



TenStep Supplemental Paper

7 January 2004

Say It Isn't So!

Going through the trials and tribulations of setting up an enterprise and running it successfully is no easy task. The business world is replete with examples of entrepreneurs did not experience the success they desired. The causes are many – depressing market conditions, recession, deep-pocketed competition, predatory practices, regulatory restrictions, irrational decision-making, bad products, etc. Despite all the information available to executives today, most failed entrepreneurs ended up backing wrong strategies, and behavioral scientists posit that it's due to flawed decision-making.

Contemporary economics is based on the assumption that man is a purely rational decision-maker. Enter the behavioral economists, who claim that human beings just don't stack up as purely rational economic decision-makers. Now, who is being irrational?

Insights from behavioral economics can explain why executives often make bad decisions. They illustrate flaws that push entrepreneurs or decision-makers to make the wrong conclusion and bet on poor strategies.

Mental accounting

Behavioral economist Richard Thaler coined the term 'mental accounting' - the inclination to categorize and treat money differently depending on where it comes from, where it is kept, and how it is spent.

For example, if an entrepreneur makes a killing because of unexpected market opportunity and loses it subsequently, he is less likely to feel that he has lost anything in the final analysis. However, the fact remains that he would have been richer by that much if he hadn't lost it.

At the height of irrational exuberance, many companies spent quite freely on dotcom initiatives and lost quite heavily. Yet, they write off these losses as part of the risk associated with new ventures. However, on close observation, it becomes clear that most of these investments were diverted from core businesses. As a result, post meltdown, companies are struggling to get the most out of their core businesses. This illustrates the magnitude of making a decision under the mental accounting trap.

To get over this delusion, entrepreneurs must judge all investments on consistent criteria, particularly those that are classified as 'strategic,' and be wary of spending that has been reclassified. Every investment decision has to be evaluated from scratch, no matter what the source of investment.

The status quo bias

If you received several million dollars in low-risk, low-return bonds in an inheritance and had the option of reinvesting it, what would you do? If you were like most people, you wouldn't change anything. What if they were high-risk securities? Chances are you still wouldn't change anything.



TenStep Supplemental Paper

Behavioral economists call it loss-aversion syndrome, which prompts people to stick with the initial allocation. Even entrepreneurs suffer from the status quo bias. Once an enterprise has crossed the mid-growth stage, entrepreneurs are averse to losses.

Adding to the complexities is the ‘endowment effect’ – an innate desire to hold on to what one owns – which contributes to poor strategy. It also makes them reluctant to sell their businesses, which is a potential source of value creation.

An entrepreneur has to distinguish between a status quo option that is conservative and one that erodes the value of the enterprise with time. It is more a matter of strategic change than anything else. Hence, the risk of not making a move needs to be identified at the decision-making stage!

Throwing good money after bad

Consider this: you return home after a tiring day at work. You have two tickets to the premiere show of the latest blockbuster. Would you go? It actually depends on who bought the tickets. If a friend gave them, you are less likely to go. However, if you have paid for those tickets, even a storm won’t keep you away!

Behaviorists call this the ‘sunk-cost effect,’ which keeps entrepreneurs flogging a dead horse. One of the most common flaws in entrepreneurs, the sunk-cost effect forces even wise decision-makers to think otherwise. Even when a project overruns its schedule and budget, entrepreneurs continue to invest in the enterprise to ‘live the dream.’

Such enterprises end up sick, their capital erodes, and finally a turnaround specialist or debtor takes over the enterprise ... usually for a fraction of what it cost to set up the enterprise.

In order to negate this syndrome, entrepreneurs should apply the ‘gated funding’ method when initiating new ventures. This will ensure that follow-up funding is released in stages, and only if the venture meets pre-set targets.

Overconfidence

Our mind is programmed to believe that we’re often invincible. This is a big help when starting an enterprise, as it gives the entrepreneur the initial impetus. However, the very same quality can blind an entrepreneur to problems with the strategy. It biases the assessment of core capabilities and makes the entrepreneur over-optimistic.

Behavioral economists illustrate this with simple quizzes. For example, they asked participants to estimate the weight of a fully loaded jumbo jet, or the length of the river Nile at a 90% confidence level. Invariably, participants fall into the same trap. Rather than spread the range wide enough to ensure 90% confidence level, they ‘guesstimate’ a narrow one that misses the mark. As one expert observed, they prefer being precisely wrong rather than being vaguely right!

To counter this overconfidence, entrepreneurs need to test strategies under a much wider range of options and add 25% downside to the most pessimistic scenarios. They also need to build more flexibility into their strategy to resolve uncertainties and scale up.