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How you count your money, counts!

**"You've got to know when to hold 'em; Know when to fold 'em
Know when to walk away; And know when to run
You never count your money; When you're sittin' at the table
There'll be time enough for countin'; When the dealin's done"**

– Song 'The Gambler', performed by Kenny Rogers, written by David Shlitz (1978)

Whenever interest rates in the economy go down, investors search for other avenues that can provide better yield. Many investors need regular income from investments to cover part or whole of their monthly expenditure. The quest for regular income lures many to dividend options in equity or hybrid mutual funds, though technically these can't be compared with the yield on fixed income products or dividend on stocks.

Economic theory says the value of money doesn't change just because one labels it differently. Yet, we come across so many decisions people make about money which shows that labels do matter

A few years back, I remember having a small debate with a few financial advisors about choosing between a Systematic Withdrawal Plan (SWP, Opposite of Systematic Investment Plan or Dollar Cost Averaging) and a dividend option in mutual fund investments (mainly in Equity-Debt Hybrid Funds). While both gave the investors a regular income from their investments and have the similar impact on the value of mutual fund holdings, SWP was a better option than dividend plan in some important respects. Certainty of income, customizable amount, tax planning (offset capital gains/losses) etc. provide an edge to SWP over a dividend plan. However, the response I got from my advisor friends was, "our clients prefer dividend option, as dividend is mentally accounted as income on capital invested; SWP, on the other hand is considered as pulling out capital".

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This is a bit strange isn't it? Economic theory says the value of money doesn't change just because one labels it differently. Yet, we come across so many decisions people make about money which shows that labels do matter. The label on the source of money and the label we allocate it to (our various budgets) drives our decisions regarding how we save, spend or even invest it. Most people don't see money as one package, they see them as separate accounts. Nobel Prize winning behavioral economist Richard Thaler calls it 'Mental Accounting' of money.

Let's have a look at an experiment conducted by Thaler and behavioral economist Hersh Shefrin (think along and see what answers come to your mind). Imagine you got a special bonus of Rs. 600,000 over and above your regular compensation. In case 1, it is paid to you in 12 equal instalments of Rs. 50,000 over the course of the year along with your regular take home pay. Think about how your monthly consumption and investment would change in the year.

Now, in case 2, suppose the same money is given to you in lumpsum. How would you spend or investment then? In the last case 3, imagine this is not a bonus but an inheritance. A distant relative has died and left you Rs. 600,000 which is currently in fixed deposit account and will be given over the next five years with appropriate interest. How will you spend or invest this money?

For most people, the three different cases lead to three unique decisions on spending and investment, though the value of the money is the same! typically, in case 1, money is mentally allocated to 'current income account' and funds regular expenses. Case 2 lumpsum is either allocated to 'wealth account' or allocated for a 'big purchase account'. Case 3 is put to 'future money' mental account and is mostly kept untouched from consumption.

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Mental Accounting and Prospect Theory are the two important pillars of research in behavioral finance. While mental accounting impacts several financial decisions of our life, I discuss a few important ones that relate more closely to our investment decisions.

WHAT WILL YOU NOT FIND IN A CASINO?

The answer is 'a Clock'. You don't find any window either. Casino gaming floors don't have clocks or windows so that the gambler is unaware of the time spent on the floor. Whether winning or losing, except time (and going broke) it is assumed, nothing else will stop a gambler from betting. This tendency of gamblers also has something to do with mental accounting.

The House money effect: Let us take winning first. A non-professional gambler will typically have money in two mental accounts: the own money account and the 'house money' account. The profits from winning are kept in 'house money' account (casino being called the house). The gambler treats this money differently as she assumes that her own money is safe with her, she is just gambling with the money she has taken away from the casino. Unfortunately, the risks she takes with this money will be higher than amount in the own money account.

This effect is seen in traders too (especially the newer ones). After an initial success, the house money effect makes them take larger risks. A concoction of house money effect with recency bias and over confidence can be detrimental to financial health of the traders and investors alike.

Long shots: In a typical day of horse race betting, Kahneman and Tversky, found that bets on long shots (horses that have a very low chance of winning) went up at the end of the day. Why were people betting money on horses least likely to win? Because if you win, the payoffs were huge. Gamblers who lost money during the day and are in the red towards the end, want to take a chance with long shots in the hope of winning their money back with some stroke of luck. They want to end the days mental account with some profit. In casinos too, gamblers who have lost money will take every chance (increase their risk taking) for a chance to break even. The lure of a chance to break even (a tendency referred to as Get-Evenitis) often leads to investors also taking losing bets.

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WASTING YOUR LOVE ON A LOSER

People feel almost twice the amount of pain in losing Rs. 100 than the amount of happiness they feel in making Rs.100. Investors are ok with paper losses (not yet booked; only marked to market losses) to some extent but they feel pain when they realize that loss after closing the position.

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Disposition effect: When investors treat each transaction or investment as a separate mental account, the profit or loss of that position influences the decision to close that position. The Investor endeavors to close each separate mental account with a profit. Hence, they readily take profits rather than book losses. This is called the disposition effect. If investors evaluate each position as part of a portfolio of bets and then accept that some of them are likely to go wrong, they may choose to accept the mistake and sell the losing position instead of the winning position.

Sunk cost fallacy: Suppose you have got free tickets to a music concert (indoor) from a friend. The venue is at a location far outside the city. The evening when you are supposed to leave, there is a storm and heavy rains. The weather department says the same weather will continue into late night and your phone shows heavy traffic. Will you still attempt to go for the concert? Now, suppose the tickets are not free, you have paid Rs. 10,000 for the tickets. Will you attempt to drive through the storm now?

The cost of tickets is sunk cost and it will not be recovered. Why put yourself in further trouble? Unfortunately, people find it tough to close the mental account of such a situation at a loss of Rs. 10,000. If the tickets are free, there is no loss in the account and staying home is an easy decision. The same happens in case of loss-making investments. Often people try to put additional resources to a loss-making position hoping to get out at an average. This decision to invest in a losing account when other better investments are available is called the sunk cost fallacy.

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Mental accounting is very helpful in decision making. It helps keep budgets, control costs, save for retirement and other important goals. But we have to be aware of some of the pitfalls too. The idea that can help in improving investment decision as avoiding some the above problems is broad framing. Make broader mental accounts rather than narrower.

- Think portfolio rather than individual stock
- Think asset allocation rather than single asset
- Think total income rather than individual streams
- Think total returns rather than single windfall or loss
- Think best future potential rather than carrying cost
- Think rolling long term rather than short term target date

Happy Investing!

CANARA ROBECO Mutual Fund

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HEAD – INVESTMENTS, EQUITIES

CANARA ROBECO

Nimesh Chandan is Head-Investments, Equities at Canara Robeco. He has almost two decades of experience in the Indian Capital Markets. Nimesh has been with Canara Robeco since 2008 and in rollingcurrent role, he guides the equity team in providing a strategy for various equity funds. He is a keen follower of Behavioral Finance and has developed tools and processes which help improve the investment decision making process. He also conducts workshops wherein he presents the concepts of Behavioral Finance to investors and financial advisors under a series called 'The Money and the Mind'.

ABOUT STOIC INVESTOR:

The word "Stoic" is used to describe someone who remains calm under pressure and avoids emotional extremes. For the purpose of this newsletter we refer to the "Stoic investor" as an investor who is realist (avoiding extreme optimism and extreme pessimism), resilient (withstand difficult conditions) and rational (who acts with logic and reason).