

Our Mission

To help individuals, teams and organizations reach their potential through strategic planning, innovative coaching, development of team effectiveness and management consulting.

Cook & Company Areas of Concentration

Strategy

Coaching

Assessments

Team Building

Consulting

Training

Workshops &
Retreats

Mergers &
Acquisitions

Ethical
Performance

A PRACTICAL PRIMER ON BEHAVIORAL ECONOMICS: PART I

Ever look back on an important decision and wonder why in the world you made the decision you did? Why you didn't weigh more heavily other information that you had at the time? Why you seemed to ignore some obvious logic and/or information that subsequently clearly seemed more relevant?

Well, Behavioral Economics (or, if you are of a financial persuasion, "Behavioral Finance") is now available to help us justify all of those bad decisions. And hopefully, by understanding what our personal tendencies are, to help us make better decisions in the future.

In fact, in recent literature, Behavioral Economics ("BE") has helped either justify, explain or been blamed for:

- The failure of the Israeli intelligence community to "connect the dots" re: the 1973 Yom Kippur attack by Egypt and Syria (for example, Israel ignored the obvious mobilization of the Egyptian army because it had mobilized 19 times in the previous 10 months alone) – "Connecting the Dots," Malcolm Gladwell, *The New Yorker*, March 10, 2003.
- The miserable failure of most mergers and acquisitions to create value (because of both the "CEO effect" and the lengthy time for such decisions to create meaningful feedback) – "Watch How You Think," Edward Teach, *CFO Magazine*, January 2004.

- Why Bush made war in Iraq (did he unconsciously use a *social filter*, ignoring information that didn't fit his notion of what he thought was actually happening?) – "What Leaders Allow Themselves to Know," Paul Michelman, *Harvard Management Update*, February 2004.

BE has become so popular and so pervasive that I recently counted over 17 "laws" of behavioral economics, appearing in publications as diverse as *The Economist*, *Harvard Business Review*, and *The New Yorker*. These "laws" range from Loss Aversion to Confirmation Bias to Counter-Productive Regret.

What is BE, what are some of its "laws," and what can they teach us?

Simply put, BE is the science of studying cognitive bias, that is, identifying repetitive and consistent errors in the way we process and apply information. The "laws" that behaviorists refer to are simply some of the most common errors we are likely to make in our decision processes. Most of these laws relate to various emotions like greed, fear,

and hubris. What is interesting about BE is that it helps us become more self-aware about our own decision-making process, our ability to make better decisions, and to avoid bad decisions.

Personally, I have found the following to be among the most useful of the BE laws:

"A simple truth: We are more likely to 'know' what we want to know than what we don't want to know,"
Richard Goodwin, *NYT*.

We're on the Web at
www.cookcompany.com

If you would like to receive these commentaries by e-mail, or if you have a colleague you think might be interested in receiving them, just e-mail your request to:

[contact@
 cookcompany.com](mailto:contact@cookcompany.com)



170 Marion St., Suite 200
 Denver, CO 80218
 Voice (303) 733-7893
 Fax (303) 698-0364

contact@cookcompany.com
www.cookcompany.com

The Law of "Creeping Determinism"

In the post mortems on 9/11, much has been made of the lack of coordination between the CIA and the FBI, as represented by an "obvious" trail of phone calls from Al Qaeda operatives (re: a jihad "up in the air") to a spike in phone traffic among Al Qaeda suspects, to the infamous note from the FBI Minneapolis field office identifying Al Qaeda members' interest in flying lessons.

However, as Malcolm Gladwell points out in the above-cited article, our separated intelligence operations are the result of an earlier failure, the Bay of Pigs, after which we decided we needed competing intelligence agencies. Whether our organizational approach is right or wrong now, the real problem may be "creeping determinism," a belief (confirmed by numerous psychological studies) that after the fact things always seem more clear than they were when the decision was made. In a sense, this law is an attempt to balance the statement that "those who forget history are doomed to repeat it," with the proposition that we need to be careful to understand what we are really learning.

As the original creator of the term, Baruch Fischhoff stated, "The occurrence of an event increases its reconstructed probability and makes it less surprising than it would have been had the original probability been remembered" (quoted in Gladwell, above).

The Law of the "CEO Effect" (sometimes also called "Captain-itis")

Most CEOs are hired in part because it is believed that they will make good decisions. The problem is that recent research suggests that CEOs may often make decisions based more on personal style than on clear criteria. According to recent research by two professors of finance at MIT's Sloan School (quoted in "A Behavioral Theory of Corporate Finance," *Strategy+Business*, David Adler, Spring 2004), CEOs were found to use more leverage if they were financially aggressive and less if they were financially conservative. Not much of a surprise until you realize that this was true, *regardless of what the CEO's firm's*

investment policies were!

Further, there is mounting evidence that CEOs make M&A decisions more on personal gut feel and hubris than on analysis. See for example, a Bain analysis showing that "74% of adjacency moves out of a core business fail" (quoted in *Harvard Management Update*, January 2004). Part of the reason CEOs may make such bad decisions is what Professor Hersh Shefrin calls "the Lake Wobegon syndrome," after Garrison Keillor's town where "all of the children are above average" (quoted in *CFO Magazine*, January 2004). CEOs can't believe that they might make even an average decision, much less a below average one! In the same article, Shefrin quotes a remarkable example: the \$5 billion dollar launch by Motorola of the Iridium space-based cell system, which he says was done with "no discounted cash flow, no net present value, no internal rate of return, no payback period – nothing"...except then-Chairman Robert Galvin's statement, "Go for it."

The Law of the "Social Filter"

Richard Goodwin talks in a recent *New York Times* Op-ed piece ("Making the Facts Fit the Case For War," February 8, 2004) about what he calls "a simple truth: We are more likely to 'know' what we want to know than what we don't want to know." He cites a 1967 Pentagon review of the well-known "body count" figures used to support the proposition that the U.S. was winning the war in Vietnam. The review concluded that the government's figures could be off "by 10% or 300% because the data is so soft." No one listened.

He goes on to suggest that, regarding Iraq, President Bush may have acquired the intelligence he wanted – not through some political or Machiavellian machination, but because of human nature. Goodwin's conclusion is that we must recognize that often the supposed rationale support for a decision may be flawed, and self-awareness is therefore the best defense. Warren Bennis sees much the same thing in what he calls "social filters," using a marvelous analogy he heard in the Middle East about people who stop listening as having "tired ears" (quoted in *Harvard Management Update*, February 2004).

In the next issue, we'll look at some of the other laws of behavioral economics that affect decision-making, as well as some of the emotions that appear to be behind them. As a teaser, one of the findings is that *we may actually make better choices when we have fewer options from which to choose!*