Are you subject to Mental Accounting?

Executive Summary: Mental Accounting is a concept wherein one separates money based on their source or use or separates their assets into safety buckets and risky buckets. Also known as two pocket theory, this concept relates to dealing with money differently which is against logical financial behaviour. It is important to understand that money is fungible and one must stick to personal finance principles. Avoid frivolous expenses irrespective of the source of the money and follow investing requirements to avoid mental accounting.

Let's take a real life instance - assume that you wish to watch a movie and have booked a ticket in advance for Rs. 200. When you reach the theatre for the show, you realize that you have lost the physical ticket (we are not taking of online ticketing and SMSes here). Would you spend another Rs. 200 and buy a fresh ticket? Probably not. But let’s say you had not bought the ticket in advance and plan to buy it at the time of the show. Suppose you enter the theatre and realize that you have lost the Rs. 200 in your pocket. Would you still go ahead and buy a ticket for the movie? Probably yes. If you have exhibited behaviour like the above, then you are subject to mental accounting.

The above classical theatre experiment was quoted by Kahneman and Tversky in their 1984 paper. They found that in the first case, 54% of people answered that they will not buy another ticket if they had lost the ticket they already bought for the movie. However in the second case, only 12% answered that they will not buy a ticket if they lose their money. Logically, the results from both cases should be the same, as it means that one has to spend an extra amount for the new ticket. However results differ because of mental accounting.

So what exactly is Mental Accounting? Mental Accounting is a concept coined by Richard Thaler. Accordingly, people divide their money into separate accounts based on the source of the money or the use of the money or both. In the above example, one may have a separate movie expense account, which allows spending a certain amount for a movie. In the first case, because a ticket is lost, spending again on a new ticket would mean that one had to spend Rs 400 for that movie instead of Rs 200. However in the second case, when cash is lost, it is not seen as double spending on the movie account. Therefore people may be more willing to buy a new ticket in the second case than the first.

Is this seemingly expected behaviour actually rational? Absolutely not. In both the cases, one has to spend extra. But yet in the second case, the expense seems to be justified to the human mind.

How does Mental Accounting occur in your personal finance decisions? There are many examples quoted by experts on how the concept of Mental Accounting occurs in personal finance and why this is not a good thing. A common example is when you divide your savings for different purposes or goals. Goal based investing is good; in fact recommended.
But not at the cost of harming your finances. All of us know about the classic case of saving money in a jar or in an envelope for different purposes. Now this money does not earn you any interest. Imagine that one of the envelopes is for an international vacation you are planning for your family. Now if you are also having an expensive home loan which you are servicing at 11% per annum, you are making a huge negative return harming your finances. Instead if you used this money to part pay your loan, you would be able to save on interest costs. Again, you may not be the one saving money in an envelope and may be investing in some avenue which earns you an interest. But say your investment earns you 9% per annum, then you are again harming your finances. You are so focused on saving for your vacation that you are actually making negative returns.

People follow mental accounting even on the source of money. Say you receive an income tax refund or an unexpected festival bonus from your employer. Most people treat this as extra money and spend this on luxuries or where it is not necessary, compared to how they would spend money from an expected source, say monthly salary. However, this is illogical as spending money from any source means increasing your overall expenses. Again, the concept of Mental Accounting violates logical and rational behaviour.

Another example of mental accounting in personal finance is when investments are earmarked as safe avenues and risky avenues in order to achieve diversification. As an investor, say you are willing to invest 30% of your portfolio in risky assets. This is speculative and you have told yourself that you want to earn higher at the cost of losing all this money. However, according to financial logic, one will never want to ‘lose’ any money and all money should be safe. An attempt to diversify your portfolio is actually not resulting in anything different and the risk and return on your total portfolio remains the same. The mental accounting concept has made it seem agreeable that 70% of your portfolio is safe, although in reality, financial rationality calls for safety of 100% of the portfolio.

**How do you deal with Mental Accounting?** All of us have been subject to Mental Accounting at some point or the other - be it similar to the simple movie ticket example or spending unexpected cash inflows. However you must realize that all money is fungible - both what you receive and what you spend. Stick to personal finance principles. Follow goal based investing, but not at the cost of mounting credit card debts and expensive loans. Avoid spending frivolously, both from your expected income and unexpected cash inflows. Invest based on your risk profile, investment timeframe and goals and not based on manoeuvring of the mind.

*While the above post is original, concepts have been reviewed from [Investopedia.com](https://www.investopedia.com) and other websites.*