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The curious case of negative volatility*

Christoph Merkle[†]

Abstract

In a panel survey of brokerage clients in the United Kingdom, participants mostly perceive their own portfolio as no more volatile than the market portfolio. Taking into account observed portfolio betas, this implies a belief in very low idiosyncratic portfolio volatility, which is even negative for a considerable fraction of the studied investor population. Possible explanations are extreme overconfidence in combination with a misunderstanding of how market and portfolio volatility are related. The identified bias contributes to underdiversification, as a belief in negative idiosyncratic volatility conceals the true benefits of diversification. In an experiment, we confirm the existence of a belief in negative volatility and rule out the underestimation of beta as an alternative explanation.

JEL classification: D03, D14, D81, G02, G11

Keywords: Risk perception, Volatility, Overconfidence, Miscalibration, Diversification

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