

# Problems of choosing strategies for diversifying companies

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**Abstract.** The paper considers the problems of choosing strategies for diversifying companies. It was revealed that in corporate practice, there is a certain tendency towards moderately diversified companies with related business lines (relational diversification). The authors analyzed a set of four main growth strategies: market penetration; market expansion; product innovation, and diversification. Their advantages and disadvantages are identified. Depending on the degree of risk appetite, three types of diversification were studied: horizontal diversification, vertical diversification, and lateral diversification (diagonal diversification). The reasons for diversification are analyzed, which may lie both in the environment of the company (exogenous) and within the company (endogenous). The diversification of stocks and monetary investments is considered, the advantages of this process are assessed. It is revealed that despite the fact that the advantages of portfolio diversification are undeniable, due to its complexity, it is almost impossible for investors to independently create effective security portfolios. The need to take into account systemic and non-systemic risks in portfolio diversification is proved. The ways to diversify the portfolio of stocks are described. It is concluded that in companies, regardless of whether they are expanding their services or opting for long-term product diversification, in both cases, an entrepreneurial restructuring plan can only be implemented under certain conditions.

## 1 Introduction

The term “diversification” is very often used in business management, not only in the field of strategic management, but also in the field of banking and stock exchange, to describe the combination of an investment portfolio, for example, with different stocks.

Diversification strategies can also carry additional risks. If the diversifying company is weak and inexperienced, it may not be strong enough to master newly built or acquired technology. On the other hand, if a diversifying company is strong and independent, it may overestimate its own capabilities and ignore clues that indicate the risk potential of a diversification decision.

Empirical study has also led to conflicting results. Each individual company must weigh which of the reasons presented here are of particular or lesser importance to it [2,3].

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Diversification of productivity as well as product is always considered risky. Companies that are considered to be the market leaders in the segment receive, on average, twice the profitability of their competitors. On the other hand, for example, all those measures that were designed to improve the company's image, but ultimately did not, as well as new products that ultimately flopped, will always be seen as negative examples of diversification. Therefore, before you introduce a measure of diversification in your business, you must think carefully about the pros and cons.

The question of whether a diversification or focusing strategy is more promising cannot be answered in the same way for all companies.

## **2 Material and Method**

The material of the study was statistical data on the diversification of the activities of Russian and foreign enterprises, the work of a number of domestic and foreign scientists, regulatory documents, as well as our own scientific, theoretical and practical research. The analysis of structural transformations of foreign countries in the development of diversification of industrial companies is carried out.

The Ansoff Matrix was used as the tool. It is a strategic management tool that helps executives, top managers and marketers develop strategies for future growth. In the area of strategic management, the Ansoff Matrix is used to explain diversification. However, today this is no longer enough to be able to adequately discuss all aspects of the company's diversification.

## **3 Results**

In corporate practice, there is a certain trend towards moderately diversified companies with related business lines (relational diversification). Variety is greatly reduced by focusing strategies.

Company owners can minimize risk by diversifying their stock portfolio. The stock trades very quickly in the capital market, and this results in significantly lower costs than when the company enters new lines of business.

There are four principal options for the growth of a manufacturing company [1,2,3].

Thus, the model is divided into four fields, categorized by product and market, each of which is divided into "existing" and "new".

There are four main growth strategies: market penetration; market expansion; product innovation, and diversification.

1. Market penetration means more intensive processing of the existing market with existing products. The company tries to maintain its own market share by acquiring new customers or acquiring competitors' customers (or both). The goal is to dominate the market through market leadership and drive out competition. There are often special promotions such as "two for the price of one".

The advantage of this strategy is that it works with existing products in a known market environment and leverages existing skills and resources. Therefore, the risk of failure is low.

The disadvantage of this capability is limited upside potential in often near-saturated markets.

However, this strategy is targeted to keep yourself consistently in a lucrative market.

2. Market expansion describes the launch of an existing product alongside previous markets in new markets (for example, entering new market segments or new geographic

regions) to achieve growth from potential new customers that the product has not previously reached.

The advantage of this expansion strategy is that it continues to work with a known product, so the required product skills are in place.

With high product competence, the originality of the product offers this opportunity.

One risk is a lack of knowledge of newly discovered groups of customers or markets.

3. Product innovation describes the introduction of a new product or an improved version of an existing product. This new, superior product is offered in the previous market. As a result, the company hopes to gain attractiveness in relation to the customer and grow above him.

This strategy is beneficial when there is a specific circle of customers and its (potential) needs are known.

However, there is also a risk here due to the need for new skills and the uncertainty of whether the new product is as good as its predecessor.

4. Diversification means adding new products to the product range and therefore opening up new markets [2,3].

Consequently, the assortment is expanding. The advantage lies in the potentially high attractiveness of the new market, which can translate into a high return on investment. At the same time, the overall risk of the business portfolio and dependence on the processed market can be reduced.

The Finnish company Nokia is considered a classic example of successful diversification, because originally Nokia was a manufacturer of tires for cars, then the management of the company changed, eventually expanding its portfolio with car radios.

Then, in the 1990s and early 2000s, Nokia became the world leader in mobile phones before it had to give up that position to Apple. The latter is currently considered one of the best examples of successful diversification at the international level. In these two stories, the benefits they have from diversification are very clear:

- minimization of operational risk due to the second part in the offer;
- definition of business niches that the market can provide in your segment of the product or customer;
- the conquest of new regions where the niche is not yet occupied;
- development of your new product from a niche market to a mass market.

Analyzing the engineering industry in Germany as a whole, it can be stated that the companies with high relevance in the production chain of the automotive industry were significantly more affected by the coronavirus crisis than the rest of the engineering companies. The numbers of machine tool manufacturers, which are highly dependent on both the development of the automotive industry and the entire machine building industry, are well below the industry average since March. They were still the industry average last year. On the contrary, despite the downturn at the beginning of the second quarter, agricultural and forestry equipment manufacturers consistently perform well above the average. Incoming orders are already above the pre-crisis level again, and the production index also shows comparable values [4]. However, it remains to be seen how sustainable growth is. In addition, there is a possibility that currently heavier companies are showing particularly strong growth rates in subsequent quarters. For example, the receipt of orders from machine tool manufacturers has recently been slightly more positive than that of the entire machine building industry.

Recent statistics show that for engineering companies, diversifying their customer base can be beneficial to reduce reliance on highly affected customer industries, especially in times of crisis.

The Cologne sugar and chips group Pfeifer & Langen opens up a new business area. The company enters the meat substitute business through a majority stake.

Gravic features a wide range of products that are unmatched in the market. This advantage is caused by the diversification of their technologies and a new fleet of machines, adapted to different technologies and production complexity.

Heraeus manufactures precious metal catalysts for the chemical industry, sensors for the steel industry, active pharmaceutical ingredients, etc. For generic manufacturers, dental implants for dentists - the business of the Heraeus Group is widely disclosed. Unlike some large corporations, the family-owned Hanauer is banking on diversifying its business portfolio with success. Last year, the group's sales grew by 13% to € 8.3 billion. The main impetus for the growth came from the international business, which accounts for three quarters of the product's sales.

GEO Magazine is the reportage magazine of the Gruner Hamburg publishing house. It was launched by Rolf Gillhausen in 1975 and introduced the first official notebook in October 1976. Today GEO is Europe's leading magazine for extensive reporting in text and image. Nowadays, there are branches in over 22 different countries in Europe, Asia and South America, as well as digital edition and applications.

In order to achieve growth in previous markets with existing products, GEO with selected partners (museums, national parks, zoos, etc.) developed the GEOcard to make the product more attractive to new customers and to link existing customers to the company. The company has also included information materials on relevant types of places that can be visited with GEOcard in its magazines. Through this editorial inclusion of partners, the company is trying to develop a product outside of the classic reading experience and provide access to real-world experiences (places of experience, museums, etc.). In this way, GEO acts as a liaison and intermediary between curious (readers) and knowledge providers.

GEO owns a working brand concept, which, however, has largely exhausted the German market. Progressive internationalization is promising due to the high competence of the product. Synergistic effects can be used primarily in the field of reporting, as they can be used quite independently of national factors and, moreover, are difficult to create. Reusing the developed content - only with translation and revision costs - will generate multiple income.

Less significant to GEO are the proposed by-products, which, however, can help expand the brand's presence and also offset the decline in print and online advertising donations.

Diversification of agricultural holdings in the Russian Federation in relation to non-agricultural activities are known to be political priorities. Agriculture receives support from the Russian state budget mainly in the form of subsidies and through some support programs, which are not always useful and purposeful. 40 to 50 percent of the funds are used for highly distorted programs to increase production. The share of support for general services, programs that contribute to the potential of the entire sector (research and development, education, inspection proposals, infrastructure development programs, etc.) decreased from 48 percent in 2006 to 26 percent in 2019.

As part of diversification, applicants are investing more and more, including in the direct marketing of regional products. This leads to a reduction in transport routes from producer to consumer and, consequently, to a positive climate impact. The creation of new jobs in rural areas also reduces paths to work and hence the associated CO<sub>2</sub> emissions, which also contributes to climate protection. The creation of additional income often leads to the fact that, due to limited working capacity, outdated industries of production are abandoned and replaced by more extensive production. This leads to a process of expansion, such as the transition from intensive milk keeping to the retention of the mother cow, which brings climate relief. Diversification often requires construction work to meet current energy efficiency and environmental requirements. It also helps protect the climate. Climate protection aspects are also taken into account when determining the selection

criteria for this measure. Projects that contribute to climate protection are, as a result, preferred when choosing financing.

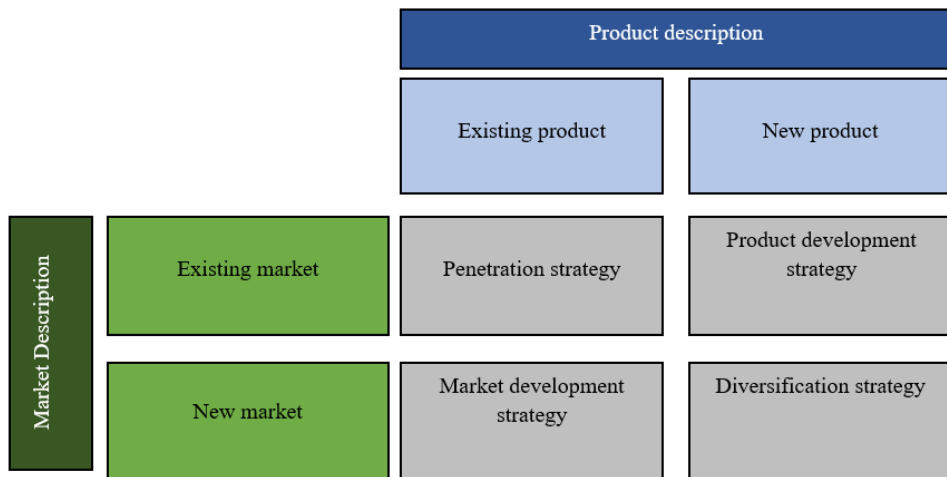
The diversification strategy of the Central Bank of Russia is to increase the share of Chinese currency and gold bars in its reserves.

As a result, according to the data from the Central Bank of Russia, the share of the yuan rose from one percent in the last quarter of 2017 to 2.8 percent in the third quarter of last year. The Chinese currency, together with a 17.2 percent share of gold, currently makes up a fifth of Russia's reserves.

Russia buys more investment in the yuan than other global central banks. With the purchase of nearly \$ 12 billion in yuan investments in the second half of 2018, the Central Bank of Russia increased the share of that currency in its holdings, being well above the average common worldwide 1.4 percent.

## 4 Discussion

There are three types of diversification [2,5,6] according to the Ansoff Matrix, depending on the degree of risk appetite (Fig. 1):



**Fig. 1.** The Ansoff Matrix: Development Strategies.

- Horizontal diversification: expansion of the assortment due to the original product, related product categories that cannot be compared in the same industry.

Ansoff Matrix classification: new products are introduced, but they are related to existing ones. It can both penetrate the old market and open up a new market associated with it. Thus, horizontal diversification will be categorized centrally in the matrix.

- Vertical diversification: also a differentiation that describes the deepening of its own product program, either in the direction of sales (direct integration) or in production (reverse integration).

Ansoff Matrix classification: the deepening of the incentive program leads the company to enter markets where, until now, it has only been active as a buyer or supplier. So the markets are not completely unknown, the products are not either. In conclusion, we are talking about the diversification of the middle category.

- Lateral diversification, also diagonal diversification: describes the expansion of the product program with no apparent logical connection with the previous performance

program. Consequently, completely new products are emerging and entering completely new markets.

Ansoff Matrix classification: brand new products in completely new markets is presented in the lower right corner of the matrix to illustrate how “new” the product and market is for the company.

The reasons for diversification may lie in the company's environment (exogenous) or within the company (endogenous):

Exogenous causes:

- search for markets and products with better growth opportunities than previous ones;
- goals and objectives can no longer be achieved in the current conditions (market saturation, competitive pressure, reduced demand, etc.);
- prevention of dependence on specific suppliers and customers.

Endogenous causes:

- risk reduction due to the distribution of activities in several economically independent markets;
- reinvestment of profits, i.e. diversification as capital investment;
- using synergistic benefits through optimized use of human and material resources

To gain access to previously unprocessed markets with new products, one can distinguish between internal and external entry strategies, and internal entry strategies mean the development of new markets on their own, and in external entry strategies, access to already built market positions.

The advantages that they have from diversification are very clearly manifested:

- minimization of operational risk due to the second position in the offer.
- identifying business niches that the market can provide in your product or customer segment.

- the conquest of new regions where the niche is not yet occupied.

- developing your new product from a niche market to a mass market.

Growth through performance or product diversification always means that your business is also growing in parallel with the diversification measure. That is, specifically: for example, if you open new branches or bring a new product to the market in a short time, then your company also needs to ensure that the tasks and problems associated with this step can be practically implemented. For this, the following aspects should be considered:

- processes in your company should be redefined;
- all information technology of your company should be armed with new problems in terms of scale and time of use;
- new employees or existing employees of your company must be appropriately trained for new projects;
- such training requires appropriate financial and time resources.

It is the professional know-how in terms of performance or product diversification that is especially important for the success of the intended measure, because only if all new and existing employees are involved in the flow of information about a new product in your home, then they can also be used for clients [7].

Diversification of shares and money investments [4,8]. Once the conditions in your company are set up so that diversification can be started, it is a question of what form the action should take through the scene. More than ever diversification occurs in investments in the money and capital markets, i.e. all diversification measures in which current savings or lump sums of assets are allocated to various forms of investment. These can be, for example, cash investments, stocks, bonds, mutual funds, as well as issuers of securities, which allow you to move from being a pure entrepreneur to being an investor. At the same time, diversification in the form of cash investments, stocks and other securities gives you the following benefits:

- risk diversification: prevention of a possible total loss if you simultaneously decide to invest partial amounts in alternative, differently risky forms of investment;
- two or more stocks or other securities that show low correlation with each other may perform better if they are placed in a common portfolio;
- the entire structure of assets of your company as a whole has less risk than the corresponding individual documents;
- this effect is achieved, especially if the underlying securities are not 100% positively correlated, which also means that they have a correlation coefficient with each other that is ultimately less than 1.

If you choose diversification in the form of stocks and other monetary investments, please note that this measure can be implemented in two forms:

1. Maximizing profitability: The goal of this form of diversification is to obtain the highest possible profitability through an appropriate mix of investment forms. But the associated risk must be calculated consistently.

2. Risk minimization: the goal of the implemented measure is to minimize the risk of losses in your company for a given profitability service.

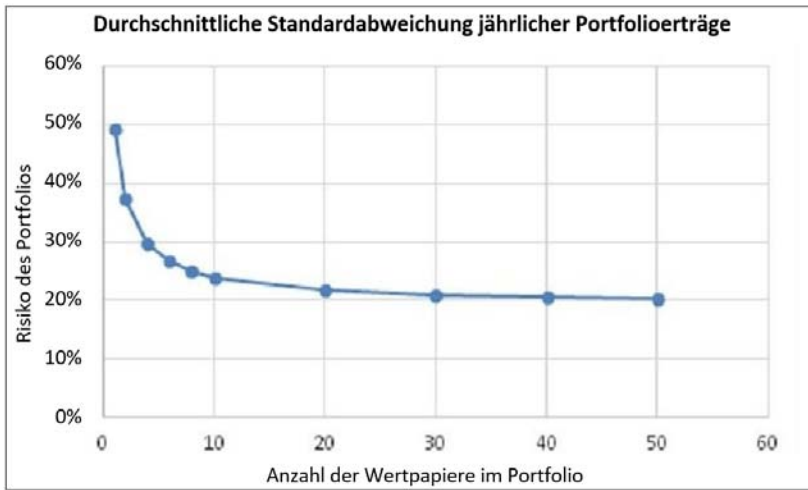
It should be borne in mind that profitability and risk are statistically interdependent to each other. This relationship is also known as the opportunity-risk ratio, or the stock-to-pension ratio. Simply, if you with your company are new to this market and are still moving as a newcomer to the diversification of stocks and other monetary investments, then it is advisable to have a professional support. Support from a stock or investment advisor can be helpful because such a specialist can advise you, as their client, to analyze where the objective or subjective risks of your planned diversification lie. Accordingly, the investment advisor will offer you the appropriate stocks or a suitable mixture of different monetary investments for you, so that you can get a positive return on investment in the long term [6-10,12].

Especially for small and medium-sized businesses, investment advisors always provide these valuable tips:

- first of all, you should focus on becoming a leader in your segment;
- only when your main business is profitable and growing, you should think about new fields for operational growth;
- only when your core areas are safe should you work to diversify your company's image that is carried outward.

It is a known fact that companies that are considered market leaders in the segment receive on average twice as much profit as their competitors. On the other hand, for example, all those measures that were designed to improve the company's image, but ultimately did not, as well as new products that ultimately flopped, will always be seen as negative examples of diversification. Therefore, before you decide to use diversification in your business, you must carefully think about the pros and cons.

Portfolio diversification is usually an expansion of product selection. In finance, portfolio diversification is used to reduce the risk of participating in a particular asset or event. In the case of stocks, portfolio diversification is achieved by including different investments in terms of stock sectors, distribution amount, location, type of investment in stocks and other asset classes (Figure 2).



**Fig. 2.** Number of securities in the portfolio.

Diversifying your stock portfolio is important to reduce the risk of being too involved in a particular industry. It is hedging against “putting all your eggs in one basket”. Stock diversification continues to be further improved by holding some stocks that are negatively correlated with other held stocks. This gives you a portfolio of stocks in which risk is controlled, thereby reducing the impact of market volatility. While a portfolio may seem well diversified, it is never fully diversified in terms of non-systemic risk.

To fully understand why diversification is so important in a portfolio, investors must distinguish between systemic and non-systemic risk [5,11-14].

**Systemic risk:** Systemic risk is the central risk for the overall market. This type of risk is commonly known as non-diversified risk because it cannot be completely avoided. Examples of systemic risk are, inter alia, political events, war, etc. Thus, one company cannot control this type of risk.

**Non-systemic risk:** Non-systemic risk is the risk associated with specific companies/stocks. These types of risks can be controlled by the company and mitigated through diversification techniques. Examples of non-systemic risks are, inter alia, competitors, business risks (internal operational or external legal factors) and financial risks (capital structure). These are non-systemic risks that investors want to mitigate by diversifying their stock portfolios. After achieving diversification of stocks, it is important to remember that the portfolio is still subject to systemic or market risk.

Ways to diversify your stock portfolio:

1. By sector. Equity sectors provide investors with the ability to spread risk across different industries. High participation in one sector can become dangerous for investors if that sector loses value. Make sure you rate each sector according to how it fits into the overall financial goal of the portfolio, because some sectors do not correlate correctly with each other.

Risk-averse investors can take more safe haven stocks to get some protection against declines during hectic market conditions. Risk-averse investors may have a higher proportion of growth stocks than safe haven stocks. However, it is important to remember that even safe haven stocks can fall if the market falls more broadly.

2. According to the size of the company. Including companies of different sizes (low, medium and high market capitalization) is another popular way to diversify a stock portfolio. Generally, Large-Caps are considered safe as opposed to small/mid-cap companies, but small companies can offer impressive growth opportunities.



3. Geographically. Geographic diversification can refer to stocks at risk (financial, political, etc.) of a particular country or location. As globalization increases and market access increases, investors can invest in stocks from other countries or from other sites. This could mean investing in the same stock market in a company that also does business in other locations or other countries, or access shares in other stock markets around the world.

4. Stock ETFs. In recent years, stock ETFs have been gaining more and more popularity among investors. An ETF is a basket of stocks that you can invest in through an investment vehicle. This makes it easier for investors, and often cheaper, to diversify without buying multiple separate titles.

5. Asset class. Including other asset classes in an investment portfolio is another way to diversify. Generally, investors are considering safer investment options such as bonds. But this type of diversification is not exclusively limited to bonds, and investors are also involved in instruments, such as commodities and foreign exchange.

## 5 Conclusion

In conclusion, it can be noted that growth by diversifying productivity or product always implies that in parallel with the measure of diversification, your business is also undergoing a growth process.

Whether you are expanding your services or opting for long-term product diversification, in both cases an entrepreneurial restructuring plan can only be implemented under certain conditions.

It is small and medium-sized enterprises that do not yet have such a large experience of practical diversification actions, first of all, proceed from the following thesis: diversification allows achieving a long-term increase in sales. But this is not the only significant benefit your business will experience over time from diversifying actions.

Diversifying your stock portfolio is important to reduce the risk of being too involved in a particular industry.

Investors need to be aware of their financial goals (period, risk, etc.) and their budgetary constraints before they make any investment. Once this is understood, investors may worry about diversifying their portfolio. For successful diversification, the following points should be considered:

- What risk are you willing to take?
- Don't take too many stock names
- Understand how stocks correlate with each other
- The risk can never be completely eliminated
- Consider diversification across different asset classes

Diversification is based on different reasons or motives, which can be crucial individually or in different combinations.

Through diversification, goals can be pursued in both business management and financial economics. These goals overlap in many areas. However, the base is changing.

The main goal of business management is to achieve business growth. Companies that invest in diversification are expanding their product market matrix. They open up new sales areas or offer additional products in the market. Perhaps even new markets will open up in existing regions. Diversification often increases either the reduced amount or the profit margin. Vertical diversification can be aimed at optimizing costs. It can also lead to lower prices. With more revenue or better margins, the company gains capital to grow. Moreover, diversification can strengthen and enhance competitiveness. The company attracts more attention on the broader or better offer. Competitive advantages are generated. The third goal is risk minimization. Other areas of business may be better able to cover overhead costs. Business area weaknesses have less impact on other business areas. The last major

goal of diversification is to make better use of existing resources. This may be caused not only by production lines, but also to the administrative apparatus. The economic efficiency of the company is optimized through the best contribution to the coverage.

The biggest and most important goal for many investors to diversify their own money investments is the spread of risks. By simply investing your capital in a company, institution, government, or mutual fund, you run less risk of a cash investment completely failing or losing significant losses. By diversifying your investments, you dissipate this risk. But at the same time, thanks to this spread, they also reduce the chances of exceptional profits. Other goals for expanding your cash investment portfolio can also be to increase your capital. After all, it's not just one investment that has the potential to multiply your capital.

The three ways of diversification also require more or less large capital investments. This can be done through additional capital or debt financing, such as corporate loans, leasing, equity or procurement financing, and factoring.

Financial and economic funds are additionally invested to implement diversification in the relevant financial markets. Own funds are recommended for financing, since the cost of debt financing is often higher, therefore, the profitability is possible.

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