DO BUSINESS FASTER™

Jim's Profit Accelerator 16:
Wise Judgment: How Reference Points, Optimism, and Distortion Undermine Success

Most strategic and tactical moves are little more than guesses, and often we guess wrong. Quite simply, our estimates are usually off. This is the major reason why business plans and initiatives fall short. Of course, implementation is always a challenge, but more frequently we choose the wrong fork in the road, or fail to take enough water to finish the trip.

This matters because leaders at every level make handfuls of judgments daily. What if there were a way to make more of those judgments *right*? There is. The examples below reveal the minefields that pepper the landscape of leadership. Knowing that they exist and the impact that may have on our business decisions is the key to improving your chances of survival—and success.

Minefield 1: The Reference Point Error
This error pulls our range of acceptable options toward our starting point—something that we know. Referencing is a common intuitive brain function, done instinctively without analysis. It's used for estimating, and it starts with a known situation and adjusts toward the unknown.[1]

For example, if two groups are asked to estimate the population of Vancouver, Washington, they will refer to what they know. Folks from Seattle, knowing Seattle's population to be about 600,000, might estimate Vancouver's at 75,000, knowing that it's much smaller than Seattle. Spokane residents, however, might estimate Vancouver at 125,000, thinking that it's somewhat smaller than Spokane (population 200,000). Vancouver's actual population is 165,000.

Estimate the Population of Vancouver

	Estimate	**Actual**	**Error**
Seattle residents	75,000	165,000	80,000
Spokane residents	125,000	165,000	40,000

As you can see, the "Seattle error" is twice as big as the "Spokane Error," but the estimators are blind to it because they have made the reference point error.

Consider this situation encountered by a national specialty manufacturing firm: Their new budget anticipated continuous improvement in production costs, as well as continuing price increases to its customers. But three months into the new fiscal year the CEO was wrestling with profit and cash shortages because actual margin dropped instead of rising. The error was starting with current results

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and extending those recent historic improvements into the future rather than digging carefully into assumptions. He knew there was substantially more competition and that there would be some slowing in demand but didn't apply it to their sales and pricing forecast. He also knew their production manager was only six months into his new position, but overlooked the common "flat spot" in improvement, as the first blush of enthusiasm waned into the daily discipline of finding real improvements.

Budgets often suffer from reference point errors. Awareness is the key to combating this issue. To estimate more effectively, understand what you're using as your reference point and adjust accordingly. It is worth the time to dig in and understand your assumptions.

Minefield 2: Unrealistic Optimism

This common error is best expressed by Garrison Keillor's Lake Wobegone: "where all the children are above average." When we think about ourselves (or the organization we lead), it's hard to imagine we'd be in the bottom half of the class. This fuels our built-in optimism, even though we might actually "know better." Entrepreneurs offer a great case in point. When people starting a new business were asked to compare their chance of success with all new businesses like theirs, here's how they answered: [2]

	Chance of success
Our business:	90%
All new businesses like us:	50%

These two don't offset each other, much as we'd wish they would. And considering that 44 percent of new businesses (across a variety of industries) fail within three years[3], it is plain to see that many entrepreneurs step into the minefield of unrealistic optimism.

Where can you see this unrealistic optimism operating in your organization? Look at the planning or budgeting process. How often does your team aim low to be sure of success? For most, it's never. The "stretch goal," a dreadful concept created by leaders in denial, sets up consistently predictable shortfalls in performance.

Optimism is one thing, but predictable failure is another. When goals and estimates are unrealistic, it dampens enthusiasm and undermines success. Instead, estimate wisely and aim for a goal that can be reached.

Minefield 3: The Loss Distortion Error

Research shows that our feelings about loss are twice as powerful as our feelings about gains. This makes it awfully difficult to give up something in order to gain something else, because our feelings get in the way. Those unbalanced feelings tilt us unrealistically toward hope (the picture of a wonderful outcome) and away from the struggle that success will require.

Unless we're mindful of reality, we can find ourselves on a steeper climb than we imagined, slogging our way toward a summit that suddenly looks farther and farther away. That can mean higher costs and lower and later profit than we expected. Because we don't accurately estimate the costs as well as the pain inherent in those costs, we may be tempted to give up. To reach the good outcome, it helps to understand the struggle and the loss that may be a part of the journey.

Awareness Isn't Optional

The trick with these errors is not to avoid them, but to be aware of them. They are like your skin: always with you on your journey. Just as you use sunscreen in summer sun, you can arm yourself with open eyes and preparation. Notice these errors as they crop up, and deal with them accordingly.

Call me.

References

1 Thaler, Richard and Cass Sunstein. *Nudge: Improving Decisions about Health, Wealth, and Happiness.* New York: Penguin Books, 2009.
2 Cooper, Arnold, Carolyn Woo, and William Dunkelberg "Entrepreneurs' Perceived Chances for Success." *Journal of Business Venturing* 3:2 (1988): 97-108.
3 http://www.statisticbrain.com/startup-failure-by-industry/

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Jim Grew is an expert in CEO-level strategy and executive leadership whose clients refer to him as the Business Defogger and Accelerator. Jim helps leaders swiftly discover the hidden opportunities within their businesses and exploit them for dramatic results. Nearly three decades of success as a COO and CEO coupled with his experience running nine thriving businesses provide the foundation for his consulting work as president of the Grew Company. He presents regularly to industry groups, mentors business leaders, and shares insights on his blog, BizBursts.com: http://bizbursts.com/. He holds BA and MBA degrees from Stanford University.

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