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Mental accounting: Rationalizations can cost you money

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PERSONAL FINANCE

Consider the following: You've bought a ticket to the Super Bowl. At the stadium, you realize you've lost your ticket, which cost $300. Assuming you had another $300, would you spend it to see the game?

Now imagine the same situation, but you're planning to buy the ticket when you arrive at the stadium. At the box office, you realize that you've lost $300 in cash on the way to the stadium. You still have enough money to buy the ticket. Would you?

Researchers have found that most people would answer "no" to the first question and "yes" to the second, though both situations boil down to a loss of $300 and the prospect of spending an additional $300 to be entertained.

For most people, the first situation equates to a total entertainment cost of $600, two tickets at $300 each. The second situation is viewed by most people as two independent costs, the loss of $300 in cash and the $300 cost of a ticket. Treating two economically equivalent losses of $300 differently because they occur in different manners is a classic example of what behavioral finance calls "mental accounting."

Mental accounting refers to the tendency to segregate and treat money differently depending on where it comes from, where it's kept or how it's spent. The process of creating mental accounts is contradictory to traditional economics, which views money as a fungible commodity. Rationally thinking, $100 is $100, regardless of whether it came from salary or gambling winnings.

Why do people engage in mental accounting? They divide investments and assets into neat, manageable compartments because they lack the mental power to consider their entire balance sheet for every decision. To avoid being overwhelmed, investors make decisions about pools of money in isolation.

Unfortunately, those decisions often aren't the best in the context of the total economic well-being. Mental accounting also explains why the casino always makes money. Certainly, casinos are profitable because the odds are stacked in their favor, but that's only part of the reason. In addition, many people view their initial amount at risk as "real money", but their winnings are "house money." In other words, gambling winnings aren't the gambler's money, so losses aren't real losses.

Mental accounting also causes problems where dollars are treated differently, depending on the amount of money in question.

Consider this example: Imagine going into a furniture store to buy a lamp. The lamp costs $100, but you learn that the same lamp is on sale for only $75 at another location of the store a mile away. Do you go to the other store to buy the lamp?

Now imagine that you go to the same store to buy a dining room set, which costs $1,800. You learn that the same set is on sale for $1,775 at another location of the store a mile away. Do you go to the other store to buy the dining room set?

Both situations pose the same basic choice: Would you go a mile to save $25? Again, research indicates that more people will go to the other store to buy the lamp than would go the same distance to save the same amount on the dining room set.

Although the amount of savings is the same in both situations, the $25 is devalued in the second situation because it's a smaller percentage of the total cost.

Obviously, mental accounting can be a serious threat to an investor's financial well-being. To avoid this behavior, investors should consider investments and assets from the perspective of their total financial picture. Important financial decisions should be made based on how they will affect total wealth. This will result in a number of benefits, including more careful spending, more careful investing, simplified investment management and greater wealth.

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