



Richard Wallace
Managing Director

5 Biases That Lead to Bad Decisions

A growing body of research reveals that our behavior and decisions are influenced by an array of strong psychological undercurrents, all of which are more powerful and pervasive than we realize.

Like streams, they converge to become even more powerful.

By charting these undercurrents and their unanticipated effects, we can identify our faulty thinking that lead us to make irrational decisions.

Despite a great need for them, judgment and decision-making skills are only beginning to appear in better business schools' curricula. But studies show we still don't know enough about how good decisions occur.

Rational versus Emotional?

Psychologist and political scientist Herbert Simon in 1957 laid the groundwork on the limits of rationality when he attacked classical economics and game theory. Simon's work made it clear that we must take the real world's messiness and irrationality into account when making decisions.

"Research indicates that people are myopic in their decisions, may lack skill in predicting their future tastes, and can be led to erroneous choices by fallible memory and incorrect evaluations of past experiences," wrote psychologist and Nobel Prize laureate Daniel Kahneman.

Neuroscientific research also proves that the brain is influenced by subconscious emotional reactions from its more primitive centers. We're not in control of our reasoning capabilities as much as we'd like to think.

Scientists have identified several flaws in how we think when making decisions. Because they're hardwired into our thinking process, we often fail to recognize them. This means they can undermine everything from new product development to acquisitions and divestiture strategy to succession planning.

These hidden currents and forces include:

- ▶ **Loss aversion**, our tendency to go to great lengths to avoid possible losses
- ▶ **Commitment**, our tendency to stick with the status quo



ORGANIZATIONAL
SUCCESS
MANAGEMENT

Think Big. Start Small. Stay Focused.

OSM understands that a business strategy is successful only to the extent that it is achievable—and that far-reaching organizational change, while often possible, always starts with small steps. If anything differentiates us from traditional consultants, we believe it is our ability to consistently translate theoretical goals into practical solutions.

We focus on the three fundamental organizational elements: People, processes, and strategies. By optimally aligning these three elements, company leaders can more effectively initiate action plans for accelerating, and maintaining, measurable results.

OSM Solutions

- ▶ **People** -- Coaching for individuals and groups to discover and use more of their potential in leadership, sales, and more.
- ▶ **Processes** -- Time proven methods through which organizations achieve measurable returns by enhancing the value proposition of their products/services.
- ▶ **Strategy** -- Coaching for executives to define and execute a master plan that is required to drive results that are predictable and sustainable.

Contact us for a Complimentary Review

- ▶ richard@osmconsulting.com
- ▶ www.osmconsulting.com
- ▶ 205.757.8321

- ▶ **Value attribution**, our inclination to imbue a person or thing with certain qualities based on initial perceived value
- ▶ **Diagnosis bias**, our blindness to all evidence that contradicts our initial assessment of a person or situation
- ▶ **Certainty bias**, where overconfidence leads us to discount inconvenient truths

Each of us is susceptible to irrational behavior's irresistible pull. Only when we gain insight into our irrationality can we see the extent to which it affects our work and personal lives. Fascinating patterns emerge, and we can master our behaviors and decisions when we connect the dots.

Loss Aversion

We experience the pain associated with loss much more vividly than we do the joy of experiencing a gain.

For example, if egg prices go down, sales go up. But if egg prices rise proportionately, sales dip by 250 percent. Consumers stop buying them because the price has increased. This response flies in the face of traditional economic theory, which dictates that people should react to price fluctuations with equal intensity, regardless of whether price rises or falls. In reality, we illogically overreact to perceived losses.

This also explains why people are much more likely to buy meat when it's labeled 85 percent lean instead of 15 percent fat. Similarly, twice as many patients opt for surgery when told there's an 80 percent chance of survival, as opposed to a 20 percent chance of dying.

The same irrational force entices us to pay for a loss damage waiver on a rental car, even though we're already insured by our credit cards and car insurance. Normally, we'd scoff at wasting money on double insurance coverage, but the feelings associated with the word loss stir our emotional brains and influence action.

Commitment

We've all experienced the pull of commitment. We have a tendency to stick with the status quo. We're predisposed to perpetuating more of the same. It's an inherent part of our thinking. Deep within our psyches, we are self-protective and risk-averse.

When we've invested our time and money in a project, it's difficult to let go—even when things clearly aren't working.

In business, sins of commission tend to be punished more severely than sins of omission, as the status quo holds a particularly magnetic position. Independently, the forces of

commitment and aversion to loss have a powerful effect on us; when combined, we find it much harder to break free and do something different.

History shows us how hard it was for Lyndon B. Johnson and George W. Bush to find solutions to the wars in Vietnam and Iraq, respectively. They were strongly influenced by the forces of commitment and aversion to loss.

Kahneman, with his colleague Amos Tversky, first discovered and chronicled the phenomenon of loss aversion.

"To withdraw now is to accept a sure loss, and that option is deeply unattractive," he wrote. "The option of hanging on will therefore be relatively attractive, even if the chances of success are small and the cost of delaying failure is high."

When CEOs and boards of directors are charged with making critical strategy decisions, determining the best outcomes often proves challenging when strong egos and competitive personalities are added to the mix.

Value Attribution

It takes enormous energy to consciously work through all possibilities and risks when weighing important decisions, so the brain looks for shortcuts. We use unconscious routines, known as "heuristics," to cope with complexity—and they normally serve us well.

But these shortcuts also present traps because they largely occur without our awareness. Value attribution serves as a quick mental shortcut to determine what's worthy of our attention. When we encounter new objects, people or situations, the value we assign to them shapes our future perceptions of them.

If, for example, we see a poorly dressed street performer playing music in a subway station, we assume he's a struggling amateur with little talent, even when the music is good. These assumptions were proved true when Joshua Bell, one of the finest violinists alive, participated in a field study for the Washington Post.

While Bell, dressed in jeans and a baseball cap, played a \$3.5 million Stradivarius, subway travelers rushed by without paying attention. While he certainly sounded far from mediocre, he looked the part—and commuters attributed the value they perceived (appearances) to performance quality.

The Bell experiment illustrates why we may turn down a pitch or idea based on appearances, rumors or any other peripheral value. It also explains why we may blindly follow the advice of someone who has been highly recommended.

Our expectations change our reality, as the "placebo effect" demonstrates. Once a doctor or advertisement tells us a drug

will relieve pain, the medication has a greater chance of working — even if it has no healing properties whatsoever.

Becoming aware of our brain's tendency to make assumptions can help us prevent disastrous mistakes and missed opportunities.

Diagnosis Bias

When we encounter new people at a party, we quickly diagnose them by placing tags on them, such as “approachable” or “standoffish.” This helps us quickly decide if we want to engage them in conversation.

By employing this mental shortcut, we fail to see a person's good qualities. Nowhere is this clearer than in job interviews.

A meta-analysis of data found there is little correlation between unstructured job interview success and job performance in new hires. The marks given to job candidates after a first date-type interview have little to do with how well those hired will actually perform on the job.

Nonetheless, companies are drawn to this interview format. Managers form impressions by asking questions they hope will ensure a person is a good fit:

- ▶ Does this candidate share my interests?
- ▶ How's the chemistry between us?
- ▶ Is there a connection?

Managers value their intuition and think they have a refined ability to truly see and understand an applicant. They overestimate their ability to form objective opinions and underestimate their subconscious' biases.

Managers should, instead, forego unstructured interviews and focus on a candidate's past experience and responses to hypothetical scenarios.

Too Much Information

Today's 24/7 connectedness to information streams can prevent us from paying attention to what really matters. The brain's prefrontal cortex can handle only limited facts and figures.

More information doesn't always lead to better decisions, but gut feelings and emotions do. We must learn to sort out patterns in the most significant data.

Decision Effectiveness

Decisions are the lifeblood of action, and little gets done without them.

A recent Harvard Business Review article recommends a decision audit to identify key organizational needs:

“Ultimately, a company's value is no more (and no less) than the sum of the decisions it makes and executes. Its assets, capabilities, and structure are useless unless executives and managers throughout the organization make the essential decisions and get those decisions right more often than not.” (Blenko, M., Mankins, M., & Rogers, P., “The Decision-Driven Organization,” Harvard Business Review, June, 2010)

Bain and Co. surveyed international executives from 760 companies with revenues exceeding \$1 billion in 2008. Researchers found that decision effectiveness and financial results correlated at a 95% confidence level or higher for every country, industry and company size.

Companies that were most effective at decision-making and execution generated average total shareholder returns nearly six percentage points higher than others.

Rate Your Company

The HBR authors urge leaders to examine their own companies for decision effectiveness, using the following short survey:

- ▶ How do your organization's decision abilities stack up against the competition?
 - » **Quality:** When looking back on critical decisions, how often have you chosen the right course of action?
 - » **Speed:** How do you rate the speed of your critical decisions in comparison to your competitors'?
 - » **Yield:** How often do you execute critical decisions as intended?
 - » **Effort:** How much effort does your company put into making and executing critical decisions?

Leaders Can Improve

Decisions can be complex, and we are never going to get everything right. We can improve decision effectiveness by becoming more aware of traps, subconscious biases and logic flaws that lead to errors.

We must also improve our awareness of common judgment errors, which occur when we're under the influence of the subconscious. These include our biases, commitment to the status quo and counterproductive personal agendas.

Leaders who continue to view strategic decisions as purely rational analyses should seek ways to better position themselves to meet core objectives.

The Certainty Bias

Leaders forget the mind's fallacies. They believe in their people and senior team. They are generally confident that colleagues are well-intentioned, with the company's best interests in mind.

After gathering as much information as possible and weighing all of the arguments, leaders must make decisions and embrace an attitude of certainty and confidence. Persuading others to execute the plans is the next step.

Certainty, however, can lead to other errors, such as failure to adjust plans, when required, and shutting out conflicting information. The only way to counteract the certainty bias is to encourage dissonance.

Perhaps Alfred P. Sloan, president of General Motors in its prime, said it best. After adjourning a meeting shortly after it began, he announced:

"Gentlemen, I take it we are all in complete agreement on the decision here... Then I propose we postpone further discussion of this matter until our next meeting to give ourselves time to develop disagreement and perhaps gain some understanding of what the decision is all about."



- » P.O. Box 382494
- » Birmingham, AL 35238
- » www.osmconsulting.com

