

Naive Diversification

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Naïve diversification is a choice heuristic (also known as "diversification heuristic"). Its first demonstration was made by Itamar Simonson in marketing in the context of consumption decisions by individuals. It was subsequently shown in the context of economic and financial decisions. Simonson showed that when people have to make simultaneous choice (e.g. choose now which of six snacks to consume in the next three weeks), they tend to seek more variety (e.g., pick more kinds of snacks) than when they make sequential choices (e.g., choose once a week which of six snacks to consume that week for three weeks). That is, when asked to make several choices at once, people tend to diversify more than when making the same type of decision sequentially.

Subsequent research replicated the effect using a field experiment: on Halloween night, young trick-or-treaters were required to make a simultaneous or subsequent choice between the candies they received. The results showed a strong diversification bias when choices had to be made simultaneously, but not when they were made sequentially.

Shlomo Benartzi and Richard Thaler commented on Read and Loewenstein's: "This result is striking since in either case the candies are dumped into a bag and consumed later. It is the portfolio in the bag that matters, not the portfolio selected at each house." Following on the Naïve diversification showed by children, Benartzi and Thaler turned to study whether the effect manifests itself among investors making decisions in the context of defined contribution saving plans. They found that "some investors follow the '1/n strategy': they divide their contributions evenly across the funds offered in the plan. Consistent with this Naïve notion of diversification, we find that the proportion invested in stocks depends strongly on the proportion of stock funds in the plan." This finding is particularly troubling in the context of laypersons making financial decisions, because they may be diversifying in a way that is sub-optimal.