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“How to Alleviate Correlation Neglect?”

Abstract

By sampling. In two laboratory experiments, we vary how correlation is presented in an investment task. When participants directly get a description of probabilities for all possible outcomes of a joint return distribution, we confirm the common finding that investors neglect correlation, keeping their diversification decision constant even if they notice changes in correlation. However, when participants sample returns from the same joint distribution, they diversify more when correlation decreases. In our first experiment, where we use only four prospects for the two risky assets, respectively, this finding is robust to sampling numerical returns or graphical bar chart returns. When we use a more complex continuous return distribution, participants only diversify more at lower correlations after graphical sampling. Hence, graphical sampling helps alleviate correlation neglect.