Watson French
WEALTH MANAGEMENT

Term of the Week- Mental Accounting

25th July 2025

For our last term of the week in the world of behavioural finance, we explore the concept of mental accounting.

Mental Accounting was introduced in 1999 by the economist Richard Thaler and refers to the differing values that individuals place on money based on subjective criteria, often leading to sub-optimal outcomes stemming from irrational decision making.

Thaler observed that when an individual was in receipt of a large cash windfall such as a bonus, tax refund or lottery winnings, they would spend this money on expensive items that they could not normally justify spending on from their regular income.

In contrast – and the solution to avoid the trap of mental accounting – is to value all money as fungible and treat it the same regardless of its origin.

An example of mental accounting in the real world is saving for a special holiday by putting money into a jar. The money in the jar earns no interest and for other priorities such as saving for retirement, a rational individual would not let their money sit there eroding to inflation. Although it may seem natural to treat money from different sources differently, the more one thinks about it the less sense it actually makes.

Mental accounting is found in investing as well as general finances. It can be common for investors to create two separate portfolios, one with high risk more speculative investments and one which is safer and less prone to big falls in value. In doing this the investor will not associate the safe portfolio with the risky portfolio. If the risky portfolio falls in value, the safer portfolio with its positive returns will be unaffected. In actual fact the return on the investors total portfolio will have been affected, regardless of whether the portfolios are separated.

Another example links in with our previous explanation of loss aversion theory. If an investor has a large expense to pay and has to sell one of two investments to pay for this, where one investment is standing at a paper loss and the other at a paper gain, the investor will be biased towards selling the winner. This is a result of both mental accounting and loss aversion (i.e. avoiding the pain of selling the loser and realising a loss). It may in fact be more beneficial to sell the loser as its value may not recover (and they may be able to use the loss for CGT purposes).

Like the other terms we discuss, it is important to be as aware as possible of all of the mental biases which can lead to irrational investment decisions. With volatility a feature of markets and the level of investor fear elevated as markets climb a wall of worry, it can be easy to make investment decisions which one would not otherwise make.

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