Research Summary

The Hidden Traps in Decision Making

This article examines a number of psychological traps that are likely to undermine business decisions. Making decisions is a key part of a manager's job. Bad decisions can irreparably damage a business and a career. For executives, whose success hinges on the many day-to-day decision making, the psychological traps are detrimental.

Where do bad decisions come from? They originate either from the way decisions are made i.e., the decision-making process or from the way the human brain works. In many instances, bad decisions can be traced to a faulty decision-making process—where the alternatives were not clearly defined, the right information was not collected, the costs and benefits were not clearly estimated. However, sometimes, the fault lies not in the decision-making process but in the mind of the decision maker. *In making decisions, your own mind may be your worst enemy.*

Research has indicated that we use unconscious routines to cope with the complexity of decision-making. These routines known as *heuristics* serve us well in many situations. For example, in judging distances, our mind relies on a heuristic that equates clarity with proximity. The clearer an object, the closer we perceive it to be. However, in fog conditions, our eyes trick the mind into thinking that the objects are distant. This distortion poses dangers for airline pilots. It is for this reason that the pilots are trained to use objective measures besides their own vision while guiding the airplanes.

Researchers have identified various hidden traps like sensory mis-perceptions, biases, irrational anomalies etc. These traps are hardwired into our thinking process, with the result that we fail to recognize even as we fall into them. It is only by becoming aware of these traps, that we can enhance our decision-making abilities.

The authors identify six psychological traps. This article reviews the causes and manifestations of these traps and provides suggestions as to what we can do to guard against them. Forewarned is Forearmed.

The Anchoring Trap

The mind gives greater weightage to the first information it receives. Initial impressions, estimates or data *anchor* subsequent thoughts and judgments. A salesman attempts to forecast the next year sales by looking at the current year sales. The old numbers become anchors, which the forecaster then adjusts based

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on other factors. This approach, while it may lead to a reasonably accurate estimate, tends to attach too much importance to past events and not much importance to other factors. In situations epitomized by rapid changes, historical anchors can lead to poor forecasts and in turn lead to misguided choices.

Savvy negotiators invariably use anchors as a bargaining tactic. The seller looks for a high but a defensible price as an opening gambit while a buyer aims at a low price. We see this phenomenon taking place day-in and day-out in various market places, be it the stock market or the real estate market. Anchors influence the decisions not only of managers, stock analysts and realty consultants but also bankers, lawyers, accountants etc. One can reduce the impact of the anchoring trap by keeping in mind the following guideposts:

- View a problem from different perspectives. Try alternative starting points and approaches rather than sticking with the first line of thought which occurs to you.
- Think about the problem on your own before consulting others and getting biased.
- Be open-minded. Be receptive and seek opinions from various people.
- Be careful to avoid anchoring others from whom you seek information. Tell them as little as possible about your own ideas.
- Be cautious of anchors in negotiations. Think through your position before the beginning of any negotiation.

The *Status Quo* Trap

We all have a tendency to perpetuate *status quo*. For example, we see this whenever a new product is launched. The first automobiles, revealingly called “horseless carriages”, looked very much like the buggies they replaced. *Decision makers display a strong bias towards alternatives that perpetuate the status quo.*

The source of *status quo* lies deep within our psyche—we don't want to damage our egos. Breaking from *status quo* means taking action and increased responsibility and opening oneself to criticism. Sticking to *status quo* is the easier path because one is put to less tension. In businesses, where sins of commission (doing something) tend to be punished much more severely than sins of omission (doing nothing), the *status quo* holds a particularly strong attraction. So also in mergers and acquisitions, when management fails to seize the opportunity of putting in place a new management structure, it becomes difficult to change the structure later. With efflux of time, the structure becomes stuck with the *status quo*.

Remember that in any decision, maintaining the *status quo* may indeed be the best decision, but you don't want to choose it just because it is comfortable. You may use the following techniques to avoid the pull of the *status quo* trap:

- What are your objectives and how are they best served by the *status quo* alternative?
- *Status quo* is not your only alternative. Think of other options and evaluate the strengths and weaknesses.

- Ask yourself whether you would choose the *status quo* alternative if, in fact, it were not the *status quo*.
- Avoid overestimating the effort involved in switching from the *status quo*.
- Note that the attractiveness of *status quo* will change over time. When comparing alternatives, always evaluate them in terms of the future as well as the present.
- Force yourself to choose. When there are several alternatives that are superior to *status quo*, don't default to the *status quo* just because you are having a hard time to pick the best alternative.

The Sunk-Cost Trap

We tend to make choices in a way that justifies past choices, even when the past no longer seems valid. For example, we may have refused to sell a stock or a mutual fund at a loss, forgoing other more attractive investments. Or we may have poured lot of effort into improving the performance of an employee whom we knew we should not have hired in the first place. Our past decisions become what economists term “sunk costs”—old investments of time and money that are now irrecoverable.

We know rationally that sunk costs are irrelevant but nevertheless they prey on our minds, leading us to make incorrect decisions. Why can't people free themselves from past decisions? Frequently, it is because they are unwilling, consciously or unconsciously, to admit to a mistake. For instance, if you fire a poor performer whom you hired, you are making a public admission of poor judgment. It seems psychologically safer to let him or her stay on, even though that choice only compounds that error. In banking, when a borrower's business runs into trouble, a lender will often advance additional funds in the hope that it would give the business some breathing space to recover. If the company recovers then it is a wise investment, otherwise it is a bad judgment.

To set aside the sunk-cost trap that will muddle your thinking, try the following techniques:

- Seek out and listen carefully to the views of people who were uninvolved with the earlier decisions.
- Examine why admitting to an earlier mistake distresses you. Remember that even smart choices (taking into account what was known at the time the decisions were made) can have bad consequences. Even the most experienced are prone to errors of judgment.
- Be alert to the influence of sunk-cost biases in the decisions and recommendations made by your subordinates. Re-assign responsibility when necessary.
- Encourage people to experiment. Remove a failure fearing culture. In rewarding people, look at the quality of their decision-making process and not just the quality of the outcomes.

The Confirming Evidence Trap

This trap leads us to seek out information that supports our existing instinct or point of view while avoiding information that contradicts it. The confirming evidence trap affects not only where we go to collect evidence but also how we interpret the evidence we do receive. This bias tends to make us give more weight to supporting information than conflicting information.

There are two fundamental forces at work. First, it is our tendency to subconsciously decide what we want to do before figuring out why we want to do it. Second, it is our tendency to be more engaged by things we like than by things we dislike.

It is not that you should not make the choice you are subconsciously drawn to. It is just that you want to be sure it is a smart choice. You need to put it to the test. Here is how:

- Check to see whether you are examining all the evidence. Avoid the inclination to accept confirming evidence without question.
- Let someone you respect, play the devil's advocate. Build the counter arguments.
- Be honest with yourself and your motives. Are you really gathering information to help you make a smart choice, or are you just looking for evidence confirming what you think you had like to do?
- Don't surround yourself with yes-men.

The Framing Trap

The initial step in making a decision is to frame the question. The way a problem is framed can profoundly influence the choices you make.

To illustrate an example of framing trap, a case involving automobile insurance is explained. To reduce insurance costs, two states New Jersey and Pennsylvania made similar changes in their laws. Each state gave drivers a new option: By accepting a limited right to sue they could lower their insurance premiums. But the two states framed the choice in different ways. In New Jersey, you automatically got the limited right to sue unless you specified otherwise. In Pennsylvania you got the full right to sue unless you specified otherwise. The different frames established different *status quos*, and, not surprisingly, most drivers defaulted to the *status quo.* As a result, in New Jersey about 80 percent of drivers chose the limited right to sue while in Pennsylvania only 25 percent chose it. Because of the way it framed the choice, Pennsylvania failed to gain $200 mn in expected insurance savings.

The framing trap is related to other psychological traps. It can establish the *status quo* or introduce an anchor. It can highlight sunk costs or lead you towards confirming evidence. There are two types of framing traps: (i) Framing as Gains versus Losses (ii) Framing with Different Reference points.

Frames as Gains versus Losses. Based on experiments, the findings reveal that people are risk averse when a problem is posed in terms of gains but risk seeking

when a problem is posed in terms of avoiding losses. Furthermore, people tend to adopt the frame as it is presented to them rather than restating the problem in their own way.

Framing with Different Reference Points. It is noticed that different reactions result from different reference points presented in the two frames. A frame with its reference point of zero emphasizing incremental gains and losses trigger a conservative response in many people's minds with the thought of losing. While a frame with its reference point other than zero, puts things in perspective and elicits a different response by emphasizing the real financial impact of the decision.

Any adverse effect of framing can be limited by taking the following precautions:

- Always reframe the problem. Don't automatically accept the initial frame.
- Try posing problems in a neutral, redundant way that combines gains and losses or embraces different reference points.
- Think hard throughout your decision-making process about the framing of the problem.
- When others recommend decisions, examine the way they framed the problem. Challenge them with different frames.

Estimating and Forecasting Traps

The Forecasting Trap has a distorting effect in uncertain situations because they cloud our ability to assess probabilities. For example, if you are asked what is the likelihood that the oil price will fall below $15 a barrel one year hence and you mention that it is 40 percent and the oil price does fall below $15 a barrel, you can't tell whether you were right or wrong about the probability of 40 percent. That would require a great deal of data, carefully tracked over a long period of time. Weather forecasters and bookmakers have the opportunities and incentives to maintain such records, but the rest of us do not. Our minds have never become calibrated for making estimates in the face of uncertainty unlike our daily adeptness in making estimates about time, distance, weight and volume.

Three of the most common forecasting traps are (i) Overconfidence Trap (ii) Prudence Trap (iii) Recallability Trap.

Overconfidence Trap. Even though most of us are not very good at making estimates or forecasts, we actually tend to be overconfident about our accuracy. This can lead to errors in judgment. Overconfidence in accuracy leads many people to set too narrow a range of possibilities.

If managers underestimate the high-end or overestimate the low-end of anticipated sales, they may miss opportunities or expose themselves to far greater risk in terms of investments and initiatives. Very often in business, much money is wasted on ill-fated product development projects because managers did not accurately account for the possibility of a market failure.

Prudence Trap. On one hand is the overconfidence trap and on the other hand is the prudence trap. This trap takes the form of overcautiousness. An extreme

example is the methodology of “worst-case analysis”. This is particularly popular in weapons systems and in certain engineering and regulatory settings. Using this approach, engineers designed weapons to operate under the worst possible circumstances, even though the possibility is minimal. The result is that the approach leads to enormous costs with little practical benefits.

Recallability Trap. We frequently base our predictions about future events based on the memory of our past events. We all, for example, exaggerate the probability of rare but catastrophic occurrences, such as plane crashes, because they get disproportionate attention in the media. A dramatic or traumatic event in your life, like that of a traffic accident, can also distort your thinking. You will assign yourself a higher chance of someday dying of cancer if, let us say, a close friend of yours has died of cancer.

To overcome the three traps, the following precautions need to be taken:

- To avoid the overconfidence trap, challenge your estimates of the extremes. Try to imagine circumstances where the actual figure would fall below your low or above your high and adjust your range accordingly.
- To reduce the effects of the prudence trap, always state your estimates honestly. Emphasize the need for honest input to anyone who will be supplying you with estimates.
- To minimize the distortions that result from recallability, carefully examine all your assumptions to ensure that they are not unduly influenced by your memory. Try not to be guided by impressions. Aim at getting actual statistics whenever possible.

Forewarned is Forearmed

The best protection against all psychological traps is awareness. Even if you cannot eradicate the distortions ingrained into the way your mind works, you can build disciplines and tests into your decision-making process that can uncover errors in thinking. At every stage of the decision-making process, misperceptions, biases and other tricks of the mind can influence the choices we make. Taking action to understand and avoid psychological traps can have the tremendous benefit of increasing your confidence in the choices you make. □

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