According to classic Portfolio Theory, the variance of the return on an investment portfolio may be used as a measure to estimate the portfolio's risk-level. One of the normative ways to reduce this risk is to diversify the sources of investment. The current research examines situations in which the way individuals perceive diversification leads them to suboptimal financial decisions. We conducted studies in which participants were required to judge, choose or manage sets of alternative investment portfolios or multiple debts. The findings revealed three systematic errors concerning diversification: (1) a biased perception of multiplicity (i.e., the number of securities in the portfolio), (2) a biased perception of distinctiveness (i.e., the correlations between the securities that form the portfolio), and (3) a preference for over-diversification after being exposed to past information on gains but under-diversification after being exposed to past information on losses.

Abstract

http://portal.idc.ac.il/en/schools/economics/about/Pages/seminars.aspx