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Despite their best intentions, executives fall prey to cognitive and organizational biases that get in the way of good decision making. In this series, we highlight some of them and offer a few effective ways to address them.

Our topic this time?

Up-front contingency planning

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BIAS BUSTERS

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The dilemma

Investing in a new process technology was supposed to breathe new life into an established business unit within your manufacturing company. It was supposed to be a sure bet, one that would reduce costs and allow your company to compete better on price. But it's a full year into the rollout, and those benefits haven't materialized. Meanwhile, your closest competitors have launched their own technology initiatives and are reducing costs, lowering prices, and growing market share.

You know that when it comes to implementing new technologies, early failures are common. It takes time to work out the kinks; maybe a redesign or redeployment of the technology to address the company's needs better would do the trick. You still see the potential upside here, but you can't afford to throw good money after bad. Given the uncertainties, should you continue to invest in this new technology and business unit? Research suggests that if you do, you may never stop.

The research

When making staged-investment decisions, managers should focus only on expected future returns from their investments, not the costs associated with previous investments. These sunk costs have already been spent and cannot be recovered and are thus irrelevant when deciding whether to continue investing. Yet research demonstrates that decision makers often focus inappropriately on them.[1] Studies also reveal the degree to which decision makers are subject to loss aversion, or putting greater value on avoiding losses than on acquiring equivalent gains. It is this combination—loss aversion and an inappropriate focus on sunk costs—that prompts managers to escalate their commitment to certain investments, even when there is evidence suggesting that the initial decision was probably wrong.

The remedies

You can counter such irrational escalation and make better decisions by developing "contingent road maps," or plans for implementing and updating your strategy over time based on unbiased feedback from the market. Such road maps capture all the changes that may occur in uncertain markets and when they might occur. Most important, they prescribe specific changes your company must make to its strategy under different scenarios. Decision makers commit up front to follow the road map and the actions required each step of the way—including, in some cases, killing a project entirely. The road map then becomes both a catalyst for change and a means to insulate decision makers from biases.

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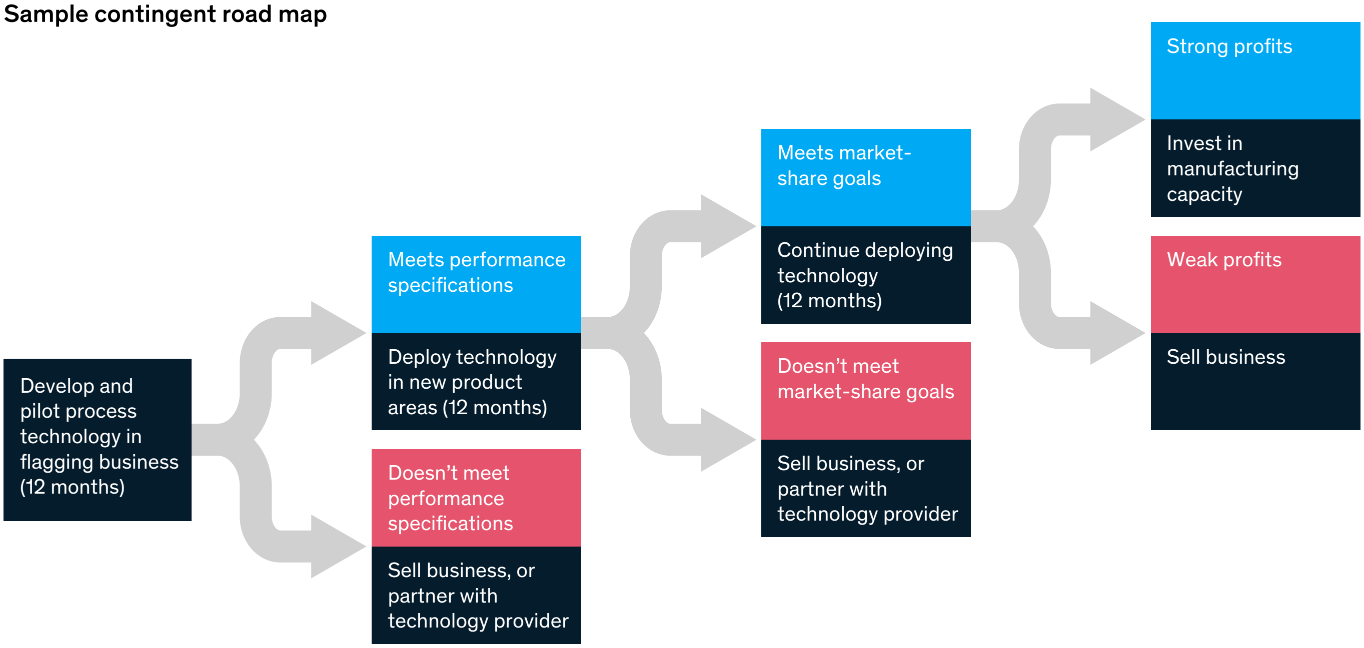
[1] Daniel Kahneman, *Thinking, Fast and Slow*, New York, NY: Farrar, Straus and Giroux, 2011.

Exhibit

A company built a 'contingent road map' to assess investment in a new process technology.

Sample contingent road map



When considering the investment in the new process technology, for instance, you could define a series of "decision forks" (exhibit). At the first fork, either the technology would achieve well-defined performance specifications within the first year of use or the company would sell the business unit or link up with a partner that has superior technology. If the technology meets its performance goals, the company would continue using it in new, differentiated product segments.

The second fork in the road map would occur a year later: if the technology meets well-specified market-share goals by that time, the company would continue with its new strategy. If not, again it would look to sell the business or seek a partnership.

The final fork would occur another year later, when the company has more information on competitive conduct and profit margins. Strong profits would result in the company investing in increased manufacturing capacity for this product, while weak profits would lead the company to divest the business line.

As this example illustrates, contingent road maps can help business leaders manage uncertainty by generating crucial insights about potential market outcomes, allowing business leaders to make the right decisions at the right times. More important, the tool can help senior leaders steer away from status quo strategies when the environment calls for bold new ones.[2]

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[2] Chris Bradley, Martin Hirt, and Sven Smit, "Eight shifts that will take your strategy into high gear," *McKinsey Quarterly*, April 2018, McKinsey.com.