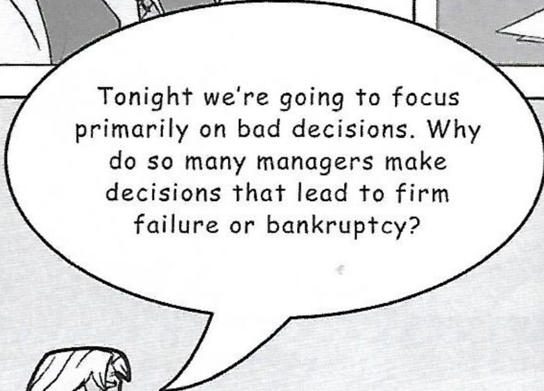
The following week in class...

Last class we discussed how strategic management is guided by top decision makers whose goal is to provide a unique strategy to lead their organization toward superior long-term performance.

He says "we" a lot, but I don't recall doing much talking.

Tonight we're going to focus primarily on bad decisions. Why do so many managers make decisions that lead to firm failure or bankruptcy?

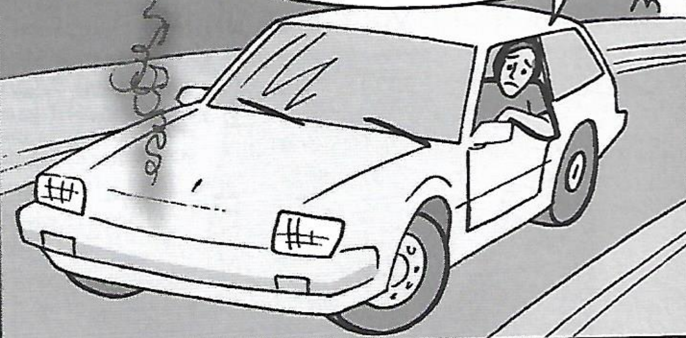


Rational Decision Making Model

1. Define the problem
2. Identify the criteria
3. Weigh the criteria
4. Generate alternatives
5. Rate each alternative on each crite
6. Compute the optimal decision

To provide a basis for contrast, let's start with an ideal decision. In economics, there is an assumption that managers will make rational decisions. At least attempting to follow rational decision-making processes can be especially useful for important decisions, like buying a car or house or making a major career move. While there are a number of variations of the basic rational decision making model, Professor Max Bazerman presents the model I have here on the board.

There are a number of problems with this model when applied to real world decision-making processes. The first is that most strategic decisions are not presented in obvious ways. In many classes you may have had, you've taken tests or analyzed case studies with clearly defined problems. Real businesses may not even be aware of their problems. This is why measuring performance using the balanced scorecard is so important, because it gives you multiple chances to discover poor performance and identify problems.



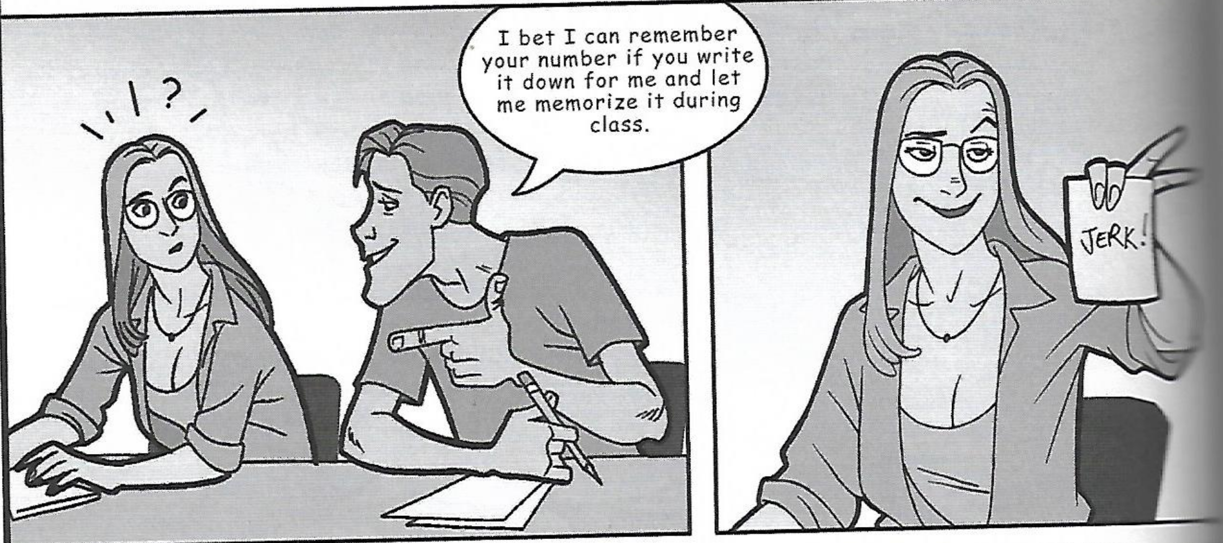
Rational decision making assumes that individuals have no time or cost constraints.

Rational decision making assumes accurate information is available. Car buying is a good example for this because it is very difficult to find out what dealers actually pay for cars. It is seldom the "invoice" price.

Rational decision making also assumes the problem is clear with clear options, preferences, and a single best solution.

For example, some have joked that marriage is one of the most important but least rational decisions in life because no one can seek out every alternative based on perfect information - even with all the online dating and friend-finding Web sites in the world.

In reality, our decisions are not always rational because there are limits on our information processing. To illustrate, how many of you can remember your last phone number before your current one?



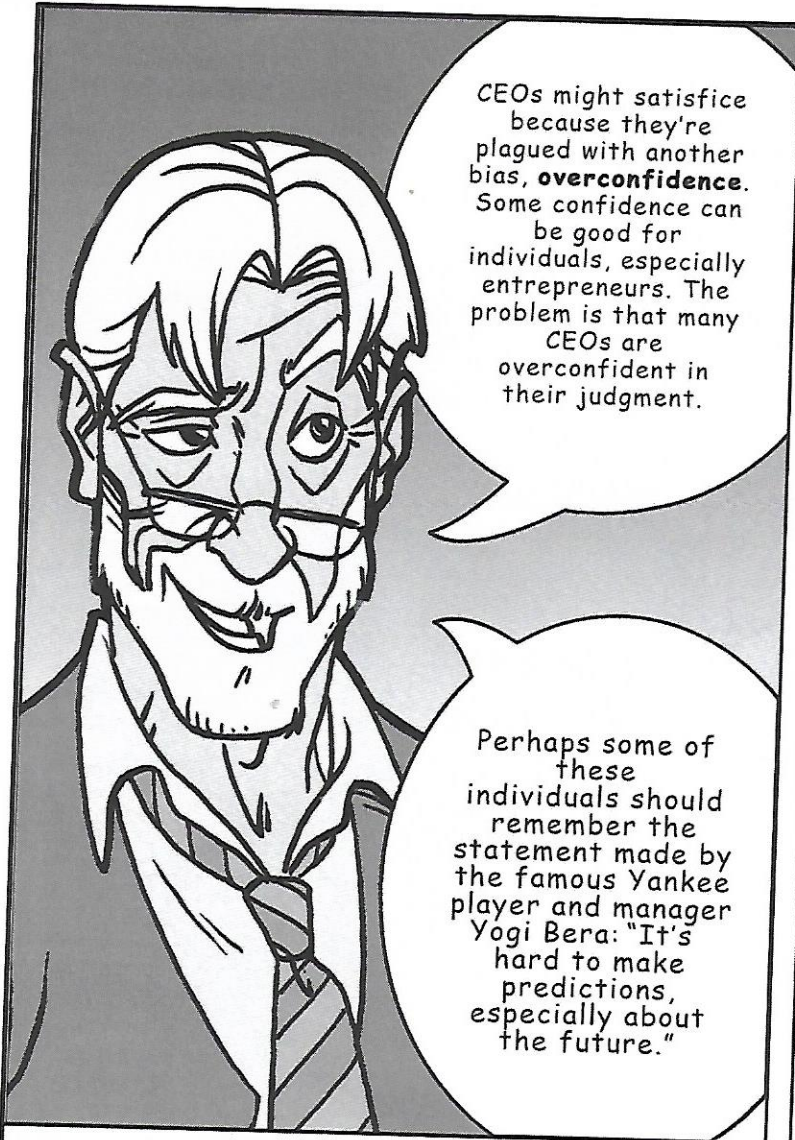
Only 1/3 of students do remember their previous number. If you cannot remember such simple facts, how can you make perfectly rational decisions?

We've greatly increased our ability to ***access*** information throug the internet and 24 hour news channels, but our ability to ***process*** information remains the same.

Our minds simplify problems because our information-processing abilities are limited. Our minds use shortcuts, and just like when hiking, sometimes the shortcuts work out, but sometimes they lead us to a bear's den.

...were to spend endless hours ...g which candy bars satisfy the most ...hich have a candy shell versus which ...cookie crunch, your friends might ...u've gone off the deep end. This is ...ple where satisficing makes a lot of ...

Unfortunately, research shows that CEOs often satisfice with major decisions like mergers and takeovers. CEOs often avoid hard data and go with their gut instinct. Such decisions can lead to the ruin of many organizations.



In general, most folks exhibit some elements of overconfidence. For example, more than two thirds of:

People say they are in the top third of safe drivers.

Harvard Business School students say they are better-looking than their classmates.

Lawyers in civil cases believe that their side will win.

New business owners think their business has at least a 70% chance of success.

THE DAILY

August 20, 2009

Accident suspends traffic for hours

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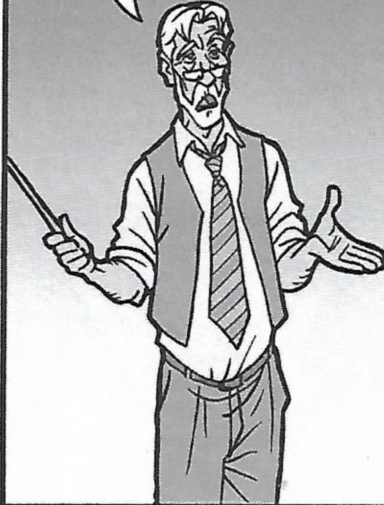
The **availability** bias occurs when you think information that is readily ***available*** to you is more ***likely*** to occur. For example, most people think traffic accidents cause more deaths than stomach cancer. Stomach cancer actually causes more (by a ratio of more than two to one), but auto accidents - even those that don't end in fatalities - are reported in the media at a ratio of more than 100 to one.

This phenomena biases individuals to overrate the likelihood of certain events.

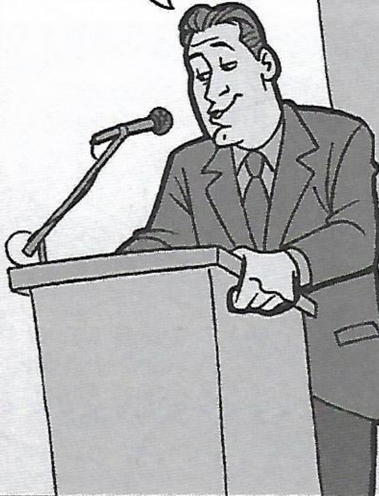


Three things are necessary to determine cause – or why one element affects another (for example, how marketing spending affects firm performance).

1. Correlation (Do sales increase when marketing increases?)

2. Temporal order (Does marketing spending occur ***before*** sales increase?)

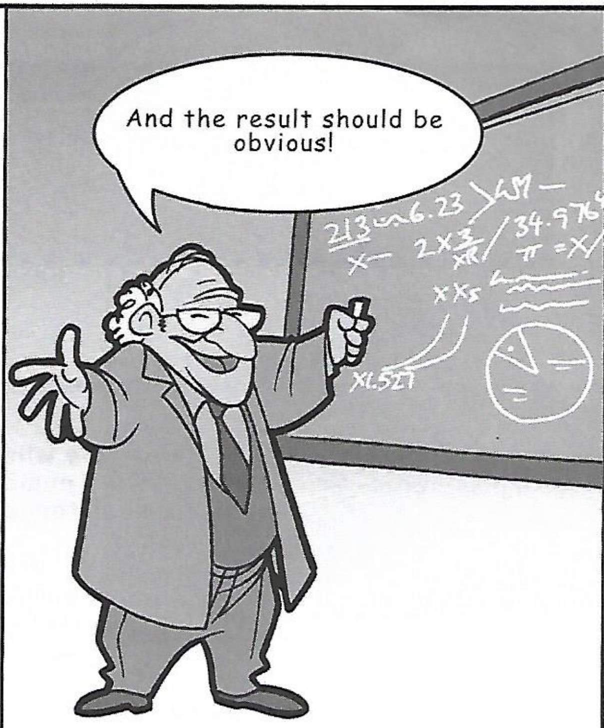
3. Ruling out other potential causes (Is something else causing sales to increase: better products, more employees, a recession, a competitor's bankruptcy, etc.?)



Of course, just because determining causality is difficult and often inconclusive does not mean that firms should be slow to take strategic actions.

This scenario frequently occurs in companies because employees are often reluctant to bring bad news to CEOs. To avoid an unpleasant message, they might be tempted to frame information in a more positive light than reality.

Hindsight is a bias that occurs when knowledge of an occurrence makes you think the outcome was obvious before it happened.



A related idea is the **curse of knowledge**, where individuals fail to take into account unique or learned knowledge that others may not have.

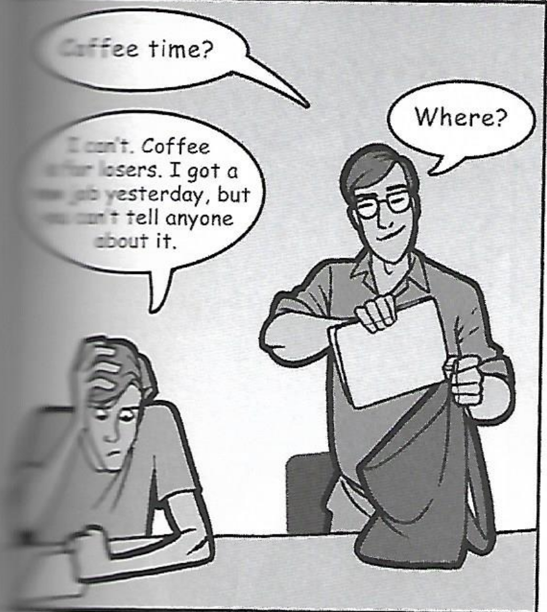
The well-known expression about problems concerning "throwing good money after bad" can be used to illustrate the bias associated with **escalation of commitment** to a losing course of action. Oftentimes, when a strategy is going poorly, managers commit even more resources hoping that just a little more money can salvage a project, but this is rarely the case.

Misunderstandings about sampling can also create problems for strategic decision making. Decisions should be based on large, randomly drawn samples, but top managers will often rely on limited information from people who are unlikely to disagree with them.

Summary of Decision Biases

Decision Bias	Definition
Anchoring and Adjustment	Bias occurs when individuals react to an arbitrary or irrelevant number when setting financial or other numerical targets.
Availability	Bias occurs where more readily available information is incorrectly assessed to also be more likely.
Escalation of Commitment	Bias occurs when individuals continue on a failing course of action after information reveals this may be a poor path to follow.
Fundamental Attribution Error	Bias occurs when good outcomes are attributed to personal characteristics (for example, intelligence), but undesirable outcomes are attributed to external circumstances (for example, the weather).
Hindsight	Bias occurs where mistakes seem obvious after they have already occurred.
Judgments about Correlation and Causality	Bias occurs when individuals make inaccurate attributions about the causes of events.
Misunderstandings about Sampling	Bias occurs when individuals rely on small samples instead of more reliable sources of information (such as large randomly drawn samples).
Overconfidence	Bias occurs when individuals are more confident in their abilities to predict an event than logic suggests is actually possible.
Representativeness (Framing Bias)	Bias occurs when the way information is presented alters the decision an individual will make.
Satisficing	Bias occurs when individuals settle on the first acceptable decision instead of the best possible (optimal) decision.

Anchoring and adjustment refers to a bias where individuals adjust numerical figures from bad information. For example, as college graduates you might be tempted to compare how good (or bad) the starting salary of your first career job is to the jobs you've worked at during school. You might also be tempted to compare your salary to parents, siblings, or friends that have different majors. Instead, you should seek to research the average starting salary for your major with your educational background, experience, and other characteristics that are more relevant to the position.



Friday night at a local house party...

Hey, Tess, I saw your buddy Atlas the other day

Yeah?

No way!

Really! Well, he needed to get a job but this is hysterical. Let's give him a call.

Hello, I'd like to order
a small vegetarian
an order of
breadsticks. Oh,
would it be possib
to request a deliver
driver. A friend o
mine just got a jo
and I really want
be supportive.
Uh huh. OK. Thanks

30 Minutes later (or less)...

RING!!!!

Hi... I... What the...?!

Say it!

Aw, come on!

Say it or I'll call your manager.

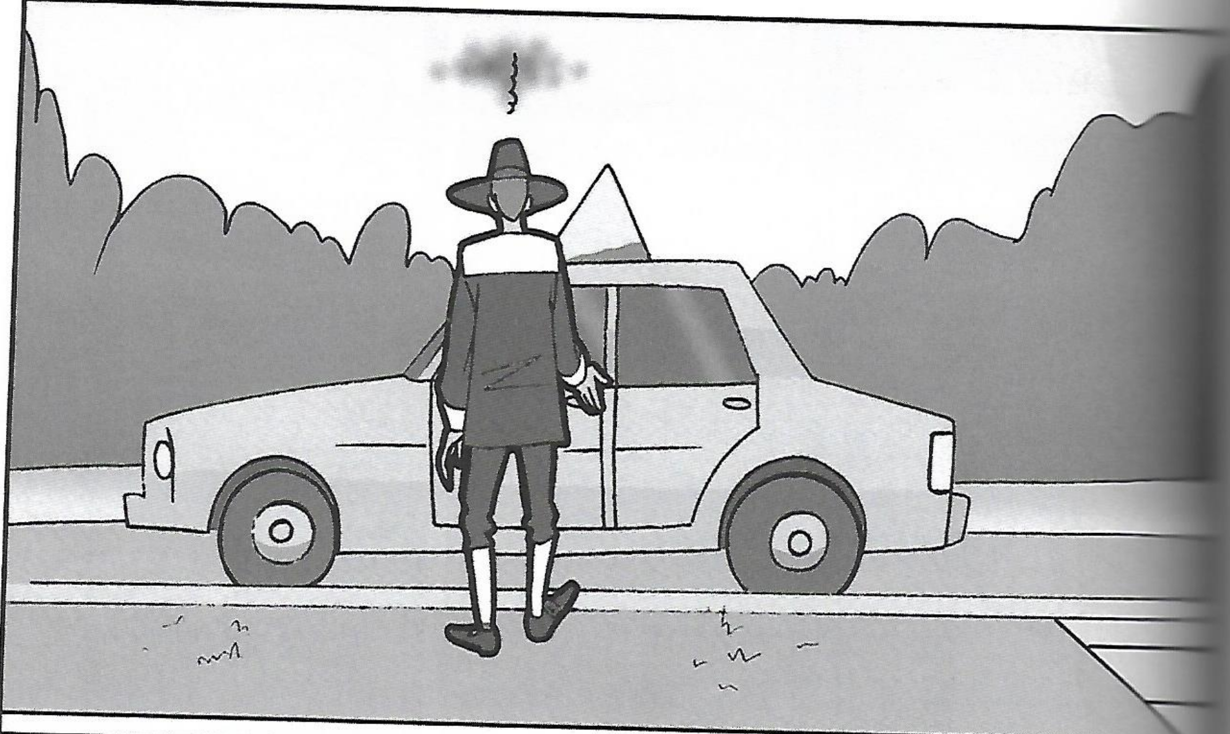
"Enjoy your Pilgrim's Pizza, where every bite takes you to a brave new world."

Cool costume dude!

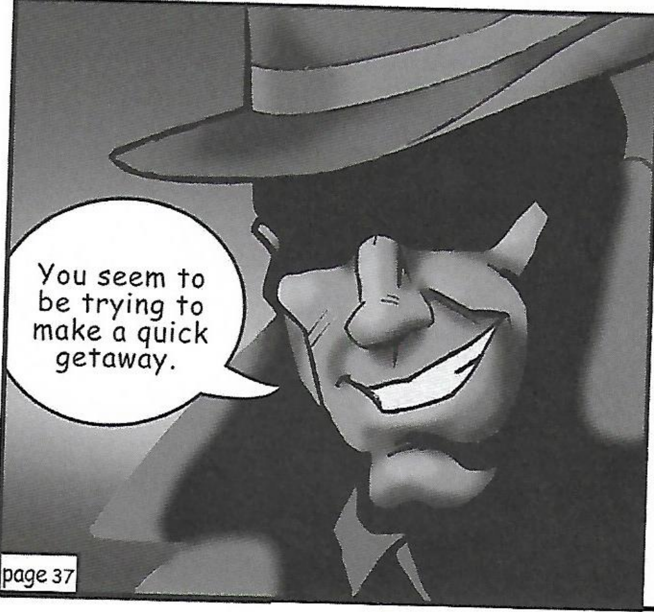
You look cute, Atlas.

I think you just made my week.

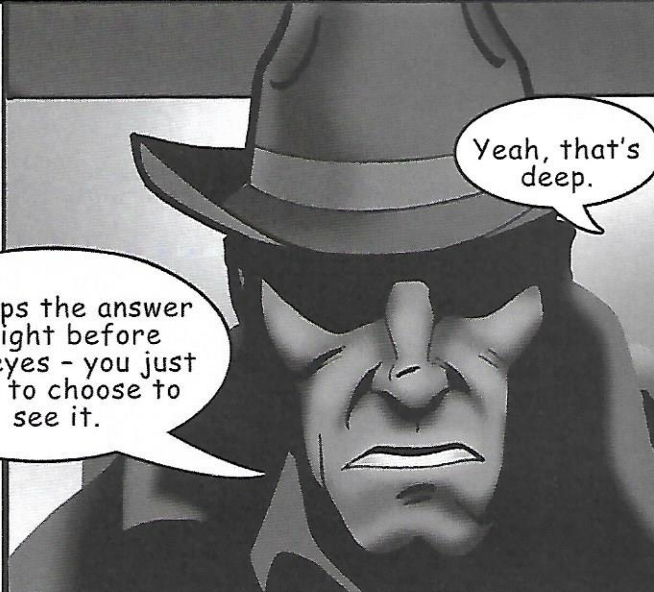
I gotta find a better job.



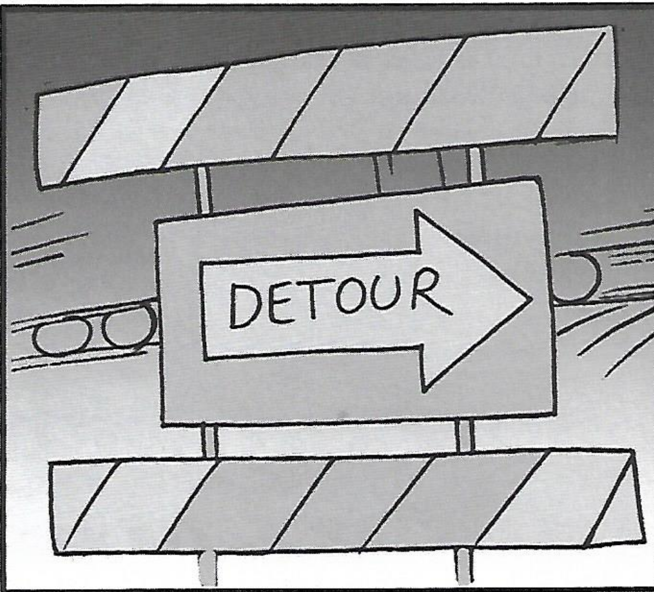
PILGRAM
PIZZA

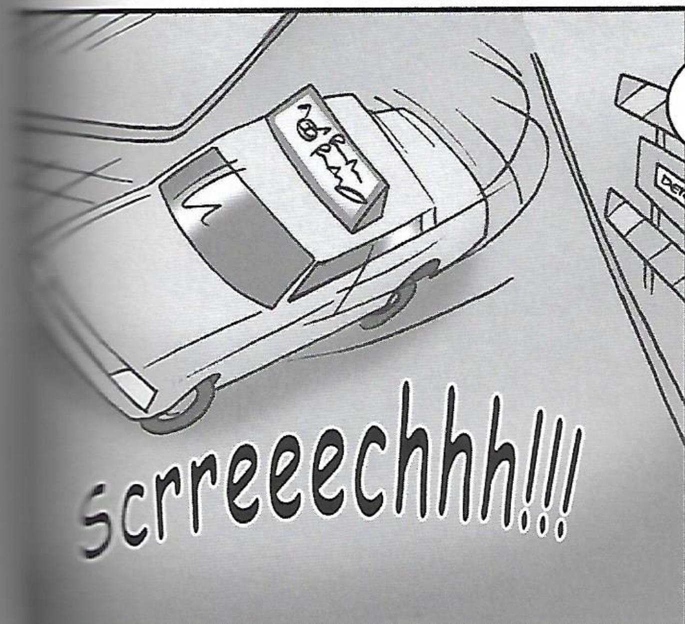

You seem to be trying to make a quick getaway.

I'd like to get away from this job.
Perhaps the answer is right before your eyes - you just need to choose to see it.


Yeah, that's deep.

PIZZA
But first, you should see the detour in front of you.


DETOUR


Scrreeeechhh!!!

That was a close one!
Well, not that close I guess.

THE STORY SO FAR...

Atlas Black has been seeing ghosts, or has he? After a much longer than planned college career, stress about paying bills, and no job in sight, who wouldn't be hearing voices?
But Atlas is cooking up a plan that will turn around his thus far uninspired career path. To start, Atlas is beginning to learn how to make good decisions (and avoid bad ones).

Making strategic decisions starts with a long-term perspective on seeking superior organizational performance. To help chart a clear course, organizations should have a unique ***mission statement*** to understand their organization's purpose while having a ***vision*** for the future.

Individuals must understand that performance can be defined in a number of different ways. Each performance measure may lead to a unique understanding of the firm's current business status. The ***balanced scorecard*** is a tool to assess both short-and long-term performance. It looks at traditional ***information*** to examine short-term measures like profits, but it also examines more long-term ***customer***, ***internal business process***, and ***learning and growth*** measures that can be used to track long-term success.

The concept of the ***triple bottom line*** embraces performance measures that include society at large and the three p's of people, planet, and profits.

In addition to difficulties in assessing performance due to the large number of varied performance measures, individuals are also continually challenged by ***decision biases*** that may encourage or otherwise lead individuals to make poor choices. Although individuals may seek to engage in ***rational decision making***, far too often they fall short of this goal.

IN OUR NEXT EPISODE...

Atlas is beginning to realize that he needs a more concrete plan if he is going to start a business. In our next episode, Atlas will learn how to understand the types of industries that are attractive for entrepreneurs like himself and David. He will begin his plan by taking inventory of his strengths and weakness. Most likely, Atlas will find that his greatest strengths and weaknesses are a function of his own personality.