Mental Accounting ~ Laurel Hickey & Garth Bluekens

What's Mental Accounting Got To Do With It?

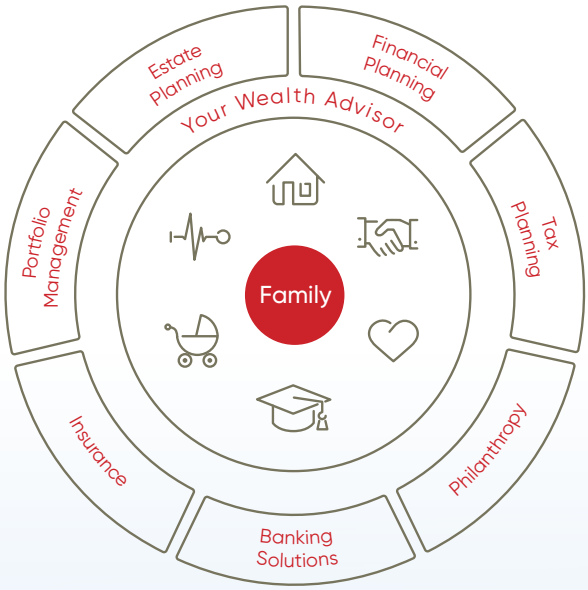
There are countless studies and published articles showing proof that there is an emotional side behind money. The way people approach money and how they view their investments can be influenced by a wide range of items like the origin of where the money came from or what the intended use for the funds is. The concept of mental accounting comes from the work of Richard Thaler. According to his research, people think of the value of money in relative rather than absolute terms.[1] For example, an individual may set aside funds monthly for retirement which they keep invested conservatively and don't withdraw. When this same individual gets an unexpected inheritance or a larger than expected tax refund, they automatically spend this on an expensive vacation. Why does the individual view the money received unexpected in a lump sum different than the money saved monthly? The reason for this is mental accounting. It is important to note, that there are situations where it is important to view your savings in different buckets. For example, an emergency fund of 3-6 months of expenses needs to be kept liquid and not tied up in riskier investments. This bucket of money should be treated differently than funds you aren't planning to use in the short term and can afford to have invested in riskier assets. The issue with mental accounting in budgeting is that by looking at your money in separate buckets, you may not be considering your financial situation as a whole. When you set up a mental account for how much you spend each month on discretionary items like coffee or movies, you stop thinking critically about whether the amount of money spent on these items is reasonable.[2]

Mental accounting can also affect how we look at an investment statement. An individual may look at each line item to see whether the investment has a positive or negative return. This does help in analyzing a portfolio, as we want to know why one investment may be underperforming relative to others, but it can also cause the benefits of diversification to be overlooked. The reason you aim for a fully diversified portfolio is so any positive returns in a portfolio help to offset any negative ones. The more the positions in a portfolio are negatively corelated (assets that generally don't move in the same direction), the less volatility the portfolio will have. By being subject to mental accounting and viewing your portfolio in sections, you may not see how the account is truly performing.

Mental accounting is a bias that can be hard to overcome. We often feel that by dividing our funds into buckets, we are viewing our finances in a responsible manner. We don't want to change this, but we feel it is important to take a step back and look at your financial situation holistically. When doing financial planning in Advice Suite, we look at all your investable assets and don't allocate funds for any specific purpose. We focus on how much you would want to land in your bank account to fund your current and/or future lifestyle. The lump sum withdrawals for luxury items like vacations or new cars can be worked into your plan to illustrate how these withdrawals can affect the value of your investments over time. Any financial windfalls like bonuses, gifts or inheritance get worked into your Advice Suite plan so we can illustrate how these funds can make a difference over time. We believe that money is meant to be spent on your dreams and desires and want to help to get you there!

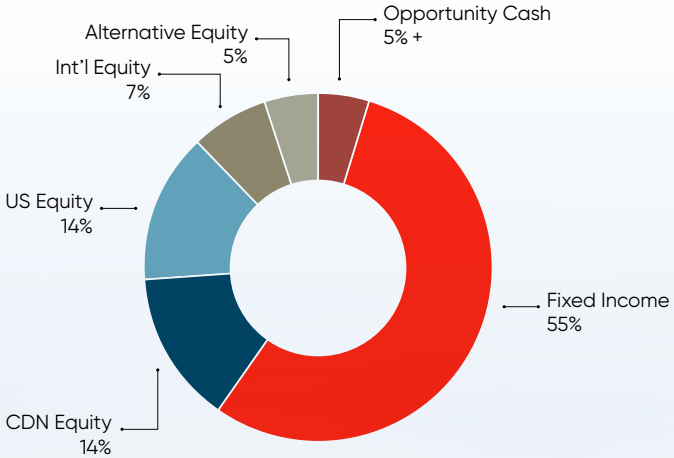
[1] Mental accounting - BehavioralEconomics.com | The BE Hub

[2] Mental Accounting - The Decision Lab



Conservative+ Investment Model Sleeve

Your Investment Policy CONSERVATIVE+: On the whole, you want fixed income investments. Although you can tolerate limited changes in the market value to ensure that your assets will grow, you prefer fixed income investments for reasons of stability. If you feel that your risk tolerance is shifting, please let us know!



Source: This information is for illustration purposes and subject to change. Your portfolio may not hold all of these positions. We enhance the composition of your portfolio with additional equity solutions that are not illustrated. The weightings change with market fluctuations and model rebalancing.

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