

Abstract

Investors and investment advisors strive to make the best investment decisions when forming a stock portfolio. However, at the Nairobi securities exchange in Kenya, most investors are not optimizing the return of their stock portfolios because they do not consider relevant factors when investing in stocks. In particular, they do not consider equity risk factors when forming stock portfolios. In the United States of America, Dimensional fund advisors have shown that if active investors tilt their stock portfolio towards equity risk factors such as value risk and size risk, the return of the stock portfolio formed is better than that of the market portfolio. Capital asset pricing model has been the generally accepted model for explaining the relationship between risk and stock portfolio return variations. However, the restrictive assumption of employing the market risk as the only source of risk in capital asset pricing model led to the introduction of multiple factors models that attempt to identify other sources of risks that are disregarded by the capital asset pricing model. Available empirical evidence suggest that much of the variation in stock returns related to size risk, value risk, momentum risk, profitability risk and investment risk is left unexplained by Capital asset pricing model. This motivated the researcher to examine a model that adds the five risk factors to capital asset pricing model. As a result, a six factors model was developed and used to determine the ability of the combined six equity risk factors in explaining the variation of stock returns at the Nairobi securities exchange in Kenya. The general objective of this study was to establish the effect of equity risk factors on the return of stock portfolios of companies listed at the Nairobi securities exchange in Kenya between 2009 and 2014. The study adopted the explanatory research design and the target population was 45 companies that were listed at the Nairobi securities exchange by January 2009 (after excluding companies that were not trading consistently and those that were delisted). A census of 45 companies was used to construct stock portfolios between 2009 and 2014. Data was analyzed using a modified Fama and French (1996) multivariate time series regression methodology. The study found out that market risk, size risk, value risk and investment risk have a significant effect while profitability risk and momentum risk have a weak positive effect on the return of stock portfolios at the Nairobi securities exchange. This study recommends a framework for enhancing factor investing strategies, introducing exchange traded funds index and reviewing policies on price determination of listed stocks. The study availed to investors, investment advisors and academia the equity risks that are worth considering when constructing a stock portfolio at the Nairobi securities exchange for optimal stock returns.