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PORTFOLIO DIVERSIFICATION ON FINANCIAL PERFORMANCE OF PRIVATE PENSION SCHEMES IN KENYA

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Abstract

Despite their late entry in the market, pension have experienced turbulent market conditions, market deregulation, stiff competition, technological advancements and reduced trade barriers thereby necessitating product diversification. According to Capital Market Authority more than 60 percent of funds did meet their financial performance targets in 2017. The continued poor performance of pension schemes has resulted to lack of interest and confidence of investors, inefficiency in funds management and imbalanced investment of available funds. It can be concluded that corporate bonds are mostly preferred since they provide long-term working capital. Regarding diversification in insurance on financial performance of private pension schemes it can also be concluded that diversification in life insurance enhance brand equity. The study further concluded that ordinary shares are considered as the easiest way of raising huge amount of money. Diversification in real estate has been considered as one of the most viable investment. Private pension scheme policies and business strategies should be tailored to address the factors that determine the risks and returns in the market.

Keywords: Portfolio Diversification, Financial Performance, Private Pension Schemes, Bonds, Shares, Assets, Insurance Policies, Government Policies

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INTRODUCTION

Portfolio diversification is a way of managing a given portfolio by diminishing instability and risk of a given set of portfolio of a given set of unlike investments, assets or products (Mutega, 2015). It entails the process of bringing together diverse assets to lower the general risk associated with the entire portfolio of an organization. Diversification of an organization's portfolio is necessary for maximum revenue realization given some minimum risk is allowed by a combination of different classes of elements of a particular portfolio. Pension schemes diversification is pursued to mitigate the turbulent markets and operational environments and further to lower portfolio volatility and losses, (Stoner, 217).

An investment portfolio can be defined as a group of investment assets, the formation of which is based on the investor's attitude towards the relationship between the risk and return, the contribution of each investment asset coming to the portfolio or going out of it to the overall size of risk and the total return of the portfolio, (Rop, Kibet & Bokongo, 2016). The portfolio is made up of either a group of financial assets such as equities and bonds, or real estate (Alimardani, Ghafari, & Farmani, 2016). Equity securities are more volatile than bonds and are subject to greater risks. Small and mid-sized company equities involve greater risks than those customarily associated with larger companies. Bonds are subject to interest-rate, price and credit risks. Prices tend to be inversely affected by changes in interest rates.

In China private pension schemes have diversified investment into various forms with majority of them diversifying into stocks. This has contributed immensely to the financial performance of pension funds. According to the Company Institute Global's statistical analysis suggests that China's long-term pension fund assets could reach $11.8 trillion China by 2050. This assumes that China has no defined contribution plan system allowing participants to invest in pension funds. If, to the contrary, China develops a pension plan system that allows contributions to be invested in pension funds, its pension fund asset could be even larger by 2050, perhaps $15 trillion (Keohane, 2011). Chinese pension funds have four dimensions of diversification as loans, deposits, assets, geography and established that they are associated with reduced profits and high costs in financial institutions.

In Nigeria, development of pension schemes has been slow but a growing number of new schemes have been springing up since the past few years. There are 21 pension schemes presently quoted in the Nigerian Stock Exchange while a number of others are not quoted. A good number of new funds are also in various floatation and setting up processes. The Nigerian pension schemes market remains underdeveloped. For instance, according to the SEC (2013) there were only 202,059 unit holders in 2012, while the funds had a Net Asset Value (NAV) of ₦104.85 billion. The SEC (2014) also indicates that, as of June 2014, there were 38 fund

managers in the country with just six of those accounting for 75% of the funds under management. As of December 2015, the Nigerian Stock Exchange (NSE) report put the NAV of the funds trading on the NSE at ₦259.72 billion ($1.039 billion) with a market capitalization of ₦263.82 billion ($1.055 billion) (Oduwole, 2015).

Pension Schemes in Ghana can be differentiated on the basis of their structure. These are open-end or closed-end pension funds. The difference between the two depends on the flexibility of sale and purchase of fund units. The open ended has a greater flexibility in the purchase and sale of its shares as compared to the close ended pension funds (Bangalore, Nandanan, & Thomas, 2013). The pension scheme has developed as one of the investment avenues in Ghana's financial market. The growth of the pension funds industry in Ghana has been remarkable since its formal inception in 2002. According to the annual reports of Ghana's Securities and Exchange Commission (SEC), the number of pension funds licensed by the commission rose from 3 in 2002 to 18 in 2012 (Yeboah, 2017). The net assets value (NAV) also increased from Ghana Cedis (GH¢) 1.1 million in 2002 to GH¢172.8 million in 2012. According to Ghanaian capital market pension fund that have diversified in assets are doing better compared to those that have diversified in insurance (Ghana Capital Market, 2015).

In Africa, South Africa is the country with the largest members of pension funds with over 1.2 million active members and about 360 pensioners and beneficiaries (Bikker & Dreu, 2018). However, just like most pension funds, South Africa pension fund is challenged with reduced cash flow and a decline in active membership. This decline in active scheme membership can have a substantial impact on cash flows and investment strategies because the annual contributions may fail to cater for pension benefits (Kigen, 2016). Occupational schemes have been growing and assets have reached the current market value of around 33 billion. However, this is not the situation in all African countries. For example, Botswana's 790,000 work force, but 84% of these employees do not have any occupational pension coverage, (Word Bank Report, 2016).

Investment companies in Kenya invest in a diversified portfolio of assets to make money for their shareholders and investors. They employ professional fund managers to invest in a wide range of assets than most people could not practically invest in themselves and are responsible for the management of billions of shillings worth of assets on behalf of investors (Nairobi Securities Exchange, 2018). The companies hold a broad range of assets which can include shares, securities and property, meaning investor's investment is diversified and is not exposed to the fortunes of just one or a few investments. Performance of the investment companies in Kenya is mainly based on portfolio composition of those best performing securities reflecting financial performance of the firms' performance evaluation of investment

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companies listed in the NSE involves a risk-based analysis approach. There are numerous methods for the performance evaluation and efficiency analysis as appropriate tools of the company.

Financial performance according to Cheong (2017) is a subjective measure of how well a firm is doing. For example, a pension scheme can improve its financial performance by using its assets to generate profit. Brady (2019) suggests that financial reports offer valuable information about the performance of pension schemes to interested parties such as employees and retirees of a firm. Financial performance is an essential aspect in determining net income and assessing the financial risk of a firm. Moreover, a pension scheme's financial status can affect the financial welfare of its members during their retirement years. To account for defined benefit pension plans, pension schemes need to make many estimates. These estimates according to Blome (2016) include prediction of future salary increment for covered employees, the discount rate to be used in determining the value of pension payments and the return on assets accumulated in the pension fund.

Among private pension schemes, products, Money Market Funds continued to be the most popular product in terms of market share, accounting for Kshs 93.9 bn, equivalent to 89.6% of all funds under management, an increase from 87.0% recorded in financial year 2019. Assets under Management of the private pension schemes have grown at a 4-year Compound Annual Growth, (CAGR) of 16.4% to Kshs 104.7 bn in financial year 2020, from Kshs 57.1 bn recorded in financial year 2016. According to the CMA (2020) as at the end of financial year 2020, there were 23 approved collective investment schemes made up of 93 funds in Kenya. Out of the 23, however, only 19 were active while 4 were inactive.

Statement of the Problem

Despite their late entry in the market, pension have experienced turbulent market conditions, market deregulation, stiff competition, technological advancements and reduced trade barriers thereby necessitating product diversification. As such, many pension schemes have resorted to diversifying their portfolios in order to stay afloat and maintain or enhance their profitability. According to Capital Market Authority (2016) more than 60 percent of funds did meet their financial performance targets. The continued poor performance of pension schemes has resulted to lack of interest and confidence of investors, inefficiency in funds management and imbalanced investment of available funds.

According to the Capital Markets Authority (CMA), (2021) quarterly statistical bulletin, the private pension scheme industry's overall Assets under Management (AUM) grew by 37.6% to Kshs 104.7 bn as at the end of financial year 2020, from Kshs 76.1 bn as at the end of financial

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year 2019. However, some pension schemes show decline in their asset growth, for instance the decline in Stanlib's AUM is mainly due to the asset manager's exit in Kenya, which was effective June 2020. The fund manager attributed the exit to the significant operating losses incurred in both Kenya and Uganda. Standard Investment pension schemes, Dyer and Blair pension Scheme, Diaspora pension Scheme and first ethical opportunities fund remained inactive as at the end of financial year 2020.

LITERATURE REVIEW

Theoretical Review

The study is informed by modern portfolio theory and Capital market theory. Modern portfolio theory was propounded by Markowitz in 1959. The theory is basically grounded on the idea that risk-averse traders can assemble a combination of assets such as the portfolios so as to enhance or snowball expected return in a given phase of market related hazard, underlining such perils is an intrinsic component of higher returns (Bodie, 2005).

MPT holds that investors are rational and that the markets are effectual. Impact of portfolio composition along green frontier is viewed by how the level of the jeopardy takes via the buyers and returns collected out of the portfolio mix depending on market general profitability. A portfolio composition with better performing securities and good investment stratagems will yield high returns which translates to high performance. MPT proposes that it is possible to construct an 'efficient frontier' of optimal portfolios, offering the optimum possible anticipated return for a given level of peril. The effective frontier can be demarcated as a compound of assets with maximum anticipated returns that is superior to any other combination and results to the highest level of returns at the lowest level of jeopardy. However, the critique of the theory emerges on the concept that it is strenuous in estimating the correlation coefficient for two assets. It is even harder for multiple assets which require complex tools, thus it is not practical. In reality, unlimited range of possibilities of investments exists. With respect to portfolio diversifications, the MPT aids pension funds in describing investment options in terms of the inherent risks and anticipated returns, establish the apportioning of resources among classes of investments, reconciling risks and returns and measuring profitability.

Capital market theory was propounded by Markowitz portfolio model in 1952. It attempts to give a clarification and prediction on financial/capital markets advancement over a period of time, built on the on mathematical model. CAPM employs assumption about markets and investor conduct to give a set of equilibrium conditions which permits us to forecast the return of an asset for its level of systematic (or undiversifiable) risk. By employing a measure of a systematic risk which may be compared with other assets in the market, theoretically, investors

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are permitted to ameliorate their portfolios and fund managers to find their required rate of return. Capital market theory holds that; every investor is effectual in and they do lend and borrow money at rate which is risk-free, the whole assets are considerably dividable, investors have same time horizon, no transactions and taxes and there exists same likelihood of results on all investors, inflation does not exist and capital markets have no mispricing.

One of the major critique of Capital market theory is that it does not show that specific risk can be removed through diversification. The theory is relevant to the study in assessing the risks of various types of assets. Any asset that has no risk has a zero variance for its assumed degrees of returns. Therefore, adding asset that have no risk to the portfolio with assets that are risk free leads to reduction in anticipated returns by the investor. Since assets that are risk free have no risk, addition of risk-free asset into a portfolio result to variation of the overall portfolios standard deviation.

Diversification in bonds and financial performance

Ratemo (2015) conducted a study on the relationship between bond prices and company performance for firms that engage in sustainability reporting in Nairobi Kenya. The target population consisted of 12 companies listed on Nairobi Securities exchange during the period of year 2012-2014. The secondary data was collected from Nairobi securities exchange and used Statistical Package for Social Sciences (SPSS) to analyze. The findings were that the coefficient of variable demonstrates that the shares prices have positive association to Return on Assets (ROA). Hence, the result of this research shows that the bond prices of firms that engage in sustainability reporting does influence a company's performance.

Chemutai, Ayuma and Kibet (2016) conducted research on the effects of bond on the share-price performance on banks Listed on the Nairobi Security Exchange in Kenya. The study was guided by the following objectives; to find out the effect of debt on share price performance in banks listed in the Nairobi Security Exchange, to establish the effects of equity on share price performance in banks listed in the Nairobi Security Exchange. The study employed a descriptive research design. The target population comprised of the eleven cross listed banks in Kenya Nairobi Security Exchange. The branch managers and operations managers were selected to participate in the study using purposive sampling. The study findings indicated that there was a significant relationship between all the study variables, debt, equity, bond and retained earnings on share price performance.

Nzau, Kung'u and Onyuma, (2019) conducted a study on the effect of bond issuance on financial performance of firms listed on Nairobi securities exchange. The study collected dated from all the six firms that had issued bonds in tranches or additional bonds within the period

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2008 to 2017. Data was analyzed via regression to assess whether bonds issuance has any effect on the financial performance of firms listed on NSE. Results indicate that about 75.4 percent of variance in financial performance could be explained by bond issuance as characterized by bond price, bonds coupon rate, bond proportion, and bond yield to maturity. Bond proportion and bond yield to maturity were found to have a statistically significant effect on financial performance. The study concluded that bond issues affected financial performance of listed firms in Kenya. It was recommended that the listed firms ought to take into consideration the various aspects of bond issues in order to enhance their financial performance.

Shaaban, Ramadhan; Ndirangu, (2018) conducted a study on influence of bond investment on financial performance of insurance companies listed at Nairobi securities. Study adopted descriptive research design. The total target population was 36 respondents from the six insurance companies listed in Nairobi stock exchange. The study used questionnaires to collect data. The findings indicated that bond investment had a significant influence on financial performance of insurance companies. Hence the study concluded that bond investment has a significant influence on financial performance of insurance firms listed in NSE.

Diversification in insurance and financial performance

Waweru (2013) conducted research on the effect of diversification in insurance on the financial performance of commercial banks in Kenya. The study used a descriptive design. The population of study was the twelve banks offering Bancassurance in Kenya. The study used secondary sources of data. This data was acquired from CBK reports for a period of 5 years, that is, from 2009 to 2013. The study found out that there was a positive relationship between annual interest on loan advances and financial performance of commercial banks in Kenya. The study further revealed there was a negative relationship between annual inflation rate and financial performance of commercial banks in Kenya, thus the study concludes that annual inflation rate negatively affects the financial performance of commercial banks in Kenya.

Ochieng (2013) sought to establish bancassurance as a penetration strategy used by insurance companies in Kenya. The research design used in this study was cross sectional descriptive survey of a defined population as it involved a study of all the eighteen insurance companies which use banc assurance as a channel of distribution. The data was collected using questionnaires and data collected cleaned, coded and entered Statistical Package for Social Sciences (SPSS). Descriptive statistics was used to analyze the data; frequencies, percentage (relative frequency), mean and standard deviation. Presentation was in form of Table, charts, graphs and explanation presented in prose. The study findings show that banc assurance has increased insurance uptake by increasing its distribution channels, attracting

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new customers while retaining the old and winning the customers trust unlike the traditional agents since most customers trust banks and they frequently visit.

Kamau, Karimi and Kinyanjui (2016) conducted research to investigate the effect of banc assurance on the performance of commercial banks in Kenya. Data was collected from 12 banks which have so far embraced banc assurance in Kenya. The study found out, that banc assurance awareness was positively related to performance of commercial banks same as banc assurance diversification and banc assurance expenses. However, banc assurance risks had a negative effect on the performance of commercial banks.

Diversification in shares and financial performance

Umar & Liliopsid, (2013) conducted a study to examine the connection between shares costs and firm EPS from 2005 to 2009 in Nigeria. The study employed a straight forward linear regression model on a panel of a hundred and forty Nigerian corporations from a complete population of 216 firms 'operated in Nigerian securities market (NSE), the findings revealed that firm EPS has no prophetical power on shares costs and will not be relied upon for the prediction of the behavior of shares costs in African nation.

Gitari (2010) sought to establish shares risk on financial performance of Kenyan Publicly quoted companies. The study adopted a three-factor model to establish the relationship between various variables. The study adopted panel regression, in order to achieve the purpose of the study. The findings indicated that it was apparent that Kenyan publicly quoted companies exhibit systematic risk that is positively related to return. This relationship was not statistically significant thereby suggesting that investors may either be under or overcompensated for taking high risks. The results also indicated a negative but statistically insignificant association between unsystematic risk and return. He also found that the nature of risk-return relationship was independent of the nature of the industry in which a company operates reinforcing the conclusion on the relationship between unsystematic risk and returns.

Diversification in assets and financial performance

Mutega (2015) sought to assess the effect of asset diversification on the commercial banks financial performance focusing on Kenyan context. This study used descriptive research design and the population of this study was 43 commercial banks in Kenya. Secondary data on financial performance and asset diversification was collected from commercial banks' annual reports from 2011 to 2015. The findings revealed that a unit increase in loans increases financial performance of commercial banks. The findings further revealed that unit change in financial assets would change financial performance of commercial banks.

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Maina (2013) sought to investigate the effect of assets diversification on financial performance of microfinance companies in Kenya. Aim of this study was to identify the types of diversification in the Kenyan microfinance market and how they relate to performance. The study adopted a descriptive survey design using secondary data obtained from financial records of Microfinance institutions and CBK. Major findings indicated that the diversification indicator, ROA indicator and ROE indicator were on a growth pace from 2008 to 2012. However, the study failed to identify the nature of product diversification whether horizontal, vertical or both.

Mugenda, Achoki and Njuguna (2016) conducted a study on the effect of assets diversification on financial performance of merged institutions in Kenya. The study adopted a mixed methodology research design. The study population included all the 51 merged financial service institutions in Kenya. Purposive sampling was used. Primary data was obtained from questionnaires and a secondary data collection template was also used. The researcher used quantitative techniques in analyzing the data. The study revealed that the merged financial institutions has established many branches as a result of merger and acquisition activity, new branches formed after the merger has attracted a wide human resource portfolio, new branches formed after the merger has led to an increase in product portfolio, new branches formed after the merger has led to an increase in investment portfolio and those new branches formed after the merger have resulted into the expansion market portfolio.

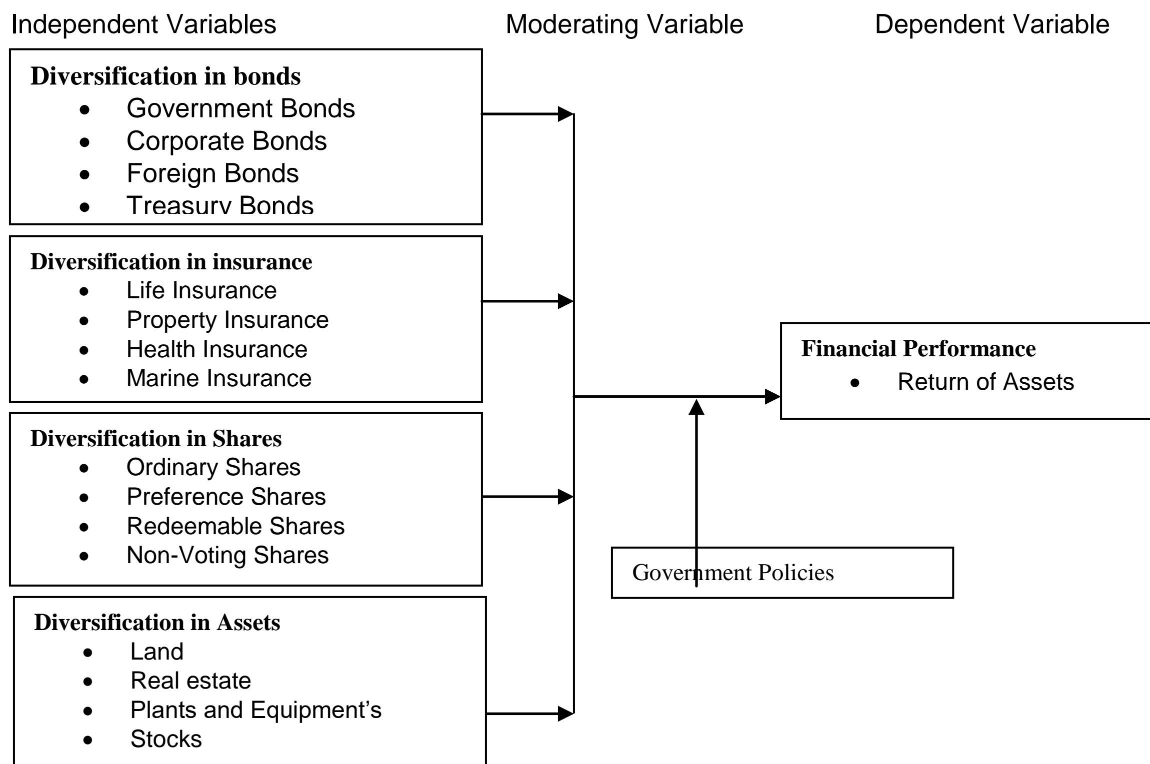

Figure 1. Conceptual Framework

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CONCLUSIONS

It can be concluded that corporate bonds are mostly preferred since they provide long-term working capital. Foreign bonds are mostly preferred since they don't dilute the value of existing shareholdings. Regarding diversification in insurance on financial performance of private pension schemes it can also be concluded that diversification in life insurance enhance brand equity. Diversification in property insurance provides multiple services at one place to the customers which enhance the customer satisfaction. Diversification in health insurance provides new services that have no technological or commercial synergies with current products, but which may appeal to new groups of customers.

The study further concluded that ordinary shares are considered as the easiest way of raising huge amount of money. The study inferred that rise in market price of the ordinary share negatively affect the organization financial performance. Preference shareholders with negative interest can hurt the financial performance of an organization. Furthermore, it can also be concluded that diversification in land provide longer term capital gains. Diversification in real estate has been considered as one of the most viable investment. Diversification in tangible assets such as stocks has more investment risk compared to intangible assets such as land. From the conclusion it is very important for the private pension schemes to conduct a strategic analysis to determine the level of risk of various portfolio diversification in order to obtain maximum returns from their investment.

RECOMMENDATIONS

Private pension scheme policies and business strategies should be tailored to address the factors that determine the risks and returns in the market. They should also adopt diversification policies to mitigate economic changes in different industries. The inflation rate is less felt in some industries than others hence a diversified portfolio will achieve better returns than undiversified ones. A large fund size enjoys economies of scale and broader diversification options. This study found that bigger funds earned higher returns than small ones. Effective marketing strategies should be adopted to attract more investors and merging of smaller funds. In light of the research findings, the study established a positive relationship between investment style and fund performance. It recommends that the Private pension managers should be trained on the best investment styles including the size of fund to hold, types of funds to invest in, frequency of change of investment style, methods of assessing fund performance among other investment style characteristics. From the recommendations further studies should be conducted to assess the effect of competence portfolio diversification on financial performance of private pension funds. In addition the study recommends that further study

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should be conducted on effect of portfolio diversification on financial performance of insurance firms in Kenya.

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