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Article

Diversification strategies, business cycles and economic performance

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Abstract

Two major diversification strategies of firms are examined: diversification into related businesses and diversification into unrelated businesses. The first strategy attempts to exploit operating synergies. In the second, the firm attempts to gain financial benefits from its ability to increase leverage due to a greater stability of cash flows.

The study utilizes a large sample affirms to assess empirically the benefits and costs of these two diversification strategies by developing a new measure of diversification across business cycles and economic sectors. This new measure is compared with Berry—Herfindahl type measures of total diversification and recent measures of diversification into related businesses.

The results indicate that pure financial diversification is associated with (a) more stable cash flows, i.e. lower operating risk; (b) increased levels of leverage; and (c) lower profitability. These observations are in accord with the theory. We also reaffirm that firms which diversify into related businesses have, on the average, higher profitability than non-diversified firms, although these results are not always statistically significant.

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