*TECHNOLOGY ACQUISITION UPDATE*

# Human Biases and Foibles in Decision Making

*Behavioral economics gives us some interesting insights to that mushy gray thing we call a brain. Our circuitry is great for some tasks and not so great for others. This article discusses some classic ways humans err in their decision making.*

Rewiring your brain is probably not an option, however a little self-knowledge can make people more aware of the psychological traps that influence their decision making.

We make decisions in real time. Every day we must make decisions where we do not have all the information. Sometimes significant acquisitions are made without the CEOs knowing as much as they should. It's a competitive, fast-moving world. When you are plunging into the unknown you have to be willing to let a few things go. Some people thrive in this environment; others do not.

The smart decision maker should be aware of the biases and foibles that we as human beings are susceptible to in our decision-making process.

## Framing

The way you set up or "frame" a decision question can affect the choice you make. The way a question is phrased may influence you to choose a different alternative. Busy decision makers generally do not spend enough time framing the issues.

Frame blindness is sneaky; many professionals are not aware that the problem is at work. To forestall it, try changing your mental structure or frame of reference. Look at the problem from different angles. Are you really working on the right problem? Pose the question in a new, imaginative way. Reverse the context -- what if you were the seller instead of the buyer? How would you see the situation then?

Should we sell the company or raise capital? A better question is—How can we optimize what we have built so far? Asking a higher level question might provoke different alternatives. Another good question: What is the total cost of ownership? This is often a better question than 'what is the price?' Whether buying a company or a new software application, management and training costs add significantly to the total cost of ownership.

Knowing other peoples' frames can help you communicate with them. The best negotiators and salesmen discern the other party's frame and then sell the decision within the context of that frame.

People make inconsistent choices when focusing on positive qualities or negative qualities. Imagine that you have made reservations at two hotels. After gathering information about each one, when asked to confirm a reservation -- you choose the first hotel. When asked to cancel a reservation you cancel the first and choose to stay at the second hotel. Why? The first hotel has more positives but also more negatives. When viewing the positive attributes you choose hotel one; when viewing negative attributes you reject hotel one.

### Implied Assumptions

Assumptions are powerful and subtle. Sometimes we are not even aware of the assumptions we make as we approach a problem. Assumptions come in many flavors: there are assumptions about the problem, assumptions about the data, assumptions about the availability of more information, and assumptions about the alternatives. Beware of your implied assumptions.

Sometimes we assume actions are mutually exclusive when, in fact, they are not. Sometimes companies assume that they cannot raise capital to grow at the same time they are seeking a larger partner or acquirer. Pursuing parallel paths makes sense in many cases and can speed up the time frame to take the company to the next level of growth. These decisions are serial. The decision to identify a set of acquirers is not a decision to sell the company. See what price you can command, then make the decision to either sell, partner or continue building the company.

### Bogus Analogies

We are prisoners of our analogies. Humans naturally draw analogies and see identical situations where they don't often exist. With only a little information people can evoke a picture that they are familiar with, that may only remotely represent the current situation.

For example, managers often analogize that selling a technology company is similar to selling a house or car, something they are familiar with. It is not. The value ranges are considerably different. For a house, value usually falls within a fairly narrow range and there are market comparables. This is not the case with selling a company, especially a technology company. The range of values can be quite large depending on the strategic importance of the technology to the buyer. The analogy inhibits the manager's understanding of the process. Bogus analogies can conceal important aspects of a situation.

### Anchoring

We tend to give a disproportionate weight to the first information we gather on a topic. Initial impressions or estimates “anchor” our thoughts and prejudice our thinking. Initial impressions are hard to shake. Rather than calculate from scratch, we take some starting point and make adjustments.

An art dealer's opening gambit is designed to anchor the buyer. The anchoring phenomenon is especially pernicious when buying or negotiating intangible goods, such as art or technology.

Wall Street has many examples of anchoring–you anchor the value of a stock around its recent trading price, even if a rational analysis would tell you that the price is out of line.

### Other Fun Biases

We humans are susceptible to some other interesting foibles including: fear of regret, asymmetric loss aversion, overestimation, the sunk cost fallacy, overconfidence and confirmation bias.

The desire to avoid feeling stupid is a strong one among human beings. Research shows that people generally feel worse when making a dumb move than when they fail to make smart moves. For example, if you sell one stock to buy another, you will feel more regret if the first one doubles in price, than you would if you didn't buy the second one and your first one lost half its value.

People often behave inconsistently when making financial decisions. People seek to avoid losses more than they seek to protect gains. The pain from losing money feels twice as bad as the joy of making money. The pain from losing $500 is greater than the amount of pleasure received from gaining $500. We all know the sunk cost fallacy—throwing good money after bad—but it is difficult for human beings to come to grips with this one. It is not easy to sell off a division at a loss, even if it is sapping management's energy that is needed elsewhere. We don't want to appear wasteful but it is important to see the bigger picture.

Confidence is a good thing, but it is often exaggerated and gets us into trouble with our decisions. Our minds seek out patterns naturally, but sometimes we see patterns where none really exist. People often pick mutual funds based on a few years of performance. If you stumbled across a mutual fund that had gained 25% each year for six years in a row, wouldn't you be just a little bit tempted to invest? Is this a pattern? Research has shown for decades that past performance is not an indicator of future performance of mutual funds. We overestimate our abilities to see patterns or make judgments, putting meaning onto things where it is not warranted. Overconfidence in our judgment can also dampen our interest to seek additional necessary information.

Confirmation bias is our natural inclination to confirm what we already think we know and look for facts that support it. We avoid asking questions and discount new information that might challenge our preconceptions.

Most of the time, your decisions will only be as good as the alternatives available to you. Creating additional options and out-of-the-box alternatives is more work but generally it is time well spent. The process can force some very creative thinking.

## Suggestions

Here are a few pointers to help you overcome your human biases. The first step is to recognize that you are prone to these foibles.

- What are the right questions to ask?
- Have flexible plans. Be willing to change direction and admit mistakes.
- Know what your alternatives are.
- Make a decision. (That's why they pay you the big bucks.) Don't be like the mule that died of hunger because it was equidistant from two hay bales and couldn't decide which one to eat.
- Go as far as you can see and when you get there you can see farther.
- Get a second opinion. Access your board of advisors. Their mental patterns are different from yours.
- Remember that the type of thinking required to solve a problem must be different from the type of thinking that created the problem. As Einstein said, problems cannot be solved at the same level of awareness that created them.





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