



UNDERSTANDING RISKY BUSINESS: the new field of Behavioural Strategy

Why do normally clear-headed, rational, business-savvy executives with a wealth of information at their fingertips so often make absurd decisions? Why do most large capital investment projects come in late – and over budget? **by Fran Molloy**



DAN LOVALLO, A new Professor of Business Strategy within the Faculty's Discipline of International Business,

says that the answers often lie in behaviours and cognitive biases very typical to senior executives that often leads them away from logical responses and expectations.

His research in the emerging field of Behavioural Strategy gives some fascinating insights into faulty entrepreneurial decisions.

Standard economic theory argues that poor outcomes are an inevitable consequence of the entrepreneurial process, where companies take rational risks in uncertain situations.

The Planning Fallacy

But Professor Lovallo argues that many executives view their decisions through rose-coloured glasses, taking credit for positive outcomes but blaming poor results on external factors and falling victim to 'the planning fallacy.'

In the grip of the planning fallacy, Professor Lovallo says that "managers

make decisions based on delusional optimism rather than on a rational weighting of gains, losses and probabilities. They overestimate benefits and underestimate costs. They spin scenarios of success while overlooking the potential for mistakes and miscalculations".

Professor Lovallo's CV is bursting with top-notch business and academic credentials that have given him a breadth of international management experience – and plenty of examples to back up his claims.

For almost a decade, he has worked with management consulting heavyweights McKinsey & Co in a variety of roles.

Professor Lovallo's work has been published in the *Harvard Business Review*, *McKinsey Quarterly*, the *American Economic Review* and *Management Science*.

He has also held academic positions with The Wharton School of Business at the University of Pennsylvania and the Australian Graduate School of Management, among others.

Overconfident, over-optimistic – and over budget

It's human frailty that leads many strategic decisions into failure, he says; and a significant body of research shows that many such decisions are underpinned by cognitive biases such as overconfidence and overoptimism.

The culture of many leading organisations rewards optimism – and interprets pessimism as disloyalty.

In such a climate, frank discussions of risk are considered evidence of 'negativity' and the risk-averse manager is disparaged for their gloom-and-doom approach, critically denounced in performance reviews for not being a 'team player.'

But it turns out that positive-thinking, optimistic managers are far more likely to have cost overruns and revenue shortfalls than their nay-saying opposites.

And it's rare that the two sides balance each other out; strategic decisions are often made by a small number of players, with a recent McKinsey Quarterly study showing that nearly 40% of key resource allocation decisions were made by one or two key decision makers in the firm.

The field of behavioural strategy takes into account the personalities, the demographic characteristics and the biases of key decision makers who are systematic and pervasive influences on the performance of an organisation.

Many key decision makers are still making 'rationality violations,' Professor Lovallo has found, falling victim to a distorted 'inside view,' becoming so focused on implementing their own plan that they neglect to consider such critical information as the likely activities of their competitors.

But behavioural strategy techniques – like the introduction of a statistical and comparative 'outside view' – can stop key organisational players becoming their own worst enemy; and ultimately turn risky business into profits.