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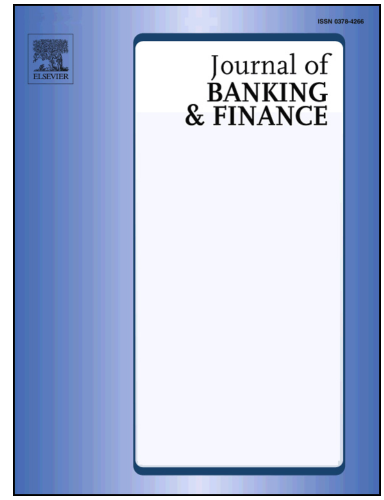

Diversification and systemic risk

Louis Raffestin

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Diversification and systemic risk

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Abstract

Portfolio diversification makes investors individually safer but creates connections between them through common asset holdings. Such connections create "endogenous covariances" between assets and investors, and enhance systemic risk by propagating shocks swiftly through the system. We provide a theoretical model in which shocks spread through constrained selling from N diversified portfolio investors in a network of asset holdings with home bias, and study the desirability of diversification by comparing the multivariate distribution of implied losses for every level of diversification. There may be a region on the parameter set for which the propagation effect dominates the individually safer one. We derive analytically the general element of the covariance between two assets i and j, and discuss the factors on which it depends. Going further, we find agents may minimize their exposure to endogenous risk by spreading their wealth across more and more distant assets. The resulting network enhances systemic stability.

Jel classification: G110; G120; C650
Keywords: Systemic risk; Diversification; Circulant network; Circulant matrix, Fire sales

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