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The Psychology of Entrepreneurial Misjudgment, part 1: Biases 1-6

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Charlie Munger is an 80-something billionaire who cofounded top-tier law firm Munger, Tolles & Olson and is Warren Buffett's long-time partner and Vice-Chairman at Berkshire Hathaway, one of the most successful companies of all time.

Some people, including me, consider Mr. Munger to be an even more interesting thinker and writer than Mr. Buffett, and recently a group of Mr. Munger's friends assembled a compilation book of his most interesting thoughts and speeches called Poor Charlie's Almanack, inspired by Ben Franklin's *Poor Richard's Almanack*. (The Munger book is only available on Amazon in used form, although you can apparently buy a new copy here.)

Mr. Munger's magnum opus speech, included in the book, is *The Psychology of Human Misjudgment* -- an exposition of 25 key forms of human behavior that lead to misjudgment and error, derived from Mr. Munger's 60 years of business experience. Think of it as a practitioner's summary of human psychology and behavioral economics as observed in the real world.

In this series of blog posts, I will walk through all 25 of the biases Mr. Munger identifies, and then adapt them for the modern entrepreneur. In each case I will start with relevant excerpts of Mr. Munger's speech, and then after that add my own thoughts.

One: Reward and Punishment Superresponse Tendency

> I place this tendency first in my discussion because almost everyone thinks he fully recognizes how important incentives and disincentives are in changing cognition and behavior. But this is not often so. For instance, I think I've been in the top five percent of my age cohort almost all my adult life in understanding the power of incentives, and yet I've always underestimated that power. Never a year passes but I get some surprise that pushes a little further my appreciation of incentive superpower.
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> ...We [should] heed the general lesson implicit in the injunction of Ben Franklin in *Poor Richard's Almanack*: "If you would persuade, appeal to interest and not to reason." This maxim is a wise guide to a great and simple precaution in life: Never, ever, think about something else when you should be thinking about the power of incentives...
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> One of the most important consequences of incentive superpower is what I call "incentive caused bias." A man has an acculturated nature making him a pretty decent fellow, and yet, driven both consciously and subconsciously by incentives, he drifts into immoral behavior in order to get what he wants, a result he facilitates by rationalizing his bad behavior [like a salesman who harms her customers by selling them the wrong product because she gets paid more for selling it, versus the right product -- see, e.g., the mutual fund industry].
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> ...Another generalized consequence of incentive caused bias is that man tends to "game" all human systems, often displaying great ingenuity in wrongly serving himself at the expense of others. Antigaming features, therefore, constitute a huge and necessary part of almost all system design.
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> ...Military and naval organizations have very often been extreme in using punishment [the inverse of reward] to change behavior, probably because they needed to cause extreme behavior. Around the time of Caesar, there was a European tribe that, when the assembly horn blew, always killed the last warrior to reach his assigned place, and no one enjoyed fighting this tribe.

Human response to incentives is indeed a huge behavioral motivator, and I think Mr. Munger is right that once you think you realize how big it is, you need to assume it's even bigger.

This is why stock options work so well in startups -- and the fewer people in a startup, the better stock options work, since when there are only a few people in a company, it's usually crystal clear to each person how her work will impact the value of the company.

There is a wrong-headed and dangerous theory afoot that restricted stock (grants of fully in-the-money shares of stock) is a more appropriate motivator of employees of tech companies than stock options:

> Mr. Gates wanted Mr. Buffett's input on whether to drop options in favor of restricted stock at Microsoft. [Gates] recalls asking: "How will employees respond to getting a lottery ticket that gives them a definite amount instead of one that could amount to nothing or a ridiculous sum?"
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> Mr. Buffett's reply, according to Mr. Gates, was: "My wife would rather have a ticket for one fur coat, than a ticket that gave her two or nothing."

Overt sexism aside, from an incentive standpoint the result of shifting from stock options to restricted stock should be obvious: current employees will be incented to *preserve* value instead of *creating* value. And new hires will by definition be people who are conservative and change-averse, as the people who want to swing for the fences and get rewarded for creating something new will go somewhere else, where they will receive stock options -- in typically greater volume than anyone will ever grant restricted stock -- and have greater upside.

And sure enough, in the wake of shifting towards restricted stock and away from stock options, Microsoft's stock has been flat as a pancake. The incentive works.

Now, against that, it is true that stock options, particularly for public companies, have an often-destructive random component: they tend to increase in value in rising stock market environments and decrease in value (potentially to zero) in falling stock market environments, regardless of whether value is being created inside your particular company.

For that reason, in the long run it probably makes sense for some new approach to stock-based compensation to be developed that both preserves the motivation to *create* as opposed to *preserve* value, but factors out the environmental swings of rising and falling stock markets. Some form of indexing against market averages would probably do the trick. This has been tried from time to time, and I expect it to be tried more in the future, at least for public companies.

As a company grows, stock options and other forms of equity-based motivation become less and less useful as an incentive tool, since it becomes harder for many employees in a large company to see how their individual behavior would have any effect on the stock price of the overall corporation. So, more tactical incentives kick in, such as cash bonuses.

The design of tactical incentives -- e.g. bonuses -- is a whole topic in and of itself, and is critically important as your company grows. The most significant thing to keep in mind is that how the goals are designed *really* matters -- as Mr. Munger says, people tend to game any system you put in place, and then they tend to rationalize that gaming until they believe they really are doing the right thing.

I think it was Andy Grove who said that *for every goal you put in front of someone, you should also put in place a counter-goal to restrict gaming of the first goal*.

So, for example, if you are incenting your recruiters on the number of new employees recruited and hired, you need to also give them a counter-goal (and tie it to their compensation) that measures the quality of the new hires three months in. Otherwise the recruiters are guaranteed to give you what you *don't* want: a lot of mediocre new hires.

One of the great unwritten Silicon Valley skewed incentive stories was a major datacenter vendor in the late 90's that incented its salespeople based on *bookings* of long-term datacenter leases, without sufficient counter-goals tied to revenue collection or the customer's ability to pay. Sure enough, soon the company's reported bookings were heading straight up, revenue was flat, and cash headed straight down, resulting in a truly spectacular bankruptcy. The salespeople got paid, though, so they were happy.

More recently, skewed incentives in the mortgage industry -- mortage issuers getting paid based on quantity of mortgages issued, versus ability to pay -- caused many of the current catastrophic Wall Street financial meltdowns you get to read about every day.

Even engineers need counter-goals: incent engineers based purely on a ship date, and you'll get a shipping product with lots of bugs. Incent based on number of bugs fixed, and you'll never get any new features. And so on.

Especially in smaller companies, peer pressure can be a very effective form of incentive. This is greatly enabled and abetted by transparency. People hate to be embarrassed in front of their peer group, so if it's crystal clear who's performing well and who isn't, poor performers will be highly motivated to improve -- and if they're not, that's good to know, since obviously then you really need to fire them.

Finally, any entrepreneur should be highly attuned to incentives when hiring outside executives, especially a CEO. Hire a CEO and give her a large stock-option grant with four-year vesting, and you can guarantee she will sell the company in year four. Give her a stock-option grant with accelerated vesting on change of control and she will sell the company sooner than that. Founders can get tripped up on this because they naturally have an emotional incentive to see the company succeed that hired executives often do not share.

And of course, never get caught between a venture capitalist and her incentives.

Two: Liking/Loving Tendency

> ...[W]hat will a man naturally come to like and love, apart from his parent, spouse and child? Well, he will like and love being liked and loved... [M]an will generally strive, lifelong, for the affection and approval of many people not related to him.
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> One very practical consequence of Liking/Loving Tendency is that it acts as a conditioning device that makes the liker or lover tend (1) to ignore faults of, and comply with wishes of, the object of his affection, (2) to favor people, products, and actions merely associated with the object of his affection (as we shall see when we get to "Influence-from-Mere-Association Tendency"), and (3) to distort other facts to facilitate love.

The application of this principle to entrepreneurs is obvious: entrepreneurs want to be liked just like everyone else, and wanting to be liked can be a major impediment to entrepreneurial success due to at least two major reasons.

First, an entrepreneur, like any CEO, has to make tough decisions about what her company will do, and those decisions will often run counter to the preferences of her employees. You don't have to be involved in that many startups to find one where the entrepreneur knows she needs to make a tough decision -- such as change strategy, or cancel a flawed project -- but can't quite do it because employees won't like it. Of course this always backfires: employees also don't like leaders who don't make the tough decisions that have to be made.

Second, an entrepreneur, like any manager, has to fire people who aren't great or who aren't right for the tasks at hand. This naturally makes people not like you, particularly the people you fire. But again, not doing this backfires: nobody great wants to be in a company populated by mediocre or ill-fitting peers.

I think these pressures are intensified in a small company versus a larger company, because in a small company everyone tends to know everyone else and people naturally form strong personal relationships within the group -- so the desire to be liked is stronger, and the perceived risk from making decisions that people won't like is higher.

A specific form of this dynamic in a startup is when you have multiple founders, of whom one is the CEO. The founder who is the CEO inevitably discovers that it becomes very hard to stay close personal friends with the other founders. As they say, it's lonely at the top -- if you're doing your job right.

Finally, some entrepreneurs have emotional resistance to pursuing a strategy that does not meet with immediate approval from press, analysts, and other entrepreneurs. This is worth watching carefully -- if everyone agrees right up front that whatever you are doing makes total sense, it probably isn't a new and radical enough idea to justify a new company.

Three: Disliking/Hating Tendency

> In a pattern obverse to Liking/Loving Tendency, the newly arrived human is also "born to dislike and hate" as triggered by normal and abnormal triggering forces in its life...
>
> As a result, the long history of man contains almost continuous war...

> Disliking/Hating Tendency also acts as a conditioning device that makes the disliker/hater tend to (1) ignore virtues in the object of dislike, (2) dislike people, products, and actions merely associated with the object of his dislike, and (3) distort other facts to facilitate hatred.

If this is a problem *inside* your company, then you have bigger issues than I can help you with.

However, I think this dynamic kicks in for a startup when thinking about competitors.

I see two destructive consequences of this bias in startups with competitors:

First, I believe startups often *overfocus* on their competitors. It's the easiest thing in the world to orient yourself in opposition to another company in the same market, and to plan your actions based on what will cause damage to the competitor or block the competitor from getting business.

In the startup world, that often leads to multiple competitors engaged in a shooting war in a market that's still too small for anyone to succeed.

I think it's much better for a startup to focus on creating and developing a large market, as opposed to fighting over a small market.

So when your startup's competitive juices get flowing -- especially for the first time -- and you find yourself fixated on a competitor, be sure to take a step back and say, is this really what we want to be focused on right now -- is the market we're both in really large enough to warrant this? If so, sure, go for it, guns blazing. But if not, stepping back and thinking about how to focus instead on creating a large market might be more valuable.

A variant on this dynamic is letting your competitor determine your strategy by watching what he does and then making countermoves. The issue here is that it's highly likely that neither one of you actually knows that much about what you are doing yet -- since you are in a new market, by definition -- and while you *know* you don't know that much about what you're doing yet, you only observe your competitors's deliberate actions as opposed to seeing their equivalent or greater level of internal confusion. So they seem like they know what they're doing, and so you fall into assuming they know more than you do, when they probably don't.

Second, when you *are* in a truly competitive situation, this bias can easily lead you to underestimate your competitor by, as Mr. Munger says, "ignoring virtues in the object of dislike".

His product sucks, his salespeople aren't as good, his venture capitalists are those morons who backed that large datacenter vendor that went bankrupt -- and so on.

Notably, this attitude can become cultural in your company very quickly. I think that if you're in a shooting war, even if you privately think your competitor is an amoral pinhead, that you establish a tone that says, we'll assume that he's highly competent and has many fine virtues, which we will respect and then systematically target with our own strengths and virtues until we have killed him.

Four: Doubt-Avoidance Tendency

> The brain of man is programmed with a tendency to quickly remove doubt by reaching some decision.
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> It is easy to see how evolution would make animals, over the eons, drift toward such quick elimination of doubt. After all, the one thing that is surely counterproductive for a prey animal that is threatened by a predator is to take a long time in deciding what to do...
>
> So pronounced is the tendency in man to quickly remove doubt by reaching some decision that behavior to counter the tendency is required from judges and jurors. Here, delay before decision making is forced. And one is required to so comport himself, prior to conclusion time, so that he is wearing a "mask" of objectivity. And the "mask" works to help real objectivity along, as we shall see when we next consider man's Inconsistency-Avoidance Tendency...
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> What triggers Doubt-Avoidance Tendency? Well, an unthreatened man, thinking of nothing in particular, is not being prompted to remove doubt through rushing to some decision. As we shall see later when we get to Social-Proof Tendency and Stress-Influence Tendency, what usually triggers Doubt-Avoidance Tendency is some combination of (1) puzzlement and (2) stress.

This is probably a good one for entrepreneurs. You'd better not have a lot of doubts about what you are doing because everyone else will, and if you do too, you'll probably give up.

Of course, an entrepreneur's doubt avoidance is only a plus right up to the point where it becomes pigheaded stubbornness that interferes with her ability to see reality, particularly when a strategy is not working.

In my view, entrepreneurial judgment is the ability to tell the difference between a situation that's not working but persistence and iteration will ultimately prove it out, versus a situation that's not working and additional effort is a destructive waste of time and radical change is necessary.

I don't believe there are any good rules for being able to tell the difference between the two. Which is one of the main reasons starting a company is so hard.

Five: Inconsistency-Avoidance Tendency

> [People are] reluctant to change, which is a form of inconsistency avoidance. We see this in all human habits, constructive and destructive. Few people can list a lot of bad habits that they have eliminated, and some people cannot identify even one of these. Instead, practically every one has a great many bad habits he has long maintained despite their being known as bad. Given this situation, it is not too much in many cases to appraise early-formed habits as destiny. When Marley's miserable ghost says, "I wear the chains I forged in life," he is talking about chains of habit that were too light to be felt before they became too strong to be broken.
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> [T]ending to be maintained in place by the anti-change tendency of the brain are one's previous conclusions, human loyalties, reputational identity, commitments...
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> It is easy to see that a quickly reached conclusion, triggered by Doubt-Avoidance Tendency, when combined with a tendency to resist any change in that conclusion, will naturally cause a lot of errors in cognition for modern man. And so it observably works out. We all deal much with others whom we correctly diagnose as imprisoned in poor conclusions that are maintained by mental habits they formed early and will carry to their graves...
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> And so, people tend to accumulate large mental holdings of fixed conclusions and attitudes that are not often reexamined or changed, even though there is plenty of good evidence that they are wrong...
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> As Lord Keynes pointed out about his exalted intellectual group at one of the greatest universities in the world, it was not the intrinsic difficulty of new ideas that prevented their acceptance. Instead, the new ideas were not accepted because they were inconsistent with old ideas in place...
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> We have no less an authority for this than Max Planck, Nobel laureate, finder of "Planck's constant." Planck is famous not only for his science but also for saying that even in physics the radically new ideas are seldom really accepted by the old guard. Instead, said Planck, the progress is made by a new generation that comes along, less brain-blocked by its previous conclusions...
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> One corollary of Inconsistency-Avoidance Tendency is that a person making big sacrifices in the course of assuming a new identity will intensify his devotion to the new identity. After all, it would be quite inconsistent behavior to make a large sacrifice for something that was no good. And thus civilization has invented many tough and solemn initiation ceremonies, often public in nature, that intensify new commitments made.

This goes hand-in-hand with doubt-avoidance, and again is usually a plus for a startup, since it leads to greater commitment on the part of the entrepreneur and the team. (And yes, I am in favor of blood oaths for startups.)

Perhaps this bias is most relevant to how new markets develop. Sometimes you get lucky -- you bring a new product to market, and the target customers all go, great, we'll take it! However, often you get a level of resistance from the market that can be puzzling -- "can't they see that our new product would be better for them than what they have now?"

This in turn leads to the odd dynamic you often see where a startup will field a new product, nobody wants it, and the startup goes belly up. Then three or four or five years later, another startup launches with a very similar product, and this time the market says, hell yes!

I think this is something that every entrepreneur needs to watch very carefully. Sometimes it's simply a matter of timing -- and if people just aren't ready for a new idea, you usually can't make them ready, and you have to wait for them to change or for a new generation of customers to come along.

My favorite way around this problem is the one identified by Clayton Christensen in The Innovator's Dilemma: don't go after existing customers in a category and try to get them to buy something new; instead, go find the new customers who weren't able to afford or adopt the incarnation of the status quo.

For example, when the personal computer was invented, the desirable market was not the universe of people who were already buying computers -- a.k.a. mainframe and minicomputer buyers -- but rather the universe of the people who couldn't afford a mainframe or minicomputer and therefore had never had a computer before.

Similarly, the desirable market for Hotmail in the early days was not existing email aficionados who were already using sophisticated email desktop software, but rather the universe of people who were coming on the Internet for the first time who didn't even have email yet and for whom web-based email was by far the easiest way to start.

Conversely, one of the reasons that today's consumer Internet companies have the wind at our backs versus our peers 10 years ago is that a whole new generation of consumers has come of age in the last 10 years for whom the Internet is their primary medium -- time and demographics are on our side now. That makes life a lot easier, let me tell you. Meanwhile, the average age of television viewers continues drifting higher and higher...

Six: Curiosity Tendency

This is, frankly, an odd one for Mr. Munger to include, since it's primarily a plus, and he doesn't really identify a downside.

The only important thing I can think to add -- aside from the importance of hiring curious people -- is that lack of curiosity can be a huge danger to a startup in the following way: often, your initial strategy won't quite work, but you can learn as you go based on other things that happen in the market and eventually iterate into a strategy that does work. Obviously, insufficient curiosity can prevent you from seeing the new data and lead you to continue to pursue a losing strategy even when you wouldn't have to.

To be continued...