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New Frontier in Leadership Development - Cognitive Biases in Leaders' Decisions

Probably the biggest advance in management thinking for the past 50 years is not being reflected in executive and leadership development and training. HR and leadership development need to take note. See below for the details.

Decisions Such Messy Things…

Ever heard of behavioral economics (BE) and behavioral finance (BF)? I give numerous speeches to CEOs, top executives, leadership development and training professionals and I am amazed that most of them have still not heard of these subjects, nor understand what it means for their personal and professional effectiveness as leaders.

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BE and BF deal with the cognitive biases that underlie decision-making, not just in economics and finance but in all decisions. They take into account the extent to which decisions are often not made on rational grounds and are influenced by unconscious psychological drivers. You know, the sort that also were instrumental in leading to both the recent Great Recession and all types of economic busts, not to mention bad decision-making generally.

Management thinkers are starting to recognize that these systematic biases in the decision-making by leaders at all levels are the elephant in the room as far as management effectiveness is concerned. As long as companies, government organizations and nonprofits ignore these, they are ignoring what increasingly we are seeing as the most important impediments to making managerial decisions more effective. In particular we are realizing that strategic decisions are massively impacted by these unconscious but systematic biases. Until strategists and leaders generally understand these issues, their strategies will often continue to be fatally flawed for reasons they do not comprehend.

You don't have to take my word for it. Recently McKinsey Quarterly carried an article on this very subject ("The Case for behavioral Strategy", Lovallo and Sibony, https://www.mckinseyquarterly.com/The_case_for_behavioral_strategy_2551). They cite some of the problems that are caused by the lack of understanding of behavioral strategy. These include failed mergers and acquisitions, large projects usually being over-budget and strategies usually ignoring competitive responses or just getting things badly wrong.

"…..systematic biases in the decision-making by leaders at all levels are the elephant in the room….."

McKinsey has conducted some fascinating research on this issue. This research concludes that, contrary to what one might expect:

"…good analysis in the hands of managers won't naturally yield good decisions…"

This of course flies in the face of conventional approaches that assume that, if we are smart, reasonably educated and have the right data, we will have a very good chance of making a good decision that will have a beneficial outcome. It explains why, to the contrary, so many decisions at all levels of management, in all types of organizations and often the ones best endowed with knowledge and expertise, informed by the best analysis possible, so often yield poor outcomes.

High Financial Literacy, Low Business Acumen?

Perth has carried out extensive research in this same area and particularly how it impacts the financial performance and outcome of individuals, teams and companies. Even in the financial area, where one would expect people to be more objective, there same phenomena still apply, which of course is why we call if behavioral finance. Indeed, a new subject is

starting to emerge, namely behavioral accounting, to study how behavior impacts activities such as accounting, budgeting and forecasting.

And new evidence is emerging that suggests that high financial literacy does not necessarily lead to profitable outcomes; rather often the reverse. The reason is the phenomenon that in behavioral finance is termed "over-confidence". This is the process by which people wrongly believe that the possession of high academic qualifications or other type of expertise leads their judgment to be automatically better and so take higher risks which are not merited and which lead to financial failure.

"….high financial literacy does not necessarily lead to profitable outcomes….."

Of course, this is exactly what we saw in Wall Street in the financial meltdown of 2008, not to mention other similar incidents such as the Long-Term Capital Management failure of 1998. In sum, the evidence is starting to suggest that there is no correlation between business acumen and financial literacy. The research suggests that he only way of repairing this deficiency is for leaders to become aware of the cognitive biases that lead them to wrongly believe that their high qualifications lead them to possess superior qualities of business acumen, and then to address this vulnerability accordingly.

Perth's research has led to our development of psychometric assessments which allow these cognitive biases in the financial realm to be identified and measured and used as the basis for leadership development and coaching programs. They show the participants of these programs how to recognize and compensate for the cognitive biases that have unproductive financial outcomes.

These programs are focused not only at the level of the individual but also at the level of the team and the organization where cognitive biases are crystallized and magnified often resulting in major financial problems or even failure. The psychometric assessments can be directly correlated with financial metrics in financial statements and with valuation metrics. This permits participants to measure their progress not just psychometrically but also through commonly-used financial measures that are transparent and able to be viewed by outsiders including shareholders, if this is so desired.

Strategy as Self-Deception…

Amongst the more intriguing aspects of BE and BF is the evidence linking cognitive biases to failures in strategic thinking and analysis. It is becoming increasingly clear that conventional models based on rational thinking and rational expectations are too simplistic to cope with most strategic situations. Cognitive biases within even the most sophisticated observers and leaders routinely lead to strategic failures.

Over-confidence in one's qualifications is just one aspect of this mental process. Other heuristics include what are called framing effects, the tendency to view particular situations within the frame with which the leader has grown and is most comfortable with, thus leading them to ignore other aspects which are not a part of that frame.

It is not an over-statement to say that these systematic biases in leadership judgment are the least understood of managerial issues today and they form the next frontier in management theory and practice. But thus far, these effects have been ignored by most managers, leaders and management trainers. This is despite the fact that several Nobel prizes have been awarded for this work. This is the significance of the recent article in the McKinsey Quarterly cited in this newsletter.

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Customers See Your Cognitive Hang-Ups Even When You Don't

Of course, it not just managers and leaders who are impacted by these factors. So are the customers of every company in the world. Studying the cognitive biases in managerial decision-making cuts both ways; it affects customers and their demand characteristics as well as the decisions on the supply side.

This is another compelling reason for managers and leaders to become familiar with the concepts of BE and BF. It is becoming a competitive necessity if they wish to study their own customers and to be able to compete effectively in what is a new framework for competitive analysis.

We can view this as reverse marketing. Marketing looks to understand the behaviors of prospects and customers. Without an understanding of behavioral analysis, this task is looking increasingly less possible.

Reverse marketing looks not only to the customer but to the view of the customer of the supplier and how this view impacts customer expectations and behaviors. In this view, the customer has an intuitive knowledge of the cognitive biases of companies and suppliers even if they themselves do not.

In this perspective, unless companies can understand how customers view the cognitive biases of their suppliers, the companies will never be able to gain the upper hand in the perennial marketing tussle between them. They will lose out in terms of branding and pricing power and ultimately in the competitive sweepstakes.

Recommendations

Chief Learning officers, HR, leadership trainers and talent managers will be impacted by this new behavioral world whether they like it or not. The McKinsey article is the recognition that a new intellectual revolution is coming to management and leadership and the companies that can benefit from these new concepts will be at a competitive advantage. Leadership trainers too need to become aware of these trends and incorporate them into their training and leadership programs if they wish to stay relevant.

1. Incorporate some of the concepts of behavioral analysis into leadership development courses, based on new advances in BE and BF
2. Link these concepts with business acumen and company valuation so that leaders and managers see directly how these concepts lead to increased shareholder value
3. Directly address the phenomenon of over-confidence in order to address the root of many failures and much under-performance.

For more information on the Perth Leadership institute and Perth upcoming events,
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