Mental Accounting

I bought ten thousand shares of Le Beau Croissant Inc. stock at ten dollars per share. I was attracted by the company's outstanding management and lack of national competition in the retail croissant market.

About a month after I bought the stock, Le Beau Croissant's entire board of directors was indicted for securities fraud. One week later, Starbucks announced its intention to install self-service croissant bars in its seventeen thousand stores.

The stock of Le Beau Croissant is now selling for one dollar a share. I am disgusted with myself and with them. The reasons I bought the stock are no longer valid.

As it happens, I have to make a ten-thousand-dollar payment this week to Hellenbach University, to cover part of my daughter's annual tuition. I don't have the cash on hand. I must sell some stock to raise the ten thousand dollars.

Will I sell my shares in Le Beau Croissant? That would be logical, since if I sell all ten thousand shares I'll have enough to pay the tuition. My reasons for owning this stock have vanished. Or will I sell my shares in Cumulous Software, up 75 percent since I bought it? They still hold an exclusive contract with the government of Bolivia, which is the reason I bought Cumulous.

Unfortunately and irrationally, however, I think of each of my stocks as a separate account. To sell Le Beau is to realize a loss on the Le Beau account. An invisible reference point—loss aversion—pushes against the rational choice: dump the Le Beau shares. They cost me one hundred thousand dollars and my unconscious mind projects the illusion that they are still worth one hundred thousand dollars.

I sell Cumulous to avoid the pain of facing up to my croissant mistake. Not logical, but certainly psycho-logical. A year later Cumulous gets a contract with Paraguay and splits its skyrocketing stock. Le Beau Croissant files for bankruptcy. Mental accounting has cost me a bundle.