Ethnic diversity reduces risk of market bubbles

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If they consider it at all, investors likely regard ethnic diversity as a matter of social policy. But new research by an MIT Sloan professor suggests a much more practical reason to consider diversity: compared to markets comprised of ethnically homogeneous traders, ethnically diverse markets tend to price assets more accurately and are less susceptible to market bubbles.

"In our experiments, ethnic diversity leads all traders, whether of majority or minority ethnicity, to price more accurately and thwart bubbles," MIT Sloan Prof. Evan Apfelbaum and his fellow researchers conclude in a paper available Nov. 17 in Proceedings of the National Academy of Sciences (PNAS). "Ethnic diversity was valuable not necessarily because minority traders contributed unique information or skills, but their mere presence changed the tenor of decision-making among all traders. Diversity benefited the market."

For their experiment, Apfelbaum and his team constructed experimental markets in Singapore and the United States in which participants traded stocks to earn money. They randomly assigned participants to ethnically homogeneous or diverse markets. The result was that the diverse traders did a 58 percent better job at pricing assets to their true value. And while pricing errors were preserved or even exacerbated in homogeneous markets, accuracy improved in diverse markets.

Overpricing was higher in homogeneous markets because traders are more likely to accept speculative trades, the paper finds. "Their pricing errors are more correlated than in diverse markets. And when bubbles burst, homogeneous markets crash more severely."

"The effects were stronger than I expected and were not driven by differences in financial pricing skills of diverse versus homogeneous markets," says Apfelbaum. Rather, he says, the findings highlight the power of the social context in which trading decisions are made. "The paper speaks more to the perils of homogeneity than the virtues of diversity," he explains. "The most prominent effect is not the increase in accuracy in diverse markets; it's the sizeable decrease in accuracy in homogeneous ones."

Apfelbaum is a social psychologist whose research examines the challenges and potential of diversity for individuals, groups, and institutions. Other members of the research team included economists and sociologists. "Past work has argued that diversity fuels conflict and makes people uncomfortable. It is clear that people work harder in diverse settings, socially and cognitively. So when it comes to creating the conditions that promote cold hard accuracy in decision-making, diversity may be an invaluable asset."

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