Ethnic diversity can deflate stock market bubbles, study finds

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Stock market bubbles have led to economic catastrophes from the Great Depression through the dot-com boom of the 1990s and up to the recent housing financial crisis. Although these episodes cause widespread financial havoc, the reasons behind economic bubbles remain unclear.

A new study proposes a cause: Bubbles happen when people mindlessly trust the behavior of others, particularly when surrounded by ethnic peers. In an article in the *Proceedings of the National Academy of Sciences*, a team of researchers found that markets of ethnically diverse traders are much less likely to suffer bubbles. These findings could have a lasting impact on economics—and ethnic diversity.

"Ethnic diversity can bring a variety of perspectives, but it is also valuable because it changes how people think, feel and behave," said Dr. Sheen Levine, an assistant professor at The University of Texas at Dallas who conducted the research while on the faculty of Columbia University.

To examine how ethnic diversity affects price bubbles, Levine and his collaborators constructed experimental markets in Southeast Asia and North America. It was a laboratory for bubbles: "We could pinpoint the true value of a stock, and compare these true values with market prices," Levine said. "So we could identify bubbles as soon as they appeared and measure their exact magnitude."

The researchers randomly assigned participants, all versed in finance, to ethnically homogeneous or diverse markets, letting them trade stocks to earn cash. There were no initial differences between traders in homogenous and diverse markets. But when trading began, a striking difference between the markets emerged.

Homogenous markets were much more likely to bubble. In them, overpricing was higher as traders were more likely to accept speculative prices. Their pricing errors were more correlated than in diverse markets. And when bubbles burst, homogenous markets crashed more severely.

"Bubbles have been long ascribed to herd behavior, but hard evidence has been scarce until now," Levine said. Across markets and locations, market prices fit true values 58 percent better in diverse markets.

What is the practical significance of the findings? Levine points to a recent study by the Graduate Center of the City University of New York, which found that more than half of Wall Street's workforce was made up of white men who earned more than twice as much as women and minorities. In the financial center of London, there may be even less diversity, suggest data from recruiting firm Astbury Marsden, Levine said.

"Our findings are another compelling reason to diversify markets, teams, boards and organizations," he said.

More information: "Ethnic diversity deflates price bubbles." *PNAS* 2014 ; published ahead of print November 17, 2014, DOI: 10.1073/pnas.1407301111

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