BEHAVIORAL FINANCE 101 - MENTAL ACCOUNTING

Suppose you are walking into Starbucks and find a $20 bill on the sidewalk. With your new-found wealth, perhaps instead of a medium black coffee you'll feel more self-indulgent and order one of those fancy long-name drinks like a "Grande 5 pump vanilla, soy with caramel mocha." Now, why would you do this? The money in your wallet is in your "serious" mental account, while the sidewalk money was placed into your "windfall" mental account, making it easier to spend on non-essential items. In fact, if you have money on a Starbucks card, it is also easier to spend, as it is yet another mental account.

Mental accounting is an information-processing bias where people divide their money into different virtual "mental" accounts based on arbitrary classifications that treat each account differently. The accounts may be based on different classifications, such as the*source* of the money (i.e. salary, bonus, inheritance, etc.) or based on the *use* of the money (i.e. life expenses, leisure, savings, etc.).

Money may also be in different physical accounts as well as being in a different mental account. For example, your 401(k) plan or your IRA are different physical accounts from a personal savings account, but you probably also view them differently. Without even considering the tax consequences, you quite rightly view the money in a retirement account as being not available to use for personal expenses prior to retirement because it is also in your mental account called "retirement."

Mental accounting can be quite helpful when you have various goals with different time frames because it can help you segregate your savings and make appropriate investment decisions for the different pools of savings. You would normally invest more conservatively with the money you are saving for a short-term goal such as buying a car or making a down payment for a home vs. a long-term goal such as retirement. Even if these are not in separate physical accounts, it is helpful to classify them in different mental accounts.

On the other hand, creating mental accounts can have negative consequences.

You may classify money or a stock that you inherited in your "windfall" account and then use it for something frivolous instead of thinking seriously about all your financial goals and where it is best deployed. Conversely, you may treat this inherited asset as being off-limits and not available for any change, causing your overall investment portfolio to have an inappropriate asset allocation. You might blow a large sum of money from a tax refund instead of saving it like you do with your "paycheck" money.

What if you are getting ready to purchase a car and have the money for the purchase in a savings account, but instead choose to finance it because your savings account has been earmarked as a particular mental account, making it unavailable for a car purchase? Now, perhaps it should be unavailable – perhaps you need the savings account money for another short-term goal, but maybe you also need to take a wider view and consider the cost of the car finance vs. the interest being earned on the savings account.

I have frequently had conversations with people who had enough money in a near-zero rate savings account to pay off their much-higher-rate home mortgage, but who were reluctant to pay it off, but also reluctant to take a different investment approach to their savings account. This is an example of letting mental accounting steer you into making nonsensical financial decisions.

Sometimes different pools of money should be treated differently, due to the purposes of the money and tax or legal implications for using it. But, quite often, money is just money, and a dollar in your right pocket is no different than a dollar in your left pocket – except in your head.

In what ways does behavioral finance impact your decisions? We're here to help as you plan for your future.

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