To The Point **PARAG PARIKH**

A Rupee Wise Stance

Money could be easy or tough to earn, but that shouldn't govern how you spend it

IT is said that a rose by any other name would smell as sweet. Apparently, this adage does not apply to money—although it is fungible in the literal sense, some sources and applications of money are more dear to us than others. This trait of compartmentalising money in our mind is called **mental accounting**. We consider 'some rupees more equal than other rupees'. Here are two such examples related to the stockmarket.

We regard income earned through regular sources (salary or business) as serious money. Viewing this sum through the prism of safety and security, we value its ability to fulfil our needs. We dread the discontinuance of this income source and strive to preserve and enhance this stream.

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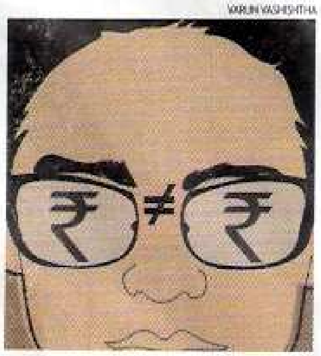

However, our perspective suddenly changes when it comes to money earned through other means such as, say, day-trading on the stockmarket or gambling at the casino. (The mention of the two in the same breath is merely coincidental!) We often consider this to be, as the Americans say, "funny money" and are far more cavalier in our treatment of such earnings.

For instance, if X earns ₹50,000 through day-trading, it may not occur to him that he should transfer this money to a bank deposit as it could help him finance his child's school education. This money is more likely to immediately find its way back into the market. Surprisingly, he may not be too dejected even if he subsequently surrenders all of his gains. He will rationalise the loss, saying the money had come to him too easily and, hence, there was no grief in losing it just as easily.

> The effort we make to earn a certain sum is proportional to the seriousness we attach to it

Similarly, we may have fewer qualms in recklessly spending money received as gifts.

Often, the effort that we have to make to earn a certain sum is directly proportional to the seriousness that we attach to it.

The amount of money involved may also lead to such behaviour. For instance, a tax refund of ₹1,000 may be frittered away, while the same recipient will treat a tax refund of ₹25,000 with more respect. In both instances, the source is the same, but our outlook is different.

The fallacy of mental accounting may also extend to expenditure. For instance, we may park our 'safe money' in a bank fixed deposit at 6 per cent per annum (p.a.) while paying hefty interest at 16 per cent p.a. on a personal loan taken from the same bank. Yet, we do not break the fixed deposit and repay the loan at one go as we do not want to reduce the amount of 'safe money' in our possession.

Overspending while using credit cards is also somewhat similar—we do not experience the pain of large wads of cash actually leaving our hands.

You can avoid being a victim of mental accounting by following a couple of rules:

All incomes are equally important. This will prevent you from frittering away any sporadic income or windfall gains that you receive. Sometimes, it may make sense to park away such a sum in a fixed deposit or a short-term debt fund for a month or two so that you are not tempted to treat it lightly, and you do not end up squandering it.

Pay in cash. While it is difficult to do so for big-ticket expenses such as a house or a car, follow this rule for all frivolous expenditures. Also, be wary of smaller expenses tagging along with bigger expenses, such as fancy doorknobs or bathroom fittings while purchasing a house. Remember, small expenses add up in an insidious manner.

To have a thorough understanding of the concept of mental accounting, please visit www.ppfas.com and under "Understanding Behavioral Biases" go to "The Colour of Money". ∎

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