

CRITICAL SUCCESS FACTORS OF UNIT TRUSTS INVESTMENTS. A CASE STUDY APPROACH

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Abstract

This study mainly focused on investigating the critical success factors of unit trusts using a case study approach. Countries that were part of the case study analysis include South Africa, Zimbabwe, Malaysia, United Kingdom and Singapore. Very few studies have so far focused on the critical success factors of unit trusts. Although some empirical studies have revealed the conditions under which unit trusts can be said to be viable, it appears the literature on the critical success factors on unit trusts is very scant. Lambrechts (1999), Woodlin (2003) and Nicoll (2005) are some of the few empirical researchers who explained unit trusts viability or success. However, the absence of focus on critical success factors of unit trusts among previous empirical studies prompted this study. This study revealed the following as critical success factors of unit trusts. These include unit trusts public education, better disclosure standards, government support, effective unit trusts products distribution channels, deregulation of unit trusts industry, stringent and prudent unit trusts regulation, deregulation of service charges and management fees, absence of trustee monopoly, relaxed exchange control regulations, unit trusts differentiation strategy, fund management specialization, financial sector liberalization, improved unit trusts regulation and favourable tax incentives. The study recommends that authorities should ensure these critical success factors are in place and well implemented to ensure the viability of unit trusts in their countries.

Keywords: Success, Unit Trusts, Malaysia, South Africa, UK, Singapore, Zimbabwe

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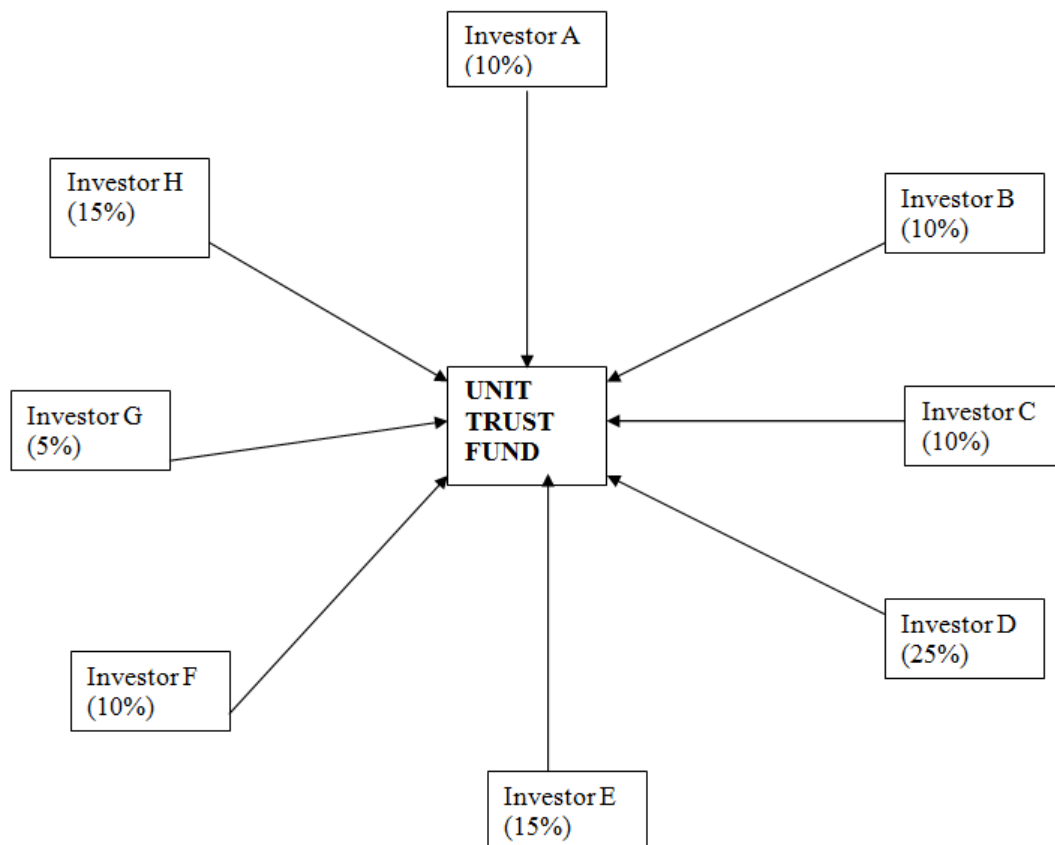
1 Introduction

Yakov (1999) defined unit trust as an investment product that allows a man in the street to pool financial resources into a fund with many other investors who have similar investment objectives. Fund managers then invest the pool of money in a wide range of assets such as shares, international equities, bonds, property and other financial instruments such as derivatives. The total value of the pool of invested money is split into equal portions called units and these are the ones acquired by investors when they invest in unit trusts. According to Boggle (2000), unit trusts refer to an investment scheme which enables investors to subscribe funds to a pool of a variety of different companies. Managers will not only sell units but will also buy back the units from unit holders who for their reasons might wish to sell them, added Boggle (2000). On the other hand, Harley (1996) defined unit trusts as a means of investment which allows investors to spread risk by investing in a fund created and managed by an investment management group. Hanson (1997) described unit trusts as a joint investment venture established by a trust deed and the parties to which are the managers who are the promoters of the trust who also undertake certain obligations in the trust deed and

the trustee who is the safe custodian of unit holders' money.

The concept of pooling money is shown in Figure 1 and it refers to the process where diverse groups of people place money into a pool or a fund, revealed Yakov (1999). The pool of money is then used to invest in various investment securities such as bonds, shares and money market instruments. Yakov (1999) added that people with the same investment needs are able to invest in securities that they, in their individual capacity would not normally be able to invest in, through pooling their money together (see Figure 1).

According to Nicoll (2005), unit trusts are viable if their returns are greater than inflation and stock exchange performance or if the return from unit trusts outweigh performance of the underlying assets. This can be achieved if unit trusts investment portfolio is well diversified and actively managed, revealed Woodlin (2003). Lambrechts (1999) added that unit trusts can be said to have been viable if they contribute towards the profitability of the company and increase shareholder wealth. It is against this backdrop that this study is investigating the critical success factors of unit trusts in United Kingdom, South Africa, Malaysia, Zimbabwe and Singapore using the case study methodology.

Figure 1. Unit trust fund model

Source: Yakov (1999)

The rest of the article is organized as follows. Part 2 looks at the operation of unit trusts whilst Part 3 discusses and synthesizes the critical success of unit trusts in Malaysia, South Africa, Zimbabwe, United Kingdom (UK) and Singapore. Part 4 concludes the study. Part 5 presents bibliography of the study.

2 Operation of unit trusts

Flourie et al (2001) described unit trusts as constituting three separate entities which are Fund, Trustee and Management Company (MANCO). The role of MANCO which is also known as an investment company falls into three categories namely fund management, fund administration and marketing, revealed Flourie et al (2001).

Flourie et al (2001) pointed out that a unit trust fund should be managed according to the investment mandate signed between MANCO and the trustee. The concept of the investment mandate as a separate document is due to the difficulty of accurately identifying the objectives and investment parameters of particular unit trusts, (Bernstein, 1995). The investment mandate has no legal standing but will be used to classify each unit trust fund. Yakov (1999) also pointed out that getting both MANCO and the portfolio manager sign the investment mandate document ensures no internal differences in perception.

According to Flourie et al (2001), a trust deed is a legal instrument which guides both the MANCO and the trustee on all fund management and unit trusts administrative issues. MANCO is obligated to buy back units should investors wish to sell their units and that is legally binding even if it does not have money. In such a case, MANCO sells back the units to the trustee, who cancels them and pays money to MANCO, revealed Woodin (2003). Flourie et al (2001) further added that the trustee will liquidate some of the investments in a bid to honour redemptions and this might even occur at a loss to the unit trust fund. According to the Zimbabwe Collective Investments Act (1998), the trustee does not necessarily know who has invested money but only sells units to MANCO and this implies that all queries relating to investors' records should be channeled to MANCO. The latter also has a duty to solicit money from the public by selling units directly to investors or indirectly through the agents.

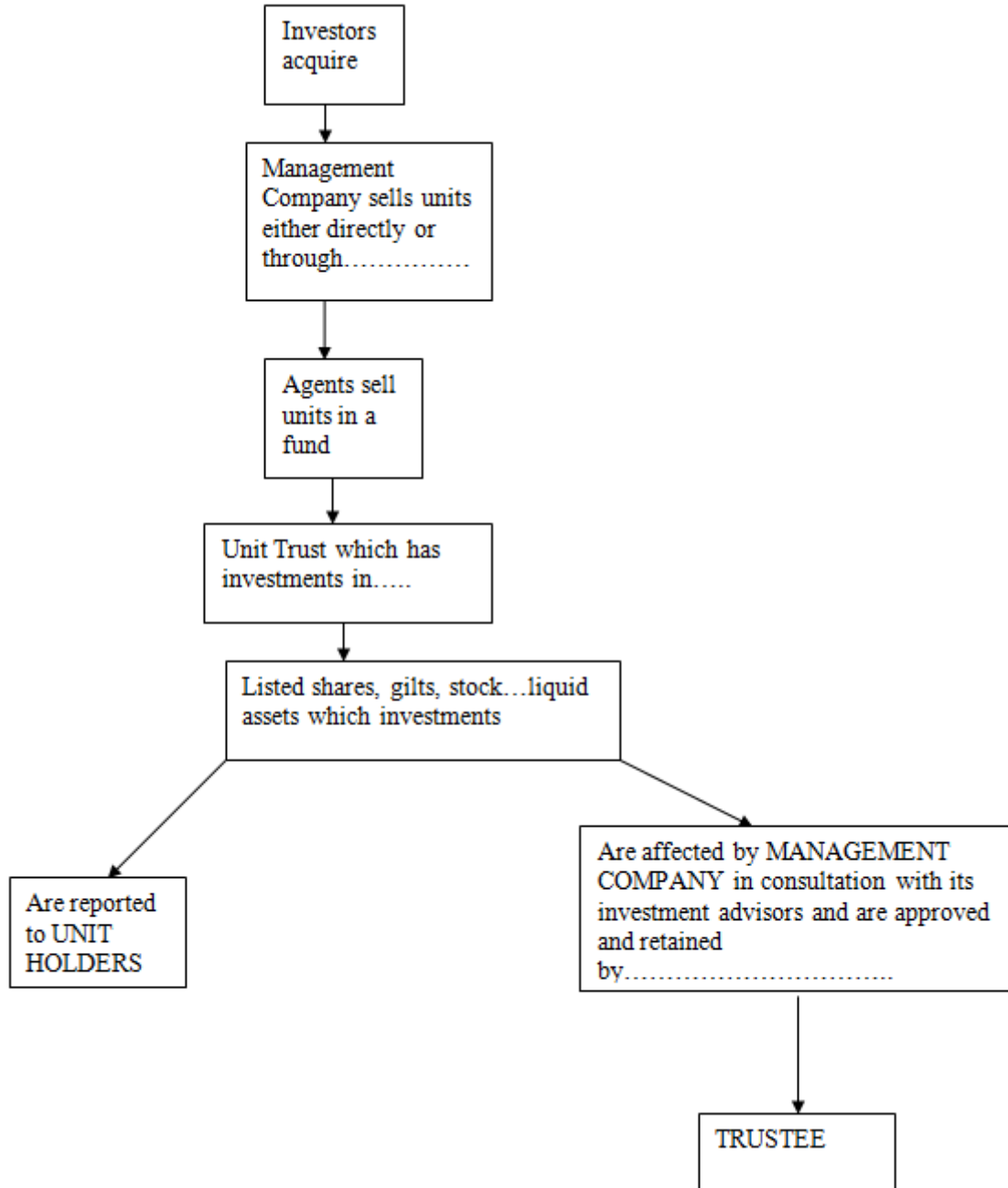
In the case of Zimbabwe, the law governing unit trusts known as the Collective Investment Scheme Act of 1998 require a company operating unit trusts to register in terms of the Companies Act and apply for registration with the ministry of finance (Registrar Of Collective Investment Schemes). MANCO is obligated to draw up a trust deed and appoint a trustee. The latter acknowledges the appointment by approving the trust deed. MANCO and the trustee are

required to submit to the Ministry of Finance a detailed report of the state of affairs of each unit trusts fund monthly and annually.

Woodin (2003) further revealed that auditors are appointed to audit records of unit trust funds and the audit scope of operation is spelt out in the trust deed. The latter spells out the objective of the fund and how

the money collected from the public is going to be invested and this legally binding on the part of the management company. According to Flourie et al (2001), the trustee creates units and sells them to the management company which buys them using money from investors (see Figure 2).

Figure 2. Operation of unit trusts



Source: Flourie et al (2001)

The trustee receives money from Management Company and the money is kept in an account controlled by the trustee. The latter is the custodian of all unit trusts assets thus it ensures that management company declares correct dividend and effects

payment once dividend declared has been approved, revealed Flourie et al (2001) – refer to Figure 2.

3 Investigating the critical success factors of unit trusts

This section discusses and synthesises the critical success factors of unit trusts in United Kingdom (UK), Zimbabwe, Malaysia, South Africa and Singapore.

3.1 Critical success factors for unit trusts in Malaysia

Syapouty (2004) and other empirical theorists came up with several critical success factors that were behind the success, viability and growth of unit trust industry in Malaysia as discussed below.

Government support. The 1970s witnessed the emergence of state government sponsored unit trusts, likely in response to the Federal Government's call to mobilize domestic household savings. This period marked the entry of government participation in the unit trust industry and the formation of a Committee to the unit trust industry called the Informal Committee for unit trust funds comprising representatives from the Registrar of Companies, the Public Trustee of Malaysia, Bank Negara Malaysia and the Capital Issues Committee, concurred Neghondw (2005).

Distribution networks. The 1980s witnessed the emergence of unit trust management companies which were subsidiaries of financial institutions, revealed Syapouty (2004). Their participation facilitated the marketing and distribution of unit trusts through bank's branch network which widened investor reach. New regulations which allowed third party distribution and the licensing of tied agents involved in the distribution of unit trusts as well as stock broking companies being permitted to manage unit trusts provided further impetus to growth and development of the industry. More banks joined the foray of unit trust management companies as Institutional Unit Trust Agents (Syapouty, 2004).

Deregulation of the unit trusts industry. The unit trust industry was deregulated in 1991 and quite a remarkable increase in unit trust companies and units in issue has been realised to date, revealed Syapouty (2004). More players have now joined the industry making it more exciting in terms of product innovation. The Malaysian unit trusts industry is poised for positive growth to confirm its importance in the Malaysian Capital Market, (Syapouty: 2004).

Stringent and prudent unit trusts industry regulation. Syapouty (2004) argued that the centralisation of industry regulation with the establishment of the Securities Commission on 1 March 1993, coupled with the implementation of the Securities Commission (Unit Trust Scheme) Regulations in 1996 played key roles in making unit trusts household products in Malaysia. Consequently, the total net asset value of funds under management grew from ZAR 11.7 billion as at end 1994 to ZAR 65 billion as at end of 2001, (Syapouty:2004).

According to Neghondw (2005), Malaysia introduced the unit trust concept relatively early compared to its Asian neighbours, when in 1959, a unit trust was first established by a company called Malayan Unit Trust Ltd. The unit trust industry in Malaysia has therefore only a short history of more than four decades, (Neghondw, 2005). The first two decades in the history of unit trust industry were characterised by slow growth in the sale of units and a lack of public interest in the new investment product, (Jorion, 1997). The latter added that only five new unit trust management companies were established with a total of eighteen funds introduced over that period. The unit trust industry was regulated by several parties including the Registrar of Companies, the Public Trustee of Malaysia, Bank Negara Malaysia and the Ministry of Domestic Trade and Consumer Affairs. Jorion (1997) further noted that the 1970s also witnessed the emergence of government sponsored unit trusts in response to the Federal Government's call to mobilise domestic household savings.

According to Neghondw (2005), the period from 1980 to 1990 marked the entry of government participation in the unit trust industry and the formation of a Committee to the unit trust industry called the Informal Committee for unit trust funds comprising representatives from the Registrar of Companies, the Public Trustee of Malaysia, Bank Negara Malaysia and the Capital Issues Committee. Despite only eleven funds being launched during this period, total units subscribed by the public swelled to an unprecedented level, (Neghondw, 2005). The 1980s also witnessed the emergence of unit trust management companies which were subsidiaries of financial institutions. Their participation facilitated the marketing and distribution of unit trusts through bank's branch network which widened investor reach, added (Neghondw, 2005).

According to Syapouty (2004), the period from 1991 to 1996 witnessed the fastest growth of the unit trust industry in Malaysia in terms of the number of new management companies established and funds under management. Syapouty (2004) alluded the success of unit trusts industry during this period to centralisation of industry regulation coupled with the establishment and implementation of the Securities Commission (Unit Trust Scheme) Regulations in 1996. Consequently, the total net asset value of funds under management grew from ZAR 11.7 billion as at end 1994 to ZAR 45 billion as at end of 2001 and this period also saw greater product innovation and deregulation of the industry, (Neghondw, 2005).

Although the pace of growth of unit trust funds from 1997 up to current has moderated since the financial crisis of the 1997-98, it has nevertheless maintained its upward trend in terms of the number of units in circulation and unit holders, (Neghondw, 2005). The latter added that the total units in circulation had gone up to 99.6 billion and unit holders had surged to 10.3 million as at 29 February

2004. Also noted by Neghondw (2005) was increasing popularity of Syariah funds in terms of increasing number of funds offered by a host of unit trust providers. Bernstein (2003) noted that new regulations which allowed third party distribution and the licensing of tied agents involved in the distribution of unit trusts as well as stock broking companies being permitted to manage unit trusts provided further impetus to growth and development of unit trusts in Malaysia. Moreover, the opening up of various distribution channels and liberal developments on the regulatory front enabled the unit trust industry to register positive growth to confirm its importance in the Malaysian Capital Market, revealed Bernstein (2003).

3.2 Critical success factors for unit trusts in South Africa

According to Woodlin (2003), unit trust business has been viable for two decades in the financial markets history of South Africa to such an extent that an increased number of unit trust companies had been registered as standalone. Below are six factors which were responsible for the success and viability of unit trusts in South Africa according to Kainja (1998).

Deregulation of service charges and management fees. Unit trust fees and charges were deregulated on 1 June 1998. Prior to deregulation, unit trusts were not legally allowed to charge more than 1 percent as an annual management fee. After deregulation, the ceiling on annual fees was removed, meaning that portfolios launched after deregulation did not have such restrictions imposed on them hence better income for unit trusts companies. Following the deregulation of fees and charges, multiple classes of units were introduced. This allows management companies to identify different types of unit holders and to differentiate between the service offered to different clients and the annual fees they charge.

Stringent regulatory framework. Unit trusts in South Africa are strictly regulated by a number of regulatory authorities in a bid to protect investors against fraud and improper management practices. They are governed and supervised by several legislative instruments which have so far ensured protection of unit holders and success of unit trusts in South Africa. The Securities Act, Securities Exchange Act and Federal Investment Company Act are all legislative instruments governing unit trust business operation in South Africa. Association of Collective Investments is also a body which oversees the smooth running of unit trusts in South Africa.

Absence of Trustee monopoly. Van (1999) concurred with Kainja (1998) on the impact of absence of trustee monopoly has so far played in promoting unit trusts viability in South Africa. Nedcor Bank Limited, Standard Bank of South Africa Limited, Standard Trust Limited, Nedbank Limited, First National Bank of Southern Africa Limited and

Standard Trusts only just but to mention a few are some of the unit trusts Trustees in South Africa, (Lambrechts, 1999). This promotes competition for business and efficiency in terms of customer service delivery hence making unit trusts viable, argued (Lambrechts, 1999).

Relaxed exchange control regulations. Unit trust funds in South Africa are allowed to invest in financial securities offered by institutions from foreign countries. Winship (2001) added that BOE Asset Management (One of South African Asset Management Company) has a fund which specifically invests in foreign financial assets called the International Growth Fund. In May 2001, the fund was investing 3 percent (Japan), 33 percent (Euro land), 13 percent (United Kingdom), 10 percent (Switzerland), 2 percent (Australia) and 39 nine percent in United States of America. According to Thabe (2003), foreign funds are unit trusts that invest at least 85 percent of their assets outside South Africa at all times.

Differentiation strategy. South Africa unit trusts are differentiated according to assets constituting the fund portfolio and risk/reward perspective. This enables unit trusts companies to maintain uniqueness of their products and in the process contain competition, revealed Joubert (2002).

Fund Management specialisation. According to Lambrechts (1999), this fund management specialisation contributed immensely to unit trusts viability in South Africa as it gives a fund manager enough time to actively manage the fund on behalf of unit holders. Each and every fund in South Africa has its own fund manager unlike in other countries where five funds might be managed by a single fund manager. Newsman (2002) also supported the abovementioned view.

However, Woodin (2003) attributed the success of unit trusts in South Africa to substantive net inflows of ZAR19 billion in 2001 in South Africa. The same study by Woodlin (2003) added that South Africa's record of positive net inflows every quarter since 1985 was very instrumental in achieving unit trusts success.

3.3 Critical success factors for unit trusts in United Kingdom

Jean (1996) divided factors which were responsible for the success of unit trusts in United Kingdom into two categories which are diverse economic framework and stringent regulatory requirement. This view was supported by Flourie et al (2001). Diverse economic framework enables the investing public to indirectly participate in the growth of diverse sectors of the economy. It also enables differentiation of unit trusts funds hence making it easy for investors to select an investment vehicle best suiting their risk/reward framework. Jean (1996) further pointed out that

economic vibrancy also acted as a cornerstone to unit trusts industry viability in the United Kingdom.

3.4 Critical success factors for unit trusts in Zimbabwe

According to Muringari (2004), poor macro-economic environment that prevailed during the period 2000 to 2004 hindered the success of unit trusts. The hyper inflationary environment that characterized the economy of Zimbabwe during this period reduced the income's purchasing power hence effectively lowering the quantity of savings on the part of investors. Reducing savings indirectly hindered the success of unit trusts and their general profitability (ZAUT, 2004). Muringari (2004) further pointed out that reduced savings was one of the reasons attributable to the collapse of some unit trust companies in year 2004.

Fixed foreign exchange rate system had negative effects on the viability of unit trusts in Zimbabwe, revealed ZAUT (2004). The fixed foreign exchange rate policy caused foreign currency shortages in the official market hence negatively affecting those companies which makes use of imported unit trust systems. Old Mutual Unit Trusts Report (2005) added that the shortage of foreign currency in the official market as a result of the fixed foreign exchange rate policy negatively affected unit trusts operations and success in Zimbabwe. ZAUT (2004) further highlighted that the delays to pay unit trusts systems maintenance fees caused unit trusts systems vendors to deliberately delay to fix minor unit trusts system mishaps thus negatively affecting not only the service delivery but hamper the success of unit trusts.

According to Syfrets Unit Trusts Report (2004), strict unit trusts regulatory framework negatively affects the success of unit trusts and overall profitability of unit trusts in Zimbabwe. Zimbabwe National Chamber of Commerce (ZNCC 2004) also revealed that high interest rate regime increased the interest rates exposure thus reducing the success of unit trusts and overall profitability in Zimbabwe. RBZ (2005) added that foreign currency shortages during the period 2000 to 2004 made it hard if not impossible for management companies to invest in staff training on latest and modern ways of administering unit trusts. According to Syfrets Unit Trusts Report (2004), the overall success and profitability of unit trusts is hindered by the fact that the bigger percentage of unit trusts profitability is used to pay software fees that are charged in foreign currency. This means that a smaller portion of unit trusts profitability is reinvested, thus making it extremely difficult to realize any meaningful success of unit trusts, argued Syfrets Unit Trusts Report (2004).

3.5 Critical success factors for unit trusts in Singapore

Radecki and Reinhart (1998) noted that government of Singapore played a critical role in promoting and transforming unit trusts into a fully fledged industry. Below are strategies which the government of Singapore employed in its positive role of developing unit trust industry, according to Radecki and Reinhart (1998).

Liberalisation of the unit trusts industry. Radecki and Reinhart (1998) attributed the unit trusts industry growth to liberalisation of Singapore's financial sector. As a result, competition intensified due to the absence of barriers to entry making it more exciting in terms of product innovation. Douglas (1998a) pointed out that Singapore unit trust industry has grown phenomenally since the launch of Singapore's first unit trust, First Singapore Fund in 1958 due to liberalisation of Singapore's financial sector. There were a total of 191 unit trust funds for an investor to choose from as at the 1st of December 1998. Douglas (1998a) predicted there will be three to four hundred unit trusts available in Singapore in ten years' time with \$20 billion of assets under management.

Effective distribution channels. In the year 1998, a greater number of unit trust management companies which were subsidiaries of financial institutions emerged and their participation facilitated the marketing and distribution of unit trust products through bank's branch network which widened investor reach (Radecki and Reinhart, 1998). New regulations which allowed third party distribution and licensing of tied agents involved in the distribution of unit trust products further provided impetus to growth and development of the unit trust industry, argued (Radecki and Reinhart, 1998).

Improved unit trusts regulation. According to Radecki and Reinhart (1998), investors' money is held separately from the managing company's assets in a trust hence if anything goes wrong with the company, investors' money is safe. Unit trust industry in Singapore is strictly regulated by the Registrar of Collective Investment Schemes and the trustee to protect investments, (Radecki and Reinhart, 1998). A vigilant financial press and analysts who continuously monitor the performance of the industry also protect investors and investors receive quarterly reports and an annual report listing all the assets in unit trust funds investment portfolio, revealed Radecki and Reinhart (1998).

Favourable tax incentives. According to Radecki and Reinhart (1998), unit trust investors only incur capital gains tax when they sell their units. Having capital gains tax paid outside of the unit trust means that portfolio managers can focus on their core business of managing investment portfolios according to the mandate rather than being distracted by tax issues.

Unit trusts public education through investment fairs/seminars. This has created consciousness in Singapore on the availability of unit trusts as an alternative investment vehicle.

Better disclosure standards. This entails disclosing return and risk involved in achieving those returns, according to Radecki and Reinhart (1998).

3.6 Challenges faced by Singapore unit trust industry

Spaulding (1997) pointed out that unit trust industry in Singapore experienced two unprecedented upheavals in its previously rather placid business environment. The ensuing Asian Financial Crisis created a very difficult investment climate, with continuously changing risk parameters. Moreover, in 1998, the Singapore government introduced a multi prolonged strategy to make Singapore a premier fund management centre in Asia in the next five to ten years and proceeded to liberalise its banking sector in the spring of 1999.

Douglas (1998b) identified four major risks associated with unit trusts in Singapore and these are currency, liquidity, regulatory and human factor risk. According to Jorion (2003), about 45 percent of unit trust funds under management invest in foreign currency assets, translating into potentially high currency risk exposures. Douglas (1998b) further suggested that currency risk can be managed by hedging strategies such as forward contract, options, futures, swaps and money market hedging.

According to Los (1998), unit trusts also suffer from liquidity risk resulting from unforeseen redemptions. Unit trusts are concerned about liquidity risk produced by redemption in volatile times such as those which were caused by the Asian Financial Crisis, (Spaulding, 1997). Spaulding (1997) further estimated that unit trusts on average put aside 20 percent of funds under management in liquid assets for redemption purposes. On regulation risks, Markowitz (1991) pointed out that regulatory risk had increased in importance in Singapore with the liberalisation of financial sector.

Ong and Lim (1998) suggested that majority of unit trust business in Singapore required their managers to have earned at least a Bachelor degree instead of a Chartered Financial Analyst (CFA) qualification. Ong and Lim (1998) further pointed out that Singapore unit trusts require very well educated and experienced people to head unit trusts as part of human factor risk management. Almost all unit trust companies now require either a CFA qualification holder or Masters Degree holder in order to curb human factor risks inherent in unit trusts, revealed Bernstein (1995). Moreover, Douglas (1998b) further stated that due to Asian Financial crisis, there was an increase in percentage of unit trust companies requiring at least 5 to 9 years' experience from fund

managers in Singapore in a bid to curb human factor risks.

3.7 The future of unit trust industry in Singapore

According to Bernstein (1998), the current liberalisation of the financial sector in Singapore and the subsequent increased competition is expected to force unit trusts to improve their distribution channels to become more user friendly and to disclose better the magnitude and kinds of risks taken in obtaining their accumulated returns. Jorion (2003) added that an increase in sophistication of risk analysis by better educated and more experienced managers was expected with more disclosure on the analysis and managers' background to the unit holders. Jorion (2003)'s research findings revealed that the newly formed Investment Management Association of Singapore was expected to take a lead in educating the public on the benefits of unit trusts.

4 Conclusion

This study mainly focused on establishing the critical success factors of unit trusts using a case study approach. Countries that were part of the case study analysis include South Africa, Zimbabwe, Malaysia, United Kingdom and Singapore. Very few studies have so far focused on the critical success factors of unit trusts. Although some empirical studies have revealed the conditions under which unit trusts can be said to be viable, it appears the literature on the critical success factors on unit trusts is very scant. Lambrechts (1999), Woodlin (2003) and Nicoll (2005) are some of the few empirical researchers who explained unit trusts viability or success. For example Nicoll (2005) said that unit trusts are viable only if their returns are greater than inflation or outperform the underlying assets. Woodlin (2003) mentioned that unit trusts are viable if their investment portfolio is well diversified and actively managed whilst Lambrechts (1999) added that unit trusts viability could only happen if they contribute towards the profitability of the company and increase shareholder wealth. The absence of focus on critical success factors of unit trusts among previous empirical studies prompted this study.

This study revealed the following as critical success factors of unit trusts. These include unit trusts public education, better disclosure standards, government support, effective unit trusts products distribution channels, deregulation of unit trusts industry, stringent and prudent unit trusts regulation, deregulation of service charges and management fees, absence of trustee monopoly, relaxed exchange control regulations, unit trusts differentiation strategy, fund management specialization, financial sector liberalization, improved unit trusts regulation and favourable tax incentives. The study recommends that authorities should ensure these critical success factors

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