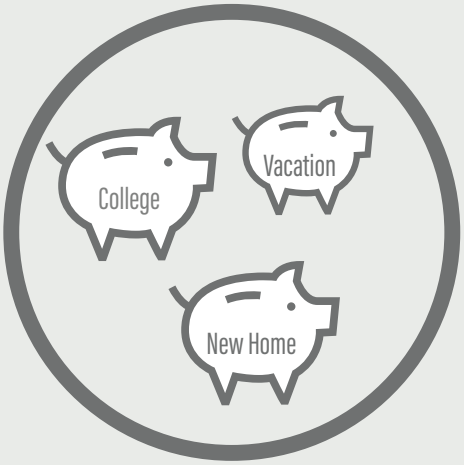
Mental Accounting

Psychology of an Investor



Mental accounting refers to the tendency for people to separate their money into different accounts based on a variety of subjective criteria, like the source of the money and intent for each account. According to the theory, individuals assign different functions to each asset group, which has an often irrational and detrimental effect on their consumption decisions and other behaviors.

INVESTMENT ESSENTIALS

INVESTOR PSYCHOLOGY

Although many people use mental accounting, they may not realize how illogical this line of thinking can be. For example, people often have a special "money jar" or fund set aside for a vacation or a new home, while still carrying substantial credit card debt.

In this example, money in the special fund is being treated differently from the money that the same person is using to pay down his or her debt, despite the fact that diverting funds from debt repayment increases interest payments and reduces the person's net worth. Simply put, it's illogical (and detrimental) to have savings in a jar earning little to no interest while carrying credit-card debt accruing at potentially 20% annually.

In this case, rather than saving for a holiday, the most logical course of action would be to use the funds in the jar (and any other available monies) to pay off the expensive debt.

This seems simple enough, but why don't people behave this way? The answer lies with the personal value that people place on particular assets. For instance, people may feel that money saved for a new house or their children's college fund is too "important" to relinquish. As a result, this "important" account may not be touched at all, even if doing so would provide added financial benefit.

The Different Accounts Dilemma

To illustrate the importance of different accounts as it relates to mental accounting, consider this real-life example:

You have recently subjected yourself to a weekly lunch budget and are going to purchase a $6 sandwich for lunch. As you purchase the sandwich, one of the following things occurs:

1) You find that you have a hole in your pocket and $6 is missing;

OR

2) You buy the sandwich, but as you plan to take a bite, you stumble and your delicious sandwich ends up on the floor.

In either case (assuming you still have enough money), would you spend an additional $6 for a sandwich?

Logically speaking, your answer in both scenarios should be the same; the dilemma is whether you should spend another $6 for a sandwich. However, because of the mental accounting bias, this isn't so.

Because of the mental accounting bias, most people in the first scenario wouldn't consider the lost money to be part of their lunch budget because the money had not yet been spent or allocated to that account. Consequently, they'd be more likely to still buy the sandwich, whereas in the second scenario, the money had already been spent.

Different Source, Different Purpose

Another aspect of mental accounting is that people also treat money differently depending on its source. For example, people tend to spend a lot more "found" money, such as tax returns and work bonuses and gifts, compared to a similar amount of money that is normally expected, such as from their paychecks. This represents another instance of how mental accounting can cause illogical use of money.

Logically speaking, money should be interchangeable, regardless of its origin. Treating money differently because it comes from a different source violates that logical premise. Where the money came from should not be a factor in how much of it you spend—regardless of the money's source, spending it will represent a drop in your overall wealth.

[Mental Accounting ≠ Logic]

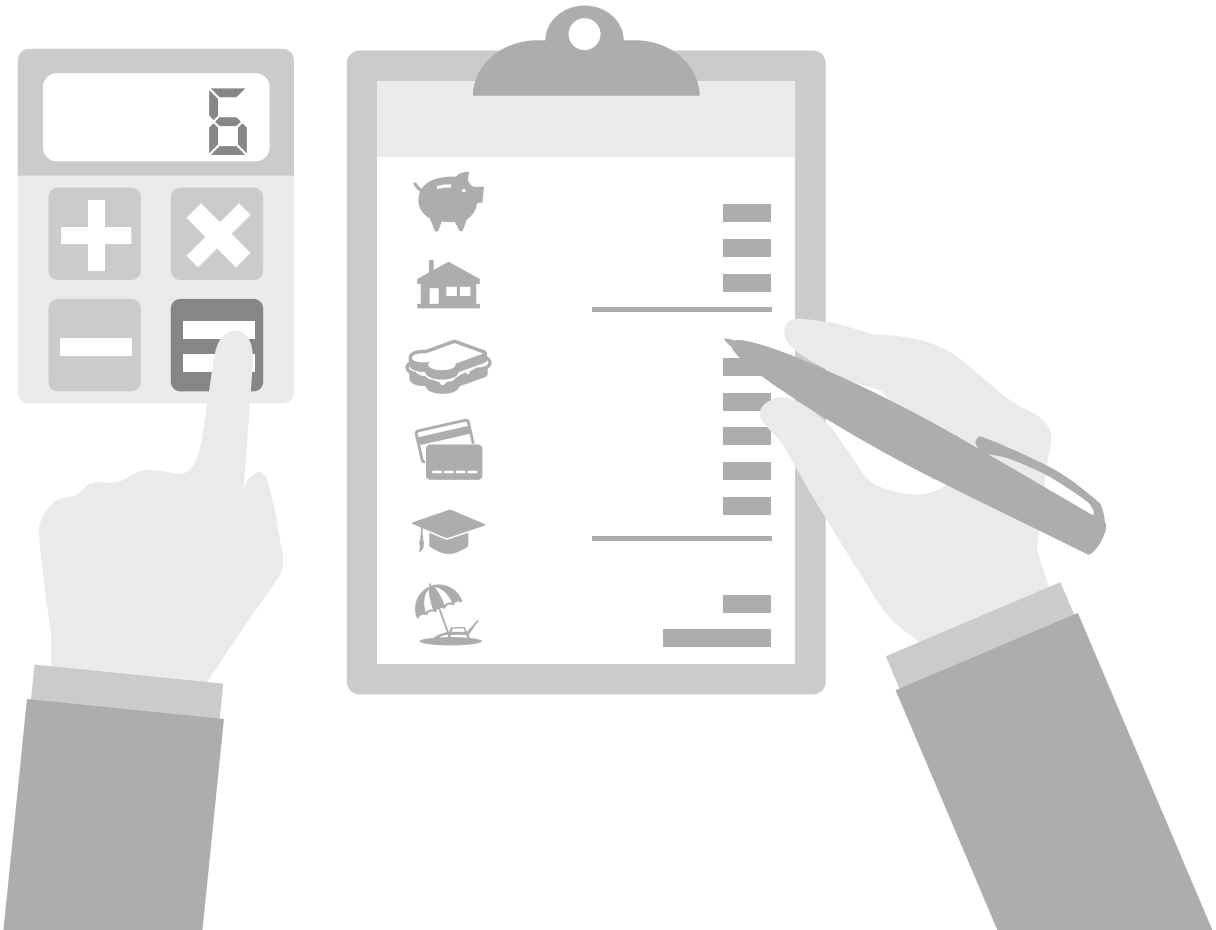
Mental Accounting in Investing

The mental accounting bias also enters into investing. For example, some investors divide their investments between a safe investment portfolio and a speculative portfolio in order to prevent the negative returns that speculative investments may have from affecting the entire portfolio. A problem with such a practice can be that despite all the work and money that the investor spends to separate the portfolio, his net wealth will be no different than if they had held one larger portfolio.

Avoiding Mental Accounting

The key point to consider for mental accounting is that money is fungible; regardless of its origins or intended use, all money is the same. You can cut down on frivolous spending of "found" money, by realizing that "found" money is no different than money that you earned by working.

As an extension of money being fungible, realize that saving money in a low- or no-interest account is fruitless if you still have outstanding debt. In most cases, the interest on your debt will erode any interest that you can earn in most savings accounts. While having savings is important, sometimes it potentially makes more sense to forgo your savings in order to pay off debt.



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