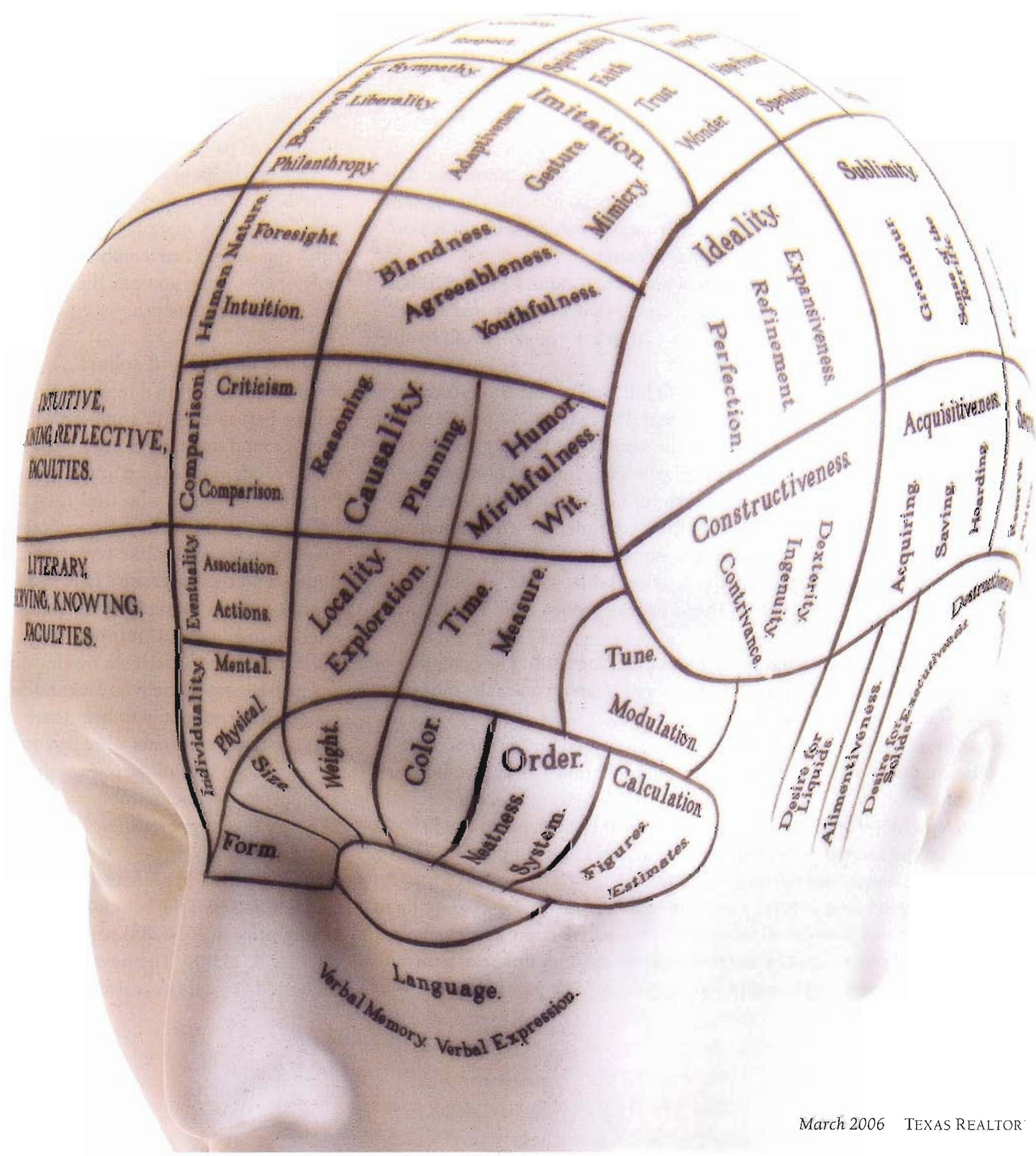
Mind over matter

Psychological accounting: Why buyers and sellers sometimes think about money the way they do and how to make sure they don't get in the way of accomplishing their goals.

by Kimberly Merriman

Twelve years have passed and I still feel regret over the house I didn't buy. A $20,000 difference of opinion stood between me and the sellers. I'm sure the sellers suffer a twinge of remorse from time to time, too. They ended up carrying an empty



house all winter before finally selling for even less.

Remorse over the deal that got away can be even more painful than second thoughts over a done deal. A lost opportunity only grows more desirable over time as flaws fade in memory. Of course, an unclosed sale is also painful for real estate agents.

So what's an agent to do? Helping buyers and sellers overcome the barriers that keep them from agreement requires more than basic sales skills. You must understand the mental sticking points and emotional obstacles your clients face. One of those obstacles—the way people think about money—can play a surprisingly big part in derailing a transaction.

What is psychological accounting?

Psychological accounting (sometimes called mental accounting) refers to the way we organize financial activities in our head. People perform much of their psychological accounting unconsciously, without recognition of how it influences their financial decisions.

Richard Thaler, Amos Tversky, 2002 Nobel Prize winner Daniel Kahneman, and other researchers have identified three key ways in which people mentally manipulate their finances.

Mental money accounts. We create different mental accounts for distinct financial activities and group like-kind financial activities in the same mental account. Furthermore, the money from one mental account is not substitutable for money in another mental account.

Imagine that you have decided to see a play where admission is $20 per ticket. As you arrive at the theater, you discover that you have lost a $20 bill. You still have enough money to buy a $20 ticket, though. Would you? Most people, the researchers found, would.

Now imagine that instead of losing a $20 bill, you've lost the $20 theater ticket. Would you pay $20 for another ticket? The majority of people would not. Why not? After all, the net result is the same: a $40 outlay during that day and one play viewed. But even though the same amount of money is involved in each situation, the mental accounting is different. Under the lost-ticket scenario, the total $40 draws from your mental "entertainment account." People don't want to pay for the same ticket twice.

Ratio-difference principle. It's the relative, not absolute, amount that matters when making a decision to spend or save money from within the same mental account.

Imagine you are about to purchase a computer for $300. The computer is on sale for $250 at another store 20 miles away. Would you make the trip to the other store?

Imagine instead that you are about to purchase a computer for $3,000. The same computer sells for $2,950 at the store 20 miles away. Would you get in your car?

Researchers found that the majority would make the drive in the first scenario but not the second. The same $50 in savings is less important when it represents only a small proportion of the total.

Grouping gains and losses. People mentally combine or separate financial gains and losses in order to increase overall satisfaction. For example, we typically find more pleasure in receiving two distinct financial gains than the same amount combined in one lump sum. The psychological pleasure intensifies with smaller, repeated occurrences.

We are intuitively acting on this quirk of human nature when we wrap multiple gifts separately rather than together. Also, think about the infomercials where each "but wait, there's more!" bonus gift is introduced one at a time.

Following form, we are more sensitive to several distinct losses than the same amount combined in one loss. One big loss hurts less for two reasons. We experience the sense of loss only once. Also, the pain from loss doesn't increase directly in proportion to the amount. A $10,000 loss may be only twice as painful as a $1,000 loss—not 10 times as painful.

This is why people spend more with a credit card than they do if paying for items separately in cash. With a credit card, the "losses" are combined and felt only once—when you pay the large bill at the end of the month.

Helping buyers and sellers

Even when it's not in a buyer's or seller's best interest to stubbornly hold their ground during the negotiating process, emotion often trumps rational behavior. The agent who tries to diffuse a standoff with logic and reason may not succeed. It's like trying to understand the buyer who falls head over heels for a house with no garage after saying a two-car minimum is a must. Decisions are driven by emotion.

The best way to help buyers and sellers reach agreement is to help them manage these emotions. One way to accomplish this is to encourage the appropriate psychological accounting in a way that supports their desires and goals.

Consider this hypothetical real estate sales scenario: A house with an asking price of $350,000 receives an offer for $325,000. The buyer has also requested several concessions totaling

Do not confuse the principles of psychological accounting with "slick" or even illegal selling techniques designed to trick the consumer—like when a store raises the price of an item only to then put that item "on sale." Understanding the workings of psychological accounting does not change anything about the terms of the negotiations; you are simply shining the light on genuine benefits in a way that helps remove emotional obstacles to an agreement.

$10,000. Now, let's apply the principles of psychological accounting to the situation.

Set up mental money accounts. If the $325,000 offer is considered distinct from the requested concessions, it encourages two separate mental accounts, each with its own monetary limits. If instead it's framed as a single net figure—$325,000 less $10,000 in concessions—the two amounts combine into one mental account.

How to apply it: A seller who has reached her limit on selling-price reductions may still have psychological room for other concessions if she holds these concessions in a different mental account. Since a mental account is as inflexible as a tangible bank account with a set limit of funds for withdraws, a second account can help absorb deficits.

The buyer in this scenario, on the other hand, has more psychological room to increase his offer price if he holds one net mental account. It's similar to buying a product with a rebate. The price feels more affordable with the rebate (or concession) amount viewed as a direct offset against the purchase price.

Apply the ratio-difference principle. The difference between the buyer's offer and seller's asking price is $25,000—a lot of money to most folks when looked at separately as a dollar amount. However, when framed in the context of $350,000, the amount feels smaller.

How to apply it: For the seller, it's best to focus on relative difference. You can discuss the offer in terms of how close it is to the asking price, pointing out that the difference between $325,000 and $350,000 is only 7%. The price difference is psychologically less significant this way, so the seller will feel better about accepting the offer.

The opposite is true for the buyer. Pointing out the absolute dollar difference of $25,000 ($35,000 including concessions) less than the asking price is psychologically more significant. Most buyers will appreciate the difference more when their focus is on the absolute dollar amount.

Present gains and losses. Each time sellers grant a concession, they experience a sense of loss. At the same time, each concession granted by the seller is experienced as a gain by the buyer.

How to apply it: When dealing with a seller, present requested concessions as one aggregated amount, so they are psychologically less painful. "The buyer is requesting concessions of $10,000."

I was once willing to walk out of a real estate deal over a request that I make a $100 concession. It wasn't the amount that was painful but the fact that I had conceded many times already and had no tolerance left for yet another, regardless of how small the amount of money involved.

When dealing with the buyer, do just the opposite. Itemize each concession granted as a separate amount, so you maximize their feeling of gain. "The seller has agreed to your request for a $2,000 roof repair, a $350 home warranty … ," until you've individually covered them all. Because of how our mind processes information, the actual dollar amount is less inspiring than the sense of multiple victories.

No regrets

Just imagine if my agent 12 years ago had known these things. I would probably be enjoying my dream house today instead of driving by it with a twinge of disappointment, and the sellers would have sold their home sooner—for more money and with less stress.

As a real estate agent, your business is people. An understanding of psychological accounting helps you go beyond serving basic business needs to address your clients' emotional needs, helping them feel good about their financial decisions. You'll undoubtedly close more deals this way. More importantly, an emotionally satisfied buyer and seller means no regrets and happy returns. ✯

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