Why Do Individual Investors Hold Under-Diversified Portfolios?

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Abstract

This study examines the diversification decisions of more than 60,000 individual investors during a six year period (1991-96) in recent U.S. capital market history. The majority of investors in our sample are under-diversified and the extent of under-diversification is more severe in retirement accounts. Investors' personal characteristics, their stock preferences, and their behavioral biases jointly influence their diversification choices. Younger, lower-income (less wealthy), and relatively less sophisticated investors and those who follow price trends, prefer local (familiar) stocks, and exhibit over-confidence hold relatively less diversified portfolios. Under-diversified investors exhibit strong style and industry preferences and they also prefer more volatile and positively skewed stocks. Furthermore, we find some evidence to support the asymmetric information hypothesis for under diversification. In contrast, we find that factors such as small portfolio size, transaction costs, and search costs are unlikely determinants of investors' diversification choices. The unexpectedly high idiosyncratic risk in investors' portfolios results in a welfare loss.

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