

# Keeping Your Head When Those About You Are Losing Theirs

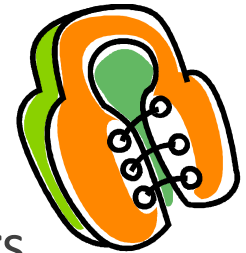
AVOIDING COMMON PITFALLS DURING AN INDUSTRY DOWNTURN

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# One fact you knew, another you might not

When it comes to potential gains, people are generally risk-averse



When it comes to potential losses, people become gamblers



# For example...

Offered a choice between:

A: A sure-fire gain of \$240

B: A 25% chance of receiving \$1000

**The vast majority choose A.**



Offered a choice between:

C: A sure-fire loss of \$740

D: A 75% chance of losing \$1000

**The majority choose D.**

Reference: Tversky and Kahneman

# Comparison of the two portfolios

A+D: 25% probability of +\$240  
75% probability of (\$760)  
EV = (\$510)

B+C: 25% probability of +\$260  
75% probability of (\$740)  
EV = (\$490)



***When we create portfolios based on our personal preferences for individual projects, we generate sub-optimal value!***

# The Framing phenomenon

If a project, decision, choice, situation, etc. is framed in terms of potential gains, most people are risk-averse

If the exact same project, decision, etc. is framed in terms of potential losses, most people become risk-seeking

***This has enormous implications during a downturn, when most projects become potential losers***

When you do apply your risk tolerance, apply it at the portfolio level, not the project level!

# Imagine a Game

## Roll a single die

Roll a six, win \$10,000

Roll one through five, win \$0

Cost to play: \$1000

You only get to play once

16.7% probability of winning

**Most people will not want to play**



# The Game

What is the mean, or the EV?

$$\begin{aligned} & \$9000 \times 16.7\% \\ & + (-\$1000) \times 83.3\% \\ & = \$667 \end{aligned}$$



**For most people, the risk is too high**



## Collaboration in the game

Suppose you and nine friends are offered the opportunity to play the game. What should you do?

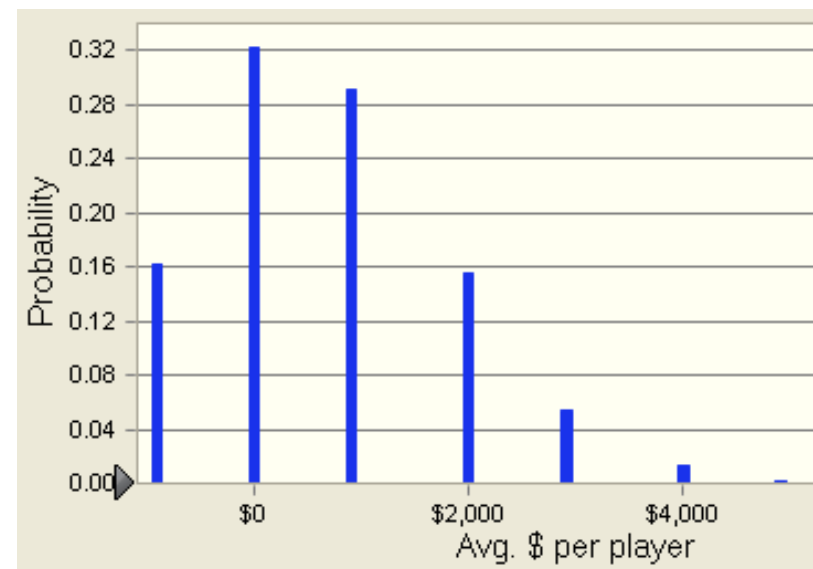
All should play and share in the proceeds

EV = \$667/player (same as before)

**51%** probability of winning money

**32%** probability of breaking even

**16%** probability of losing money



**=> Despite the riskiness of individual games, the risk at the portfolio level is acceptable**

## Applying risk tolerance

“Am I comfortable with the risk associated with this investment?”

**Inappropriate question**

Appropriate question:

**“Am I comfortable with the risk associated with my *portfolio* of investments when this investment is included?”**

Additional revelations from Kahneman,  
Tversky, Thaler, and Ariely

The Endowment Phenomenon

The Immediacy Phenomenon

Anchoring

The pain of a loss is greater than the pleasure of a gain of  
equal size

“Payments” or “Costs” are preferred to  
“Losses”

Game 1:

10% chance of +\$95

90% chance of -\$5

Game 2:

10% chance of +\$100

90% chance of \$0

Costs \$5 to play

***Game 2 was strongly preferred***

Reference: Tversky and Kahneman

## 4 reasons it is so hard to kill a bad project:

1. Sunk costs
2. When faced with potential losses, people become gamblers
3. As long as the project is still alive, the funds spent are costs; as soon as we kill it, they are losses
4. Managing a killed project can be a CLM

What is the rule?

2 4 6 8 10



Reference: P.C. Wason

# Seeking validation

People tend to actively seek out and believe information that reaffirms their currently held positions

People tend to ignore – and sometimes actually fail to see – information that contradicts their currently held positions

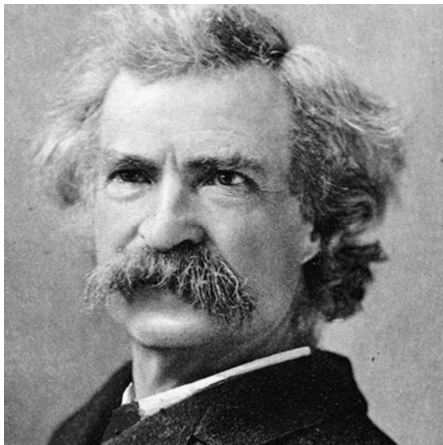
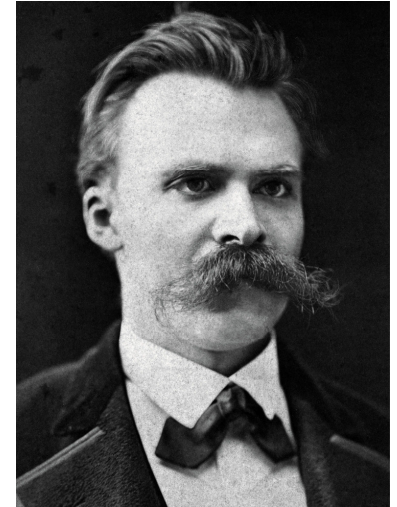
People fail to consider and plan for scenarios in which their predictions turn out to be wrong

Reference: Bazerman and Chugh

Or to put it more eloquently:

**"Convictions are more dangerous enemies of the truth than lies."**

- Friedrich Nietzsche



**"What gets us into trouble is not what we don't know, it's what we know for sure that just ain't so."**

- Mark Twain



# Groupthink: the antithesis of diverse thought

“... ‘groupthink’ [is] the mode of thinking that persons engage in when *concurrency-seeking* becomes so dominant in a cohesive ingroup that it tends to override realistic appraisal of alternative courses of action.”

- Irving L. Janis



Teams in groupthink often:

Are comprised of highly intelligent, skilled individuals

Feel a strong sense of purpose

Display high levels of camaraderie

Have mutual respect between members

Have tremendous pride in their work and mission

# Symptoms of groupthink

An illusion of ***invulnerability***

Warnings and negative feedback are ***rationalized*** away

Unquestioning belief in the inherent ***morality*** of the ingroup

- Leads to ignoring the ethical consequences of their decisions

Enemies are viewed as ***stereotypes***

***Pressure*** is applied to individuals who express doubt

***Self-censorship***

An illusion of ***unanimity***

- Silence is interpreted as agreement

Members of the ingroup act as ***mindguards*** to protect each other – and especially the leader – from information that might break their complacency

Reference: I. Janis

# Results of groupthink

Few alternative courses of action are discussed

The agreed course of action is never reexamined

Little to no time is spent discussing potential gains or costs that might have been overlooked

Experts are not sought out, and may be ignored

Facts that support the course of action are seized upon; facts that do not are ignored or suppressed

Events or accidents that might derail the chosen course of action are not discussed

- Contingency plans are not developed

Reference: I. Janis

# Fighting groupthink

The leader must encourage the open airing of objections and doubts

Appoint a devil's advocate team at each meeting

The leader (especially) must accept criticism of his or her judgments

- Opinions should be withheld initially

Imagine train wrecks

- Take a survey of warning signs
- “What could cause this plan to fail?”
- Pre-mortems

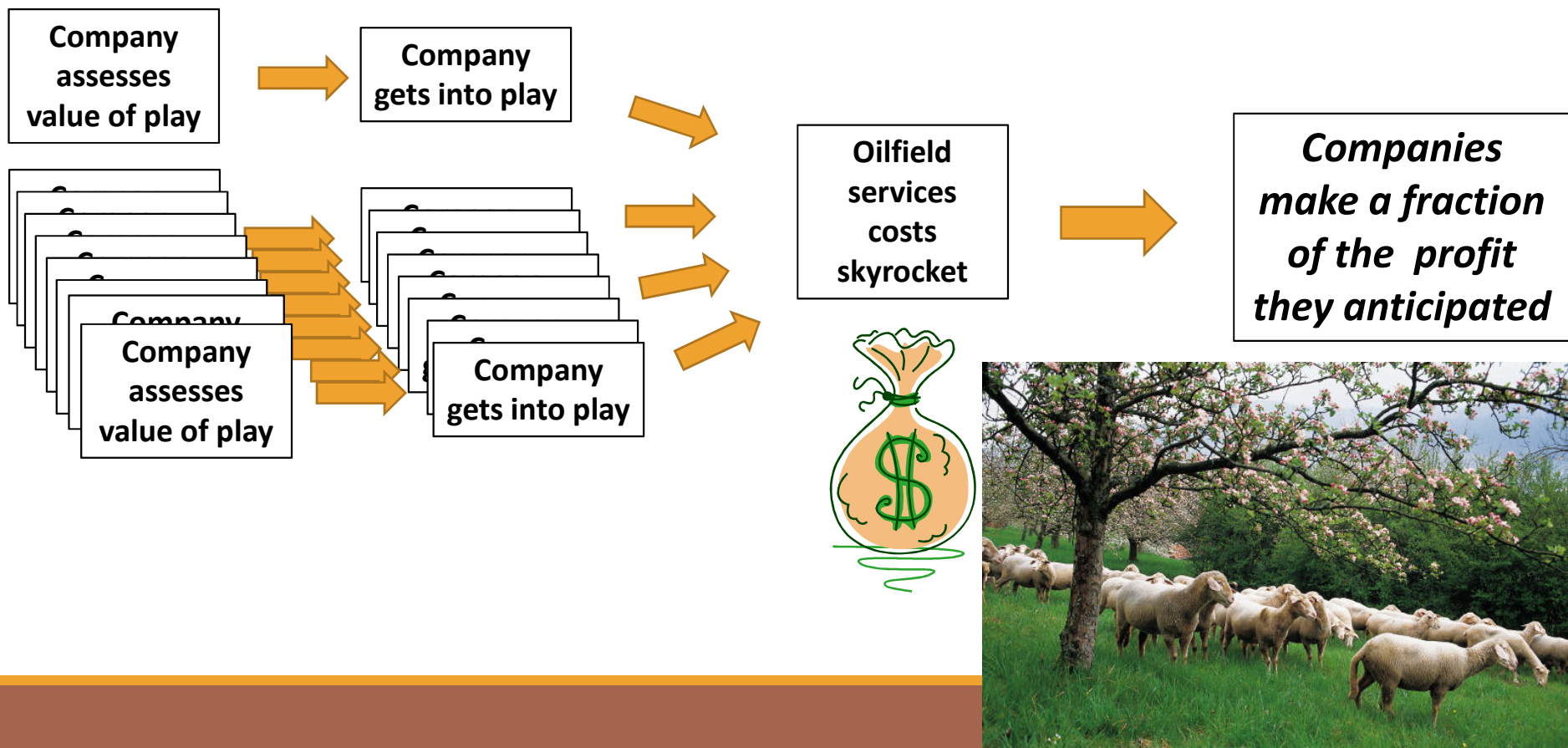
Generate alternative courses of action

Reference: I. Janis

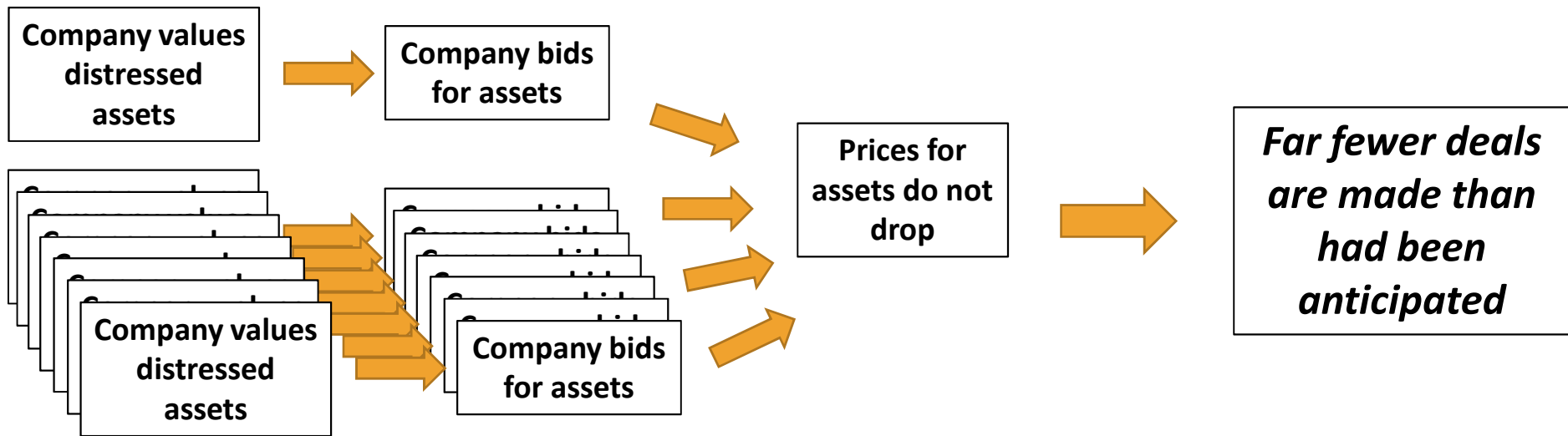
# Understanding your competitors' perspectives



# What happened to many companies during the boom in shale plays?



# What do we see happening now?





# Avoiding decision traps



# “Divide and Conquer”

**Handle the complexity of a difficult decision by separating the issues into the appropriate categories:**



***Each must be dealt with differently***

The first question most people ask when in a difficult situation...

**“What should we do?”**

**...is in fact the *last* question you should ask.**

# The questions you should ask:

**What do we want? What are our objectives?  
How do they relate to one another? Where  
are the tradeoffs?**

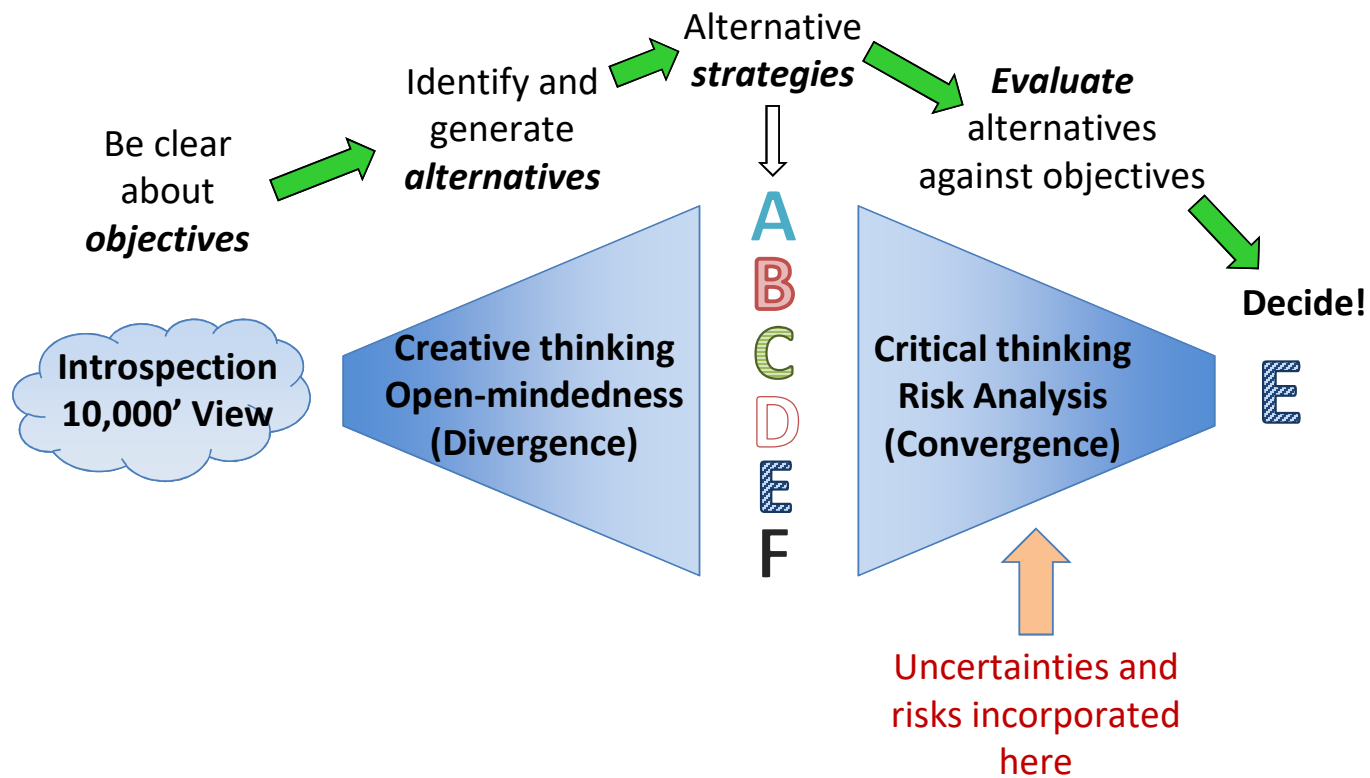
**What do we know? What don't  
we know?**

**What *could* we do?**

**For each alternative, what is the  
range of possible outcomes?**

**What *should* we do?**

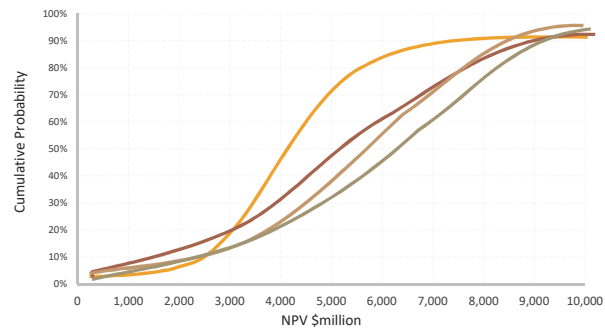
# A better approach



# Dealing with uncertainty

**Stop trying to predict what will happen**

**Start trying to imagine what *might* happen**



# Summary

Avoid the tendency to become a gambler when facing potential losses

How you frame a project will strongly affect how you view it

Apply your risk tolerance at the portfolio level

Avoid the common pitfalls (the endowment phenomenon, anchoring, etc.)

Use devil's advocate teams, pre-mortems, etc. to combat Groupthink

Use Game Theory to put yourself into the mind(s) of your competitor(s)

Employ a structured approach to making decisions

“To be absolutely certain about something, one must know everything or nothing about it.”

- *Olin Miller*



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# Questions?

