



Paper Losses And Real Profits

By

[Padraig O'Hannelly](#)

Published in **Investing Strategy** on **25 June 2009**

[2 comments](#)

Some say the only share prices that matter are the prices at which you buy and sell. This Fool has a different opinion.

The Motley Fool is home to a spectrum of positions and views, so it shouldn't surprise anyone that Fools will disagree from time to time. For example, in a very interesting [article](#) recently, most of which I happen to agree with, the author argued that "*a profit is not a profit until the shares are sold*"; and similarly, that "*a loss isn't a loss until you sell the shares*".

Well that's one opinion, but it's not mine.

Are 'paper' losses real?

Here's how I see it: 'Paper' losses are losses, and 'paper' gains are gains, regardless of whether you convert them into something else. Psychologically, many people choose not to acknowledge the profit or loss until they sell the shares, but the change in their wealth is just as real.

Businesses have value, and property has value -- cash is not the only form in which wealth can be held, and the loss of wealth in any form is exactly that, a loss.

Decision making

This matters, because how you view paper profits and losses, and the significance or otherwise of crystallising them, will affect how you behave. The *disposition effect*, as academics call it, is the tendency to sell winners too early and hold losers too long, and this can be partly explained by this tendency to accord the wealth more significance at the point at which we convert it back into cash.

It's related to the '[get-evenitis](#)' described recently in another article. Closing our mental account for an investment at a loss is a pain we'd rather avoid, even when it enables us to make a better investment elsewhere. Our decision making would be more rational and honest if we could, in our minds, fully register the loss or gain when it actually occurred, instead of at the time of sale.

And it goes hand-in-hand with that other mantra of "*no-one ever went broke taking a profit*". On the contrary, they went broke because they didn't make sufficient profit on their winners to compensate for their losers. Unless you know a foolproof way to buy shares that only rise, snatching every small profit won't benefit you in the long run.

When [Warren Buffett](#) said: "*Rule #1: Never lose money. Rule #2: Never forget Rule #1*", he wasn't advocating stop-losses and mechanical trading rules, as if simply deciding not to lose money was somehow going to guarantee wealth. Rather, he was exhorting us not to treat any funds as play money that we can afford to lose on ill-considered punts.

Past performance is irrelevant

It's not a simple numbers game, and setting arbitrary rules to sell at plus or minus some percentage is a recipe for disaster. Your gains and losses are historical and real, even if they are not converted into cash, and they have no relevance to your selling decision. All that matters is future performance.

Like this article? Get our best articles delivered direct to your inbox at no cost. Sign up for Foolwatch Daily by entering your email below.

[Click Here. It's Free](#)

Comments