

# Effects of Portfolio Diversification on the Financial Performance of Listed Investment Firms in Kenya

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**Abstract:** The study investigated how the portfolio diversification affects the financial performance of listed investment companies in Kenya. The study was based on Modern Portfolio Theory. The study targeted five investment whose stock were publicly traded at the NSE as at 31 December 2023. The annual secondary was collected from the published annual reports and audited financial statements of investment firms that are publicly listed at the NSE. The data period was from 2014 to 2023. Standard deviation, mean, minimum, and maximum was adopted as descriptive statistical analysis. Panel regression model was adopted to examine the portfolio diversification on financial performance. The study established that portfolio diversification has a strong and positive effect on financial performance of listed investment firms in Kenya. The study recommends to listed investment firms to diversify their portfolio across a number of investment areas including bonds, bills, real estate, equity and mutual funds. Such increased diversification would result to reduced portfolio risk and enhanced returns. Further, the study recommends to capital market authority to formulate and revise existing policy on the diversification by listed investment firms in Kenya. The regulator should encourage listed investment firms to hold optimal portfolio and revise them accordingly as assets features change and macroeconomic factors evolve.

**Keywords:** Portfolio diversification, Financial performance.

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## 1. INTRODUCTION

The concept of portfolio diversification is becoming increasingly important as a process of determining the financial performance of investment companies. Consequently, portfolio diversification serves as a crucial approach in investment that tailored to eliminate asset specific risks via spread of investable funds across different asset classes (Adhiambo, Melly, & Mwanza, 2023). Equity securities are normally more volatile than government bonds and therefore subject to greater risks. Government bonds and bills are typically considered low-risk investments with low volatility depending on the economic and political stability of the issuing country which normally affects their prices and the interest rates (Cheruiyot, Aluoch, & Ndungu, 2024). Even though, investments in stock are relatively riskier compared to bonds, as time horizon increases, stocks often outperform bonds (Kamau & Maina, 2019). An investment portfolio is a collection of assets that reflects the risk tolerance of the investor, the effect of each investment on the portfolio's overall risk, and the portfolio's total return (Obiero 2018). Diversification helps reduce unsystematic risk, which is the risk associated with individual investments or sectors. Therefore, by spreading investments, such that a loss in one asset class is offset by a gain in another asset class (Qarni & Gulzar, 2021). Diversification aims to balance the risk-return trade-off and a well-diversified portfolio can achieve more stable returns without significantly increasing risk. By holding a variety of asset classes, investors can lower the risk of the overall portfolio (Koumou, 2020). However, while diversification reduces volatility, it can also limit upside potential if a specific sector performs exceptionally well (Zaimovic et al., 2021).

### 1.1 Statement of the Problem

Portfolio diversification can influence performance by spreading investment risks among different classes of assets, therefore minimizing the effect of adverse market movements on the firm's overall performance. Therefore, diversification of the portfolio is a vital strategy for investment firms, offering a pathway to improved financial performance through risk

mitigation and enhanced returns (Kamau & Maina, 2019). Thus, diversification enhances profitability and shareholder value in addition to aiding in risk management. Investment firms with diversified portfolios tend to report higher Return on Asset and Return on Capital employed compared to those with concentrated investments. Even though extant literature exists, a few knowledge gaps were noticed. Contextually, most studies have tended to be in the banking, insurance, and Saccos sector with few studies in listed investment firms in Kenya. Few recent studies are using the most current data and adopting firm size and liquidity to control portfolio diversification on financial performance. The current study sought to assess the effect of portfolio diversification on the financial performance of listed investment companies in Kenya.

## 1.2 Research Objective

The study sought to determine the effects of portfolio diversification on the financial performance of listed investment companies in Kenya

## 2. LITERATURE REVIEW

### 2.1 Theoretical Review

The link between investment portfolio diversification and financial performance is based on Modern Portfolio Theory. The Modern Portfolio theory, developed by Markowitz (1952), is the foundation of modern diversification practices. Markowitz argued that investors tend to avoid risk and are only willing to take on risk that commensurate with expected returns. Markowitz also revealed that markets are efficient, and returns on investments follow a random distribution. The theory reports that efficient frontier of optimal portfolios can be created from a collection of risky assets. Each portfolio located on this frontier avails optimal returns subject to specified risk. Consequently, investors can modify their overall market risk by utilizing a portfolio that is most effectively aligned with a risk-free asset, such as government bonds (Markowitz, 1952). This theory guides investment firms in diversifying their investments and developing their investment strategies. By doing so, investment companies can make prudent investment decisions by carefully considering the risk and expected returns of their investments. Diversification enables firms to spread risks over a broad number of assets such that non-systematic risks are reduced in the portfolio and thus enhanced financial performance from reduced portfolio exposure.

### 2.2 Empirical review

Mwania (2023) investigated on how profitability affects portfolio diversification among investment companies in the EAC region. The causal study sourced data from eight publicly listed investment firms. The results showed that profitability was inversely affected by portfolio diversification in Tanzania and Kenya while its effect in Uganda was direct. The study was undertaken in the EAC region and another study focusing on Kenya only would be more useful for a local setting. Besides, the inverse and insignificant effect of portfolio diversification was contrary to theoretical expectations. Ogum and Jagongo (2022) evaluated whether financial performance was explained by investment decisions in DT-Saccos. Utilizing a causal research design that involved 40 DT-Saccos, investments in real estate had a negligible negative effect, whereas bonds and money markets exhibited a negligible direct effect. Since the study focused on Saccos, conducting further research on publicly listed investment firms would enhance the reliability of the findings.

Nigam and Gupta (2023) assessed the influence of diversification on three key aspects of a firm's financial performance. The findings revealed an insignificant effect of diversification on performance. Subsequently, the study discovered that diversification is advantageous compared to remaining undiversified only when it pertains to a non-related area. The study established an insignificant effect of diversification contrary to theoretical expectations. Amahalu, Okudo, and Ezechukwu (2023) investigated whether financial performance and diversification were correlated among banks in Nigeria. The ex post facto study was based on a sample of thirteen publicly listed commercial banks with secondary data sourced from financial statements from 2009 to 2022. Panel Least Square study showed that investments in debt securities, equity securities, and subsidiaries directly affected return on assets. The study adopted ROA only to measure financial performance hence a gap exists for a study using other measures of financial performance.

Komen et al., (2024) examined whether financial performance of DT-saccos was explained by investment structure. The study was a census of 42 DT-saccos with secondary data being sourced from 2018 to 2022. The multiple regression analysis indicated that loan portfolios, unit trust investments, and stock investments directly and strongly explained financial performance. The study contextualized in the Saccos sub-sector thus limited generalization in other contexts like listed investment firms.

In a study based on listed investment firms in Kenya, Osewe (2020) examined how financial performance is affected by portfolio diversification. The descriptive research design was a census of five investment firms and sourced data from 2010 to 2019 from the audited financial statements. Ordinary Least Squares (OLS) results revealed that financial performance was strongly explained by firm size, portfolio diversification, and liquidity. The study was undertaken with older data and another study using the most current data would capture recent developments in the investment industry.

### 3. METHODOLOGY

The study utilized a descriptive survey design with the aim of achieving the objectives of the study. The study targeted five investment whose stock were publicly traded at the NSE as at 31 December 2023. The annual secondary data was collected from the 'published annual reports' and 'audited financial statements' of investment firms that are publicly listed at the NSE. The data gathered was from year 2014 to year 2023. Data Analysis involved the use of STATA to conduct descriptive analysis, correlation tests, and regression modelling. Standard deviation, mean, minimum, and maximum was adopted as descriptive statistical analysis. Panel regression model was adopted to examine the portfolio diversification on financial performance.

### 4. RESULTS AND DISCUSSION

The chapter present results and discussion where panel secondary annual data from 2014 to 2023 was adopted. The analysis targeted 5 listed investment firms; however, one investment firm was excluded from the study as it lacked reliable data for the study period. The study therefore proceeded with 4 listed investment firms that participated in the study.

**Table 4.1: Descriptive Statistics**

Variable	Obs	Mean	Std.Dev.	Min	Max
HHI	40	.286	.174	.00	.56
ROA	40	.015	.401	-.3	.13

Note: HHI is the Herfindahl Hirschman Index

Investment portfolio diversification was the independent variable measured based on Herfindahl Hirschman Index (HHI). The HHI index values ranges between 0 and 1 where 0 implies no diversification and 1 implies perfect diversification. The mean HHI for the study was .236 which is nearer 0 and implies weak form of portfolio diversification. The standard deviation (SD = .174) captures the distribution of individual firms' diversification away from mean diversification. The minimum diversification was 0.001 implying the firm had very low-level diversification while the maxim diversification was .56 meaning the firm had moderately diversified its investment.

The dependent variable in the study was financial performance (ROA) measured as the ration of after-tax profit and total assets. The mean ROA was .015 implying after tax profit of 1.5% of total assets. The standard deviation was .401 capturing the spread of individual firms ROA around the mean ROA. The minim value of ROA was -.3 showing that the firm with the lowest financial performance had made a loss of 30%. Maximum value of the ROA was .13 showing after tax profitability of 13%.

**Table 4.2: Generalised Least Squares Model (Absence of control)**

ROA	Coef.	St.Err.	t-value	p-value	[95% Conf Interval]	Sig	
hhi	0.064	0.032	2.01	0.045	0.001	0.126	**
Constant	-0.041	0.019	-2.18	0.029	-0.078	-0.004	**
Mean dependent var		-0.045		SD dependent var		0.101	
Number of obs		40.000		Chi-square		4.027	
R-squared		0.147					

\*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$

Note: HHI is the Herfindahl Hirschman Index, and ROA is the return on Assets

The model was thus estimated as:

$$\text{ROA} = -0.041 + 0.064\text{hhi} \dots \dots \dots [1]$$

The study first examined the effect of Portfolio diversification on financial performance. The findings presented in Table 4.7 showed that portfolio diversification explained 14.7% of the variation in financial performance with the residual variation being captured unobserved variables. Further, the portfolio diversification had a significant and positive effect on financial performance ( $\beta_1 = 0.064$ ,  $t = 2.01$  and  $p = 0.045 < .05$ ). The intercept term ( $\beta_1 = -0.041$ ) captured the level of financial performance when portfolio diversification is held constant at zero.

## 5. CONCLUSION

The effect of portfolio diversification on financial performance of listed investment firms was positive and significant. The findings imply that increasing portfolio diversification among listed investment firms in Kenya resulted to improved financial performance. Further, the effect of portfolio diversification on financial performance was significant thus it was a strong predictor of financial performance of listed investment firms in Kenya. The positive effect of portfolio diversification on financial performance of listed investment firms in Kenya is explained by the fact that increased portfolio diversification results to reducing asset specific risk when portfolio returns is given. The finding is further informed by Modern Portfolio Theory that explains that diversifying investments across different classes of assets such that non-systematic risks are reduced in the portfolio and thus enhanced financial performance increases from reduced portfolio exposure.

## 6. RECOMMENDATION

The findings inform recommendations for theory and practice. The strong and positive effect of portfolio diversification informs the management of listed investment firms to diversify their portfolio across a number of investment areas including bonds, bills, real estate, equity and mutual funds. Such increased diversification would result to reduced portfolio risk and enhanced returns. Further, the study recommends to capital market authority to formulate and revise existing policy on the diversification by listed investment firms in Kenya. The regulator should encourage listed investment firms to hold optimal portfolio and revise them accordingly as assets features change and macroeconomic factors evolve.

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