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A THEORITICAL REVIEW OF THE IMPACT OF PORFOLIO DIVERSIFICATION ON FINANCIAL PERFORMANCE OF INVESTMENT FIRMS LISTED IN NAIROBI SECURITIES EXCHANGE, KENYA

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Abstract

The concept of diversification has taken a universal centre stage in the process of management and continues to be an increasingly important aspect of doing business in the world of today. The relationship between diversification and firm performance has formed the subject of many researches but many researchers have disagreed on the nature of the relationship between diversification and performance. Because of the contradictory results concerning the relationship between diversification and performance, the question of whether diversification improves or worsens firm performance is still worthy of further research such as the one being undertaken in this study. In addition, despite the existence of these studies, very little attention has been given to the developing countries. Besides, the impact of diversification on firm performance has not received adequate research attention in Kenya. The study will examine the Impact of portfolio diversification on financial performance of investment firms listed in the NSE in Kenya. The study will take an explanatory non experimental research design. The target population for the study will be the investment firms listed in the NSE. A census total of 5 investment firms will be considered. Data collection will be done using secondary data to be obtained from the company websites, handbooks, printed materials from the NSE and CMA. The five firms are Olympia capital holdings, Tran century limited, centum investments, Home Africa limited and Kurwitu ventures. The study will span between 2011 and 2016. The study will employ the panel regression model to analyze the impact of portfolio diversification on financial performance of investment firms listed in the NSE. Given that the data had both time series and cross sectional dimensions, the study estimated a linear panel regression. Panel data analysis is more advantageous than either cross-section or time series alone because it allows the researcher to account for unobservable heterogeneity. The panel methodology will be aided by STATA 13.0 software. After extracting data from the financial statements, an Excel program will be used to compute the relevant values for each of the companies across time. The data will then be formatted in STATA long form before being imported to STATA from Excel. Descriptive statistics will be used to summarize and profile Stocks, real estate, bonds and the combined Impact of the three and performance among companies listed in the NSE. Feasible Generalised Least Square estimation will be performed after accounting for various violations of classical linear regression assumptions. Panel data can be estimated using any of the following models: pooled effects or constant effects, random effects, and fixed effects.

Keywords: diversification, performance, financial markets, portfolio, stock exchange

1.0 Background to the study

Financial markets bridge the gap between people and organizations in need of money with those with surplus funds. Different markets exist and each market deals with different type of instruments, customers and location. The classification of financial markets equally varies. Financial markets deal with the so called Stocks which comprise of stocks, bonds, notes, mortgages, derivatives and other financial instruments. Markets can also be spot or futures depending on whether the assets are being bought or sold for on the spot delivery or delivery on some day in the future which could be several months or an year. Financial markets can also be money markets or financial markets; Money markets are markets for highly liquid short term debt securities whereas capital markets are markets deal in common stocks and bonds with maturity of more than one year (Erdhart & Brigham, 2009).

Investment can be defined as that process of committing resources for a given period of time with a view of receiving resources in future in order to compensate the investors for committing their funds commensurate to the risk taken and prevailing inflation rate. The main reasons as to why companies invest is because of fear of

future cash shortages and maximizing shareholder wealth through risk return trade off (Karimi, D.G., 2011) Renshaw (2008) defined a portfolio as an investment collection which may be owned institutionally or individually. The portfolio composition includes stocks characterized by investment in individual companies, investment in companies also called bonds and investment in collective investment vehicles such as unit trusts and mutual funds which are professionally managed. He further argued that the portfolio could also be a group of assets considered financial in nature such as bonds, stocks and mutual funds. This was in agreement with Nyora (2015) who added that a portfolio could comprise of hedge funds, equity funds, exchange traded funds and futures, mutual funds, options, bonds and stocks.

Diversification was defined as a designed strategy of reducing risk through combinations of various investments (Rop, kibet & Bokongo, 2016). The returns from a portfolio will be dependent on risk. In order to minimize the risk associated with the individual assets in the portfolio, investment firms resort to diversification whereby different assets which are negatively correlated are mixed in the portfolio in order to maximize returns and minimize risk. However, the risk premium varies from country to country and has been found to be particularly high in emerging and developing markets because of volatility and risk associated with such markets (Vishwanath, S.R., 2007).

Evaluation of the returns of a portfolio of assets especially risky assets still remains one of the biggest challenges in finance today. The evaluation of returns for any portfolio is crucial in determining the ability of investment managers to add value the resources under their disposal. The main aim of investing is to increase and protect investor's wealth (Musembi, 2016).

According to Jabbazadeh et al. (2014) firm growth is very crucially affected by effective investments. Investments exist in different forms and of key importance would be the increase of the firms' physical assets or capacity and Stocks characterized by bonds and shares. After all the investors are interested in how the portfolios have performed and will even go an extra mile to compare their returns with those of other investment firms. By investing in Stocks of other companies to obtain a return on their shareholders, investment firms play the role of financial intermediaries. The fact that investment firms' deal in buying and selling of Stocks such as bonds and shares instead of the normal goods and services separates them from other businesses (Jabbazadeh et al. 2014).A firm cannot be managed properly without making investment decisions in order to enhance the value of the firm. Investors have to evaluate the portfolio performance of the firm in order to make key decisions involving when to hold, buy and sell their investments. More, importantly, shareholders are interested in investments which will give them the highest returns (Eslamibidgoli, Tehrani & Shrazian, 2005).

1.1.1 Financial performance

Financial performance for investment firms is done from the customer perspective and firm perspective. The customer perspective is concerned with the return rates entitled to customers on
the principal invested. Firm perspective concerns itself with returns paid to the customers and the balance is adjusted for administrative costs like depreciation and salaries. Adjustment of the final figure for taxes and interest expenses gives the profit after taxes (Kimeu, 2015).

Various profitability measures have been adopted in analysis of financial statements planning in the long term. Performance measurement makes organizations accountable. There is a need for managers to improve performance coupled with value judgment for all the stakeholders.

Among the most prominent measures of performance is Return on investment which is computed by subdivision of net income by the amount of assets. Return on assets (ROA) is considered the most accurate when it comes to measuring performance (Kamwaro, 2008). However, Willie and Hopkins (1997) argued that the final measure of performance for any institution should not be its asset size, number of branches or its technological capacities but rather the Return on equity for its shareholders abbreviated as ROE. They surmise that ROE is the ultimate measure of financial performance. ROA and ROE will be used as measures of performance for this study.

1.1.2 Portfolio diversification

Diversification has been one of the most popular strategies adopted by corporate across the globe in the past two decades. The strategy was more prominent in the United States and Europe in the 1960s and 80s.The period was characterized by corporations trying to expand through mergers and acquisitions. However, questions and arguments abounded on the value of the diversification strategy on creating value of the firm (Eukeria and Favourate , 2014).

The portfolio problem was formulated by Harry Marokwitz (1959) as a choice of the mean and variance of the given assets based on the principles that when variance is kept constant while expected returns are maximized. Diversification of operations by firms is done across multiple lines of business or different markets with a view

to increase economies of scale, efficiency and scope. Diversification improves debt capacity, minimizes distress costs and leads to increase in asset deployment and improvement in firm profitability (Hitt, Hoskinson and Kim, 1997)

Portfolio performance is measured in terms of risk adjusted return. The objective of diversification is reduction of risk without reduction in the return or yield. The investment firm can reduce or eliminate risk through combination of assets into a portfolio. The aforementioned reduction is regarded as low cost (Claurette and sirmans, 1996). In order to understand diversification; risk is divided into systematic and unsystematic risk. To a greater or lesser extent, systematic risk affects all assets in the market while systematic risk is asset class and submarket specific. The latter also called diversifiable risk is associated with random factors that can be eliminated via diversification (Welner & Thomas , 2004).

Portfolio diversification is implemented albeit in the simplest level by merely spreading the investment over many assets to remove unsystematic risk. For real estate, the common risk measured called average portfolio variance rapidly decreases as more properties increase from one to ten. For shares, arrange of 12 to 18 stocks do achieve 90% of diversification benefits (Reilly & Brown, 2004).

1.1.3 Portfolio diversification and financial performance

Studies on the relationship between portfolio diversification and financial performance of investment firms have produced mixed results. Kamwaro (2008) undertook a causal research design approach in studying the impact of portfolio choice on financial performance of investment companies in Kenya. He did a census of the 4 investment firms which were listed at the Nairobi securities exchange covering the period between 2007 and 2011 using secondary data. He applied multiple linear regression and the method of ordinary least squares to establish the impact of investment portfolio choice on investment firms. The findings indicate that investment in bonds, real estate, equity and size of the company positively impacted on financial performance of unit trusts.

Another study by kimeu (2014) undertook a descriptive study to find out the impact of portfolio composition on financial composition of investment companies listed with Nairobi securities exchange. He did a census of all the five companies listed with the exchange covering the period between 2012 to 2014 using secondary data. He also applied multiple linear regression and operation of least squares like kamwaro (2008).The findings are in agreement with kamwaro (2008).

Rop, kibet and Bokongo (2016) investigated the effect of portfolio diversification on financial performance of commercial banks in Kenya. The study employed an exploratory research design whereby secondary data was collected using data collection sheets for secondary data and interviews were conducted to collect primary data from a sample of 40 banks. The study concluded that much work was needed to promote diversification of bank portfolios.Karimi (2013) investigated the relationship between portfolio choice and profitability of investments companies listed with Nairobi Securities exchange by employing a descriptive research design .The study's population was 4 companies listed at the NSE as at 2012.A stratified sample of 49 managers was selected and questionnaires administered. The findings of the study indicate that investment is about selecting the right combination of stocks with minimal risks.

1.1.4 Investment Companies listed in the NSE Kenya

Licensing of Investment companies is done by the capital markets authority of Kenya (CMA).Registration is done under the collective investment schemes with each company operating according to the terms and conditions of the license taken. Over 50 % of the economic power of eastern Africa is represented by Kenya which has the most active stock market called Nairobi Securities exchange. However, even with growth in the number of investment firms, stakeholders have been slower in embracing the investment opportunities that come with the various schemes. As of February 2017, there were 5 investment companies listed with the Capital markets authority and listed with Nairobi securities exchange in Kenya .These include centum, Olympia capital holdings, Transcentury, Kurwitu ventures and Home Africa limited.

1.2 Statement of the problem

The concept of diversification has taken a universal centre stage in the process of management. Elango and Ma (2003) argued that diversification was an increasingly important aspect of doing business in the world of today. The relationship between diversification and firm performance has formed the subject of many studies but many researchers have agreed to differ on the nature of the relationship between diversification and performance (Hitt, Hoskinson and Kim, 1997).

Some studies have shown that diversification improves financial performance over time

(Kamwaro, 2008; Mulei and Kosgei, 2010; Odhiambo, 2013; Karimi, 2013 and Kimeu, 2014) others have

indicated that diversification negatively affects performance (Lloyd and Jahera, 1994; Wan, 1998). Still others have shown that no relationship exists whatsoever between diversification and firm performance (Shyu and Chen, 2009).The empirical evidences from emerging markets about the impacts of diversification on firm performance have so far yielded mixed, inconclusive and contradictory results.

Odhiambo (2013) studied the association between portfolio diversification and financial performance of deposit taking savings and credit cooperative societies in Kenya authorized to operate in Kenya by Nairobi County. Portfolio diversification was measured by working capital management represented by financial conversion cycle, current ratio, debt ratio and turnover growth. The study concluded that portfolio diversification influences the performance of SACCOS positively. The study focused on SACCOS in Nairobi only negating the rest of the country.

Another study by kimeu (2014) undertook a descriptive study to find out the Impact of portfolio composition on financial composition of investment companies listed with Nairobi securities exchange. He did a census of all the five companies listed with the exchange covering the period between 2012 to 2014 using secondary data. He also applied multiple linear regression and operation of least squares like kamwaro (2008).The findings were in agreement with kamwaro (2008).

Mulwa and kosgei (2016) used an expose facto design to investigate the Impact of diversification, solvency and credit risk on financial performance on banks using panel data from 43 banks in Kenya over nine years. The findings of the study indicate that income and asset diversification negatively and significantly affects the commercial banks ROA while geographical diversification positively and significantly affects ROA and ROE. Also, a significant positive moderation Impact was found between geographical diversification and ROE. This was in agreement with Makhoha, Namusonge and Sakwa (2016).

An investigation by Shyu and Chen (2009) evaluated the extent of firms diversification and their performance with respective to their different stages in life in China. Firms in their growth stage showed significant results but those at their maturity showed dismal results vis a vis performance. The findings also indicated that firms in mature stage engaged which were engaged in related business had wonderful performance. The study concluded that the stage of the firm in its lifecycle significantly affected the relationship between diversifying into related and unrelated business and performance.

Lloyd and Jahera (1994) investigated the relationship between diversification and firm performance as measured by Tobin q. They measured diversification with the help of related ratio which is based on the firm's sales from different segments. Diversification strategies were divided into related and unrelated diversification. Their findings indicated that there was no significant relationship between firm diversification strategy and long run performance as measured by Tobin q. No significant results were found by testing an alternative model. This was in agreement with Wan (1998).The relationship between diversification and financial performance remains controversial because of the diversity in research findings shown. Thus, the question of whether diversification improves or worsens firm performance is still worthy of further research such as the one being undertaken in this study.

In addition, despite the existence of these studies, very little attention has been given to the developing countries. Besides, the impact of diversification on firm performance has not received adequate research attention in Kenya. This means that there is a major gap in the relevant literature on developing countries including Kenya, which has to be covered by research. This research attempts to fill this gap by studying the situation of the Kenyan companies and provide more empirical evidence on the Impacts of portfolio diversification on investment firms' performance in Kenya.

1.3 Objectives of the study

1.3.1 General objective

To determine the impact of portfolio diversification on financial performance of investment firms listed with NSE Kenya.

1.3.2 Specific objectives

i. To determine the impact of Stock investments on financial performance of investment firms listed in the NSE Kenya.
ii. To establish the impact of real estate investments on the financial performance of investment firms listed in the NSE Kenya
iii. To determine the impact bond investments on financial performance of investment firms listed in the NSE Kenya
iv. To establish the combined impact of stock investments, real estate investments and bonds investments on financial performance of investment firms listed in the NSE Kenya

v. To determine the moderating role of Gross Domestic Product on the impact of portfolio diversification on financial performance of investment firms listed in the NSE Kenya.

1.4 Research hypothesis

The null hypotheses will be:

i. There is no significant relationship between Stock investments and financial performance of investment firms listed in the NSE Kenya
ii. There is no significant relationship between real estate investments and financial performance of investment firms listed in the NSE Kenya
iii. There is no significant relationship between bond investments and financial performance of investment firms listed in the NSE Kenya.
iv. There is no significant combined Impact of Stock investments, real estate investments and bond investments on financial performance of investment firms listed in the NSE Kenya
v. There is no significant effect of Gross Domestic product on the impact of portfolio diversification on financial performance of investments firms listed in the NSE Kenya.

1.5 Significance of the study

The research will be of importance to fund managers, the government, policy formulators, researchers and academicians. The management of investment firms is charged with the responsibility of investing investors' funds with an objective of maximizing wealth. This study can significantly benefit them by availing crucial information on how portfolio diversification affects the financial performance of their firms enabling them to take precautionary measures and diversify their portfolios.

The study will also assist prospective investors understand how their investment objectives are influenced by diversification. Prospective investors will find this study quite informative and ground breaking in terms of providing guidance and impetus to invest in investment firms which provide good returns on investment if done correctly.The government of Kenya plays a key role in the economy through policy formulation, implementation and taking corrective measures to restore equilibrium to the economy in case of undesirable effects. This is aimed at spurring economic growth and protecting investors. By providing insights on how portfolio diversification affects financial performance of investment firms, my study will help the government formulate and implement better policies which will be guided by key macroeconomic variables analysis and evidence as presented in my research.

To academics and researchers, the study will provided a platform for constructive discussion and debate amongst academicians, policy makers, and professionals and provides a basis for further research regarding macroeconomic variables and unit trust financial performance.

1.6 Scope of the study

The research will cover a population of 5 investment firms which have been licensed and approved by the NSE in Kenya. The Stocks will comprise of both quoted and unquoted stock investments, real estate investments will be measured by the value of money invested in investment property and the value of bonds will be used as taken from the firm's financial statements. The study will cover the period between 2011-2016.

2.0 Theoretical literature

The study will be based on Markowitz portfolio theory, capital market theory, and total portfolio theory.

2.1 Markowitz Portfolio Theory

According to Markowitz (1952) several assumptions must be formulated concerning investor behavior in portfolio management. The assumptions include; the investor views each investment alternative to be represented by distribution probability of the expected returns over the period of the investment was held. Also, there is maximization of expected utility for one period the curves of utility demonstrate marginal wealth utility, utility curves of investors are a function of expected risk and returns because investors solely base decisions on expected risk and return. He also argued that less risk will always be preferred by investors for any given expected return level. A good understanding of the shareholders wealth was advocated for in evaluating the asset classes for various investors by the fund manager as it also influence the risk appetite for trustees in a pension fund.

Investors weigh all investment options as representations of potential classifications of future returns for given period of time. Also, one period expected utility is maximized by investors as they are in possession of utility

curves demonstrating diminishing wealth marginal utility. Concurrently, variability of expected returns is used as basis for estimating risk. In this framework, assets and portfolios are efficient if no other alternative offers higher expected returns for similar or lower risk (Pandey, 2010).

2.2 Capital markets theory

The theory posits an upward sloping market. This means that greater risk accompanies greater return. According to Van Horne and Wachowicz (2010) during recession bond risk premiums go up very fast due to increase in default risk obligations which are rated low. The theory also relates with risk return behavior of fixed income securities to other Stocks. This is an important factor in evaluating the asset mix. The fixed income securities are expected on the lower end of the capital market line since they are relatively considered conservative investments.

The capital market theory being a buildup of Markowitz portfolio model assumes that investors follow the efficient frontier by Markowitz and hence invest in portfolios along the capital market line, investor have the ability to lend or borrow at the risk free rate meaning investors have lack of taxes and transaction costs, same probability of outcomes for all investors, no inflation and no mispricing within the capital markets (Capital markets, n.d.).

The different types of assets are traded in the stock market and they include stocks, bonds, real estate and mortgages. Most of these instruments have long maturity periods. One has to determine the risk and return for individual assets and portfolio of assets when pricing securities according to the capital markets theory. Risks are defined by the variability and uncertainty of returns on assets and possibility of losses. Returns according to the capital markets theory are defined as follows:

$K = Pt + Ct – Pt-1 / Pt-1$

Where K is the return for the time period t-1 , Ct is cash gotten from assets between t-1 and t, Pt is asset price at time t and t-1 is time purchase of asset of price Pt-1.(Capital markets theory, n.d)

2.3 The Total Portfolio Theory

Total portfolio theory posits that bond performance is actually higher that the indicated returns owing to the significant diversification benefits associated with bonds. When the market is efficient, combination of stocks and bonds yields higher risk adjusted returns than individual stocks or bonds (Njeru, Dominic and Fredrick, 2015).The combination of stocks and bonds improves the return per unit risk because of the low correlation between said bonds and stocks.

The end product would be maximization of the portfolio returns. Bonds create a balance for returns and liquidity. Total return represents the actual rate of return of an investment or a pool of investments over a given evaluation period. It includes interest, capital gains, dividends and distributions realized over a given period of time. Total return accounts for two categories of return: income and capital appreciation. Income includes interest paid by fixed-income investments, distributions or dividends. Capital appreciation represents the change in the market price of an asset (Total portfolio return, n.d.).

2.3 Empirical literature

2.3.1 Impact of stock investments on financial performance of investment firms in NSE Kenya

Studies on the Impact of portfolio diversification on financial performance have produced different results. Different perspectives have been used to define the impact of portfolio diversification on firm performance. The said impact is influenced by many factors. In some instances, the strategies adopted by firms in diversification have been used as a base for the various studies. The conclusions from the said studies have been equally diverse. Some studies have concluded that diversification into related business had a positive Impact on performance while diversification into unrelated business had a negative on performance and decrease in shareholders' value. Management decision making, risk and location were identified as factors influencing diversification (Hameed and Qadeer, 2012).

According to Kimani and Mutuku (2013) stock markets provide an avenue for portfolio diversification to individuals and company investors by pooling and mobilizing savings from those who don't need them currently and availing them to alternative corporations for utilization. They also added that investment in shares leads to financial gains coupled with liquidity. Studies on the relationship between portfolio diversification and financial performance of investment firms have produced mixed results.

2.3.2 Impact of real estate investments on financial performance of investment firms in NSE Kenya

Kamwaro (2008) undertook a causal research design approach in studying the impact of portfolio choice on financial performance of investment companies in Kenya. He did a census of the 4 investment firms which were

listed at the Nairobi securities exchange covering the period between 2007 and 2011 using secondary data. He applied multiple linear regression and the method of ordinary least squares to establish the impact of investment portfolio choice on investment firms. The findings indicate that investment in bonds, real estate, equity and size of the company positively impacted on financial performance of unit trusts.

Odhiambo (2013) studied the association between portfolio diversification and financial performance of deposit taking savings and credit cooperative societies in Kenya authorized to operate in Kenya by Nairobi County. Portfolio diversification was measured by working capital management represented by financial conversion cycle, current ratio, and debt ratio and turnover growth. The study concluded that portfolio diversification influences the performance of SACCOS positively.

Karimi (2013) investigated the relationship between portfolio choice and profitability of investments companies listed with Nairobi Securities exchange by employing a descriptive research design .The study's population was 4 companies listed at the NSE as at 2012.A stratified sample of 49 managers was selected and questionnaires administered. The findings of the study indicate that investment is about selecting the right combination of stocks with minimal risks. The study also concluded that institutional investors are more conservative when it comes to investment and their strategy is to combine the highest return with the lowest risk possible.

Another study by kimeu (2014) undertook a descriptive study to find out the Impact of portfolio composition on financial composition of investment companies listed with Nairobi securities exchange. He did a census of all the five companies listed with the exchange covering the period between 2012 to 2014 using secondary data. He also applied multiple linear regression and operation of least squares like kamwaro (2008).The findings are in agreement with Kamwaro (2008).

2.3.3 Impact of bond investments on financial performance of investment firms in NSE Kenya

Rop, kibet and Bokongo (2016) investigated the Impact of portfolio diversification on financial performance of commercial banks in Kenya. The study employed an exploratory research design whereby secondary data was collected using data collection sheets for secondary data and interviews were conducted to collect primary data from a sample of 40 banks. The study concluded that much work was needed to promote diversification of bank portfolios.Mulwa and kosgei (2016) used an expose facto design to investigate the Impact of diversification, solvency and credit risk on financial performance on banks using panel data from 43 banks in Kenya over nine years. The findings of the study indicate that income and asset diversification negatively and significantly affects the commercial banks ROA while geographical diversification positively and significantly affects ROA and ROE. Also, a significant positive moderation Impact was found between geographical diversification and ROE.

Makhoha, Namusonge and Sakwa (2016) examined portfolio diversification on financial performance of banks. Mixed research design was used and data collected using questionnaires and interviews on 43 commercial banks in Kenya and 133 managers randomly selected. It was established portfolio diversification significantly and positively influenced financial performance of commercial banks in Kenya and that diversification of investments dad enabled increase in profits and performance in the past years. This was in agreement with Mulwa and kosgei (2016).

Ojo (2009) examined the impact of corporate diversification on firm performance of selected Nigerian companies. Survey design was adopted for the study with application of simple random sampling technique in selecting case study companies as well as the respondents. Primary data was collected through questionnaires. The hypothesis was tested using data analyzed through descriptive statistics, correlation and coefficient of determination. The study concluded diversification positively impacted on performance of firms in Nigeria. The study focused on the diversification strategies on selected firms and disregarded other firms.

2.3.4 The combined impact of stock, real estate and bond investments on financial performance of investment firms in NSE Kenya

In Taiwan, Hsu and Liu (2008) illuminate how a firm's operating context affects the relationships between corporate diversification strategies and firm performance. The study examined the features of diversification; a firm's operating context and its impacts on economic performance in detail. Using a longitudinal data containing firm-level operation information during 1997-2002, the empirical investigation found that product diversity and customer diversity were positively associated with firm performance, whereas geographic diversity is negatively associated with firm performance.

However, contractual manufacturing model was not only positively associated with firm performance, but also acts as a moderator between product diversity and firm performance. Taiwan is a developed economy and thus the findings of the study may not apply in Kenya which is a developing market. This creates a contextual gap which is filled by my study (Taiwan, Hsu and Liu, 2008).

An investigation by Shyu and Chen (2009) evaluated the extent of firms diversification and their performance with respective to their different stages in life in China. Firms in their growth stage showed significant results but

those at their maturity showed dismal results vis a vis performance. The findings also indicated that firms in mature stage engaged which were engaged in related business had wonderful performance. The study concluded that the stage of the firm in its lifecycle significantly affected the relationship between diversifying into related and unrelated business and performance.

Lloyd and Jahera (1994) investigated the relationship between diversification and firm performance as measured by Tobin q. They measured diversification with the help of related ratio which is based on the firm's sales from different segments. Diversification strategies were divided into related and unrelated diversification. Their findings indicated that there was no significant relationship between firm diversification strategy and long run performance as measured by Tobin q. No significant results were found by testing an alternative model.

2.3.5 The moderating effect of Gross Domestic Product on portfolio diversification and financial performance of investment firms listed in the NSE Kenya.

Studies were conducted in India to examine how stock prices of listed companies were affected gross domestic product, inflation and interest rate for the period of 1997 to 2009. Stock market index was used as a proxy for stock prices in the model. Data analysis was done using regression and the findings indicate that the macroeconomic variables fully explained volatility in stock prices with a percentage of 95.6%. Interest rate and inflation positively affected stock prices whereas GDP negatively influenced stock prices (Reddy, 2012).

A comparative study was done on four Anglo Saxon economies located in different continents for the period between 1959 to 2010.The countries of interest were US, UK, Canada and Australia. The objective of the study was to explore the mechanics of cross country volatility transmission for the 4 countries. The study employed the GARCH model. The study found that cross mean spillovers from GDP to returns of stock markets were prevalent in the growth of the US towards the stock market. Crossovers mean spillovers which were specific to countries were concentrated in the US and Australia while the US economy had the greatest impacts on the other three economies. Co volatility was confirmed for stock returns and growth of GDP for all the countries of interest (Karunanayake *et al*., 2012)

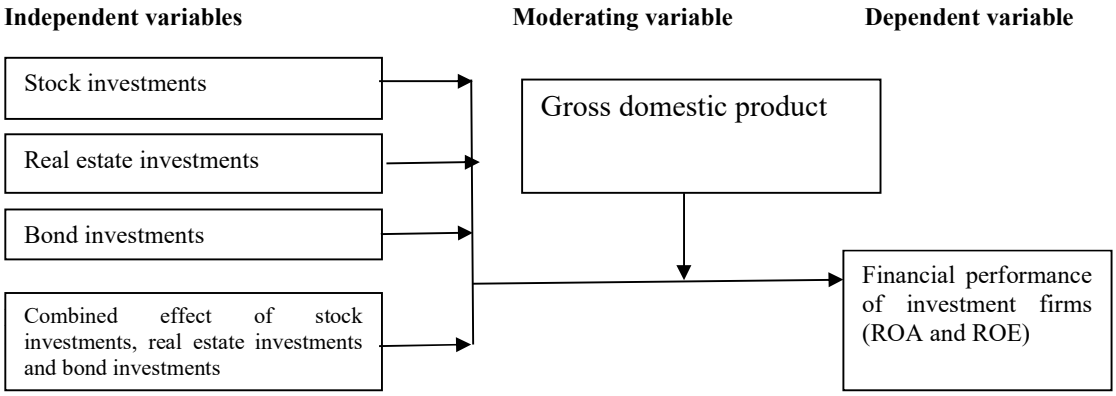
A research in Kenya sought to test whether macroeconomic variables significantly influenced performance of deposit taking microfinance institutions in Kenya. The findings indicate that MFI financial performance could be determined to a very large extent by three macro-economic variables, namely economic growth measured by GDP, interest rates and Inflation-CPI. It was found that increase in GDP led to increased MFI performance which was determined by ROA increase in interest and rates led to reduce ROA. The numbers of years the MFIs had been operating were also found to positively affect MFI (Patrick, 2013)

2.4 Summary of research gaps.

The concept of diversification has taken a universal centre stage in the process of management. Elango and Ma (2003) argued that diversification was an increasingly important of doing business in the world of today. The relationship between diversification and firm performance has formed the subject of many researches but many researchers have agreed to differ on the nature of the relationship between diversification and performance (Hitt, hoskinson and Kim,1997).Some studies have shown that diversification improves financial performance over time (Kamwaro , 2008; Mulei and Kosgei, 2010; Odhiambo,2013; karimi, 2013 and kimeu, 2014) whereas others have indicated that diversification negatively affects performance (Lloyd and Jahera,1994; Wan, 1998). Still others have shown that no relationship exists whatsoever between diversification and firm performance (Shyu and Chen, 2009).The empirical evidences from emerging markets about the Impacts of diversification on firm performance have so far yielded mixed, inconclusive and contradictory results. Thus, the question of whether diversification improves or worsens firm performance is still worthy of further research such as the one being undertaken in this study. In addition, despite the existence of these studies, very little attention has been given to the developing countries like Kenya. This research attempts to fill this gap by studying the situation of the Kenyan companies and provide more empirical evidence on the Impact of portfolio diversification on investment firm's performance in Kenya.

2.5 Conceptual framework.

The conceptual framework is the researcher's conceptualization of the interactions between the variables of the study. The graphical representation of the conceptual framework for this study is shown in Figure 2.1



The conceptual framework indicates the relationship between the variables under study. The independent variables are Stocks, real estate, bonds and the combined Impact of Stocks, real estate and bonds. The dependent variable is the financial performance of which is measured by ROA and ROE while the intervening variable is represented by Gross domestic product**.**

4.0 Summary and Conclusions

This paper has analyzed the impact of portfolio diversification on performance of investment firms in Kenya with a bias to investment firms listed in Nairobi securities exchange. The key problem addressed by the paper poor returns by investors and the researcher recommends that the subject can be taken further to the actual data collection to find out whether the finding are in agreement with the literature reviewed in the paper.

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