Avoiding Systematic Decision Errors

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Turnaround professionals and their clients often find themselves making difficult decisions under extremely stressful conditions. The ability to make good decisions during a crisis when the stakes are high is a hallmark of an effective turnaround professional. This article highlights some key findings from behavioral science studies conducted on the decision-making process and how intelligent, competent people inadvertently make decision errors.

Several recognized systematic decision-making errors commonly affect even the most sophisticated, experienced, and highly trained decision makers. Identifying and avoiding these systematic errors is a surefire way for professionals to improve their decision-making success rate.

The most important but often overlooked step in the decision-making process is the preliminary assessment of the problem. The purpose of this initial step is to consider the decision within the context of all relevant high-level issues. This big picture perspective provides a platform from which to effectively plan the entire decision-making process. A suitable theme for this step would be “a problem well stated is a problem half solved.”

How someone approaches the remaining steps of framing the situation, generating options, gathering intelligence, coming to conclusions, and learning from experience flows from the preliminary assessment. While this concept seems elementary, failing to consciously and adequately
focus on this initial step can easily lead to a flawed process and decision.

An error in the assessment phase can allow critical issues to escape attention and cause the rest of the decision-making process to go in an entirely wrong direction.

The next steps in the decision-making process are framing the problem and identifying options. Frames have several features that distort thinking, and the way a situation is framed will determine the issues focused on, the options recognized, and the solutions chosen. Decision makers need to be aware of the “framing effect,” which causes people to draw different conclusions based on how information is presented, and should guard against using too narrow of an approach to a situation.

The difficulty of properly framing decisions increases with the complexity of the circumstances under consideration. Failing to identify enough alternatives is a common decision-making error. It can be difficult to imagine all the ways events can unfold. The process of identifying viable potential options requires considerable focus, creativity, and patience, and is easily short-changed under stressful conditions.

The goal is to identify as many viable alternatives as possible, no matter how seemingly far-fetched they may seem at first glance, and then perform scenario planning to rank them. Qualifying alternatives should be evaluated through a decision tree analysis by applying a value and probability (incorporating both qualitative and quantitative factors) to each outcome. Many professionals perform this probability analysis subconsciously; however, formalizing the process can greatly reduce the risk of decision errors arising from overconfidence and other biases.

Bias, Heuristics
Failing to accurately estimate probabilities during the decision-making process is extremely common. Researchers have found that people tend to be wildly overconfident in their judgments. Overconfidence systematically arises among even the most skilled decision makers as a result of heuristics and biases. Heuristics are rules of thumb that people follow, often subconsciously, to make judgments quickly and efficiently in the face of overwhelming amounts of information. People also use rules of thumb when dealing with incomplete information. While generally useful, they inherently include judgmental biases that individuals should be aware of.

A few common heuristics that can be particularly troublesome to decision makers are representativeness, availability, anchoring, and adjustment. These heuristics frequently cause people to apply overconfident probabilities to successful outcomes and fall victim to myriad other bias-related logic errors.

Representativeness, also referred to by researchers as the illusion of validity, is the tendency to erroneously apply concepts or conclusions from other seemingly similar situations to the one at hand. People assume commonality and make decisions based on those underlying assumptions, which may not be correct. In a thorough and rigorous decision-making process, these underlying assumptions are methodically examined for validity to reduce the risk of making a bad decision based on subconscious reliance on a faulty assumption.

Availability is the tendency to estimate the probability of an event or the frequency of a certain trait in an entire population based on how easily an example comes to mind. Recent events or those that are unusual or emotionally charged and therefore more easily recalled will seem to have a higher probability of occurrence than is statistically warranted.
For example, very rare fatal incidents, such as shark attacks and lightning strikes, are widely perceived as occurring much more frequently than they actually do.

Similarly, a tendency exists to consider a single example that is easily brought to mind as being representative of an entire population when it is in fact just a single data point. This phenomenon is related to the stereotype bias, whereby insufficient anecdotal evidence, rather than concrete statistical data, is used to draw conclusions. The anecdotal evidence that individuals rely most heavily on is that which happens to be most readily available in their memories. This hardly qualifies as the logical reasoning process to which most professionals aspire.

The anchoring heuristic is the tendency to rely too heavily on one trait or piece of evidence when making a decision. Individuals start with an implicit reference point and then make adjustments from that point to reach a particular estimate. Once the “anchor” is set, they tend to have a bias toward that point and may unconsciously underrate the importance of other relevant factors. Decision makers need to step back and objectively consider whether that bias is reflected in their decision.

By way of example, an MIT researcher asked an audience to first write down the last two digits of their social security number and then submit mock bids on several items, such as wine and chocolate. Audience members with higher two-digit numbers submitted bids that were 60 to 120 percent higher than those with lower two-digit numbers. This dynamic has repeatedly held true in estimation experiments. Researchers have found that the simple act of thinking of the first number strongly influences the second number, even though there is no logical connection between them.

The adjustment heuristic is the tendency to make insufficient
adjustments when estimating probabilities of events that vary from a particular starting point. People tend to be “sticky” in their thinking and systematically underestimate the magnitude of the adjustment they should be making.

The adjustment problem further exacerbates the anchoring problem; people may both rely too heavily on a certain reference point and then make insufficient adjustments from that reference point in arriving at their decision. Anchoring and adjustment can cause a decision maker to overestimate the probability of conjunctive events (leading to excessive optimism that a plan will succeed) and underestimate the likelihood of failure in complex systems. These biases also cause people to have overly narrow confidence intervals that reflect more certainty than is justified by their knowledge.

Again, these surprisingly persistent tendencies impact even highly skilled decision makers and should be considered carefully when applying probabilities to alternatives in the decision tree. Underestimating their impact and failing to adjust thought process to compensate for these deeply rooted systematic biases can lead to costly decision-making mistakes.

Successful decision-makers must guard against many cognitive biases. Some of the more common known biases include the confirmation bias, the tendency to search for or interpret information in a way that confirms one’s preconceptions; selection bias, a distortion of evidence arising from the way data is collected; the bandwagon effect, the tendency to do or believe something because other people do; and the gambler’s fallacy, the tendency to assume that individual events are influenced by previous random events.

Other biases include extreme aversion, the tendency to avoid extremes
and instead choose an intermediate option; the ambiguity effect, the avoidance of options for which incomplete information makes probability difficult to judge; and neglect of probability, the tendency to completely disregard probability when making a decision when one faces uncertainty. Clients under duress can be particularly susceptible to biases like denial, the tendency to disbelieve or discount an unpleasant fact, and loss aversion, the perception that the disutility of giving something up is greater than the utility associated with acquiring it.

Decision errors arising from the loss aversion bias often include some element of the sunk cost fallacy, under which the amount previously invested is perceived as a benchmark of value, regardless of what the current value actually is. This often occurs with clients who are dismayed by the value that potential investors attribute to their business, particularly when the business is distressed.

This non-rational reasoning pattern has unfortunately led to many unnecessary business liquidations as owners in desperate need of new capital investment reject reasonable offers, choosing instead to hold out for a deal that reflects their own sunk cost benchmark of value. Of course such an offer never materializes, because outside investors simply don't experience the loss aversion or sunk cost biases when assessing the value of a business.

Other biases that clients frequently experience include disregard of reversion to the mean, the tendency to expect extreme performance to continue, and positive outcome bias, the tendency to overestimate the probability of good things happening. Effective professionals identify and avoid biases in their own thought processes, but they also need to help clients develop an awareness of their own biases and avoid making mental errors at a time when they need to be making good, rational
decisions.

Another common error occurs during the “lessons learned“ analysis after the decision-making process is complete. There is a tendency to judge the quality of a decision solely by the resulting outcome based on the faulty assumption that if a desirable outcome occurred, then the related decision must have been a good one and vice-versa. Researchers refer to this dynamic as the outcome bias, defined as the tendency to judge a decision by its eventual outcome instead of the quality of the decision at the time it was made. One can’t ignore the impact that luck and uncontrollable circumstances have on outcomes.

**Optimal Decisions**

A skillful decision maker using a rigorous and effective process arrives at statistically optimal decisions and, as a result, has the highest possible frequency of successful outcomes. And inevitably, incompetent decision makers stumble upon decisions that result in successful outcomes. Even a blind squirrel finds a nut once in awhile. It is a mistake to measure the quality of the decision and the skill of the decision maker solely by the outcome. Experts clearly agree that a “good decision” is defined by a rigorous and effective decision-making process that results in the selection of the statistically superior option.

Of course clients only care about results, so a good decision from a client’s perspective is one that achieves a desired outcome. Cynical turnaround consultants, too, might scoff at the idea of the process being more important that the outcome, saying, “The only thing that matters is the outcome, so a good decision is one that results in a good outcome, period!”

How does one reconcile that outcome-focused perception with the experts’ process-focused definition of a good decision? Easily. Of course
the outcome is all that matters to the client. But the process is what should matter to the professional, because those who focus on using a thoughtful and rigorous process arrive at the right answer more often than those who shoot from the hip. Nobody is right 100 percent of the time. The best one can do is to strive constantly to improve one’s success rate, and improving the quality of the decision-making process is the mechanism for doing so.

How do experience and education affect the decision-making process? They both go a long way toward helping one avoid decision-making errors. Professionals who truly understand the complexities of the issues at hand, either through experience or through advanced education and technical training, can generate more viable alternatives and will more accurately estimate probabilities than professionals with less experience or education.

Neither experience nor education, however, is of much help in the absence of a sound decision-making process. Everyone knows of professionals who seemingly have been around forever but have not managed to build successful track records, as well as technical experts who struggle with the “big picture” and practical solutions. An inability to identify and compensate for natural biases in judgment will sabotage even the brightest professional’s track record.

One of the most difficult decisions that turnaround professionals and their clients can face is whether to close a failing business. While decisions based on quantitative factors might be fairly straightforward, clients can also be driven by deeply compelling and overwhelmingly complex qualitative factors.

For example, a client who has spent a lifetime building a business may have an intense aversion to closing the company. Emotional attachment
to the business and the perception that closing it represents a personal failure will surely distort how they frame the situation and the options they identify. Clients are particularly susceptible to biases and decision errors in these types of circumstances.

An effective turnaround professional facilitates a client’s decision-making process by ensuring that all relevant issues, both obvious and obscure, are identified, articulated, and fully explored, and by assisting in identifying and ranking viable options. A client who enjoys running a business and is not ready to retire might fail to recognize the possibility of launching or purchasing another business rather than clinging to a failing one.

Effective professionals also assist clients in recognizing and avoiding biases that cause decision errors. For example, a client who was able to pull a struggling business through a rough patch years ago might succumb to the illusion of validity by assuming that it can be done again, perhaps ignoring fundamental changes in the economic environment that will prevent a recovery this time around.

**Quality Thought Processes**

What separates brilliant decision makers from the rest of the crowd is the quality of their thought processes. Professionals using a sound decision-making process will be those with the most consistently successful track records because their decisions will result in positive outcomes more often than those made by professionals with sloppy decision-making skills. It boils down to simple statistics. And being able to effectively guide clients through difficult decisions when they’re under pressure and not thinking as clearly as they should be is an extremely valuable service.

Decisions made during a turnaround situation are often characterized
by incredible complexity, pressure, and consequence. One must take the
time to perform a thorough assessment of the problem at hand, focus on
properly framing the decision, consider as many alternatives as
possible, and then guard against the effects of heuristics and biases
while analyzing options and drawing conclusions. One must remember
that a good decision is defined by an effective and statistically optimal
decision-making process, not just by the outcome.

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