House money: all of the thrill with none of the stress

Spending free money can be fun, whether it be from winnings or when accessing a government stimulus package

A day at the races

Picture the scene. Two friends go to the horse races. Neither is a particular horse racing fan with special knowledge when it comes to betting on the horses. It's a fun day out.

It comes to the last race of the day. The first person has had a successful day. She's won €100. To her, this is a reasonable sum. Come the last race, she has the opportunity to bet again or take the winnings and go home. For the sheer fun of it, she decides to take the €100 and place it on the favourite. At short odds of 1/5, she stands to win €20 at the risk of losing the €100 she's already up. Easy come, easy go!

Her friend has been less fortunate. She's down €100, which is also a reasonable sum to her. Come the last race, she can decide to call it quits or bet again. She decides to bet in an attempt to make up her losses. To do this she puts €20 on an outsider with long odds of 5-1 in the hope...
of making up her losses. Better a lion than a lamb.

Until the result of the last race is announced, no one knows what the finances of the two friends will look like. But even before the last race is run, it is clear that the two friends are making very different decisions by the end of the day.

**The house money and break-even effects**

The first friend is in a fortunate position. Because of her previous luck, she can take a low risk bet and still end the day square.

The second friend is less fortunate. She is under stress. Losing €100 may mean having to cancel some fun nights out planned for the next two weeks. She takes a high-risk gamble.

This difference in behaviour demonstrated in the example of the two friends provided the basis of a 1990 article by Richard Thaler and Eric Johnson titled "Gambling with the House Money and Trying to Break Even: The Effects of Past Outcomes on Risky Choices".

The term 'house money' comes from gambling parlance, where winnings are often spoken of as coming from 'the house' rather than an individual's own funds.

In our example, the lucky friend is displaying the house money effect. The unlucky friend is displaying the break-even effect noted in the title of the paper.

**Irrationality all round**

Thaler and Johnson felt the need to carry out a series of experiments and write the paper to help explain the behaviour of the two friends because their actions challenged the way some economists thought about how people make decisions when it comes to money. Two insights in particular from the paper are worth noting.

First, some explanations of how people make decisions argue that it should not matter where money comes from. Money is money. The technical term is that “money is fungible”. In other words, all money is identical and interchangeable. It should make no difference if you won it or earned it. The behaviour of the lucky friend, however, suggests that she treats her winnings – the house money – differently to that which she bought to the track. House money displays a particular form of mental accounting. In his 2015 book "Misbehaving", Thaler places the short chapter covering house money under a section titled mental accounting.

Second, some ways of explaining how people behave assume they weigh up risks and benefits and then choose the option that has the greatest chance of making them happy. Some may argue that the unlucky friend is doing this subconsciously. Others would say that is unlikely and suggest that emotions and past experience are affecting the decision of the unlucky friend.

The decisions made by the two friends also support an idea behind prospect theory – that people avoid risks when they are in a position of gain, but take risks when they are in a position of a loss.

Another observation may be that the unlucky friend is behaving irrationally. However, it is equally apt to extend this observation to the lucky friend. That €100 could fund some great fun over the next two weeks.

**From racetrack to real life**

You may never gamble so consider the house money and break-even effect irrelevant to you. However, the principles behind these effects influence all of us.

Richard Thaler writes “Once you recognize the break-even effect and the house money effect, it is easy to spot them in everyday life. It occurs whenever there are two salient reference points, for instance where you started from and where you are right now.” The house money effect
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contributes to bubbles in financial markets and played a key part in the global financial crisis – as this video clip featuring international pop star Selena Gomez and Richard Thaler from the film The Big Short explains.

Decisions by business managers on whether an investment is approved is another example. If a previous investment disappointed, the next idea suggested may be rejected even if the prospects for it are good. It has also been found that fund managers tend to take more risk if they are behind their benchmark in the last quarter of a year.

These examples may seem removed from everyday life. But it can be argued that the person who knocks back a reasonable offer on her house when property prices are falling because it is lower than the price paid when it was first bought is displaying a break-even effect in reverse. Similarly, the person who receives an unexpected tax refund and splurges it could be demonstrating a house money effect. Covid-19 stimulus packages may offer incentives – such as the UK government’s Eat Out to Help Out Scheme - to spend in ways that they would not otherwise do so. It’s free money, so why not spend it?

The final race

But let’s go back to our friends at the racetrack. The unlucky friend gets lucky. Her horse wins. But that means the lucky friend is now unlucky. Both go home square. Which friend would you rather be? There is a behavioural answer to this – the peak end rule. But more on that later...
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