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Influence of Portfolio Diversification Practices on the Financial Performance of Investment Firms Trading at the NSE

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Abstract

Purpose: Portfolio diversification plays a pivotal role in determining firms' financial performance. However, there is limited evidence of studies specifically focusing on how portfolio diversification influences the financial performance of investment firms in Kenya. This study, therefore, sought to provide a comprehensive analysis of the firm factors influencing the financial performance of investment firms trading at the NSE.

Materials and Methods: Using a correlational research methodology and positivist philosophy, this study looked at how firm-specific characteristics affected the financial success of 63 investment businesses that were listed between 2014 and 2023 on the Nairobi Securities Exchange (NSE). Utilizing a census methodology, information was gathered from secondary sources such as NSE, CBK, and KNBS. With the use of diagnostic tests to guarantee data reliability, panel regression models examined the connections between risk management, corporate governance, portfolio diversification, and asset allocation. Utilizing statistical analytic methods such as SPSS, the results were presented, and the moderating influence of ownership structures was also assessed. Additionally, the data was presented using tables and figures.

Findings: Descriptive analysis revealed significant variability in diversification strategies, with an average portfolio size of Kshs 211.06 billion and notable disparities in asset bases. Trend analysis from 2014 to 2023 showed fluctuations in portfolio sizes and turnover, with loan portfolios steadily growing to a peak of Kshs 177.45 billion in 2023. Regression results confirmed that portfolio diversification positively influenced financial performance, explaining 39.22% to 44.97% of variability.

Implication to Theory, Practice and Policy: To enhance this aspect, firms should expand their portfolios to include a broader range of asset classes and geographic regions, thereby reducing risk and improving potential returns. Conducting thorough market research to identify diversification opportunities and utilizing sophisticated analytics will guide effective diversification strategies. Regular portfolio reviews and adjustments based on market conditions are essential for maintaining a well-diversified portfolio aligned with financial objectives.

Keywords: *Portfolio Diversification, Investment, Financial performance,*

INTRODUCTION

Portfolio diversification practices measured by number of stocks in a portfolio, number of bonds in a portfolio, and number of money market instruments in a portfolio, minimizes risk exposure by spreading investments across various assets, and was selected due to its potential impact on mitigating market volatility (Hitzemann, Prokopczuk, & Wese Simen, 2018). Furthermore, portfolio diversification plays a pivotal role in determining financial performance. In the USA, diversification is not limited to asset classes; it extends to international markets, reducing country-specific risks (Hull, 2021). Luthifia and Suherman (2018) explain that the comprehensive diversification approach enhances resilience and ensures steady returns. Besides, Feng and Wu (2022) indicated that firms, by diversifying across industries, protect themselves from sector-specific vulnerabilities, thus contributing to stable financial performance. While evaluating the aspect of global diversification in Canadian markets, Kyere and Ausloos (2021) pointed out that Canadian companies diversify globally, especially in the energy and natural resources sectors, which cushions them against regional market fluctuations.

Diversified portfolios and stringent governance enhance investor confidence, attracting more capital. On the other hand, inadequate portfolio diversification significantly result in overdependence on specific assets, making a firm vulnerable to sector-specific downturns. Portfolio diversification is a strategy that enhances financial performance by spreading risk across different assets. Mukumbi (2020) found that firms in Zambia are increasingly diversifying their portfolios by venturing into multiple sectors, including mining, agriculture, and telecommunications. This diversification has contributed to improved financial performance and resilience. Tunisia, on the other hand, has been limited in its diversification efforts due to economic challenges. Ben Rejeb and Zouari (2017) noted that Tunisian firms tend to have more concentrated portfolios, which can lead to increased vulnerability during economic downturns.

Diversification across sectors and geographical regions helps firms mitigate risks, enhance resilience, and ensure steady returns. A company operating in manufacturing may invest in services or agriculture to balance its portfolio, minimizing sector-specific vulnerabilities. Similarly, geographical diversification expanding into regional East African or international markets reduces country-specific and currency risks (Ndiritu, 2017). Despite the acknowledged benefits of portfolio diversification, there is limited research on its impact on financial performance among investment firms in Kenya. This study, therefore, examines key firm factors influencing financial performance among Nairobi Securities Exchange (NSE)-listed investment firms, filling a critical research gap in Kenya's investment landscape.

Statement of the Problem

While governance, business size, and liquidity have been shown to impact financial performance (Chen & Mahmood, 2020; Kiragu & Namusonge, 2017), there is limited research on the role of portfolio diversification in shaping the financial stability of investment firms in Kenya. The fluctuations in financial performance observed at the Nairobi Securities Exchange (NSE), including the collapse of Discount Securities Limited and the contrasting success of Sanlam Investments East Africa Limited (NSE, 2022; Sanlam, 2022), indicate that firms with diverse investment portfolios may be more resilient to market volatility. Given that portfolio diversification mitigates risks and enhances returns, this study seeks to fill the research gap by analyzing its influence on financial performance and providing practical insights for investment firms, stockbrokers, and fund managers in navigating market uncertainties.

LITERATURE REVIEW

Theoretical Framework

Markowitz's Modern Portfolio Theory (MPT) (1952) provides a strong theoretical foundation for evaluating portfolio diversification strategies among Nairobi Securities Exchange (NSE) investment firms. The theory emphasizes optimizing risk-return trade-offs through diversification, making it particularly relevant for investment firms aiming to enhance financial performance while minimizing exposure to market fluctuations. MPT is applicable to this study because investment firms in Kenya operate in volatile financial markets, where risk management is crucial for sustaining profitability and investor confidence. The collapse of Discount Securities Limited and the financial success of Sanlam Investments East Africa Limited (NSE, 2022; Sanlam, 2022) demonstrate how portfolio composition can influence stability and growth. By examining how NSE-listed firms diversify their portfolios across asset classes and industries, this study applies MPT to assess whether diversification improves financial performance and reduces exposure to unsystematic risk.

Despite criticisms regarding rationality assumptions and market irregularities (Mandelbrot, 1963; Fama & French, 1992), MPT remains fundamental in investment decision-making. Its concepts of the efficient frontier, risk quantification, and asset correlation provide a structured approach for firms seeking optimal diversification strategies. Therefore, this study uses MPT as a guiding framework to analyze the effectiveness of portfolio diversification in enhancing financial stability among NSE investment firms.

Empirical Review

Portfolio diversification strategies have been widely examined in relation to financial performance across various sectors and markets. Oladimeji and Udosen (2019) investigated the effect of diversification strategies on organizational performance within the manufacturing sector in Nigeria. Using a quasi-experimental design and analyzing data from 31 organizations listed on the Nigerian Stock Exchange over a 20-year period, the study revealed that diversified organizations significantly outperformed undiversified ones in terms of Return on Assets (ROA) and Return on Investment (ROI). Different diversification strategies, including related, unrelated, and hybrid approaches, were assessed, showing that related diversification yielded a positive ROA of 26.8%, while unrelated and hybrid diversification demonstrated high returns on equity (ROE) at 81.7% and 20.5%, respectively. This evidence underscores the contribution of diversification to growth and profitability, as well as the establishment of a strong capital structure to manage liabilities effectively. Although this study confirms the profitability of diversification, its findings are limited to manufacturing firms and do not account for financial firms' portfolio allocations, necessitating an exploration of how diversification strategies impact NSE-listed investment firms.

Similarly, Bikeri (2022) explored the impact of portfolio diversification on the financial performance of investment firms in Kenya. Analyzing secondary data from 29 financial publications, the study employed Spearman's correlation analysis to assess the relationship between diversification and firm size. The results indicated a significant positive correlation between the diversification index and financial performance, suggesting that a broader portfolio enhances firm outcomes. However, a negative correlation with firm size was noted, implying diminishing returns with increased scale due to diseconomies of scale. Weak correlations between capital structure, liquidity, and financial performance further suggested that these variables had minimal influence on firm outcomes in the context of diversification. However, this study lacked a direct focus on NSE-listed firms and did not account for asset class diversification

Osewe (2020) examined portfolio diversification among investment firms listed on the Nairobi Securities Exchange (NSE), using indicators such as the Herfindahl-Hirschman Index (HHI) for portfolio diversity, firm size measured by total assets, and liquidity measured by the current ratio. A descriptive research design was adopted, targeting all five investment firms listed on the NSE. Findings from multiple regression analysis revealed that diversification significantly influenced financial performance, as measured by ROA. These results underscore the critical role of diversification strategies in enhancing investment firm performance in Kenya. While insightful, the study did not explore the risk management aspect of diversification, an aspect this research aims to address.

In Nigeria's industrial goods sector, Ehiedu and Priscilla (2022) assessed how corporate diversification strategies influenced financial performance. Historical data from 2012 to 2021, analyzed using least square regression, revealed contrasting impacts of diversification. Income diversification did not significantly affect ROA, but diversifying business segments positively influenced performance. This divergence highlights the importance of tailoring diversification strategies to industry-specific contexts for optimal outcomes. Ndungu and Muturi (2019) studied the impact of income, geographical, and product diversification on the financial performance of commercial banks in Kenya. Data from 2013 to 2017 indicated that income source and geographical diversification positively influenced performance, while product diversification had a negative impact. These findings emphasize the need for bank managers to carefully align diversification strategies with organizational structure, policies, and goals to maximize performance benefits. This study focused on the banking sector and not NSE.

Portfolio size also plays a crucial role in financial performance. Kimani and Aduda (2016) investigated the influence of portfolio size on the performance of investment firms in Kenya. Using a descriptive survey design and analyzing secondary data from 45 firms, the study found that stocks constituted the largest and most profitable portfolio allocation, followed by bonds and money market investments. Real estate portfolios, while prominent, yielded the lowest returns. These results highlight the importance of strategic asset allocation in optimizing financial outcomes for investment firms. Loan portfolio diversification has similarly attracted scholarly attention. Kumanayake et al. (2019) analyzed the impact of loan portfolio diversification on commercial bank performance in Sri Lanka. Using the Hirschman-Herfindahl Index to measure diversification and the CAMEL model to assess performance, the study revealed a negative relationship between loan diversification and financial performance. This finding challenges conventional wisdom and suggests that focusing on fewer, well-performing loan segments may enhance bank profitability. Similarly, Adzobu et al. (2017) found that loan diversification across sectors did not improve profitability or mitigate credit risks in Ghanaian banks, as measured by ROA and ROE. These results underscore the complexity of loan portfolio management and the need for banks to adopt focused strategies tailored to specific market conditions.

In Uganda, Luvuma (2021) explored the correlation between loan management practices and the financial performance of microfinance institutions (MFIs), focusing on BRAC as a case study. Key practices, including loan portfolio planning and client screening, showed significant positive relationships with financial performance metrics such as sales growth and return on investment. However, credit risk control had no significant impact, suggesting that its effectiveness may depend on the unique objectives and clientele of MFIs. These findings underline the importance of effective loan management strategies in enhancing financial outcomes for MFIs.

Onchomba (2020) examined the influence of loan composition on the financial performance of commercial banks in Kenya. Using data from 42 banks over a decade, the study revealed that personal, real estate, SME, and insider loans significantly influenced financial performance metrics such as ROA and ROE. Bank size, introduced as a moderating variable, enhanced the predictability of the model, demonstrating its critical role in shaping the relationship between loan portfolio composition and performance. These findings suggest that tailoring loan portfolios to specific market demands and leveraging bank size can optimize financial outcomes. Portfolio turnover is another critical aspect influencing financial performance. Silva et al. (2019) studied portfolio turnover in Brazilian equity investment funds, using fixed effects panel data and instrumental variable models. Findings indicated a positive relationship between turnover and performance, reflecting fund managers' ability to capitalize on market opportunities. This evidence supports the strategic use of portfolio turnover as a tool to enhance financial performance, particularly in dynamic investment environments.

Research Gaps

The review of literature highlights specific gaps in understanding the influence of portfolio diversification strategies on the financial performance of investment firms trading at the Nairobi Securities Exchange (NSE). First, while studies by Bikeri (2022) and Osewe (2020) establish a positive relationship between diversification and financial performance, they fail to provide detailed insights into which specific portfolio structures; such as asset allocation ratios or optimal portfolio size, contribute most significantly to financial outcomes among NSE-listed investment firms. This lack of granularity limits the applicability of findings for investment managers and financial strategists operating within the NSE. Second, most studies focus on broader financial institutions, such as banks and manufacturing firms, rather than investment firms listed on the NSE, which function under unique market dynamics (Osewe, 2020). Consequently, there is limited research on how portfolio turnover, sectoral diversification, and asset class allocations (stocks, bonds, and real estate) impact the financial performance of NSE-listed investment firms. Given that investment firms rely on capital markets rather than direct lending, their diversification strategies differ substantially from those of commercial banks, making this an important area for further research. Third, the role of external factors in moderating the relationship between diversification and financial performance at the NSE remains largely unexplored. While Bikeri (2022) highlights the benefits of diversification, there is little discussion on how macroeconomic conditions, regulatory environments, or market volatility influence its effectiveness. Additionally, the impact of diversification across different economic cycles, such as bear and bull markets or periods of economic uncertainty, is not well documented. This study seeks to address these gaps by assessing the influence of portfolio diversification practices on the performance of investment firms trading at NSE.

MATERIALS AND METHODS

Using a positivist approach, the research focused on empirical observation to investigate how firm-specific characteristics affect the financial performance of investment businesses registered on the Nairobi Securities Exchange (NSE). Panel data from secondary sources including NSE, CBK, and KNBS covering the years 2014–2023 was gathered using a correlational study approach. A census technique guaranteed thorough coverage free from sample error, and the target population included 63 investment businesses. To examine the connections between corporate governance, risk management procedures, portfolio diversification, and asset allocation, data analysis used panel regression models. Autocorrelation, Hausman, normality, and heteroscedasticity were among the diagnostic tests that confirmed the dependability of the data. Ownership structures' moderating influence on

these interactions was also evaluated. The degree and direction of the correlations between the variables were assessed using Pearson correlation analysis. Data analysis was supported by SPSS Version 27, and regression models were used to display the results. The strategy complemented the study's objective of methodically assessing the financial performance and firm-specific procedures.

FINDINGS

Descriptive Results for Portfolio Diversification Strategies

The descriptive analysis of portfolio diversification strategies revealed the following: The average portfolio size of investment firms was 211.06 billion, with a standard deviation of 81.62 billion, indicating significant variability in portfolio sizes. The loan portfolio had an average value of 147.69 billion, with a standard deviation of 69.49 billion, suggesting variability in loan exposures. Portfolio turnover averaged 0.586, with a standard deviation of 0.226, showing a moderate range in the frequency of asset trading. These statistics reflect diverse approaches to managing portfolios among firms, influencing their financial performance.

Table 1 Descriptive Results for Portfolio Diversification Strategies

Variable (billions)	Obs	Mean	Std. Dev	Min	Max
Portfolio size	530	211.0609	81.6159	55.4526	520
Loan portfolio	530	147.6889	69.49486	29.2572	438.7028
Portfolio turnover	530	0.5859695	0.2264577	0.189	1.5

Trend Analysis for Portfolio Diversification Strategies

The trend analysis of portfolio size from 2014 to 2023 revealed notable fluctuations in the asset portfolios of investment firms. In 2014, the portfolio size was 204.45 billion, showing a strong start. This figure decreased significantly in 2015 to 159.22 billion but increased steadily through 2017, reaching a peak of 239.72 billion. The trend then exhibited variability, with a drop to 203.03 billion in 2018 and a minor rise to 210.38 billion in 2019. Subsequent years saw a decrease to 170.87 billion in 2020, followed by an increase to 249.73 billion in 2022, and a slight drop to 239.73 billion in 2023. Overall, the trend indicated a general upward trajectory in portfolio size over the period, with some annual volatility, suggesting that firms had been expanding their portfolios but faced varying influences affecting their growth each year.

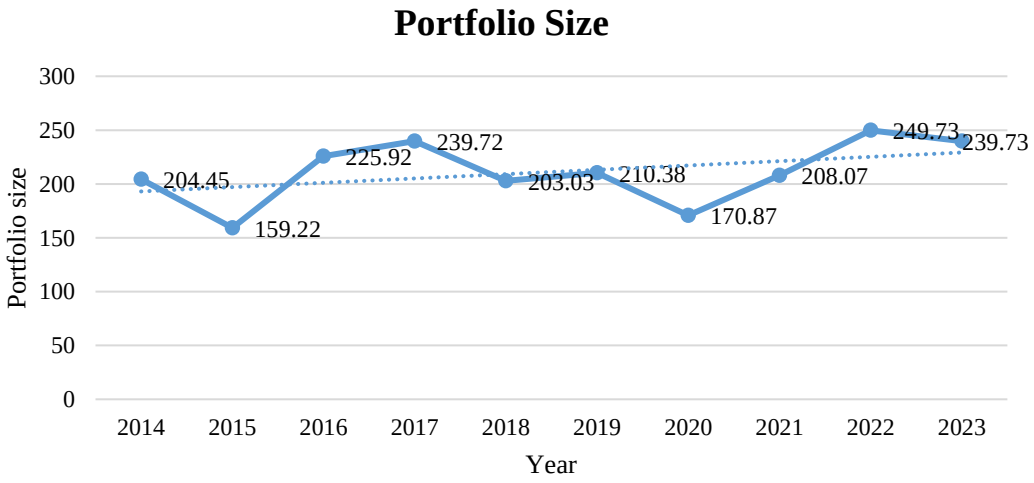

Figure 1 Trend Analysis of Portfolio Size

The trend analysis of the loan portfolio from 2014 to 2023 highlighted significant variations over the period. In 2014, the loan portfolio was 78.83 billion, showing an initial modest level. It increased substantially in 2015 to 129.89 billion and continued to rise, reaching 155.49 billion in 2016. However, the growth moderated slightly in 2017, with the portfolio amounting to 154.02 billion, and remained relatively stable in the subsequent years, peaking at 172.89 billion in 2019. The loan portfolio then experienced a decline to 150.99 billion in 2020, before rising again to 159.06 billion in 2021. It decreased to 140.57 billion in 2022 but surged to 177.45 billion by 2023. Overall, the trend indicated a general upward trajectory in the loan portfolio, with notable fluctuations, reflecting varying lending strategies and market conditions over the years.

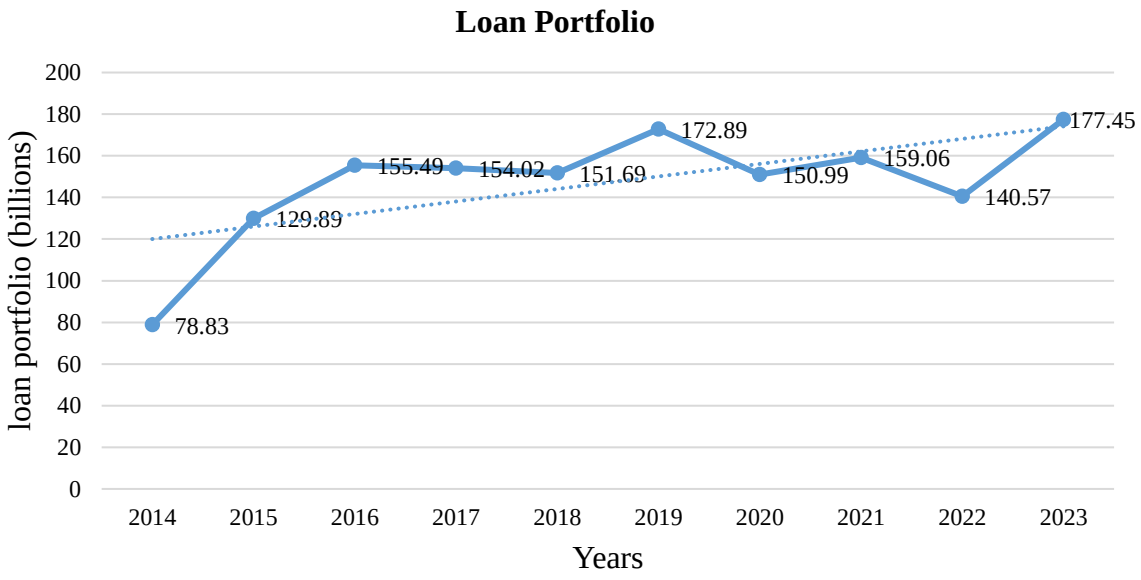

Figure 2 Trend Analysis of Loan Portfolio

The trend analysis from 2014 to 2023 showed fluctuating patterns in the frequency with which firms traded their assets. In 2014, the portfolio turnover was 0.65, reflecting relatively high trading activity. It decreased to 0.48 in 2015 butlater a rise to 0.55 in 2016. The turnover rate then dipped to 0.49 in 2017 and increased to 0.53 in 2018. A notable increase occurred in 2019, with the turnover reaching 0.68, and it remained at the same level in 2021. The rate decreased to 0.50 in 2022 before rising again to 0.78 in 2023. This overall trend indicated variability in trading activity, with periods of increased turnover suggesting more active portfolio management, while lower turnover rates reflected periods of reduced trading activity.

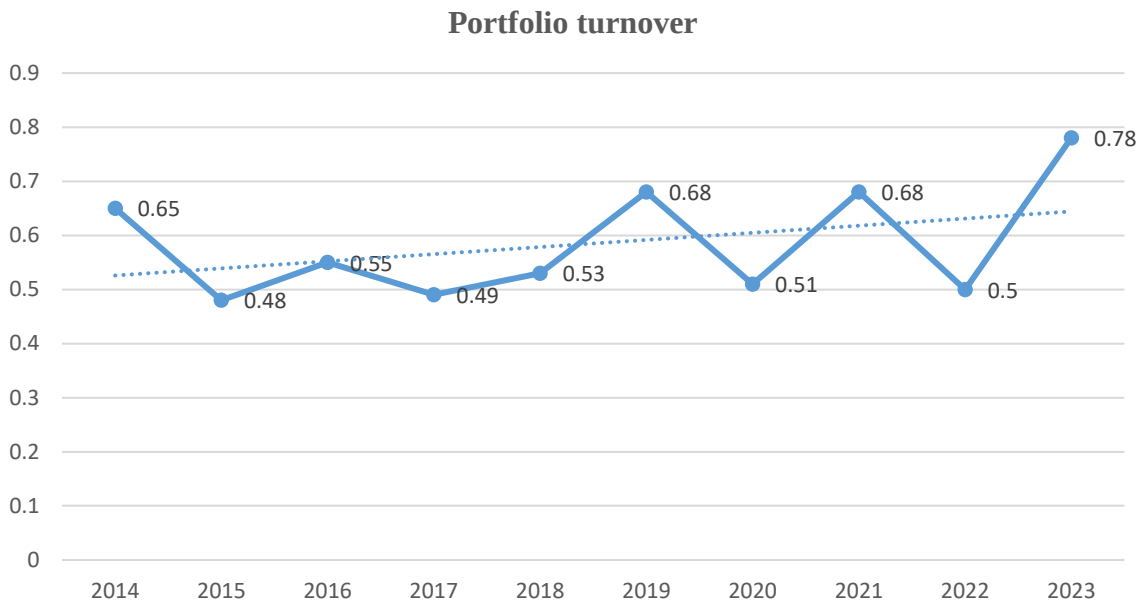

Figure 3 Trend Analysis of Portfolio Turnover

Relationship between Portfolio Diversification and Financial Performance Indicators

The study aimed to assess how portfolio diversification impacts financial performance indicators; ROA, ROE, and a composite measure of financial performance, among investment firms trading at NSE. In the analysis of ROA, portfolio diversification exhibited a coefficient of 0.007968. This positive, though relatively small, coefficient suggested that increased diversification had a minor but beneficial impact on ROA. The R-squared value for this model was 0.3922, indicating that approximately 39.22% of the variability in ROA was explained by portfolio diversification. According to Modern Portfolio Theory (MPT), diversification can reduce unsystematic risk, potentially leading to more efficient use of assets and improved asset-based returns (Sharpe, 1964). The small coefficient in this model reflected that while diversification contributes positively to asset utilization, the impact may be incremental rather than substantial. The findings agree with empirical evidence by Luvuma (2020) and Abad et al. (2022), who highlight that diversification stabilize earnings, which aligns with the observed positive effect on ROA.

The second model focused on Return on Equity (ROE), with portfolio diversification showing a coefficient of 0.0561571. This coefficient indicated a more pronounced effect of diversification on ROE compared to ROA. The R-squared value for this model was 0.4261, meaning that 42.61% of the variance in ROE was explained by portfolio diversification. This indicates a stronger relationship compared to ROA, suggesting that diversification strategies had a more pronounced effect on equity returns. The Capital Asset Pricing Model (CAPM) supports this finding by associating diversification with a reduction in risk and an enhancement in expected returns (Sharpe, 1964). Diversification helps mitigate portfolio risk, allowing firms to achieve higher returns on equity as they better manage market fluctuations. The findings align with previous studies, such as those by Kimani and Aduada (2016), which found that diversification positively influences ROE, validating the observed impact in this study. The substantial coefficient for ROE reflects the effectiveness of diversification strategies in improving returns on equity, providing a clear benefit to shareholders.

The third model utilized a composite measure of financial performance, with portfolio diversification having a coefficient of 0.0320625. This intermediate coefficient suggested a

moderate positive effect of diversification on overall financial performance. The R-squared value for this model was 0.4497, suggesting that 44.97% of the variability in composite financial performance was explained by portfolio diversification. This higher R-squared value reflects a relatively strong explanatory power, indicating that diversification strategies were important in influencing overall financial health. According to the RBV theory, firm-specific resources, such as effective diversification strategies, can lead to enhanced financial performance. Diversification enables firms to leverage a variety of assets, improving overall financial stability and performance. The composite measure's positive coefficient indicates that diversification contributes to a well-rounded improvement in financial performance. Empirical research, including findings by Luvuma (2021) and Abad et al. (2022) support this view by demonstrating that diversification enhances overall financial performance through risk reduction and improved returns.

Table 2 Relationship between Portfolio Diversification and Financial Performance Indicators

Model	Model 1(ROA)	Model 2(ROE)	Model 3 (Composite Financial Performance)
Portfolio Diversification	.007968	.0561571	.0320625
_Cons	.1853884	.9562181	.5708036
Number of obs	530	530	530
F	340.65	392.01	433.34
Prob > F	0.0000	0.000	0.000
R-squared	0.3922	0.4261	0.4497
T	149.2981	6825.36051	2103.14298
DoF	529	529	529

Hypothesis Testing for the Relationship between Portfolio Diversification Strategies and Financial Performance

H_{02}: Portfolio Diversification Practices have no significant influence on Financial Performance of Investment Firms Trading at the NSE.

The hypothesis H_{02} was rejected. The analysis showed significant coefficients across all models: ROA (0.007968), ROE (0.0561571), and composite financial performance (0.0320625). These results indicated that portfolio diversification did have a measurable impact on financial performance. The R-squared values, ranging from 0.3922 to 0.4497, confirmed that diversification explained a substantial portion of the variance in financial performance indicators. This suggests that portfolio diversification practices significantly influenced financial performance, affirming the importance of diversification strategies in enhancing financial outcomes for investment firms at the NSE.

CONCLUSION AND RECOMMENDATIONS

Summary

The study found that portfolio fluctuations impacted financial performance among NSE-listed investment firms, with diversification acting as both a stabilizing and profit-enhancing factor. Despite annual volatility, portfolio sizes showed an upward trend, while loan portfolios exhibited steady growth, peaking at Kshs 177.45 billion in 2023. Regression results indicated

that diversification positively influenced ROA (0.007968), ROE (0.0561571), and overall performance (0.0320625), explaining 39.22% to 44.97% of financial variability. While trading strategies shifted over time, well-diversified firms demonstrated greater financial resilience and profitability, aligning with Modern Portfolio Theory by reducing unsystematic risk while optimizing returns.

Conclusions

The study examined how portfolio diversification affects the financial performance of investment firms at the NSE. It found considerable variability in portfolio sizes and loan exposures among firms, with average portfolio turnover reflecting moderate trading activity. Regression analysis revealed that diversification had a minor but positive effect on Return on Assets (ROA), with a coefficient indicating incremental benefits. However, its impact on Return on Equity (ROE) was more pronounced, suggesting that diversification significantly enhances shareholder returns. The composite measure of financial performance also showed a moderate positive effect from diversification, highlighting its importance in improving overall financial stability. These findings align with theories suggesting that diversification reduces risk and improves returns, supporting the view that effective diversification strategies enhance financial performance.

Recommendations

The study findings highlight that robust portfolio diversification practices positively impact the financial performance of investment firms. To enhance this aspect, firms should expand their portfolios to include a broader range of asset classes and geographic regions, thereby reducing risk and improving potential returns. Conducting thorough market research to identify diversification opportunities and utilizing sophisticated analytics will guide effective diversification strategies. Regular portfolio reviews and adjustments based on market conditions are essential for maintaining a well-diversified portfolio aligned with financial objectives.

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