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Prediction is very difficult, especially about the future.

Niels Bohr

Mental Accounting and Broken Windows

Professor Richard Thaler is one of the leading figures in the Behavioural Finance academic world and has been credited with the term “Mental Accounting”. Here is one of my favourite examples used to describe the bias.

The Man in the Green Bathrobe

A couple go to Las Vegas on honeymoon and after an enjoyable evening of dinner, theatre and some bedroom activity Joe decides to soak in the night air by smoking a cigar on the balcony of their suite. After what seemed like a short break Joe discovers that Sophie is fast asleep. On his way over to kiss his gorgeous wife good night Joe puts his hands in the pocket of his green hotel bathrobe and discovers a casino chip in his pocket. It has the number 17 on it and an inner voice starts speaking to him, “Joe, this is the one.” Without wasting any time, Joe is off to the casino with his lucky number 17 chip.

He puts the \$5 chip on 17 and up comes 17. Next spin he puts his winnings on 17 and again it comes up. Joe repeats this routine a number of times until he reaches the maximum bet the casino will take; he now has \$268 million riding on 17 and after what seems like an eternity the ball lands on 18. Joe has lost it all. With the little bit of energy left in him, he walks to his room and flops on the bed. His beautiful young wife Sophie wakes up from her sleep and asks Joe where he has been. He responds that he was gambling, so she asked how he did, and he said “not too good; I lost \$5.”

This example illustrates how we compartmentalise our finance. Joe put the \$5 and then the subsequent \$268 million in a separate compartment from his wealth. To him it was never really his. The very same kind of mental accounting happens when we receive a refund from the taxman that was somewhat unexpected. Instead of absorbing the new money into our existing pot, we somehow see this new money as a windfall and worthy of extravagant spending, which is different from how we would treat our ‘own’ money. I hope you can start to see how this error in judgement could have disastrous effects when approaching investing. I am sure none of you have treated the profits made on a stock as winnings to have a full go with.

The Broken Window Fallacy

I really get annoyed when in the aftermath of a disaster both natural or “man made” you get economic talking heads spruiking the benefits to GDP that will come from the increase in infrastructure spending.

In fact this is precisely what Keynes himself argued in his magnum opus, “*The General Theory of Employment, Interest and Money*” when describing during the Great Depression that building useless pyramids would be good for the economy by increasing jobs and thus increasing aggregate demand.

It is very easy to get carried away with this logic. In 1850 Frederic Bastiat dealt with this very issue by way of a parable in which he described how a young boy playing with a stone accidentally threw it through a shop-keepers window causing it to break. Stepped forward one of the towns' wise men and proclaimed this to be a good thing. His reasoning being that the owner of the broken window would have to get it fixed, the glazier would take the 6 francs and go and spend it on a new suite, the tailor in turn would take the money from the sale of the suite and go spend it on other consumables in the town and so the money would be circulated into the economy to the net benefit of the whole society.

Bastiat was quick to show the fallacy of this argument, "it is not seen that as our shopkeeper has spent 6 francs upon one thing, he cannot spend them upon another. It is not seen that if he had not had a window to replace, he would, perhaps, have replaced his old shoes, or added another book to his library. In short, he would have employed his 6 francs in some way which his accident has prevented."

It is not a good thing to destroy wealth, Bastiat again, "Society loses the value of things which are uselessly destroyed." However, it doesn't take long after natural disasters such as Katrina or floods in Queensland or the still unfolding devastation of the Japanese earthquake/tsunami for economists to upgrade their forecasts for economic growth as measured by GDP and produce a positive spin.

What many people chose to ignore is the fact that GDP is nothing more than a metric like turnover. It is very easy to increase turnover, if I was Steve Jobs and decided to sell iPads for \$10 I am sure turnover would launch to new orbits but would I be making profits at this greatly reduced sales price?

I argue that mental accounting is fit and well when used to describe economic growth in the aftermath of a natural disaster such as the one taking place in Japan. Yes of course when looking at the accounting identity for GDP we are going to see an improvement in investment and government spending:

$$\text{GDP} = \text{consumption} + \text{investment} + \text{government spending} + (\text{exports} - \text{imports})$$

Yes according to the math GDP will increase, but just as getting a bunch of kids to run up and down streets throwing stones through windows is unlikely to bring lasting economic wealth, so to the case with infrastructure spending that wasn't necessary in the first place. A sober approach is required when considering an investment, especially against the backdrop of immense human suffering; however, it is important to avoid compartmentalising the economic metrics and see the process as a whole.

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