

Keep in mind

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In financial theory, the optimal allocation of assets and its relationship with profitability has been one of

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the main concerns; the question has always been if banks should focus or diversify their assets. In our case, we would like to answer this question focusing in diversification of the loan portfolio, presenting a theoretical model that considers the possible gains from diversification, while taking in to account the effects of monitoring. Additionally, we present empirical evidence on this matter for the Colombian banking system. According to the model, we find that once the banks have chosen its optimal level of monitoring, expected return is always higher when the bank decides to focus. Additionally, the empirical results suggest that there are no possible gains from diversification in bank's cost and that, on average, the effects of focusing the loan portfolio reduces bank's return while showing positive effects of focusing on an specific sector.

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