

"Naive Diversification: Preferences and Representation"

by Ola Mahmoud, University of St. Gallen

Abstract:

A widely applied diversification paradigm is the naive diversification choice heuristic. It stipulates that an economic agent allocates equal decision weights to given choice alternatives independent of their individual characteristics. This article provides mathematically and economically sound choice theoretic foundations for the naive approach to diversification. We axiomatize naive diversification by defining it as a preference for equality over inequality and derive its relationship to the classical diversification paradigm. In particular, we show that (i) the notion of permutation invariance lies at the core of naive diversification and that an economic agent is a naive diversifier if and only if his preferences are convex and permutation invariant; (ii) Schur-concave utility functions capture the idea of being inequality averse on top of being risk averse; and (iii) the transformations, which rebalance unequal decision weights to equality, are characterized in terms of their implied turnover.