Mental Accounting

Episode 1.

Dilip was just out of college after doing his MBA in finance. He was very smart and intelligent person. He had that sixth sense when it came to picking stocks. He was working in a brokerage firm and was very well respected for his ability to read the markets. After a couple of years having gained work experience he got married to Sonia a girl whom she knew since his college days. When they got married he had a meager savings of around Rs.2 Lacs in his bank account. This was 1991 when the liberalization process had started and the stock markets were just taking off. Dilip, the adventurous and enterprising person that he was decided to use his meager savings of Rs.2 lacs by trading in stocks. It was a very wise decision considering his track record as a stock picker and his past success with the broking firms clients. He had a very successful streak. In the first year his capital of Rs. 2 lacs was up to Rs.8 lacs. In 1993 his winning streak continued and his capital was now Rs.14 lacs. Two years of success made him very confident of his abilities and he quit his job much against Sonia's wishes to be a full time trader. However he convinced her of his confidence to go it all alone as this would give him more time to develop his skill on investment by attending various seminars and keep up with his reading which was so very important for him. His success did not stop and in 1994 his capital had increased to Rs.3o lacs. They went on their first foreign trip to London. Sonia was very happy as they moved to their own small one bedroom apartment. 1995 saw his capital going to over Rs.60 lacs and his confidence level soared. Sonia was from a very conservative family. She would always like to play safe. She always insisted that Dilip put aside some money in different safe assets, which they could fall back on in times of need. She was against Dilip investing all the capital in the stock markets. Dilip did not heed her advice, as he knew that if he had more investment surplus he would be able to make more money. Both of them being very different in their approach to money the rift started widening. More arguments followed and the relationship started straining. His streak had ended. No more was he making money every time. But he had a comfortable balance and there was no need to worry. He started betting heavily in a market that was going down and went on going wrong. Enter 1997 Dilip had lost it all. He was back to his college days. Even his flat was mortgaged to a financer. Sonia filed for divorce. Her main argument was that he was a compulsive gambler and lacked financial prudence to take care of his wife. He was not capable of handling money, as he had lost Rs.60 Lacs in just two years in spite of her warning to save for their future. Dilip was shocked at such a blatant lie. How could she allege something like this? He filed his petition arguing that Sonia's argument is utterly false and baseless. He had only lost Rs.2 lacs and that also over a period of six years.

Episode 2.

Then there were these two very good friends Sunil and John. They were working together in the same company and financially they both were doing fine. Fun loving as they were they decided that every Saturday they should go for dinner at a five star restaurant. Alternately each would pay the bill. The first Saturday arrived and they went to the Taj and Sunil paid the bill of Rs.3000 by his credit card. Next Saturday they went to the Hilton and this time John paid the bill of Rs.2800by cash, as he did not have a credit card. Then the next Saturday Sunil again paid a bill of Rs.4200 by his credit card. Next when John was due to pay, the bill was Rs.3900, which he paid by cash. After a couple of more such Saturday bashes, John told Sunil that they should quit going to five stars as it was becoming very expensive. Sunil was shocked. Look here we both have the same salary and I don't think that we are extravagant. We need this recreation. We are working so hard. Sunil insisted that they carry on. John much against his wishes agreed. Next when Sunil had to pay the bill he had forgotten his credit card and he paid cash. Next day when he met John in the office he told him that it would be a good idea as John had suggested to avoid these Saturday bashes at five star hotels. Why did Sunil suddenly change his mind? What's wrong with John? Why is Sunil not feeling the same as John?

Episode 3.

Then there was this incidence when I had gone to witness a cricket match. Next to us there was this gentleman whose name I assume was Bomsy as I overheard his friends calling him. He was carrying a bag, which contained his water snacks and lunch. One thing that attracted my attention about this man was his loudness and his continuous talking on the mobile phones. He was carrying three of them. In the midst of an interesting game I suddenly heard him screaming an arguing with a hawker who was selling ice creams. The argument was regarding the price. He was mad at the hawker for charging such exorbitant prices. Now any one in his right mind knows that during such games the prices are high. This guy shows the hawker his bag and says to him: I have got every thing from home even my water. I will not allow you to make money out of me. The only thing I can't carry from home is the ice cream as it melts and that is the reason I have to come to you. But I will not pay this price and you can go. This guy was really interested in the game and he was cheering both the teams. Next day I was shocked. After lunch break a player completed his century and this guy was dancing. He calls the ice-cream vendor, grabs his bag and throws ice creams all around. This is my gift to all those who are lucky to catch one. Within the next three hours we had two more of such ice cream distribution. After the game ended I saw him settling his ice-cream bill with the vendor and giving him a hefty tip. I was confused by his behavior. He was fighting for the price of an ice-cream in the morning and then the same gentleman was distributing ice creams by the dozens to people he did not even know. Impressed by his charitable behavior the next day I asked him the reason for the celebration? He laughed, put his hand on my shoulder and replied; yesterday was a great day for me. I won a lot. I love cricket and I love to gamble on the game. All my bets were paying off. The bookies must be mad at me. When I win I like to celebrate. The bookies are losing. They are paying for the ice creams, so why not make people enjoy. Good thinking I told myself and walked away.

"Mental Accounting" an idea developed and championed by Richard Thaler underlines one of the most common and costly mistakes people make when dealing with money. It is the tendency to place different values to the same sum of money depending on how it has been acquired and the effort required to acquire. Traditional economic theory assumes that money is fungible, that is the notion that one rupee is capable of being used in place of another rupee This means that Rs. 100 in lottery winnings, Rs.100 in salary and a Rs. 100 tax refund should have the same meaning as they have the same purchasing power. However when individual behavior is studied, money can become less than completely fungible. People separate their money in to mental accounts, necessarily treating a rupee in one account differently from a rupee in another since each account has a different significance.

Coming back to the first three instances lets analyze as to how mental accounting is affecting each one's behavior:

<u>Episode 1</u>

Dilip and Sonia: Who is right? Dilip or Sonia? If your guess is Dilip then like most you have a problem. This is what Dilip also honestly felt. He had started with Rs.2 lacs and now he had nothing. So he lost on Rs.2 lacs. All what he had made in the stock markets were not his money. They were his winnings from his original capital of Rs.2 lacs. In Dilip's mental account make up, his money was only Rs.2 lacs and the rest were not his money but his winnings. So he was treating both these separately. Sonia does not suffer from this bias.

Episode 2

Sunil And John: What made John cautious of his extravagance? Every time John is paying the bill he is experiencing the real pain of parting with hard cash. He becomes aware as he sees cash going out. Sunil does not experience such a pain. He does not see cash going out of his pocket because he is paying by a credit card. Actually both the situations are the same that is money going out of pocket. Why did Sunil's behavior suddenly change after he paid the bill in cash? When he pays cash, he realizes the pain of parting with cash. Previously he was not experiencing this as he was paying by his credit card. This is mental accounting. In our mind there are two different mental accounts one for hard cash and the other for credit card. Actually both are the same but we view them differently because we suffer from mental accounting bias. We tend to be more extravagant when we use credit cards.

Episode 3

Bomsy the gambler: What was his thought process? Quite a stingy guy with his own money. But when he is winning he becomes very extravagant. He genuinely believes that the money he is winning is not his own money but the bookies money. And hence the celebration. He has two different mental accounts in his mind. One account for his own money and the other for his winnings. He treats them separately.

Lets know what would you do in the following two scenarios?

You have bought tickets for Rs.500 for a movie show. When you reach the theatre you find that you have lost the ticket. What would you do? Buy a new ticket? Or would you go back?

Now you are in a different situation. You go to the theatre to watch a movie. When you reach the ticket window you find that you have lost Rs.500 out of the Rs.2000 you were carrying. Would you still go to the movie and buy the ticket?

Most would say no to the first scenario while yes to the second. However both of them are identical situations. Both entail a loss of Rs.500 and the cost of watching the movie is Rs.1000 in both the cases. Then why the different decisions? Because for most of the people the loss of the ticket of Rs.500 and the loss of cash Rs.500 are separated mentally in two independent categories or accounts. And that is the reason individuals react to different situations differently.

We create different mental accounts for the same sums of money and that is directly correlated to our emotional state. To go a little deeper lets consider the following different types of mental accounts and human behavior dealing with unique situations.

Following are the different types of mental accounts:

- Earned income v/s gift income: When you receive your salary cheque you would be very careful as to how you would spend that money. For you that is holy money and it is the fruit of your hard work. You will be very careful with it. Say against that when you get a gift of the same amount of money you will tend to treat it very differently. You will tend to spend it lavishly on your indulgencies. Mentally for you this is free money, it was never there and now since it has come you will tend to spend it more freely. But your salary money is not free money, you earn it. Hence it sits in a different mental account in your head.
- Size of the money in question: we create mental accounts according to the size of the money and treat them differently. A tax refund is a tax deferral payment by the tax authorities. But when one gets a tax refund of say Rs.1000 one is likely to spend that away without giving it due thought. However a tax refund of Rs.20000 will make one start thinking whether to put it as a bank deposit or buy a mutual fund or buy stocks. Why does this happen? Small size money goes in to miscellaneous account and big size money goes in to important decision account.

- Large purchases v/s small purchases: You need to buy a fridge for your house. Observe the amount of research you will start doing. Being a white good the prices are very competitive and similar models of different manufacturers sell around the same prices. You do some hard bargain and manage to get a discount of Rs. 500 on your fridge costing Rs.20000. Ah! That was the best you could do and you are happy as for the next 5 to 10 years you will not have to go through this bargain hunting. Do you take so much trouble when you are buying your groceries? Imagine with a little effort put in the purchase of your groceries, if you are able to save Rs.10 a day at the end of the year it comes to over Rs.3500. And for that Rs.500 saving on the fridge you went through all the trouble. Apply this in your daily life and see your financial well being changing. Many people are cost conscious when making large financial decisions but they relax their discipline when it comes to small purchases. But that's where the difference comes.
- Cash v/s Credit cards: Today it has become a status symbol to flash your credit cards. Everyone possesses one. Every bank is aggressively marketing credit cards. Why? It's a great business to be in. It is a big profit center for the bank and a hole in the pocket for the user if you are not aware of how it harms you. Remember Sunil and John. Once Sunil paid cash he realized the value of money. As long as he was paying by credit card he was not filling the pinch.

We have different mental accounts and hence we treat cash and credit card differently. Actually both represent your own money. Credit cards make you extravagant on your spending. Moreover it is a costly way to live, as you tend to pay interest on the credit you are offered. . It is for this reason that credit cards companies do a flourishing business not only because you tend to spend more but you also end up paying interest on the credit you are offered. People tend to shop more if they use credit cards as against paying cash.

Now this was my personal experience: I had bought a couple of sports coats and a suit from the Raymond's showroom at Horniman Circle. I had made the payment through a credit card. I use credit cards for the convenience of not carrying a lot of cash. Yes may be on this occasion if I was paying by cash my spending pattern could have been different. After a couple of days I get a call from the credit card issuing bank regarding the purchase. I told them yes. Prompt comes the question. Sir we can allow you to pay in installments if you so desire? I refused and told them I do not require such credit. Can you imagine they are asking you to buy clothes on installments? Imagine the cost of your clothes once the interest is added. Today all such temptations are before you. You have a choice. Fall in to the trap or steer clear.

- Sacred money: Dilip was a very successful investor and had done reasonably done well for himself. One fine day he inherited from his uncle a handsome sum of Rs.10 lacs. His uncle was a very hard working person and all throughout his life he had slogged and saved the money. He would not venture in to any risky venture and treated his money with intense care. Dilip considered this money as very sacred as he had received the same from an uncle who had toiled in his life. It became impossible for him to put the money in to the stock markets where he had done reasonably well. Instead he put them in to bank deposits. The money was marked "Sacred" in his mental account. Had his uncle been a high flyer and extravagant maybe Dilip would have played the stock markets with that money.

Mental Accounting and Investors

No doubt mental accounting makes us act in unique ways and its end effect is felt on our financial well-being. It not only affects our personal finances but is more pronounced in the world if Investments.

- **Why do investors hold on to losing investments?** This is a question posed to each and every investor and my experience says that we are all prone to doing this. Whatever reasons you may have to justify your argument for holding but the fact remains that mentally you are unwilling to accept that you are making a loss. Mentally you tend to believe that you book a loss only when you sell. Intellectually you know that the loss is sitting there and you cannot do much about it but only hope that it vanishes. This is one of the most common mental accounting errors. On the contrary a loss is adjustable against a profit resulting in tax savings, but still investors fall prey to this common mental accounting error.

- **Why do investors earn less interest and pay more?** There was a person who was fairly well off and highly educated. He was quite successful in his career and a savvy investor. One day we were discussing investments and the various investment opportunities available. He was narrating his success story in margin trading. In spite of the higher interest paid by him his returns from the business seemed quite handsome. He was talking about his conservative nature and how he had comfortable bank deposits to take care of any unforeseen eventualities. He understood the lower rate of return the bank deposits offered but he felt that was a price he would pay for the margin of safety banks offered. Is it not a classic case of a recurring financial blunder by this highly educated gentleman? He is paying higher interest in his margin trading and his own money is lying in bank deposits earning much lower interest. How much better well off he could be if he utilized his own money for his own stock trades and avoid paying such high rates of interest. This is not a stray case, 90% of the people are making such mistakes. The problem here is there are two mental accounts “safe money” and “risk money”. The same person treating the same money differently.
- **Bonus shares or Splits as you call them:** What is a bonus share? It’s a freebee given by the company to its shareholders. You are dead wrong if you think so but a lot of people follow this train of thought. Most investors think it that way and get very excited when the company issues bonus shares. They also go and buy on

such news. Bonus shares are given to investors by capitalizing the reserves and hence the financial balance sheet remains the same. But investors don't see it that way. They consider it as a windfall. This leads them to be extravagant. Most of the investors suffer from this mental accounting error and it is evident with the stock markets going up on such announcements.

- **Day Traders:** They go on trading in and out of a stock time and again with very narrow spreads. What are they doing? They are thinking that they are in a profitable business generating income. Consider the transaction costs and the brokerage they pay on such volumes. They are in the business of enriching their brokers and the tax authorities. This is something like buying groceries and not heeding to the cost.

You may be prone to mental accounting if;

1.You don't think you are a reckless spender but you are unable to save enough.

2.You have savings in your bank but revolving balances on your credit cards and share overdrafts.

3.You are more likely to splurge with a tax refund than with savings.

4.You tend to spend more when you use credit cards than when you use cash.

5.Most retirement savings are in fixed income or other conservative investments.

Before I go ahead with the plan of action it is important to understand that there are no set rules to be followed. The practical advice would be asking you to refrain from using credit cards, treat all your money as the same. I hope it was all that easy. But each individual has his own set of cognitive defects and he is the best person to understand and decide for him as to what he needs to do. Mental accounting also has its positives and negatives and it is up to each individual to know what is best for him. For instance if you are a big spender and unable to curtail your urges, mental accounting could be the most effective way to plan your fixed mortgage payments, kids education money and retirement savings. In order to eliminate the harmful effects of mental accounting while preserving its benefits you need to audit your own internal mental accounting system.

Plan of Action

The following two steps could help you to assess your being prone to mental accounting. Firstly what are your answers to the following two scenarios?

Imagine that you are at the mall shopping for an expensive suit. Yesterday you won Rs.10000 in a lottery game. Will you use that money to buy the expensive suit?

Once again imagine that you are at the mall shopping for an expensive suit. Yesterday you noticed that you had Rs.10000 in your savings account, which you had forgotten. Will you use that money to buy the expensive suit?

If your answer is yes to the first question and no to the other, as most people would, you are prone to mental accounting, meaning that you are prone to wasting money as you wrongly put different values to the same rupees.

The second step is to review your finances and answer the following two questions:

1. Do you have emergency savings put aside?
2. Do you avail of revolving credit on your credit cards from month to month?

If your answer is “Yes” to both of the above questions, you are a victim of mental accounting. You stack away your emergency money at low interest rates and pay high interest on your credit card balances. You would be earning around 6% and paying around 18% on credit card debits. Imagine the blunder you are making because of this mental accounting error and at what phenomenal cost. Financially you would be much better off not having any emergency savings set aside and utilize the same money for your spending needs. This would entail a clean credit card record and a higher credit limit. Moreover in case of an emergency the credit card is always at your disposal. With this change you are getting richer by 12%.

Always pay cash: This is in no way to suggest that you throw away your credit cards. But whenever you make a spending decision try to pay cash rather than the credit card. This will automatically make you aware of the outflow of cash from your pocket and you may consider the price too high or avoid the purchase altogether.

Another way would be imagine visually the money when you are signing your credit card. The thought of that money will at least make you alert.

Needles in the Haystack: When ever you are making a big purchase like a car be very careful of what other accessories the salesman is trying to push on you. Since the car entails a big expense the accessories form a very negligible portion of expenses and you may be tempted to spend on things really not required. Do you really need the Rs.25000. leather seats when the originals are so good? Do you really require that Rs.15000. pioneer deck when the one, which comes with the car, is good enough? These expenses don't seem much when compared to the cost of the car but on their own they are big and definitely avoidable.

Be patient: Whenever you get a windfall income make it a point to wait at least a couple of months before you take any decision. Get in to the decision paralysis mode and don't do anything. Put that money aside in a bank. By the time your deadline rolls you will see this money as savings and will treat it as hard earned after a month decide what you need to do. By that time you will view this money as savings. You will not be wasteful with it.

Imagine all income is earned income: The best way to be resourceful with your money is to treat all money as earned income. Make it a point to train your mind thus. Whenever you get any money ask yourself this question. How long will it take me to earn this amount of money after taxes? Over a period of time this habit will fine-tune your internal auditing system.

After having learned the art of fine-tuning the internal audit system it is time to go ahead and learn how our brain works when it has to process information. This knowledge will help you get over your mental anomalies.