

BEHAVIORAL ASPECTS OF DECISION MAKING

“People are the hardest part of our jobs.”

Larry Forney, Monday, 2 June 2014

Today’s session covers why people are the hardest part of our jobs.

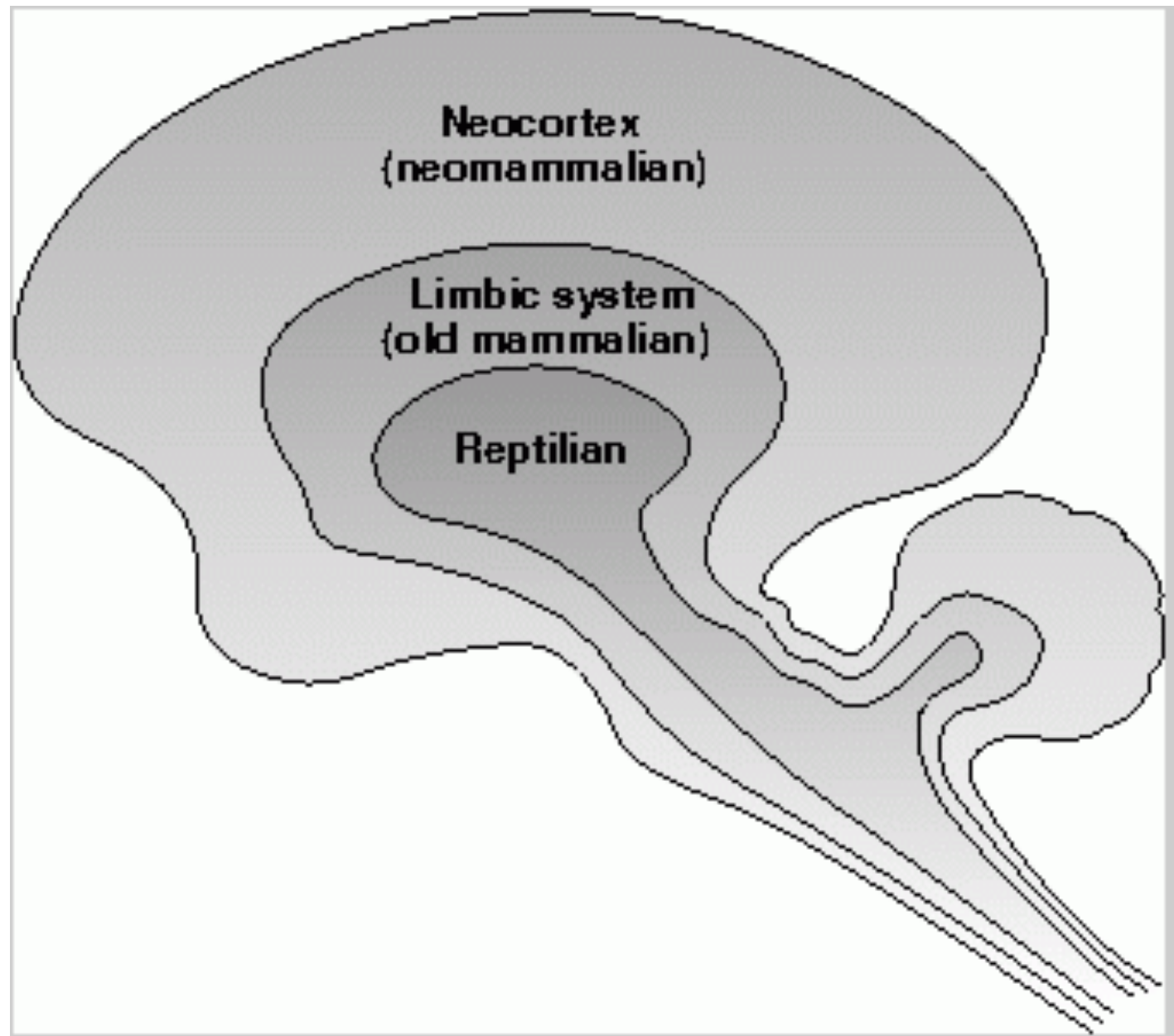
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Chapter 1 Introduction to Managerial Decision Making

System 1 and System 2 Thinking

System 1 thinking is intuitive thinking – it is fast, automatic, effortless, implicit, and emotional.

System 2 thinking is cognitive thinking – it is slow, conscious, effortful, explicit, and logical.



Basic Decision Problem

Value	Lottery 1	Lottery 2	Probabilities
Heads	100	0	0.5
Tails	25	144	0.5

Simple Pessimism

Value	Lottery 1	Lottery 2	Probabilities
Heads	100	0	0.5
Tails	25	144	0.5
Min Value	25	0	
Max (Min Value)	25		

Risk Neutrality

Value	Lottery 1	Lottery 2	Probabilities
Heads	100	0	0.5
Tails	25	144	0.5
Expected Value	62.5	72	
Max (EV)		72	

Risk Aversion

Value	Lottery 1	Lottery 2	Probabilities
Heads	100	0	0.5
Tails	25	144	0.5

SQRT(Value)	Lottery 1	Lottery 2	Probabilities
Heads	10	0	0.5
Tails	5	12	0.5

Expected Value

7.5

6

Max (EV)

7.5

Bounds

Humans face various cognitive bounds:

bounded attention

bounded rationality

bounded will power

bounded self-interest

bounded awareness

bounded ethicality

Fundamental Aversions

Humans face three fundamental aversions:

aversion to uncertainty

aversion to risk

aversion to loss

Judgmental Heuristics

Humans work around these bounds and aversions via heuristics:

- the availability heuristic

- the representative heuristic

- the confirmation heuristic

- the affect heuristic

The heuristics create biases.

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Chapter 2

Overconfidence: The Mother of All Biases

Overconfidence

“Overconfidence has been blamed for wars, stock market bubbles, strikes, unnecessary lawsuits, high rates of entrepreneurial bankruptcy, and the failure of mergers and acquisitions.” (p. 15)

Overconfidence is nicely captured by the saying “often wrong, but never in doubt”.

Overprecision

Causes:

the internal causes stem from our aversion to uncertainty;

the external causes stem from our need to be seen as confident and knowledgeable.

Overprecision

Consequences:

the “often wrong, but never in doubt” status earned by so many individuals,

the inability to accept advice and make revisions in one’s view. (p. 21)

Overestimation

the Lake Woebegon Effect – the belief that we are simply better than we are across an array of dimensions.

self-enhancement – the delusional view of one's self as just being heads and shoulders above the rest.

Overestimation

Illusion of control – the delusional belief that one has control over events when, in fact, there is no such control.

The planning fallacy – the mistaken belief that a project will follow the schedule and stay within the budget.

Overestimation

Optimistic biases – optimists, the folks for whom the cup is always (at least) half full.

These people are fun to be around, they are cheerful, upbeat, and deluded.

They can be very dangerous, as in “I am certain we will be greeted as liberators.”

Overestimation

Defensive Pessimism –

The involuntary version of overestimation is the brain protecting itself from despair and depression induced by pessimism.

The voluntary version of overestimation is the realistic assessment of all the things that can go wrong with a project. This is simple realism.

Overplacement and Underplacement

Overplacement – the belief that we are better than others, in specific ways, when, in fact, we are not.

Underplacement – the mistaken belief that we are worse than others, when, in fact, we are not.