Financial Hypochondria

Individuals who suffer from hypochondria have an excessive preoccupation with their physical health, which manifests itself into an unrealistic fear of having a serious disease. As they focus on and worry about physical sensations, a cycle of symptoms and worry begins which can, in and of itself, contribute to adverse health effects.

We are not making light of the disorder; if untreated, it can be very serious. Financial hypochondria, another condition of the mind, can also be very serious as it can prevent an individual from achieving good financial health. It can be characterized as a tendency to allow cognitive biases and emotional reactions to adversely affect your decision-making process. In effect, this creates the impression that something is wrong when it is not or the belief that something exists when it does not. The end result is often a distorted and pessimistic view.

The fields of psychiatry and psychology continue to evolve in their studies of the mind and of mental function and behavior respectively. Psychiatrists can be instrumental in determining the root cause of hypochondria, while psychologists have been very helpful in uncovering the core tendencies that contribute to financial hypochondria. As a result of these observed cognitive challenges, a relatively new branch of psychology, behavioral economics, has emerged. This field combines the study of our mental functions and behavior as they relate to financial decisions.

The field is so widely accepted that in 2002, Princeton psychologist Daniel Kahneman won the Noble Prize in Economic Sciences for his groundbreaking work in behavioral economics. There are other likely future Nobel Laureates, like Richard Thaler at The University of Chicago Booth School of Business, who have made substantial contributions to this quickly growing field of study.

Some common cognitive biases, if left unchecked, can create an artificially pessimistic outlook regarding financial decisions including:

1) Myopic risk aversion - This bias results in the tendency to be short-sighted in choices that involve a potential loss. This can result in being overly conservative as you place an inordinate amount of emphasis on an isolated short-term loss, rather than focusing on long-term gains.

2) Recency Bias – This bias promotes a tendency to overestimate the likelihood of events recurring that are recent in our memory. In addition to recent events, we are also influenced by how unusual or emotionally charged the past event has been. As an example, a great many investors missed out on the market rally over the last five years as a result of the intense fear inspired by the recent Great Recession, thinking that it would be repeated.

3) Loss Aversion & Risk Taking - Studies show that while investors are risk averse when considering gains (they don't want to give them up) they are risk seekers when it comes to losses (they take excessive risk to avoid realizing them). In general people find losses up to two and a half times as painful as they find gains pleasurable. This results in people selling winners and hanging onto losers without considering the merit of either choice.

4) Gambler's fallacy – This bias promotes a tendency to think that future probabilities are altered by past events, when in reality they are unchanged. For example, "I've flipped heads with this coin five times consecutively, so the chance of tails coming out on the sixth flip is much greater than heads." History has shown us that past events have little influence over future events.

5) Availability cascade – This is a self-reinforcing process in which our "belief" gains more and more plausibility through its increasing repetition in public discourse. Essentially if something is repeated often enough it must be true. It is this cognitive bias that provides the media so much influence over the public's collective thought process. Believing what we read and hear in the media is often counter-productive.

These cognitive biases (and many more left unmentioned), alone or in conjunction with one another, can create an environment that inhibits a sound, rational thought process.

It should come as no surprise that the mind can contribute to both better physical health as well as better financial health. Sound financial decisions, in fact most decisions, should be made rationally and objectively. A certain amount of caution in decision-making is a healthy thing, but when unfounded fears overwhelm your judgment, a problem exists.

If you can limit cognitive biases and emotional reactions relative to financial events you will increase the probability of achieving your financial objectives. If you cannot, take two aspirin and call us in the morning.

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