Cook & Company Commentary

Summer 2004

BEHAVIORAL ECONOMICS & DECISION-MAKING

In our Spring newsletter we outlined some of the so-called "laws of behavioral economics" and how they can influence our behavior without our awareness.

As promised, in this issue we'll discuss how other laws of behavioral economics can affect our decision-making. Overall, behavioral economists are beginning to see that individuals perform in three key ways that "rational" models of behavior do not explain:

- They don't always consider all of the key factors relevant to a decision (e.g., sometimes erroneously defer to others perceived to have greater expertise)
- They sometimes do not act in their own long-term interest
- They are sometimes willing to sacrifice their interests by helping others.

Knowing these laws (some might call them "tendencies") can help us make better decisions as well as understand better how others make their decisions. We'll discuss four such laws: The Law of Captainitis, The Law of Asymmetrical Risk-Taking, The Law of Plausibility Theory, and The Paradox Choice Law.

The Law of Captainitis

Captainitis is the corollary to the CEO Effect that we talked about in the last newsletter which is focused on the hubris of leaders, while this law is focused on the lack of confidence of followers.

This is easily one of the most debilitating laws, in that it robs us of our freedom to think and act independently. The Law of Captainitis states that it is all too easy to defer to someone else to make a decision whom you may think is smarter, better-informed, or has positional authority. Not so fast.

The law gets it name from the kind of passivity sometimes shared by nurses, enlisted men, or – in the case of aircraft crews – copilots, who may defer blindly to the authority figure, e.g., the captain of an airplane. A classic case occurred in the 1982 crash of an airplane on takeoff from what is now known as Ronald Reagan National Airport in Washington, D.C. As recorded on the flight recorder:

> **Copilot:** Let's check the ice on those tops (wings) again.
> **Captain:** No. I think we get to go in a minute.
> **Copilot:** (referring to an instrument) That doesn't seem right. Uh, that's not right.
> **Captain:** Yes, it is.
> **Copilot:** Ah, maybe it is.
> **Copilot:** Larry, we're going down!
> **Captain:** I know it.
> ...Sound of the impact that killed the captain, copilot, and 76 others.
>
> -- Quoted in *Harvard Management Communication Letter*, Spring, 2004

A similar phenomenon was found in a case where 95% of nurses blindly went to administer a drug to a patient when told to do so by an anonymous doctor. In this case, the anonymous doctor would call the nurse over the phone, and prescribe twice the maximum daily dose of a drug, which had not even been cleared for use in the hospital in question (*Ibid*). Thank goodness the nurses were stopped before the drugs were actually administered! The lesson? Remember the adage from Highly Reliable Organizations, "Defer to Front Line Expertise," and use it when either a co-captain or a nurse!

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The Law of Asymmetrical Risk-Taking

Studies show that most individuals are much more adverse to losing money than taking the same level of risk to make an equivalent amount of money. Beyond that, individuals will often take much more risk to avoid a further loss than to make an equivalent amount of money.

The result is that people hang on to loss positions when they shouldn't. This doesn't only happen in the stock market. Studies also show that executives are prone to make the same mistake when dealing with the sunk costs of projects already underway. They may say that they will only concentrate on the risk of making an initial investment, but their actions often say otherwise.

The lesson? We need to train ourselves to realize that money already invested and apparently lost must be treated as though it *has been lost*, and therefore any additional potential investment or loss must be considered as a totally new investment or potential for loss (I try to remind myself to think this way when looking at my own portfolio!).

The Law of Plausibility Theory

Economists know that we tend to make decisions without regard to their true *expected value*. Thus, confronted with a decision to either: a) toss one coin and either win $100,000 if it comes up heads, or lose $50,000 if it comes up tails, or b) accept a second situation in which you could make the same bet based on 100 flips of the same coin, most people would opt for the second bet. Alas, since each coin flip is independent of the others, according to probability analysis of all the outcomes, the odds themselves are exactly the same.

However, there is a different way of looking at the same bet -- *Plausibility Theory* -- which focuses on the risk threshold we are prepared to accept (in this case, of losing money). Thus, if we said we wanted to have less than a 1% risk of losing money, we would still choose the second option (and our intuition about risk, as opposed to probable outcomes, would have been right) because the risk of losing money would be less than 1% by flipping the coin 100 times. (For a more in-depth analysis of this problem, see Laseter and Hild, "The Power of Plausibility Theory," in *Strategy+Business*, Summer, 2004).

The lesson? Sometimes we are right, if even for the wrong reasons!

In summary, the lesson is not necessarily that we should each strive to act in a perfectly "rational" way (after all, there are other benefits to helping others, to collaborating, and yes, even sometimes to choosing short-term pleasure at the expense of longer-term greater gain). Rather, the notion is that the more *self-aware* we are of how we make decisions, the better decisions we will make, and hopefully, the more gratification, monetary and/or qualitative, we will gain from them.

The Paradox of Choice Law

Normally we think that we have too few choices. Research shows, however, that having too many choices may even be more of a problem! As Cornell Professor Thomas Gilovich says, "You can know so much that your knowledge becomes useless." (*Real Simple*, March 2004).

Example: In one study of shoppers, those who were offered free samples of six different jams were more likely to end up buying one than shoppers who were offered free samples of 24 jams. Why? According to one theory, we may calculate our opportunity cost (in this case, of not picking some of the jams) as the sum of the opportunity costs of each one not picked. If we instead calculated the opportunity cost of not buying the single most attractive jam not picked (the most "rational" approach, according to behavioral economists), we wouldn't have this problem.

A very good example of how consumer goods take advantage of this law is the success of Costco, the discount retailer, which has found its success by offering only a few lines of appliances instead of many. Applying this law to our own decision-making, we probably should spend only some period of time agonizing over making sure we have enough options for any one decision, in favor of doing the best job we can of calculating the opportunity cost of not taking the one option that seems to be best next to the one we are taking. (For a wonderful introduction to the world of "the paradox of choice," see "Select All," by Christopher Caldwell, *New Yorker*, March 1, 2004).

Next Issue? "It's all about their lack of values . . .or is it?" How often do we take a course of action based on the "bad" behavior of someone else, and the related assumption that that behavior is the result of the person in question being "evil," "bad," or at the very least, not a very desirable person? Is this a good idea?

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