Bias and Other Irrationalities: Some Behavioral Economics for Owner Managers

By Phil Thompson – Thompson Dymond: Business Lawyers, Corporate Counsel – www.thompsonlaw.ca

Beware of the Rationality Assumption

In *The Wealth of Nations* in 1776 Adam Smith made the following statement: *Every individual is continually exerting himself to find out the most advantageous employment for whatever capital he can command.*

It has been a basic assumption of economists ever since that these exertions and assessments are always made on rational grounds, and that given a variety of choices we will over time always tend to make the most rational (or logical, or statistically valid, or mathematical) choices. Throughout most of the 20th century almost all accepted economic theories (e.g. utility theory) and some very influential public policy (e.g. Chicago School) were based on this core assumption of collective rationality.

However human nature has proven time and again that we are not always rational when it comes to money and wealth, and over the past few decades some psychologists have been able to prove just how irrational we can be when it comes to money and wealth both individually and collectively.

This intersection of economics and psychology is called behavioral economics, and thoughtful owner managers and their advisors should have some working knowledge of its current state of thought and how this discipline can be used for or against owner managers in business decision making and risk assessment.

The first idea we have to accept is that we are **not** always rational when it comes to money and business. Each of us is affected by predisposition, prejudice, bias and other irrationalities which impact our business decision making, and that these same things are affecting our customers, suppliers and competitors.

The good news is that while we might not always be rational we tend to be consistently irrational, and therefore with awareness and forethought our irrationalities can be predicted and guarded against.

It is also important to know there is more involved here than Mr. Spock's dichotomy of logic and emotion. The Nobel Prize winning social scientist Daniel Kahneman has argued we have two different circuit systems at play in our brains at the same time. One circuit is fast and intuitive, making snap judgements on the fly with limited information. The other is slower and more methodical, and needs time to concentrate, focus and think things through; although this slow and methodical circuit is also lazy, and given a chance it will follow the powerful lead of the fast, intuitive and often biased circuit.

Overcoming all these challenges is possible but requires conscious effort, self-awareness and equanimity.

The important lesson for owner managers and those that advise them is to not assume we or the other parties we are interacting with will always perceive, choose, decide or act in the most rational way or out of what is truly in their objective self-interest. This assumption of rationality can be a dangerous fallacy.

And we must not assume that we are always more rational than anyone else around us.

We must work to understand the forces at work in the context of our decision-making and the decision making of others, especially those forces that can produce Behaviors, choices or outcomes that are not consistent with the wholly rational system suggested by traditional economic and market theory. We must learn how to recognize, influence and overcome the obstacles to rational decision making.

What follows is a summary of some of the key concepts I learned from reading and considering two recent books about Behavioral economics written for the general public:

- *Predictably Irrational, The Hidden Forces That Shape Our Decisions* – Dan Ariely – 2008 – HarperCollins Publishers.

- *Thinking, Fast and Slow* – Daniel Kahneman – 2011 – Anchor Canada, a division of Random House Canada Limited.

Choice: Bias and Rational Decision-Making

Here are some key concepts that I found made a useful grouping when thinking about making business choices and decisions and just tendencies to be aware of in ourselves and others:

Algorithm Bias – This is a tendency to dismiss statistical evidence and mathematical formulas in favour of intuition, especially if the evidentiary conclusions are counter-intuitive. I recently heard a politician begin an argument in favour of his private member's bill with the statement "*I hate to talk numbers*". That is a strong indicator of Algorithm Bias, and made me question everything he had to say after in support of his public policy initiative, including why it was necessary and what impact it would have.

Anchoring Effect – This occurs when people consider a particular value for an unknown quantity before estimating that quantity. Asking pricing, rules of thumb, what the seller paid for the asset she is now selling, and what someone else recently paid for a similar property are all examples of Anchors. The problem is that when we do take the time to sit down and consider the value in question we are tend to be pulled toward the Anchor we already have in mind, even if it is irrational or arbitrary. These first impressions can be hard to overcome. We must be careful what Anchors we set or allow to affect us, we must be aware of Anchors the other parties may have, and we must at times think about examples that contradict these Anchors if we want to overcome them.

Availability Basis – This is the tendency to judge the frequency of an event by the ease with which an example comes to mind. This can produce irrational and paradoxical results, and can affect risk perception. We have to be aware that when we are influenced by Availability Bias we are really substituting one question for another. We are substituting the question "How easily can I think of an example" for "How likely is this to happen"? Just because we can easily think of an example of an event does not increase the likelihood of the event has occurred or will occur.

Coherence Bias – This is the tendency to assign a higher probity to a story than it deserves because the story is coherent and easy to understand. In other words the story easily makes sense to us. But just because it easily makes sense does not mean it is more likely to be true, or that meaningful evidence to the contrary should be dismissed or underweighted.

Comparison Effect – This is an important concept in modern economic decision-making. People like to make economic decisions by comparing things. We need to actively and consciously frame the choices we want people to consider, and offer comparisons that lead them to the choices we want them to make. And of course we have to be careful that another party is not doing the same thing to us.

Competition Neglect – This is the tendency to believe our fate is in our own hands, and that we are most responsible for our own success. Competition neglect can cause us to know less about our competition and the marketplace than we should, and could mean we have difficulty imagining a future in which the competition plays a part. There will be times in business we need to remind ourselves, or another party, of the possibility that competition neglect has us underestimating risk or over-estimating opportunity.

Confirmation Bias – This is the tendency to find proof for what we already believe; to overweight evidence that supports our pre-existing beliefs; to not look for, underweight or dismiss evidence that contradicts what we already believe; and to hear what we want to hear. This is a particular risk for owner managers, who by nature seem to be inherently optimistic, overconfident and control oriented.

Contagion Effect – Emotions are more contagious than rationality, and negative emotions are more contagious than positive ones. We must be judicious in how we introduce negative emotions into our business affairs, and must guard against being caught up by negative emotions introduced by others, as our risk of being involved in less than rational choices goes up if we do not.

Context Effect – This is another way of expressing Comparison Effect. This summarizes our tendency to focus on relatives and on the relative value of one thing over another and to estimate value accordingly. We often do not know what we want unless we see it in context. But this can also skew us away from the most rational choices. We need to be careful how we frame and perceive context for ourselves and others, and how others frame context and get us to perceive it. For example, we can decide to buy a more expensive car than we can rationally justify if we focus on comparing it to the highest price and most feature rich model in the show room versus the most modestly price and featured model in the show room.

Decoy Effect – This ties into the Comparison Effect and Context Effect. Given three choices people tend to prefer the middle one. In business it is possible to frame the choices, or have the choices framed for us, by introducing decoys which entice us toward a choice that is contrary to the most rational choice we should be making. Decoys are not introduced because anyone wants the party in question to choose the decoy, but to make another choice seem more attractive.

Disappointment Bias – This is the tendency to allow our disappointment in accepting a loss, lost opportunity, or failure to do better, to affect our decision making and the risks we are willing to accept or reject, pushing us to take a higher risk or settle for something less than the measured odds suggest. We have to be careful that Disappointment Bias does not cause us to make a poor decision, and may have to manage the disappointment effect in another party if we want them to make the choice we want them to make.

Emotive Effect –We have trouble exercising rational judgement when aroused emotionally. Once passions are aroused they are hard to turn off. Emotive Effect tell us that we have trouble predicting how we will act when we are emotionally engaged. We must be careful when triggering or dealing with emotions as they can unpredictably affect decision making in ourselves and others.

Endowment Bias – This is the tendency to have one price if we are a seller and a significantly lower price if we are a buyer, for something that we already own or have. It can also been seen in our tendency to perceive a higher value in something we have than we assigned to it before we acquired it. This is related to Loss Aversion Bias and Ownership Bias, referred to below, and is especially applicable to relatively rare properties or opportunities. It can cause us to make less than fully rational decisions, and may be something we need to overcome in trying to get others to make the choices we want them to make.

Expectation Effect – How we subjectively experience something is affected by our expectations. If we expected a lot we might have a negative experience even if what we experienced was really outstanding. The opposite is true as well - if we expected the worst we can overrate the quality of the experience we actually had if it turned out better than we expected. We need to be conscious of our expectations and take them into account, must be careful of the expectations we set in others, and must be aware of their expectations in discussing the experience with them after the fact.

Experience Bias – This is the tendency to dismiss statistical information that conflicts with our own personal experiences. Our subjective data set of one can be more powerful than an objective data set of many. It is something to guard against in ourselves and overcome in others, as it can lead to less than rational decision making.

Fear Effect – Fear is one our strongest emotions, and reduces rationality. We have to manage fear in ourselves and others, and be judicious in using and responding to fear, threats and intimidation in our business dealings.

First Impression Bias – The proof is in. First impressions are very important, and once set are harder to overcome. We must set a good first impression ourselves, but be open to looking past first impressions as well. First impressions can negatively impact rational decision making.

Fourfold Pattern Effect – This term refers to pattern of preferences supported by Prospect Theory, and is summarized by the following chart. When all prospects are bad, people will take higher risks and may choose the most risky of the prospects offered. When all prospects are gains, people will be more risk adverse and may rate the risk of loss higher than it deserves and settle for a smaller gain than the odds suggest. We must be careful how we perceive where we are in this chart, and where we try to get others to place themselves when dealing with us.

	Gains	**Losses**
Perceived High Probability (Certainty Effect)	**Risk Adverse** Could accept unfavourable settlement	**Risk Seeking** Could reject favourable settlement
Perceived Low Probability (Possibility Effect)	**Risk Seeking** Could reject favourable settlement	**Risk Adverse** Could accept an unfavourable settlement

FREE! Effect – Free is not perceived as a price. It evokes an emotional response and can cause us to focus on the upside not the downside. If we put FREE! into a bundle we want people to choose they make look more favourably on it than they should. We should not get unreasonably attracted to any FREE! features when making choices, but should consider using them when trying to get others to make the choices we want them to make.

Group Bias – This is the tendency to overweight the views of the group to which we belong and to not look for, underweight or dismiss evidence that contradicts what the group believes. It can also lead to less than optimally rational decisions, by us or by those we are doing business with.

Loss Aversion Bias – This is the tendency to focus more on what we have to lose than we have to gain. This is very important when we actually have something in hand we could lose. It causes us to weight risks differently than their straight odds might suggest. It relates to Prospect Theory, which suggests that when all prospects are perceived as gains we tend to overweight the risk of loss and settle for what we perceive as less risky sure thing even if the mathematical odds suggest something different. It also suggests that are willingness to take risks goes up when we perceive we faced with a certain loss.

Optimism Bias – This is a tendency to be excessively optimistic. It is largely inherited but makes those who have it more resilient with stronger immune systems and longer life expectancies. People with Optimism Bias seek challenges and take risks. But they can also underestimate those risks. They are more likely to believe they are being prudent even when they are not. They are prone to the illusion of control. They are prone to WYSIATI (see below) and can suffer from Competition Neglect and Overconfidence. It is probably endemic in entrepreneurs, so we need to guard against it.

Outcome Bias – This is the tendency to judge and reward the quality of a decision or the decision-maker by the nature of the outcome – good or bad – rather than on the quality of the decision in context. Just because something turned out well or poorly does not mean the original decision was well-made. Outcome Bias can result in our making decisions outside the scope of what is optimally rational.

Overconfidence Effect – This is the tendency to be excessively optimistic, and to ignore or dismiss material evidence to the contrary or that challenges our optimism. It can cause us to underestimate obstacles, and relates to Confirmation Bias and Optimism Bias.

Ownership Bias – It appears that the more we put into something the more we feel ownership of it, and the more we value it. Ownership Bias applies to ideas and points of view as much as to property or business assets. It can also arise even before we own the subject matter of the bias, as just imagining owning something can start the sense of ownership. This bias ties into Loss Aversion and Regret Bias as letting go of something we own can create a sense of loss. This can affect how we approach decisions in terms of buying or selling, or how another party might be dealing with the same issue. It can have an adverse effect on rational decision making.

Planning Fallacy – This is the tendency to make plans and forecasts that are unrealistically close to best-case or worst-case scenarios by utilizing too much inside view and not enough outside view. One antidote to this bias is to make a point of seeking out and considering comparisons to actual outcomes of similar cases that are outside the personal experience of the decision-makers. Planning Fallacy can tie into Confirmation Bias and WYSIATI.

Prospect Theory – This is a key underlying theory to Behavioral economics, and ties into the Fourfold Pattern Effect noted above. It holds that when all prospects are bad, people will take tend to take higher risks and may choose the more risky of the prospects offered. On the other hand when all prospects are gains, people will be more risk adverse and may rate the risk of loss higher than it deserves and settle for a smaller gain than the odds suggest. These tendencies connect to each person's assessment of their Reference Point and results from the tendency of people to attach values to gains and losses rather than to absolute wealth.

Reference Points – Whether we perceive things as good or bad, or feel happy or unhappy about an outcome, can depend on the transactional change from our initial Reference Point or Anchor, and how we see good or bad affects the choices we make. It is also important to note that goals can be Reference Points. It is therefore important to be aware of the Reference Points at play in our business dealings, and to be careful that we or another party is not missing the optimally rational choice because they are over focussed on the change from their Reference Point rather than the more rational risk or outcome that is on table.

Regression Bias – This is the tendency to overweight exceptional events as predictive trends and to ignore or underweight long term regression to the mean. This can result in mistaking correlation for causation. There is a need to know the mean and maintain a healthy skepticism of results that in the short run are exceptions when compared to it. This bias applies both to gains and to losses, and can lead to poorer decisions or choices than ought to be made based on the objective evidence.

Regret Bias – This is a tendency to allow the potential regret we might feel from an imagined lost opportunity or failure to win to affect our decision making and the risks we are willing to accept or reject, pushing us to take a higher risk than the measured odds suggest. This can be particularly important to someone facing a certain loss, as suggested by Prospect Theory and the Fourfold Pattern Effect.

Representation Effect – It appears that a rich and vivid representation of an outcome, either good or bad, can affect risk or likelihood perception. The manner in which choices are represented to us, or are represented by us to others, can skew decision making away from choices that strict rationality would suggest. For example, in presenting the likelihood of a very unlikely event occurring people tend to see that presentation as a fraction (e.g. 1 out of 1,000) as more likely to occur than the presentation as a percentage (0.1%) even though they are mathematically equivalent.

Stereotype Bias – Everyone maintains a library of stereotypes. We use them to make sense of the world quickly, to help us predict, and to help us remember. We tend to look for evidence to support and reinforce them. If they are triggered they can overcome base rates and other logical and statistical anchors. Stereotypes have their daily uses, but they can interfere in rational decision making. We must be careful about using them, and must be careful about being perceived as one, and stereotypes can negatively impact rational decision-making.

Stress Effect – Stress reduces rationality. Combined with a Stereotype it influences memory longer, especially if negative. We have to be careful how we use and perceive stress in our business dealings as it can lead to less than ideally rational choices.

Talking Heads Bias – This is the tendency to overweight or underweight the subjective confidence of experts. Experts have their time and place, and their "sixth sense" intuition built up over time can be an important tool in rational decision making. However three things are needed for an expert to be in a position to justify their subjective confidence. The first is an environment that is sufficiently regular to be predictable. The second is an opportunity to learn from those regularities through prolonged practice. The third key factor is the actual prolonged practice by the expert within those environments. We must be cautious of the expertise offered or accepted if these conditions are not meant, no matter how sincere or confident the expert might appear to be.

WYSATI – What You See Is All There Is – This is the tendency to unquestioningly accept the information provided for the purpose of making a likelihood assessment or choice, without questioning or looking for what is <u>not</u> included in the information provided. The ability to look critically at an opportunity or to make the most rational decision about it requires us to not only consider the information that has been provided, but to take to time to consider what other information we do not have that could affect the assessments or choices we are about to make.

This is not an exhaustive list, but it is an interesting one. All of these biases are proven to affect how we make decisions, and to cause many of us to make less rational decisions than perhaps we should.

Advocacy: Best Behaviors for Rational Negotiations

In this section I outline some concepts that made a useful grouping for me when thinking about being an effective advocate or negotiator on behalf my clients. This grouping is mostly about Behavior and communication, but it effectively returns to the issue of choice. As an advocate or negotiator I am trying to get someone else to make the choice my client wants them to make, and am trying to get my client to think logically and rationally about a choice someone else wants my client to make.

In that regard, all the biases outlined in the previous section apply as well, to be guarded against, overcome or used to advantage. However while the previous section is mostly about <u>what</u> needs to be overcome, this section is more about <u>how</u> they can be overcome and the attitudes and Behaviors that affect how successful I will be in that regard:

Apologies – Apologies have been proved to be effective in taking wind from someone's sails. They are a tool that should be considered even if you do not think you have anything to apologize for, as long as you can do it without adding fuel to a fire.

Change Resistance – When it comes to change and people, the general rule is that it is easier to resist a change than to embrace. When advocating for change we should not make change more difficult to accept than necessary, and should be prepared to sell the benefits.

Commonality – We are more persuasive when we focus on our similarities than our differences.

Consistency Effect – Consistency is an important foundation of trust, and this is more a question of style than of substance. You can take differing substantive positions as long as your original style of dealing with the negotiation does not change. It does not have to be a pleasing style – although as my mother says we catch more bees with honey than with vinegar. What matters is that we do not flip flop styles, for if we do we are less likely to be trusted in the process.

Disappointment – As noted above we have to be careful when advocating a choice to a person that will be disappointment because we are asking them to accept a loss, lost opportunity or failure to do better. That disappointment can affect their decision making and the risks they are willing to accept or reject. We may have to manage the disappointment effect in another party if we want them to make the choice we want them to make.

Emotive Effect –People have trouble exercising judgement when aroused emotionally, and once passions are aroused they are hard to turn off. We must be careful when triggering emotions, especially fear or other negative emotions, as they can lead to other parties taking a higher risk position than they might otherwise take and that could be against our interest.

Empathy Effect – People respond favourably when dealt with empathetically. Using empathetic technique like empathetic questioning and mirroring effect can increase the chance of your point of view being accepted, even if begrudgingly.

Fear Effect – Fear reduces rationality. We have to manage fear in ourselves and others, and be judicious in using fear, threats and intimidation in our business dealings.

First Impressions – First impressions are very important, and once set are harder to overcome. We must be sure to set a good first impression in our negotiations.

Fourfold Pattern Effect – This term is summarized by the following chart, reproduced from above. In our negotiations we must try to get the other party into one of the two Risk Adverse boxes, and try to avoid putting them in either of the Risk Seeking boxes.

	Gains	**Losses**
Perceived High Probability (Certainty Effect)	**Risk Adverse** Could accept unfavourable settlement	**Risk Seeking** Could reject favourable settlement
Perceived Low Probability (Possibility Effect)	**Risk Seeking** Could reject favourable settlement	**Risk Adverse** Could accept an unfavourable settlement

FREE! Effect –If we put FREE! into a bundle we want people to choose they make look more favourably on it than they should. We should consider using them when trying to get others to make the choices we want them to make.

Mirroring Effect – Mirroring back to someone demonstrates that you understand them, and builds trust. This is a good thing to do in our negotiations.

Money Effect – The more money is part of the conversation the less collaborative people will want to be with us. Money is an important part of any business negotiation but we must try to not make it the only focus of the conversation. We must find other non-monetary factors to include in the transactional discussion.

Monopolizing Effect – Monopolizing the conversation has a negative effect on those we are in conversation with. We must work to not do this, and to engage in a true dialogue.

Perspective Bias – This is the tendency to assume other people see an issue or transaction from the same perspective we do. It is better to ask and seek clarification than to assume, and to explain and offer perspective than to let them rely on their own perspective bias in dealing with you.

Representation Effect – A rich and vivid representation of an outcome reduces the role of probability in the evaluation of risk or likelihood. In other words if you can present your case in rich and vivid terms it might be more appealing than it deserves. However we have to be careful to not channel this effect into the risk seeking situations outlined in the Fourfold Pattern Effect, or the result could be counterproductive to our goals in the negotiation.

Ridicule Effect – Ridicule reduces rationality and provokes a negative emotional response. It can be tempting to prove how smart or witty we are while in the middle of a difficult negotiation, but it can weaken your chances of getting the other party to make the choice we want them to make.

Social Norms Effect – As people we recognize there are market norms (e.g. "it's not personal, it's business") and social norms (e.g. "this is the special way we do things in our community"). It is acceptable to invoke social norms in a negotiation, as social norms make people want to extend themselves in our direction. However we must be careful how we do it. Introducing or reverting to market norms after social norms have been put into play can be damaging, and can affect rational decision making. If social norms collide with market norms then trust and the social norms can be damaged for a long time.

Statement Effect – We respond more rationally and more favourable to statements than we do to threats. Presenting analysis, positions and choices as non-judgmental statements could be more effective in negotiations, and could help avoid the sort of emotional responses that lead to less than optimally rational choices and decisions.

Stress Effect – As noted above, stress reduces rationality. Creating situations of stress can be counterproductive. Working to avoid and alleviate stress in the negotiation should improve the likelihood of the parties making the most rational choices.

Trust Effect – Trust is important to getting another party to make the choices you want them to make. Making the transaction mutually rewarding, and saying that is what you are doing, is important in achieving trust. Mirroring and the use of empathetic questions also help promote trust. On the other hand stress fear, ridicule, judging, coming across as the smarter party (even if it's true) or monopolizing the conversation are all Behaviors that inhibit or reduce trust.

Values Gap – The Values Gap is the differential between a party's present Behavior and their stated goals or values. Most people are more open to changing their Behavior than their goals or values, and this can be an opportunity in negotiation if you can calmly and fairly point out the discrepancy to the other party, without judgment or ridicule, and encourage them to adjust their Behavior to meet their stated goals and values.

The Honesty Scale

In a series of experiments Dan Ariely and his colleagues began to unravel the unsavory world of lying, cheating and stealing. Here is a summary of some of the things he learned:

- When given the opportunity, the majority of people will cheat.

- When given the opportunity, the majority of otherwise honest people will cheat.

- When people do cheat they mostly cheat just a little bit, and not as much as they could.

- Most people will only cheat over things they perceive as small or petty while at the same time expecting a high honesty standard with respect to things considered highly valuable or very important.

- The fear of being caught is not as high a deterrent as most of us expect, and removing the risk of being caught altogether did not cause most people to cheat any more than they would when the risk of being caught was at play (which could tie into the previous two bullets in that risks are managed not by measuring the risk of getting caught by limiting how much is being taken).

- People are more likely to cheat when they are dealing with things they perceive as removed a step or two from actual cash. (One famous experiment involves leaving a six pack of Coke in a dormitory fridge along with a six one dollar bills on a plate. The Cokes would disappear one by one over a couple of days but no-one ever took any of the dollar bills. In another experiment subjects were more likely to cheat when their prize was tokens they handed in for cash than when their prize was the cash itself, even if all they had to do was to cross the room to get the cash.)

- People are much less likely to cheat if they are reminded about a moral or ethical benchmark of some kind before given the opportunity to cheat.

So what does this mean for us in the owner-manager community?

- We have to assume we are all willing to be dishonest just a little all the time.

- In order to combat this we need to put a real dollar value on the items at risk (both individually and at times cumulatively), and make sure those values are well known and not perceived as petty or unimportant.

- We must strategically remind the people we deal with of the importance of honesty and ethics in business, which we know are things most of them profess to value.

- We must openly value and reward honest and ethical behavior and choices.

- We must maintain our own non-hypocritical personal standard for honesty and ethical Behavior, as it is very easy for us to give permission or incentives for those around us to do to us what they see us doing to others.

Some Concluding Thoughts

In addition to all the subtle biases and tendencies scientifically identified by Behavioral economists some of which we are summarized above, we must also not lose sight of the grander and well documented sins that cause us to engage in irrational Behaviors, choices and decision making, including: Greed, Envy, Vindictiveness, Revenge, Control, Domination, etc. These are also part of the inherent human condition, and as a practising lawyer with decades of experience I have seen my fair share of them within the owner manager community.

But if there are important lessons from this developing field of study I can summarize them this way: *We might not be choosing or behaving most rationally even when we think we are, and even when we are supported in those choices and behaviours by those around us, by our gut feelings and instincts, and by what we think is our methodical mind hard at work.*

As in many things in life, an open mind, self-awareness, equanimity and inclusiveness are profoundly important in avoiding the traps set for us by our fundamental human nature.