What's your money story?

Mental Accounting, Behavioural Finance and Personal Finance Decisions

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Purpose

- Objectives of the session
  - Introduce the concept of Mental Accounting and Behavioural Finance
  - Understand the psychological process behind Personal Financial Decision making

- Expected outcome
  - Enable us to make more informed day to day (and long term) financial decisions by understanding our own money story

Content

- Mental Accounting and How it works
- Our Money Story
- Changes in the ‘Information age’ - Fintech

Congratulations !

You have just won a lucky draw contest for
£1,500

What will you do with this money?
Will it make you feel different (happy/elated/jubilant)?

- Most of us also receive salary every month. Why does your salary not make you feel like this?

- You also feel different for
  - Unexpected tax refunds
  - Birthday Money
  - Sudden Bonuses

- Economic Theory says that the utility of an extra unit of income is the same no matter which source it comes from
  - A dollar is a dollar is a dollar!

- Then why do we treat income from different sources differently?

Mental Accounting

Defined as the

"set of cognitive operations used by individuals and households to keep track of financial activities"

(Thaler, 1999).

Basic Components

1. Framing of Decisions
2. Mental Accounts
3. Choice Bracketing

1. Framing of Decisions

How the decisions and outcomes are framed (perceived):

1. Value function tend to be relative rather than absolute
   - Comparison with a standard is easier, as absolute value is difficult to determine

2. Losses are more sensitive than gains - loss of £100 vs gain of £100

3. 3. <u>Significant timing effect – Now (Loss / Gain) is more salient than later</u>

1. Framing of Decisions – Value Function

Framing – What information (the decision frame) you use to inform your decisions?

If we change the information, the decision outcome will be different -

Acquisition utility (True Value) vs transaction utility (Relative Value)

- Amount paid vs value of the goods (Value -difficult to determine)
- Amount paid vs reference price of the goods (Easy to determine - good deal!)
- E.g. beer on a beach (five star resort/supermarket)
- E.g. Brand value represents transactional utility

1. Framing of Decision - Loss Vs Gain

Opening and closing accounts (losses are more painful)

- £500 invested each in two shares – after one month one goes up and one goes down. Which one would the owner likely to sell if he needs some cash?
- Closing an account in ‘red’ is more painful – we favour selling the winner while rational analysis favours selling the loser
- Bought ill fitting expensive clothes??? – Difficult to get rid off!!

1. Framing of Decision - Timing separation

Payment decoupling – used by marketing professionals

- Credit cards
  - Separation of payment and purchase makes payment less salient
  - Mixed Payment - £20 larger by itself but when a part of a £771.29 monthly credit card bill, it seems smaller.
  - This effect is stronger when the bill is not paid in full immediately (timing).
- Pay Day Loans, Klarna (https://www.bbc.co.uk/news/business-56841948)

- Difficult to start exercising (immediate inconvenience vs decoupled future benefit)
- Difficult to quit smoking/drinking (immediate pleasure vs decoupled future loss)
- Delay in saving for retirement ((immediate cost vs decoupled future benefit)
- Difficult to start a portfolio (immediate pain of learning vs decoupled future benefit)

2. Mental Accounts

In order to make our decisions easy we label our expenses, wealth and income under different categories -

1. Expenditures as Budgets: Food, housing, clothes, Entertainment etc.

2. Wealth as Accounts: Pension, house purchase, college fund etc.

3. Income into Categories: Regular (salary), windfall (Lottery, unexpected bonus)

If money is completely fungible (substitutable) we do not need these accounts. We do this as:

1. Budgeting can facilitate making rational trade-off decision easy
2. The system acts as a self control device

2.1 Mental Accounts - Expenses

The process

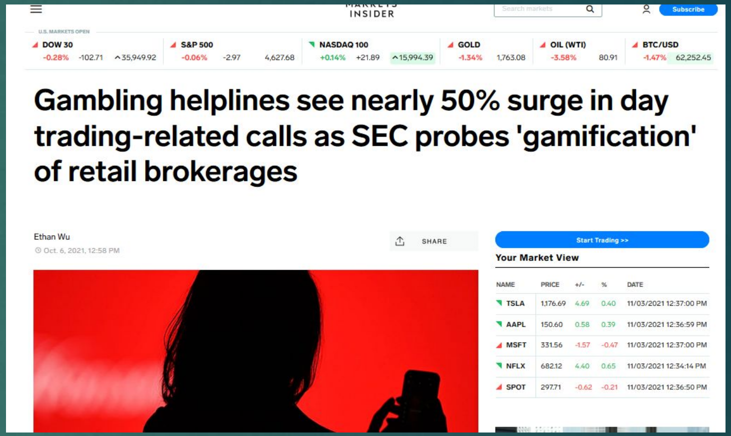
1. Expenses must be noticed
2. Then should assigned to proper accounts

Small expenses are less seriously booked – daily coffee vs £500 Burberry jacket

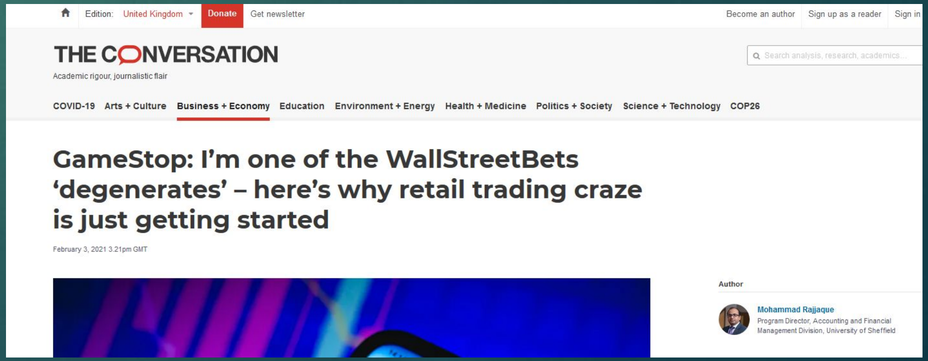
Car for £299 a month vs price £25,000 + £3,400 interest – easy to justify small expenses

2.1 Mental Accounts - Expenses

- When budgets are not fungible
  - Leads to severe (illogical) restrictions
    - Can spend on clothes but no more eating out



- Rise of day traders – Investing is easy to justify than gambling - https://markets.businessinsider.com/news/stocks/gambling-day-trading-robinhood-retail-investors-tenev-sec-gamification-brokers-2021-10



- I am not so innocent either!!! https://theconversation.com/gamestop-im-one-of-the-wallstreetbets-degenerates-heres-why-retail-trading-craze-is-just-getting-started-154584

2.2 Mental Accounts – Wealth

- Wealth Accounting – We divide our wealth across different accounts – and they can not be 'mixed'
  - Current accounts – household expenses, pocket money etc
  - Current Wealth – Savings account, Stock, Bonds
  - Equity – Mortgage payments, child's education fund etc
- This again may lead to illogical decisions -
  - 18% payment on credit card but can not touch house improvement fund (earning 4%) to pay it off
  - More likely to spend from current account than from the equity (in that order)
  - Tip: Transfer your money to your more restrictive accounts – setting a direct debit helps.

    (Save and then spend vs spend and what remains is saved)

2.2 Mental Accounts – Income categories

- Income is categorised as regular and windfall
  - Regular Income - is hard earned and needs to be spend wisely
  - Windfalls – can be enjoyed in relatively unrestricted manner on ‘luxuries’

- (We discussed this in the beginning of our presentation)
  - This effect remains dominant for one off money earned through a small project/side work – even you earn it through the skills you have gained through the same hard work!!!

- to avoid “free money effect” - “sleep over expense decision” - A new 75” TV seen today will be much less tempting a week down the line once the ‘windfall effect’ is diluted!

2.2 Mental Accounts – Choice Bracketing

In a series of decision making scenario, subsequent choices that we make are affected by our imaginary boundaries -

- Prior outcomes and risky choices
  - Gambling with own money vs house money
    - Gambling Apps offering 'free bets' (relative value of free money) - https://www.888.com/
  - More risky investments / trades once some profits are realised
- Narrow framing – taxi drivers earn day's income quickly on a rainy day and go home early

Our Money Story

The quick recap of our discussion suggest that the human mind does not make purely rational economic choices. The psychological effects are important.

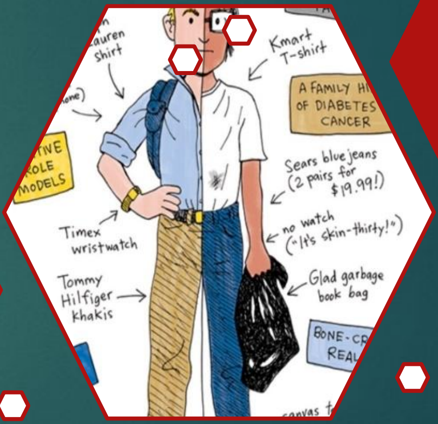
And as there are a number of variables that define our psychological status – these variables also affect our financial decision making.

Individual personality, gender identity, childhood experiences, family background, peer structure, Income level, educational background, political viewpoint, community traditions, stereotypes, broad economic aspects – Just to name a few.

££££££

Personality

Family



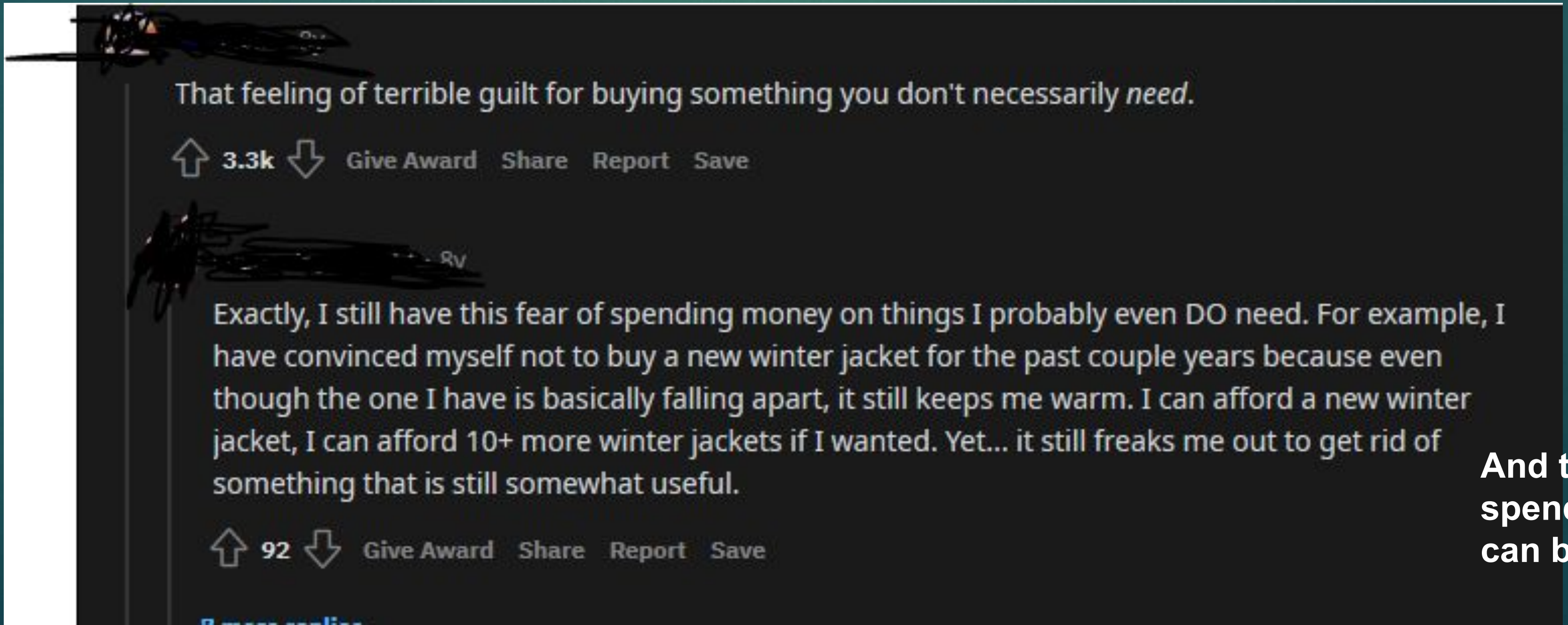
Peer

Our Money Story

SUM (ALL variables) = ‘OUR Money Story’ & STEP 1 is to understand it

HELP to work out our mental financial framework and to control our financial decisions.

As a society we have made significant progress to remove the taboo around physical and mental health – but financial health and money matters are still a taboo subject – despite it being closely related to both physical and mental health.



[redacted]

That feeling of terrible guilt for buying something you don't necessarily *need*.

3.3k Give Award Share Report Save

[redacted]

Exactly, I still have this fear of spending money on things I probably even DO need. For example, I have convinced myself not to buy a new winter jacket for the past couple years because even though the one I have is basically falling apart, it still keeps me warm. I can afford a new winter jacket, I can afford 10+ more winter jackets if I wanted. Yet... it still freaks me out to get rid of something that is still somewhat useful.

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And the opposite is also true – spending when you don’t need to can be a habit!

So What?
Our Money Story – Social Media + Fintech

And as it happens when the society doesn't have access to professionals, the 'self-proclaimed experts' tend to fill the gap – Just like alternative medicines in underdeveloped countries.

We are witnessing that in the rise of 'Finfluencers' on various social media.

Availability of retail investment apps, alternative investments like Crypto and prevalence of social media has created a situation where its very easy to make mistakes.

Only a handful 'finfluencers' are sensible – Most do not make sense and some are even downright wrong!

Some Statistics for UK!

- https://www.finder.com/uk/saving-statistics

Key statistics

- **1 in 10 Brits (9%)** have no savings at all.
- In 2020, the average person in the United Kingdom (UK) had **£6,757** saved.
- A third of Brits have **less than £600 in savings**.
- 41% of Brits don't have enough savings to live for a month without income.
- The number of Adult ISAs in the UK is up from **10 million in 2017-2018** to **over 11 million in 2018-2019**.
- The average amount in Adult ISAs has fallen from **£6,466 in 2017-2018** to **£6,049 in 2018-2019**.
- The **number of Junior ISAs in the UK is rising**, with just below **50,000 extra accounts** opening in 2018-2019.
- The average amount invested is now **£1,020**, up from £994 last year.

Going Forward!

- We need to talk and share experiences!
- Personal Financial Management need to be part of the curriculum!! (There are some attempts, but it still remains fragmented and unorganised)
- Very limited research focus on personal finances from individual perspective.

Thank you

Journal Articles:

Thaler, R. H. (1999) Mental Accounting Matters, Journal of Behavioural Decision Making, Vol 12, pp 183-206

Books

Thaler, R. and Sunstein, C. (2009) Nudge – Improving decisions about health, wealth and happiness, Penguin Books, London

Uwagba, O. (2021) We need to talk about money, Fourth Estate, UK

Article

https://www.forbes.com/sites/michaelkay/2016/12/06/overcoming-your-money-story/?sh=364f9b5925bb

Academic Book

Ackert, Lucy F. and Deaves, R. (2015) Behavioural Finance – Psychology, Decision-making and Markets, South-Western Cengage Learning, Mason, USA