Introduction

Beating the odds in market entry
John T. Horn, Dan P. Lovallo, and S. Patrick Viguerie
The McKinsey Quarterly, 2005 Number 4
How to avoid the cognitive biases that undermine market entry decisions.

Distortions and deceptions in strategic decisions
Dan P. Lovallo and Olivier Sibony
The McKinsey Quarterly, 2006 Number 1
Companies are vulnerable to misconceptions, biases, and plain old lies. But not hopelessly vulnerable.

Learning to let go: Making better exit decisions
John T. Horn, Dan P. Lovallo, and S. Patrick Viguerie
The McKinsey Quarterly, 2006 Number 2
Psychological biases can make it difficult to get out of an ailing business.
We hope you enjoy this special collection of McKinsey Quarterly articles about how to understand—and avoid—psychological biases that can undermine strategic decision making.

These articles collectively illustrate the Quarterly’s best traditions: written by McKinsey consultants, they combine the practicality of client work with extensive proprietary research to offer new ways of thinking about business management. They are only a small sample of the knowledge available on www.mckinseyquarterly.com.
The annals of business history report that for every successful market entry, about four fail. Inexperienced start-ups suffer some of these disappointments, but so do many sophisticated corporations and seasoned entrepreneurs who should know better. After all, industrial economists and strategists generally agree about what makes market entrants successful: factors such as timing, scale relative to the competition, and the ability to leverage complementary assets. Moreover, the magnitude and importance of entry decisions—encompassing everything from geographic expansion to new products to diversification efforts—should prompt detailed analysis.

But cognitive biases—systematic errors in the way executives process information—often wreak havoc on market entry decisions.¹ For one thing, when confronted with a difficult decision, most executives rely solely on an inside view: they focus excessively on the specific case at hand. This tendency prevents many of them from developing an outside view.

¹ Behavioral economists have written extensively about the impact of cognitive biases on financial markets and on a wide range of decisions. See Charles Roxburgh, “Hidden flaws in strategy,” The McKinsey Quarterly, 2003 Number 2, pp. 26–39 for an overview of the relationship between cognitive biases and strategic mistakes, as well as a partial summary of the broader literature on this topic.
perspective based on previous market entries and even from evaluating opportunities in the light of common predictors of success. Furthermore, when an analysis is conducted, cognitive biases often lead executives to believe that a company’s skills are more relevant than they really are, that the potential market is bigger than it actually is, or that rivals won’t respond to the entry move.

The costs of miscalculation can be large. The efforts of Anheuser-Busch to diversify into the snack food business, for example, went awry when the beer giant underestimated Frito-Lay’s response to a threat to its Doritos franchise. Similarly, EMI failed to capitalize successfully on an exciting medical innovation—the CAT scanner—because the company overestimated its ability to compete in this new market and underestimated the strengths of experienced competitors such as General Electric and Siemens.

Fortunately, some practical steps can help executives control cognitive biases in market entry decisions. Objective predictors of success, for example, can be used to create a reference class: a group of similar decisions that other companies have made in the past. The reference class yields comparative data that are an invaluable reality check on the inside-view analysis. (Government bodies in the United Kingdom have used reference class forecasting to predict the cost of infrastructure projects, and the American Planning Association, a society of professionals focused on public-works projects, has endorsed the use of reference classes.) Additional tools, which can improve the quality of the inside view itself, include competitive-gaming exercises, the study of industry life cycles, and a policy of involving managers from diverse parts of the organization in important decisions. In our experience, the combination of a robust outside view and an improved inside one—better assessments of value propositions,

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A reference class—a group of similar cases—provides a valuable reality check.

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capabilities, market size, competitors, market share and revenue, and costs—dramatically raises the odds of making good entry decisions.

**Step outside**
Companies have no reason to repeat the mistakes of others. Yet they frequently fail to learn from history, because a myopic focus on the market entry decision at hand prevents them from creating a reference class of at least five (and preferably more) similar entry decisions in the past. Such a reference class promotes systematic learning from the successes and failures of other companies. It also counteracts the tendency of many decision makers to fall into the “confirmation trap”: seeking information that confirms their hypotheses. A broad reference class, in other words, forces analysts to consider more possibilities and new data.

The failure rate of projects is high in industries such as pharmaceuticals, oil and gas, and motion pictures. Companies in these sectors do understand how important it is to play the probabilities and can draw on a rich body of cases in creating a reference class. But companies that place product bets less frequently, and with less apparent risk, have fewer internal reference cases to compare and generally either don’t consider looking at the experience of outside companies and industries or, if they do, often conclude that the effort isn’t worth the expense. Since the tens (if not hundreds) of millions of dollars at stake in a typical big-company market entry far outweigh the costs of forming a reference class, that conclusion is penny wise and pound foolish.

Companies developing an outside view can benefit from a wide body of statistical research showing that six factors are particularly important predictors of successful market entry (Exhibit 1). Even before companies select their reference cases, an explicit review of these factors sometimes shows that the dice are loaded against going forward.

In constructing a reference class, the first step is to review which of these factors are most relevant. Say a small, technologically adroit company that lacks complementary assets enters a new industry at the same time as large, diversified companies that do have them enter it. In this case, the small company should create a reference class of similar entrants in other industries, not this one. Next, companies should look for reference cases involving as many of the most important factors as possible (Exhibit 2). It’s important to uncover both successful and, even more, failed entries so that the reference class approximates the distribution of actual outcomes. The greater the overlap with the experience of the industry in question, the more valuable each example will be for the reference class. But it is also useful—
and sometimes, if the industry is a new or emerging one, necessary—to reach out across different industries.

The use of a reference class guards against a weak and dangerous alternative: hypotheses based on an analysis of just one or two cases, whose selection is subject to the “availability bias”: choosing whatever comes to mind most readily. During the buildup to the current conflict in Iraq, for example, the two analogies consistently reported in the press were the Vietnam War and the 1991 Gulf War. These were natural choices, since they were the two most recent large-scale conflicts involving the United States, but they weren’t necessarily the most similar ones. Expanding the reference class to include the troubles in Northern Ireland, Britain’s involvement in the Middle East after World War I, and US policy in Europe after World War II might have raised fresh, relevant questions.

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**EXHIBIT 1**

**Predictors of success in market entry**

<table>
<thead>
<tr>
<th>Predictor</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td>Size of entry relative to minimum efficient scale</td>
<td>Companies that are closer to an industry’s minimum efficient scale upon entry are much more likely to succeed. Entering below minimum efficient scale and then quickly scaling up is more viable when companies test a new market than as part of a plan for gradual growth.</td>
</tr>
<tr>
<td>Relatedness of the market entered</td>
<td>The more related the market is to a company’s current portfolio of products and services, the greater the chance of success, but properly measuring how related is crucial. A thoughtful assessment requires careful examination of the degrees of difference between the current portfolio and the potential market. For example, Dell’s move into business servers was a related move in the 1990s, while DEC’s(^1) foray into PCs in the 1970s required many more changes to its business model and economics and thus was much less related. Judgment and nuance are critical to avoiding mistakes like DEC’s.</td>
</tr>
<tr>
<td>Complementary assets</td>
<td>Core assets and capabilities are important when entering a new market. However, complementary assets, such as marketing and distribution, are often more important factors for success than core assets, such as engineering prowess. Counting on core assets to save the day when a company lacks complementary ones is a risky path.</td>
</tr>
<tr>
<td>Order of entry</td>
<td>While first movers have the advantage over laggard rivals in some settings, greenfield and diversifying companies are on very different entry clocks. Early greenfield entrants often are “optimistic martyrs,” losing out to experienced players that diversify into the market later.</td>
</tr>
<tr>
<td>Industry life cycle stage</td>
<td>The life cycle stage of an industry when a company enters it is easily determined and greatly influences opportunities for success. Companies entering early in an industry’s life cycle have greater odds for success than those entering near the shakeout.</td>
</tr>
<tr>
<td>Degree of technological innovation</td>
<td>When a high level of ‘inside’ industry knowledge is necessary to innovate, incumbents have a major advantage over new entrants. When ‘outside’ knowledge is essential, entry is easier. Innovative entrants are more likely to succeed by staying small in niches that dominant players ignore rather than by expecting to compete with them as equals.</td>
</tr>
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\(^1\)Digital Equipment Corporation; acquired by Compaq in 1998.
about troop requirements, the policing of occupied populations, and postwar reconstruction.

**Improve the inside view**

Besides developing a reference class, companies should remove any bias from their analysis of the entry decision. Start by targeting five core issues: the value proposition and capabilities, the market’s size, the competition, market share and revenue, and costs (Exhibit 3). Of course, other analyses (of regulatory issues, for example) are occasionally necessary and sometimes of paramount importance.

**What value proposition and skills are necessary?**
The closer a company stays to its core capabilities and value proposition, the greater its chances of mounting a successful entry. But companies can

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**EXHIBIT 2**

**Developing the reference class**

<table>
<thead>
<tr>
<th>Ideal reference class</th>
<th>Reference class for selected companies</th>
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</table>
| Reference class = group of similar business situations; key to finding the most similar situations is to base choice of cases on intersection of relevant industries with relevant predictive factors of success | EMI  
- Unrelated diversifiers  
- Medical-diagnostic-imaging companies  
- Companies in early stage of business life cycle  
- Technological leaders with few complementary assets for target market competing against diversifiers with complementary assets for markets related to it |

<table>
<thead>
<tr>
<th>Diversifying food entrants</th>
<th>Niche entrants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diversifying consumer packaged-goods entrants</td>
<td></td>
</tr>
</tbody>
</table>

**Anheuser-Busch Eagle**
- Diversifying food product entrants:  
  - Beverages  
  - Snacks  
  - Candy  
- Diversifying consumer packaged-goods entrants  
- Niche entrants competing against dominant broad-based incumbent in both diversified food and consumer packaged goods

**Segway**
- Early transportation manufacturers, including  
  - Automobiles (early 1900s)  
  - Fuel cell, hydrogen cars  
  - Private airplanes  
  - Bicycles, scooters  
  - Motorcycles  
- Other entrants requiring unique infrastructure  
  - Electric power  
  - Telephones  
  - High-definition television (HDTV)

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3 Companies should measure the distance in “degrees.” Selling the same product through the same distribution channel to the same customer groups, but in a new geography, represents one degree of difference. Selling to different customer groups as well adds a second degree.
be egocentric: they may assume, for example, that since their employees are excited about a product customers will feel the same way, that the resources and assets they already have are the ones needed to meet the needs of the target market, that what they do well is sufficient for success in it, or that they can easily acquire any missing skills. All of these biases undermine the analysis.

A memorable example of a company that underestimated the difficulty of developing new skills dates back to the 1970s, when the music producer EMI entered the CAT scanner business on the back of an innovation developed primarily by Godfrey N. Hounsfield, a researcher in the company’s labs. EMI had no experience in the manufacture of medical-diagnostic-imaging equipment or in medical sales and distribution. Its senior management decided to build these capabilities rather than partner with other companies to obtain them. More than five years passed before
EMI delivered the first product. Soon thereafter, General Electric, with its world-class manufacturing and sales and distribution networks (and 75 years of experience with X-ray equipment), entered the US market. So did Siemens, which had already entered the European one. Not surprisingly, GE and Siemens became dominant and EMI exited after sustaining substantial losses. (Hounsfield, however, won a Nobel Prize in 1979.)

To avoid such mistakes, companies should use the reference class to identify the key determinants of successful entries into similar markets. Which product attributes and business models have succeeded in the past? Were the winners superior marketers? Did they have outstanding distribution systems? If new capabilities seem to be needed for success, companies should exercise caution and consider contractual approaches, such as joint ventures and licensing, that can help them secure the missing assets. It’s frequently valuable to have people who are not directly involved in making the decision help determine what’s needed for a successful entry. After all, the analysis of managers from different divisions will be less biased by ingrained knowledge of the organization’s current value proposition and skills.

How big is the market?
Estimating a market’s potential size typically involves categorizing customers into a number of segments and then using pricing and elasticity assumptions to estimate the percentage of buyers in each category the company might capture. Two biases typically distort such estimates. One is the fact that human beings, when considering potentially positive outcomes, are almost always optimistic. The second is “anchoring and adjustment”: the failure to adjust estimates sufficiently from an initial value, regardless of its origin. An optimistic anchor that often infects market estimates is an industry’s current growth rate, which rarely endures for long. Another anchor is the initial “gut” forecast number an analyst plugs into a spreadsheet with the intention of making adjustments as more information arrives.

How influential are such anchors? In one recent study, experienced real-estate brokers, who had contended that the listing price⁴ of a house wouldn’t affect their evaluation of its “true” value, were asked to assess a property. Each broker received a ten-page booklet on the house and on the prices and characteristics of houses in the area. Each then visited it, plus others in the neighborhood. The agents didn’t know that the listing prices they had been given for the house in question were all different and had

⁴The price a person selling a house asks for it publicly.
been randomly manipulated within a range of plus or minus 11 percent of the actual listing price. Those spurious listing prices significantly affected the evaluations of the agents. Yet even when they were told about the results, they maintained that the listing-price anchor had had no effect on them.

To avoid anchoring estimates on a target market’s current growth rate, companies should always try to determine the life cycle stage of the business they wish to enter. At some point, most industries experience shakeouts, which can be particularly severe in fast-growing sectors. Although it is difficult to predict the exact timing, efforts to think through the possibility of a shakeout—and how many companies are likely to survive it—often highlight the unsustainability of current growth rates.

A second useful way of improving estimates of market size is to use the reference class of other entrants as a benchmark. Consider the fate of the Segway, a new type of two-wheeled vehicle unveiled in December 2001. Although we don’t know for sure what the inventor, Dean Kamen, did to estimate the size of the market, we do know how many Segways he thought could be sold after a year: 10,000 a week. A typical approach for arriving at such a figure would have involved combining an analysis of the number of consumers who could both afford the Segway and realistically use it for commuting or recreation, on the one hand, with penetration rates in this demographic for similar products, such as scooters and bicycles, on the other.

But the Segway’s usefulness depended on changes to infrastructure. How many cities would allow people to drive the vehicle on sidewalks? If roads were the only alternative, how many potential purchasers would still be willing to use it? Since the answer to both questions was “not many,” just 6,000 Segways were sold in the first 21 months. A broader reference class that included conventional automobiles, fuel cell cars, hydrogen cars, and infrastructure-dependent technologies such as high-definition television and telephones might have shown that securing the right to ride the Segway in cities was of paramount importance. After all, it took years to create the roads, power grids, standards, and networks necessary for cars, electric lighting, HDTV, and telephone service to become ubiquitous.

Many companies don’t grasp the likelihood that their rivals may enter the same market they have targeted

Who are the potential competitors?
Other market entries fail because companies underestimate the competition. Many decision makers, for example, don’t grasp the likelihood that their
rivals may enter the same market they have targeted; they suffer from competitive blind spots when thinking about what could go wrong. That’s what happened to British Satellite Broadcasting (BSB) after it outbid Rupert Murdoch’s Sky Television, in 1988, to win the contract to broadcast on a new British satellite. Even as BSB prepared to launch its service, Murdoch obtained the rights to broadcast from a Spanish satellite that could reach Great Britain. Sky went on the air in early 1989, beating BSB to the market by 13 months. Despite Murdoch’s 1988 bid, Richard Brooke, BSB’s treasurer, said that “Murdoch’s announcement came from left field and took everybody by surprise.”

While it is difficult to generate a reference class for potential entrants, in our experience it can be very helpful to brainstorm about them and then to test these hypotheses in a disciplined way. The first companies to consider are those in the same industry; after all, if one of them is contemplating plunging into a market, its competitors probably are too. If companies in other industries could succeed in the target market, they should be considered as well. Hindsight will always reveal the “necessary” capabilities, but expanding the list of possible competitors increases the odds of spotting unexpected threats. Although discretion is sometimes the better part of valor, this analysis is meant to help companies react to the competition’s moves before they happen, not to scare entrants away from a fight.

The benefits of recognizing and countering potential entrants can be large. Consider the case of Softsoap, the first liquid-soap manufacturer. The shift from hard to liquid soap was an incremental innovation that couldn’t be protected by a patent; there are too many ways to make the product. The businessman who had the idea for Softsoap, Robert Taylor, knew that if it entered the industry without protection, consumer-marketing giants like Dial would crush it. His solution: signing contracts to obtain all of the existing capacity for the pumps capable of dispensing Softsoap. The result was an 18-month lead on the competition. Today, Softsoap is synonymous with the product category in the same way Coke is with cola drinks.

What market share and revenue can be achieved?
In addition to overlooking potential competitors, companies often fail to factor in the likely responses of current ones. We call this the “brick wall effect”: assuming that competitors won’t adjust their prices, broaden
their product offerings, or otherwise change strategy in response to the entry. (The focus on current competitors rather than potential new ones distinguishes the brick wall effect from the competitive blind spots described previously.)

Consider the experience of Anheuser-Busch after it diversified into snack foods, in 1979. Its Eagle Brand operation initially succeeded by staying small and focusing on supplying airlines and taverns. Once Anheuser-Busch expanded beyond these markets, however, it was encroaching on Frito-Lay’s turf, stimulating a harsh counterattack: deep across-the-board price cuts by Frito-Lay and a concerted effort to drive Eagle out of supermarkets. These aggressive moves ultimately forced Anheuser-Busch to sell Eagle to P&G.

The best way to anticipate competitive responses is to conduct gaming exercises, with executives role-playing competitors to gain insight into their likely behavior. One telecommunications company that leaned toward using a premium-feature, low-cost strategy to enter a new market assumed that the incumbents would maintain the status quo of premium features and high prices. But after using game theory, simulations, and competitive analysis to assess the incumbents’ likely responses, the prospective entrant realized that it had overestimated its returns by a hefty 800 percent. It modified its entry strategy and performance expectations accordingly.5

Using the reference class to set reasonable bounds on market share estimates also helps. If the reference class attained only a 3 to 5 percent market share, decision makers should pause when they see higher estimates.

How much will it cost?
Good cost estimates can make the difference between creating value and destroying it, but many companies can’t arrive at them, because of the “planning fallacy”: the tendency to underestimate the duration and cost of any endeavor. Most of us recognize this problem in our own lives, and research shows that we should. One study assessed the accuracy of the estimates that psychology students made of the time they would need to complete their honors theses. Even though the question was asked toward the end of the year, 70 percent of the students took longer than they had

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predicted—on average, 7 days longer than their worst-case forecast (48 days) and 22 days longer than their “realistic” one (33 days). Studies of holiday shopping, tax filings, and other routine chores yield similar results.

Large corporations are also susceptible to the planning fallacy. Even in fairly routine endeavors (such as launching new consumer products), expenditures often exceed forecasts dramatically. In more novel initiatives, the effects of the planning fallacy are often severe. A Rand Corporation study of 44 chemical-processing plants owned by Fortune 500 companies, for example, found that the actual construction costs of these facilities, on average, were more than double the initial estimates. One year after start-up, about half of the plants produced less than 75 percent of their design capacity; a quarter produced less than 50 percent.

If sufficiently broad, a reference class is a potent tool to counteract the planning fallacy. For a new type of polymer-processing plant, say, the reference class should include not only plants built by the company contemplating it but also cutting-edge processing plants in the chemical industry and perhaps new types of processing plants in other industries. A broad reference class gives would-be entrants a realistic range of costs associated with attaining various market share levels. Cost estimates far below the realized costs of the reference class should make decision makers think again.

Paraphrasing Thomas Hobbes, the renowned late economist Paul Geroski, of the London Business School, once said, “The life of a typical entrant is nasty, brutish, and short.” He was right. Fortunately, companies can boost their odds of success by tackling cognitive biases head on.

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The chief executive of a large multinational was trying to decide whether to undertake an enormous merger—one that would not only change the direction of his company but also transform its whole industry. He had gathered his top team for a final discussion. The most vocal proponent of the deal—the executive in charge of the company’s largest division—extolled its purported strategic advantages, perhaps not coincidentally because if it were to go through he would run an even larger division and thereby be able to position himself as the CEO’s undisputed successor. The CFO, by contrast, argued that the underlying forecasts were highly uncertain and that the merger’s strategic rationale wasn’t financially convincing. Other members of the top team said very little. Given more time to make the decision and less worry that news of the deal might leak out, the CEO doubtless would have requested additional analysis and opinion. Time, however, was tight, and in the end the CEO sided with the division head, a longtime protégé, and proposed the deal to his board, which approved it. The result was a massive destruction of value when the strategic synergies failed to materialize.

Does this composite of several real-life examples sound familiar? These circumstances certainly were not ideal for basing a strategic decision on objective data and sound business judgment. Despite the enormous resources that corporations devote to strategic planning and other
decision-making processes, CEOs must often make judgments they cannot reduce to indisputable financial calculations. Much of the time such big decisions depend, in no small part, on the CEO’s trust in the people making the proposals.

Strategic decisions are never simple to make, and they sometimes go wrong because of human shortcomings. Behavioral economics teaches us that a host of universal human biases, such as overoptimism about the likelihood of success, can affect strategic decisions. Such decisions are also vulnerable to what economists call the “principal-agent problem”: when the incentives of certain employees are misaligned with the interests of their companies, they tend to look out for themselves in deceptive ways.

Most companies know about these pitfalls. Yet few realize that principal-agent problems often compound cognitive imperfections to form intertwined and harmful patterns of distortion and deception throughout the organization. Two distinct approaches can help companies come to grips with these patterns. First, managers can become more aware of how biases can affect their own decision making and then endeavor to counter those biases. Second, companies can better avoid distortions and deceptions by reviewing the way they make decisions and embedding safeguards into their formal decision-making processes and corporate culture.

**Distortions and deceptions**

Errors in strategic decision making can arise from the cognitive biases we all have as human beings. These biases, which distort the way people collect and process information, can also arise from interactions in organizational settings, where judgment may be colored by self-interest that leads employees to perpetrate more or less conscious deceptions (Exhibit 1).

**Distortions**

Of all the documented cognitive distortions, overoptimism and loss aversion (the human tendency to experience losses more acutely than gains) are the
most likely to lead people who make strategic decisions astray, because decisions with an element of risk—all strategic ones—have two essential components. The first is a judgment about the likelihood of a given outcome, the second a value or utility placed on it.

When judging the likelihood of potentially positive outcomes, human beings have an overwhelming tendency to be overoptimistic or overconfident: they think that the future will be great, especially for them. Almost all of us believe ourselves to be in the top 20 percent of the population when it comes to driving, pleasing a partner, or managing a business. In the making of strategic decisions, optimism not only generates unrealistic forecasts but also leads managers to underestimate future challenges more subtly—for instance, by ignoring the risk of a clash between corporate cultures after a merger.

When probabilities are based on repeated events and can therefore often be well defined, optimism is less of a factor. But loss aversion is still a concern. Research shows that if a 50-50 gamble could cost the gambler $1,000, most people, given an objective assessment of the odds, would demand an upside of $2,000 to $2,500.\(^2\) Overoptimism affects judgments of probability

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and tends to produce overcommitment. Loss aversion influences outcome preferences and leads to inaction and undercommitment. But the fact that overoptimism and loss aversion represent opposing tendencies doesn’t mean that they always counteract each other.

Loss aversion wouldn’t have such a large effect on decisions made in times of uncertainty if people viewed each gamble not in isolation but as one of many taken during their own lives or the life of an organization. But executives, like all of us, tend to evaluate every option as a change from a reference point—usually the status quo—not as one of many possibilities for gains and losses over time across the organization. From the latter perspective, it makes sense to take more risks. Most of the phenomena commonly grouped under the label of risk aversion actually reflect loss aversion, for if we integrated most gambles into a broader set, we would end up risk neutral for all but the largest risks. This truth has important implications for strategic decision making.

Deceptions
The strategic decisions that companies make result from interactions among their executives: a manager proposes an investment, for example, and an executive committee reviews and evaluates it. In this kind of setting, a conflict of interest often arises between an “agent” (in this case, the manager) and the “principal” (the corporation) on whose behalf the agent acts. Such “agency problems,” which occur when the agent’s incentives aren’t perfectly aligned with the principal’s interests, can lead to more or less intentional deceptions—misleading information provided to others—that compound the problem of the agent’s unintentional distortions. Recall the CEO who was grappling with the big merger decision: trusting the protégé (the head of the largest division) exposed the CEO to the risk that the merger’s proponent was not only overoptimistic but also attempting to further his own career by exaggerating the deal’s upside or underestimating its risks.

When companies evaluate strategic decisions, three conditions frequently create agency problems. One is the misalignment of time horizons between individuals and corporations. Several consumer goods companies, for example, have noted that brand managers who rotate quickly in and out of their jobs tend to favor initiatives (such as introducing new product

Overoptimism and loss aversion, though opposing tendencies, don’t always counteract each other

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variants) with a short-term payback. These managers’ deception, intentional or not, is to advance only certain projects—those aligned with their interests. The development of radically new products or other important projects with longer payback times can rarely succeed without a senior sponsor who is likely to be around longer.

Another problem that can generate harmful deceptions is the differing risk profiles of individuals and organizations. Consider a real-life example. A midlevel executive at a large manufacturing company decided not to propose a capital investment that had a 50-50 chance of either losing the entire $2 million investment or returning $10 million. Despite his natural loss aversion, the chance of a 5:1 gain should have enticed him into accepting the bet, and his superiors, for the same reasons, would have deemed it attractive. Instead, he worried that if the investment failed, his reputation and career prospects would take a blow, though he didn’t anticipate being punished if the investment was forgone. As a result, he decided not to recommend it and thus in effect acted deceptively by not promoting an attractive investment. This asymmetry between results based on action and inaction is called the “omission bias,” and here it magnified the executive’s loss aversion.

The final agency issue arises from the likelihood that a subordinate knows much more than a superior does about a given issue. Higher-ranking executives must therefore make judgments about not just the merits of a proposal but also their trust in the person advancing it. This is unavoidable and usually acceptable: after all, what more important decision do CEOs make than choosing their closest associates? The tendency, however, is to rely too much on signals based on a person’s reputation when they are least likely to be predictive: novel, uncertain environments such as that of the multinational that went ahead with the megamerger. We call the tendency to place too much weight on a person’s reputation—and thus increase the exposure to deception—the “champion bias.”

Furthermore, the multinational’s merger decision exhibited an element of “sunflower management”: the inclination of people in organizations to align themselves with the leader’s real or assumed viewpoint. The CEO had expected to find dissenting voices among his senior executives. But except for the CFO, they believed that the CEO favored the deal and that the merger would proceed no matter what they said and thus kept their doubts to themselves for fear of harming their careers. In effect, they misled the CEO by suppressing what they really thought about the deal.
Improving individual decisions

Knowing that human nature may lead decision making astray, wise executives can use this insight to fortify their judgment when they make important decisions. To do so, however, they must know which bias is most likely to affect the decision at hand. Exhibit 2 offers a road map for the types of decisions where overoptimism or excessive risk aversion will probably be the determining factor.

In general, the key to reducing overoptimism is to improve the learning environment by generating frequent, rapid, and unambiguous feedback. In the absence of such an environment—for instance, when companies face rare and unusual decisions, which, unfortunately, are the most important ones—there is a bias toward optimistic judgments of the odds. The size of a decision determines the appropriate degree of risk aversion. For major ones, a certain amount of it makes sense—nobody wants to bet the farm. For smaller ones, it doesn’t, though it often prevails for reasons we’ll soon explore. Companies should see minor decisions as part of a long-term, diversified (and thus risk-mitigating) strategy.

As Exhibit 2 shows, companies don’t always rationally factor risk into their decisions. In the large, infrequent ones (for instance, the industry-transforming merger that went horribly wrong) represented in the exhibit’s upper-left quadrant there is a tendency to take an overly optimistic view.

<table>
<thead>
<tr>
<th>Size of investment decision</th>
<th>Large</th>
<th>Bias: excessive optimism</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td>• Market entry/new products</td>
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<td>• Unusual M&amp;A decisions</td>
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<td>• Investments in new technologies</td>
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<td>• New investments in private equity companies</td>
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<td>Biases tend to cancel out</td>
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<td>• Early R&amp;D investments in mature industries</td>
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<tr>
<td>Bias: excessive risk aversion</td>
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<td>• Small M&amp;A decisions for serial acquirers</td>
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<td></td>
<td></td>
<td>• Smaller product launches</td>
</tr>
</tbody>
</table>

Exhibit 2

Most likely to affect the decision

Ability to learn from decision

(includes how frequently decision type presents itself)
In essence, faulty judgments lead executives to take risks they would have avoided if they had had an accurate judgment of the odds. Since executives facing such a rare decision can’t benefit from their own experience, they should learn from the experience of other companies by collecting case studies of similar decisions to provide a class of reference cases for comparison.4

Conversely, excessive risk aversion is usually the dominant bias in the small but common decisions shown in the exhibit’s lower-right quadrant: good learning environments temper optimism, and the human reluctance to bet—unless the potential gains are much bigger than the losses—comes to the fore. A key factor in such cases is the tendency of companies not to see individual projects within a stream or pool of similar undertakings. If companies did so, they would move closer to risk neutrality. Instead they tend to evaluate projects in isolation, which leads them to emphasize a single project’s outcome and thus to fear the losses. A complicating factor, as we have already noted, is the possibility that the decision maker expects to be blamed if an investment fails and thus has a more risk-averse attitude than might be rational for a company, which can pool comparable investments into an attractive risk-mitigating portfolio. Senior executives sometimes fail to compensate for this bias, as they could by encouraging a higher degree of risk taking in minor decisions, which are often made in lower levels of the corporate hierarchy.

The remaining two cases in the exhibit are relatively unproblematic. In large, frequent decisions—for example, a private equity firm’s deliberations about a new investment or the construction of a new plant using existing technology—a significant degree of risk aversion is sensible and the frequency of the endeavors offers ample learning opportunities. In small, rare decisions optimism and loss aversion may counteract each other, and by definition this class of decision is comparatively unimportant.

**Engineering better decision making**

Organizations don’t all suffer equally from distortions and deceptions; some are better at using tools and techniques to limit their impact and at creating a culture of constructive debate and healthy decision making.

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Corporate leaders can improve an organization’s decision-making ability by identifying the prevalent biases and using the relevant tools to shape a productive decision-making culture.

**Identifying the problems**
Corporate leaders should first consider which decisions are truly strategic, as well as when and where they are made. Applying process safeguards to key meetings in formal strategic-planning exercises is tempting but not necessarily appropriate. Often the real strategic decision making takes place in other forums, such as R&D committees or brand reviews.

After targeting the crucial decision-making processes, executives should examine them with two goals in mind: determining the company’s exposure to human error and pinpointing the real problems. A decision-making safeguard that is useful in one setting could be counterproductive in another—say, because it reinforces a high level of risk aversion by enforcing hard targets for new projects. An objective analysis of past decisions can be a first step: does the company often make overoptimistic projections, for example?

**Tools against distortions and deceptions**
Once companies undertake this diagnostic process, they can introduce tools that limit the risk of distortions and deceptions. One way of tempering optimism is to track the expectations of individuals against actual outcomes in order to examine the processes (such as sales forecasts) that underlie strategic decisions. Companies should review these processes if forecasts and results differ significantly. They can also provide feedback where necessary and show clearly that they remember forecasts, reward realism, and frown on overoptimism.

A more resource-intensive way of avoiding overoptimistic decisions is to supplement an initial assessment with an independent second opinion. Many companies try to do so by assigning important decisions to committees—for instance, the investment committees of investment firms. If the members have the time and willingness to challenge proposals this approach is effective, but committees depend on the facts brought before them. Some private equity firms address that problem by systematically taking a fresh look: after a partner has supervised a company for a few years, a different partner evaluates it anew. An executive with a fresh pair
Distortions and deceptions in strategic decisions

of eyes and no emotional connections can sometimes see things that escape the notice of more knowledgeable colleagues.

Loss aversion, magnified by career-motivated self-censorship of “risky” proposals, has its roots in explicit and implicit organizational incentives. Lower-level managers typically encounter more but smaller risks, so organizations can embed a higher tolerance for them in certain systems—for instance, by using different criteria for the financial analysis of larger and smaller projects.

Financial incentives also can be used to counter distortions and related principal-agent problems. Many companies, for example, find that operating-unit managers tend to optimize short-term performance at the expense of long-term corporate health, partly because their compensation is tied to the former and partly because they might well have moved on by the time long-term decisions bear fruit. Some companies address this problem through “balanced scorecards” that take both dimensions into account. Others tie compensation to the performance of an executive’s current and previous business units.

Another technique is to request that managers show more of their cards: some companies, for instance, demand that investment recommendations include alternatives, or “next-best” ideas. This approach is useful not only to calibrate the level of a manager’s risk aversion but also to spot opportunities that a manager might otherwise consider insufficiently safe to present to senior management.

Finally, the radical way of counteracting the loss aversion of managers is to take risk out of their hands by creating internal venture funds for risky but worthwhile projects or by sheltering such projects in separate organizations, such as those IBM sets up to pursue “emerging business opportunities.” The advantage is that norms can change much more easily in small groups than in companies.

Fostering a culture of open debate

It is essential to realize that these tools are just tools. Their effectiveness ultimately depends on the quality of the resulting discussions, which can’t be effective unless the organization has a culture of reasonably open and objective debate.

Shaping such a culture starts at the top, as one chief executive discovered. This CEO was eager to encourage debate on the strategic plans of his company’s divisions but didn’t want to put his direct reports under pressure
by publicly challenging them himself. He therefore created a process intended to make all division heads challenge one another in open debate. These managers refrained from voicing any real dissent, however, so the result was a dull and pointless exercise. Later, they made it clear that they had seen no upside in challenging their peers, given the company’s nonconfrontational culture and rigid organizational silos.

Although the CEO’s experiment failed, he was on the right track. A CEO in a health care company ingeniously solved a similar problem by separating proposals from the proposers. Previously, strategic options for the company’s future were closely identified with their most vocal proponents, so it was hard to conduct dispassionate debates. Instead of having each executive present his or her favorite option, the CEO organized a senior-management seminar where he asked each person to advocate another’s preferred strategy. Although everyone knew that the exercise was intentionally artificial, it helped foster rational debate instead of a battle of egos. More important, perhaps, it helped senior executives see the merits of other strategies and led the group to adopt a plan that synthesized aspects of several proposals.

One way to initiate a culture of constructive debate is for the CEO and the top team to reflect collectively on past decisions. A willingness to ask how they emerged—in effect, holding a conversation about conversations—shows that the company can learn from its mistakes.

Another prerequisite of good strategic decision making is the ability to “frame” conversations in order to ensure that the right questions get asked and answered. One key principle, for instance, is clearly distinguishing a discussion meant to reach a decision from one meant to align the team, to increase its commitment, or to support a project champion. This elementary but often overlooked distinction may also change the composition of the group that attends discussions intended to reach decisions.

Once it becomes clear that a meeting has been called to reach a decision, framing the discussion involves understanding the criteria for reaching it and knowing how far the range of options can be expanded, especially if the decision is important and unusual. Thus a well-framed debate includes a set of proposed criteria for making the decision and, when appropriate,
Companies can’t afford to ignore the human factor in the making of strategic decisions. They can greatly improve their chances of making good ones by becoming more aware of the way cognitive biases can mislead them, by reviewing their decision-making processes, and by establishing a culture of constructive debate.

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Anchoring and adjustment

Escalation of commitment

Confirmation bias

Sunk-cost fallacy
Learning to let go: Making better exit decisions

Psychological biases can make it difficult to get out of an ailing business.

John T. Horn, Dan P. Lovallo, and S. Patrick Viguerie

When General Motors launched Saturn, in 1985, the small-car division was GM’s response to surging demand for Japanese brands. At first, consumers were very receptive to what was billed as “a new kind of car company,” but sales peaked in 1994 and then drifted steadily downward. GM reorganized the division, taking away some of its autonomy in order to leverage the parent company’s economies of scale, and in 2004 GM agreed to invest a further $3 billion to rejuvenate the brand. But 21 years and billions of dollars after its founding, it has yet to earn a profit.¹

Similarly, Polaroid, the pioneer of instant photography and the employer of more than 10,000 people in the 1980s, failed to find a niche in the digital market. A series of layoffs and restructurings culminated in bankruptcy, in October 2001.

These stories illustrate a common business problem: staying too long with a losing venture. Faced with the prospect of exiting a project, a business, or an industry, executives tend to hang on despite clear signs that it’s time to bail out. Indeed, when companies do finally exit, the spur is often the arrival of a new senior executive or a crisis, such as a seriously downgraded credit rating.

Research bears out the tendency of companies to linger. One study showed that as a business ages, the average total return to shareholders tends to decline. For most of the divestitures in the sample, the seller would have received a higher price had it sold earlier. According to our analysis of a broad cross-section of US companies from 1993 to 2004, the probability that a failing business will grow appreciably or become profitable within three years was less than 35 percent. Finally, researchers who studied the entry and exit patterns of businesses across industries found that companies are more likely to exit at the troughs of business cycles—usually the worst time to sell.

Why is it so difficult to divest a business at the right time or to exit a failing project and redirect corporate resources? Many factors play a role, from the fact that managers who shepherd an exit often must eliminate their own jobs to the costs that companies incur for layoffs, worker buyouts, and accelerated depreciation. Yet a primary reason is the psychological biases that affect human decision making and lead executives astray when they confront an unsuccessful enterprise or initiative. Such biases routinely cause companies to ignore danger signs, to refrain from adjusting goals in the face of new information, and to throw good money after bad.

In contrast to other important corporate decisions, such as whether to make acquisitions or enter new markets, bad timing in exit decisions tends to go in one direction, since companies rarely exit or divest too early. An awareness of this fact should make it easier to avoid errors—and does, if companies identify the biases at play, determine where in the decision-making process they crop up, and then adopt mechanisms to minimize their impact. Techniques such as contingent road maps and tools borrowed from private equity firms can help companies to decide objectively whether they should halt a failing project or business and to navigate the complexities of the exit.

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The psychological biases at play
The decision-making process for exiting a project, business, or industry has three steps. First, a well-run company routinely assesses whether its products, internal projects, and business units are meeting expectations. If they aren’t, the second step is the difficult decision about whether to shut them down or divest if they can’t be improved. Finally, executives tackle the nitty-gritty details of exiting.

Each step of this process is vulnerable to cognitive biases that can undermine objective decision making. Four biases have significant impact: the confirmation bias, the sunk-cost fallacy, escalation of commitment, and anchoring and adjustment. We explore the psychology behind each one, as well as its influence on decisions (Exhibit 1).

Analyzing the project
Let’s start with a brief test of a person’s ability to analyze hypotheses. Imagine that someone deals four cards from a deck, each with a number

<table>
<thead>
<tr>
<th>Decision-making process</th>
<th>Description</th>
<th>Cognitive bias</th>
<th>Definition of bias</th>
<th>Prescriptive advice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Analyze the project or business unit</td>
<td>• Is the project or business living up to initial expectations?</td>
<td>Confirmation bias</td>
<td>• Seeking out information that supports the argument and discounting that which does not</td>
<td>• Replace incumbents with a new manager • Create additional accountability</td>
</tr>
<tr>
<td></td>
<td>• Has it met or exceeded the goalposts initially set?</td>
<td></td>
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<td></td>
</tr>
<tr>
<td></td>
<td>• What have been the historic revenues and costs and how do they compare to expectations?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• What is the expected profitability?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Decide whether to exit or divest</td>
<td>• Should the project be terminated or the business sold, or do future profits justify continued activity (i.e., can the project be turned around)?</td>
<td>Sunk-cost fallacy</td>
<td>• Factoring in unrecoverable costs already incurred when making a decision</td>
<td>• Set up contingent road maps • Use zero-based budgeting</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Escalation of commitment</td>
<td>• Investing additional resources even when all indicators point to failure of continued investment</td>
<td></td>
</tr>
<tr>
<td>Proceed with exit or divestiture</td>
<td>• Who is the natural owner of the business to be sold?</td>
<td>Anchoring and adjustment</td>
<td>• Tendency to adjust estimates insufficiently from an initial value</td>
<td>• Use caretaker managers • Employ independent evaluators</td>
</tr>
<tr>
<td></td>
<td>• What is the minimum acceptable price for the business?</td>
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</tbody>
</table>
printed on one side and a letter on the other. Which pair would you choose given an opportunity to flip over just two cards to test the assertion, “If a card has a vowel on one side, then there must be an odd number on the other side”?

Most people correctly choose the $U$ but then incorrectly select $7$. This pattern illustrates the confirmation bias: people tend to seek information that supports their point of view and to discount information that doesn’t. An odd number opposite $U$ confirms the statement, while an even number refutes it. But the $7$ doesn’t provide any new information—a vowel on the other side confirms the statement, but a consonant doesn’t reveal anything, since consonants can have even or odd numbers on their flip sides. The correct choice is the $8$ because it could reveal something: if there is a vowel on the other side, the statement is false.

Now imagine a group of executives evaluating a project to see if it meets performance hurdles and if its revenues and costs match the initial estimates. Just as most people choose cards that support a statement rather than those that could contradict it, business evaluators rarely seek data to disprove the contention that a troubled project or business will eventually come around. Instead, they seek market research trumpeting a successful launch, quality control estimates predicting that a product will be reliable, or forecasts of production costs and start-up times that would confirm the success of the turnaround effort. Indeed, reports of weak

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Learning to let go: Making better exit decisions

Demand, tepid customer satisfaction, or cost overruns often give rise to additional reports that contradict the negative ones.

Consider the fate of a US beer maker, Joseph Schlitz Brewing. In the early 1970s, executives at the company decided to use a cheaper brewing process, citing market research suggesting that consumers couldn’t tell beers apart. Although they received constant evidence, in the form of lower sales, that customers found the taste of the beer brewed with the new process noticeably worse, the executives stuck with their low-cost strategy too long. Schlitz, once the third-largest brewer in the United States, went into decline and was acquired by rival Stroh in 1982. Likewise, when Unilever launched a new Persil laundry detergent in the United Kingdom, in 1994, the company tested the formula on new clothes successfully but didn’t seek disconfirming evidence, such as whether it would damage older clothing or react negatively to common clothing dyes. Consumers discovered that it did, and Unilever eventually had to return to the old formula.

Deciding which projects to exit

At this stage, the sunk-cost fallacy is the key bias affecting the decision-making process. In deciding whether to exit, executives often focus on the unrecoverable money already spent or on the project-specific know-how and capabilities already developed. A related bias is the escalation of commitment: yet more resources are invested, even when all indicators point to failure. This misstep, typical of failing endeavors, often goes hand in hand with the sunk-cost fallacy, since large investments can induce the people who make them to spend more in an effort to justify the original costs, no matter how bleak the outlook. When anyone in a meeting justifies future costs by pointing to past ones, red flags should go up; what’s required instead is a levelheaded assessment of the future prospects of a project or business.

The Vancouver Expo 86 is a classic example. The initial budget, CAN $78 million in 1978, ballooned to CAN $1.5 billion by 1985, with a deficit of more than CAN $300 million. During those seven years, the expo received several cash infusions because of the provincial government’s commitment to the project. Outrageous attendance estimates were used to justify the added expense (the confirmation bias at play). Predictions of 12.5 million visitors, which would have stressed Vancouver’s infrastructure, grew at one point to 28 million—roughly Canada’s

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population at the time. Moreover, Canadians had seen budget deficits for big events before: the 1967 Montreal Exposition lost CAN $285 million—six times early estimates—and the 1976 Montreal Olympics lost more than CAN $1 billion, though no deficit had been expected.

Contrast that with the story of the Cincinnati subway. Construction began in 1920. When the $6 million budget ran out, in 1927, the leaders of the city decided that it no longer needed the subway, a point suggested by studies from independent experts. Further construction was stopped, though crews had finished building the tunnels. The idea for the subway had been conceived in 1884, and the project was supported by Republicans and Democrats alike, so this decision was not a whim; World War I and shifting demographic needs had altered the equation. Fortunately for Cincinnatians, during the past 80 years, referendums to raise funds for completion have all failed.

Proceeding with the cancellation
The final bias is anchoring and adjustment: decision makers don’t sufficiently adjust future estimates away from an initial value. Early estimates can influence decisions in many business situations, and this bias is particularly relevant in divestment decisions. There are three possible anchors. One is tied to the sunk cost, which the owner may hope to recover. Another is a previous valuation, perhaps made in better times. The third—the price paid previously for other businesses in the same industry—often comes up during merger waves, as it did recently in the consolidation of dot-com companies. If the first company sold for, say, $1 billion, other owners may think that their companies are worth that much too, even though buyers often target the best, most valuable company first.

The sale of PointCast, which in the 1990s was one of the earliest providers of personalized news and information over the Internet, shows this bias at work. The company had 1.5 million users and $5 million in annual advertising revenue when Rupert Murdoch’s News Corporation (NewsCorp) offered $450 million to acquire it. The deal was never finalized, however, and shortly thereafter problems arose. Customers

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complained of slow service and began defecting to Yahoo! and other rivals. In the next two years, a number of companies considered buying PointCast, but the offer prices kept dropping. In the end, it was sold to Infogate for $7 million. PointCast’s executives may well have anchored their expectations on the first figure, making them reluctant to accept subsequent lower offers.

Axing a project that flops is relatively straightforward, but exiting a business or an industry is more complex: companies can more easily reallocate resources—especially human resources—from terminated projects than from failed businesses. Higher investments, which loom larger in decision making, are typically tied up in an ongoing business rather than in an internal project. The anguish executives often feel when they must fire colleagues also partially explains why many closures don’t occur until after a change in the executive suite. Divestiture, however, is easier because of the possibility of selling the business to another owner. Selling a project to another company is much more difficult, if it is possible at all.

When a company decides to exit an entire business, the characteristics of the company and the industry can influence the decision-making process. If a flagging division is the only problematic unit in an otherwise healthy company, for instance, all else being equal, managers can sell or close it more easily than they could if it were the core business, where exit would likely mean the company’s death. (Managers might still sell in this case, but we recognize that it will be hard to do so.) It sometimes (though rarely) does make sense to hang on in a declining industry—for instance, if rivals are likely to exit soon, leaving the remaining company with a monopoly.

**Becoming unbiased**

Several techniques can mitigate the effects of the human biases that confound exit decision making. One way of overcoming the confirmation bias, for instance, is to assign someone new from the management team to assess a project. At a multinational energy and raw-materials

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company, a manager who was not part of an initial proposal must sign off on the project. If the R&D department claims that a prototype production process can ramp up to full speed in three months, for example, the production manager has to approve it. If the target isn’t met, the production manager too is held accountable. Making executives responsible for the estimates of other people is a powerful check: managers are unlikely to agree to a target they cannot reach or to overestimate the chances that a project will be profitable. The likely result is more honest opinions.

Well-run private equity firms adopt these practices too. One leading US firm assigns independent partners to conduct periodic reviews of businesses in its portfolio. If Mr. Jones buys and initially oversees a company, for example, Ms. Smith is later charged with the task of reviewing the purchase and its ensuing performance. She takes her role seriously because she is also accountable for the unit’s final performance. Although the process can’t eliminate the possibility that the partners’ collective judgment will be biased, the reviews not only make biases less likely but also make it more likely that underperforming companies will be sold before they drain the firm’s equity.

Another tool that can help executives overcome biases and make more objective decisions is a contingent road map that lays out signposts to guide decision makers through their options at predetermined checkpoints over the life of a project or business. Signposts mark the points when key uncertainties must be resolved, as well as the ensuing decisions and possible outcomes. For a contingent road map to be effective, specific choices must be assigned to each signpost before the project begins (or at least well before the project approaches the signpost). This system in effect supplies a precommitment that helps mitigate biases when the time to make the decision arrives.

One petrochemical company, for instance, created a road map for an unprofitable business unit that proposed a new catalyst technology in an attempt to turn itself around (Exhibit 2). The road map established specific targets—a tight range of outcomes—that the new technology had to achieve at a series of checkpoints over several years. It also set up exit rules if the business missed these targets.
Road maps can also help to isolate the specific biases that may affect the corporate decision-making process. If a signpost suggests, for example, that a project or business should be shut down but executives decide that the company has invested too much time and money to stop, the sunk-cost fallacy and escalation-of-commitment bias are quite likely at work. Of course, the initial road map might have to be adjusted as new information arrives, but the changes, if any, should always be made solely to future signposts, not to the current one.

Contingent road maps prevent executives from changing the decision criteria in midstream unless there is a valid, objective reason. They help decision makers to focus on future expectations (rather than past performance) and to recognize uncertainty in an explicit way through the use of multiple potential paths. They limit the impact of the emotional sunk costs of executives in projects and businesses. And they help decision makers by removing the blame for unfavorable outcomes that have been specified in advance: the explicit recognition of problems gives an

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**EXHIBIT 2**

**A contingent road map**

Disguised example of petrochemical company

- Company considers sale or closure of unprofitable business unit
- Management identifies $100 million improvement with new catalyst technology
- Company monitors risks from technology, market acceptance, and response from competitors

![Diagram of contingent road map]

organization a chance to adapt, while a failure to recognize problems beforehand requires a change in strategy that is often psychologically and politically difficult to justify. Before the invasion of Iraq in 2003, for example, it was uncertain how US troops would be received there. If the Bush administration had publicly announced a contingency plan providing for the possibility of increased troop levels should an insurgency erupt, the president would most likely have had the political cover to adopt that strategy.

When companies are finally ready to sell a business, the decision makers can overcome any lingering anchoring and adjustment biases by using independent evaluators who have never seen the initial projections of its value. Uninfluenced by these earlier estimates, the reviews of such people will take into account nothing but the project’s actual experience, such as the evolution of market share, competition, and costs. One leading private equity firm overcomes anchoring and other biases in decision making by routinely hiring independent evaluators, who bring a new set of eyes to older businesses in its portfolio.

There are ways to ease the emotional pain of shutting down or selling projects or businesses. If a company has several flagging ones, for example, they can be bundled together and exited all at once or at least in quick succession—the business equivalent of ripping a bandage off quickly. Such moves ensure that the psychological sense of failure that often accompanies an exit isn’t revisited several times. A onetime disappointment is also easier to sell to stakeholders and capital markets, especially for a new CEO with a restructuring agenda.

In addition, companies can focus on exiting businesses with products and capabilities that are far from their core activities, as P&G did in 2002, when it divested and spun off certain products in order to focus on others with stronger growth prospects and a more central position in its corporate portfolio.⁹

Although canceling a project or exiting a business may often be regarded as a sign of failure, such moves are really a perfectly normal part of the creative-destruction process. Companies need to realize that in this way they can free up their resources and improve their ability to embrace new market opportunities.

By neutralizing the cognitive biases that make it harder for executives to evaluate struggling ventures objectively, companies have a considerably better shot at making investments in ventures with strong growth prospects. The unacceptable alternative is to gamble away the company’s resources on endeavors that are likely to fail in the long run no matter how much is invested in them.

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