FINANCIAL POST

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Needless cost of mental games

Michael Nairne, Serious Money

You and your spouse are standing in line for a play and, to your dismay, you find that you've lost the expensive tickets you'd purchased for $300. Do you buy replacement tickets or do you head home in a funk?

Now change the setting. You and your spouse are in line to buy the tickets and to your disappointment you find you've lost your money clip with $300 in it. Do you still buy the tickets or do you bail out?

Behaviour finance experts in a similar quiz found that 88% of respondents would buy a ticket when they'd lost the cash, while only 46% would buy another ticket if they'd lost the ticket. The same dollar loss can result in dramatically different behaviour.

What is at work is a psychological process called "mental accounting." People set up separate notional accounts or classifications in their mind and then assign different items and events to them. In the case of the tickets, a mental account was opened when the tickets were first purchased for $300. When the tickets were lost, many people found it too painful to see another $300 charged to the ticket account. In contrast, the loss of the equivalent cash in the money clip left the notional ticket account in balance.

This illustrates how mental accounting often violates one of the most basic principles of economics -all dollars are fungible.

In other words, a dollar is a dollar. But while mental accounting facilitates ease of decision-making, it frequently leads to needless costs or sub-optimal behaviour.

One of the classic mistakes caused by mental accounting is to view assets and debts as totally independent categories. I can't tell you how many times over my career I have seen individuals with plenty of low-yielding cash on hand pay the higher interest costs associated with a loan.

Because they keep their cash in a separate mental account labeled "safety and liquidity," they are subconsciously reluctant to use it to pay debts even though, practically speaking, they would still enjoy ample liquidity after paying them off.

An even more prevalent error is to keep investments and taxes in separate mental accounts. Investment planning and selection, as well as performance tracking, are handled on a pre-tax basis in the "money manager" or "broker" mental account, while taxes are assigned to a separate classification labeled "accountant's issues and tasks."

The result is that needless taxes are incurred as inefficient investments are acquired or assets are improperly allocated within the household. For example, it is not uncommon to see tax-advantaged Canadian equities housed inside an RRSP while more heavily taxed bonds are held in the open account.

In a similar vein, participating life and universal life insurance policies, which can have a significant investment component, are often assigned to a different mental account than traditional portfolio investments. The failure to unify these into an integrated asset allocation view can result in a distorted asset mix relative to an individual's objectives and risk profile.

Mental accounting can even detract from a family's budgeting efforts. Unanticipated bonuses or tax refunds are classified as "found money" and blown on frivolous expenditures instead of being used to pay down the mortgage or save for long-term objectives.

Holistic wealth management views the entire balance sheet in an integrated fashion that incorporates liquidity, risk and tax elements. Unfortunately, most investors have difficulty merging their mental accounts, but this is the best antidote for the deleterious effects of mental accounting.

-Michael Nairne, CFP, RFP, CFA, is the president of Tacita Capital Inc., a private family office and investment counselling firm in Toronto.