparty Risk: Higher risk because there's no central clearinghouse; one party could default.
- Use Cases: Commonly used by businesses for hedging foreign exchange, interest rates, or commodity risks.

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Real Estate Investment Trust (REIT)

- A Real Estate Investment Trust (REIT) is a regulated collective investment vehicle that enables persons to contribute money's worth as consideration for the acquisition of rights or interests in a trust that is divided into units with the intention of earning profits or income from real estate as beneficiaries of the trust.
- Investors can also invest directly in Real Estate through residential, commercial, or industrial properties purchased
- REITS can be I-REIT or D-REIT
- Development Real Estate Investment Trusts (D-REIT): A D-REIT is a type of REIT in which investors pool their capital together for purposes of acquiring real estate with a view to undertaking development and construction projects and associated activities.
- Income Real Estate Investment Trust (I-REIT): An I-REIT is a type of REIT in which the investors pool their capital for purposes of acquiring long term income generating real estate including housing, commercial and other real estate.
- Islamic Real Estate Investment Trusts: This is a unique type of REITs which only undertakes Shariah compliant activities. A fund manager is required to do a compliance test before making an investment in this type of REIT to ensure it is Shariah compliant

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REITS Cont'd

Benefits

- ✓ **Long Term Returns**- REITs offer investors competitive returns as their performance is based on the performance underlying real estate assets in the REIT structure,
- ✓ **Liquidity**- REITs offer investors' enhanced liquidity compared to direct ownership of real estate assets. REITs thus enable investors to easily buy and sell units in a trust which has invested in real estate assets.
- ✓ **Income Stream–** REIT structures specifically income REITs are mandated by the law to distribute at least 80% of their net after tax profits to their unit holders as dividends.
- ✓ **Diversification–** When combined with other asset classes, REITs provide a unique diversification tool when incorporated in an investment portfolio.
- ✓ **Tax Benefits**– REITs enjoy various tax considerations making them an attractive asset class for investors. REITs are exempt from income tax except for payment of withholding tax on interest income and dividends. Equally, REITs are exempt from stamp duty, value added tax as well as capital gain tax in some instances.

Parties involved in REITS

- ❑ **Promoter:** This is party involved in setting up a real estate investment trust scheme. The promoter is regarded as the initial issuer of REIT securities and is involved in making submissions to the regulatory authorities to seek relevant approvals.
- ❑ **REIT Manager**: This is a company that has been incorporated in Kenya and has been issued a license by the authority (CMA) to provide real estate management and fund management services for a REIT scheme on behalf of investors.
- ❑ **Trustee:** The Trustee's main role is to act on behalf of the investors in the REIT, by assessing the feasibility of the investment proposal put forward by the REIT Manager and ensuring that the assets of the scheme are invested in accordance with the Trust Deed.
- ❑ **Project/Property Manager:** The role of the project manager is to oversee the planning and delivery of the construction projects in the REITs

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Real Estate Investment Trust (REIT)

Approved REITS	
1.	ILAM Fahari I-REIT
2.	Acorn D-REIT
3.	Acorn I-REIT
4.	Laptrust I-REIT
5.	Insignis I-REIT

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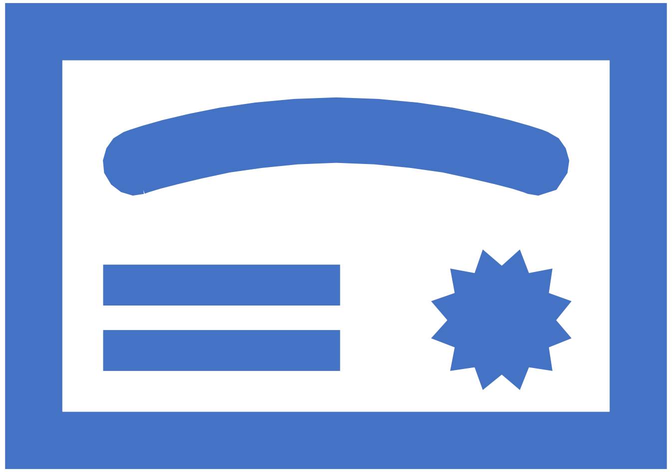
Sukuk

- ❑ Sukuk are Islamic financial certificates akin to bonds in conventional finance. However, unlike conventional bonds, sukuk comply with Islamic law (Shariah), which prohibits earning interest (riba).
- ❑ Instead of representing a debt obligation, sukuk represents partial ownership in a tangible asset, project, or investment.
- ❑ Sukuk are widely used for infrastructure projects, corporate financing, and sovereign fundraising, contributing to the global Islamic finance industry's rapid growth.



Key Features of Sukuk:

- Shariah Compliance: Structured to comply with Islamic law, avoiding activities like charging interest or financing businesses involved in prohibited sectors (e.g., alcohol, gambling).
- Asset-Backed: Sukuk holders have ownership rights in the underlying assets and earn returns based on the profit generated by these assets, not fixed interest payments.
- Risk Sharing: Investors share in the risks and rewards associated with the assets.

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Sukuk Cont'd

Types of Sukuk:

- Ijarah Sukuk: Based on lease agreements; investors earn rental income.
- Murabaha Sukuk: Based on cost-plus financing; typically involves asset sales.
- Mudarabah Sukuk: Based on profit-sharing partnerships.
- Istisna Sukuk: Financing for manufacturing or construction projects.
- Musharakah Sukuk: Joint ventures with shared profit and loss.
- Wakala Sukuk: Investments managed by an agent.

Benefits:

- Ethical Investment: Aligns with principles of fairness and ethical practices.
- Diversification: Offers exposure to a wide range of underlying assets.
- Market Growth: Sukuk have gained significant popularity in Islamic finance, particularly in regions like the Middle East and Southeast Asia.

Challenges:

- Complex Structuring: Ensuring compliance with both Shariah principles and regulatory standards can be complex.
- Market Liquidity: Secondary markets for sukuk can be less liquid compared to conventional bonds.
- Standardization Issues: Varied interpretations of Shariah can lead to inconsistencies in sukuk structures.

Asset Backed Securities

- Asset-Backed Securities (ABS) are financial instruments that are backed by a pool of assets, such as loans, leases, credit card debt, or receivables.
- The pool of assets generates cash flows that are used to pay back investors in the ABS.
- The main aim is to transform illiquid assets into liquid securities that can be sold to investors in the financial markets.
- ABS are a key part of the global financial system, providing liquidity to markets while also offering investors a way to gain exposure to various asset classes.

Examples of ABS:

- Credit Card ABS: Backed by the balances on credit card accounts.
- Auto Loan ABS: Backed by car loans.
- Student Loan ABS: Backed by student loans.
- Mortgage-Backed Securities (MBS): A specific form of ABS backed by mortgage loans.

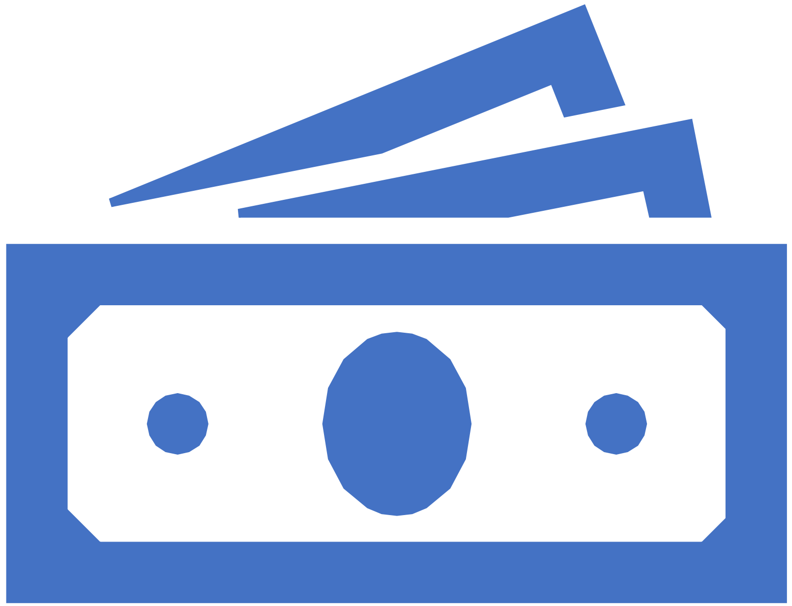
Benefits:

- For issuers, ABS provide a way to raise capital, offload risks, and improve liquidity.
- For investors, ABS offer opportunities to diversify portfolios, with varying degrees of risk and return depending on the tranche.

Risks:

- Credit Risk: If the underlying assets default or perform poorly, the value of the ABS may decline.
- Liquidity Risk: Some ABS may be difficult to trade in secondary markets.
- Prepayment Risk: If borrowers repay their loans early, it can affect the cash flow timing and the returns to investors.

Alternative Investment Funds



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The New CIS and AIF Regulations

Taking cognizance of the evolving world and constantly innovative capital markets, the Capital Markets Authority overhauled the Capital Markets Collective Invest Schemes Regulations 2001 to:

The Capital Markets (Collective Investment Schemes) Regulations 2023 and The Capital Markets (Alternative Investment Funds) Regulations 2023 to accommodate the evolving financial and capital markets. This includes deployment of alternative investments and related strategies.

The two regulations above were gazetted in 2023 and ratified by parliament in April 2024.

This followed a jurisdictional review of the regulatory status and developments in the asset management sector across best practices.

These jurisdictions were also selected as the had either developed guidelines or regulations. They include **South Africa,** United Sates of America. India, United Kingdom, **Mauritius,** and Malaysia. SEC Nigeria has Rules for infrastructure Funds. The aim was to develop a dynamic, facilitative and innovation friendly regulatory framework incorporating useful elements from best practice standards and active jurisdictions.

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Alternative Investment Fund (AIF)

Alternative investment fund means a collective investment scheme that privately pools funds **from at least two but not more than one hundred investors** in Kenya or outside Kenya to invest on the investor's behalf in accordance with a defined investment policy statement.

An AIF shall not make an invitation to the public to subscribe to its securities.

Minimum investment is Kes. 1 million or USD 10,000.

Forms of an AIF

- a debt fund and debt-linked fund;
- an equity and equity-linked investment;
- a hedge fund;
- a property fund;
- an infrastructure fund; or
- any other alternative investment fund.

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Arrangements not considered AIFs

Family trusts;

An employee participation scheme or employee savings scheme;

Holding company; or

A securitization special purpose vehicle; and where the pooling is by members of a club or association,

Key Features and Disclosures

- Placement memorandum
- The investment objective;
- The targeted investor;
- Details of the fund manager, trustee and custodian of the fund
- The key investment team
- The proposed scheme assets;
- Business plan
- Investment policy outlining investment strategy
- Redemption
- Valuation
- Risk Management Policy outline risk disclosures
- Fees
- The proposed tenure of the alternative investment fund;
- Conditions or limits on redemption; and
- Any other additional information requested by the Authority.

Licensed Players

Funds/Product:

(a) Spearhead Africa Asset Management Limited – Infrastructure Fund

(b) Investcent Hedge Fund (KES) – Hedge Fund

(c) Investcent Hedge Fund (USD) – Hedge Fund

(d) Linzi Sukuk

(e) GenAfrica – Batian Property Fund

(f) CMX – Commodities Exchange

Derivatives Exchange:

NEXT (NSE Derivatives Market)

Coffee Exchange:

Nairobi Coffee Exchange

Thank You!

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