Chapter One

Decision Making Shapes Your Life

You know how it is. You’re 21 or 22, and you make some decisions; then—whish!—you’re 70. —T. Wilder

Your typical day is full of decisions. What time should I get up in the morning? Should I wear black shoes or brown shoes? What will I have for breakfast? Do I fill up the car with gas this morning or do it on the way home from work? When I get to work, what do I do first: respond to email, go through my in basket, listen to my voicemail, meet with colleagues?

Throughout your workday, you’re confronted with dozens more of these mundane decisions. And after work, you get no rest from making choices. Do I make dinner at home or eat out? What am I in the mood for? When will I read the newspaper and go through my personal mail? Do I want to watch TV tonight, and, if so, what shows do I watch? Should I make a few calls to family and friends?

Every once in a while, your unrelenting life of routine decisions is interrupted by the need to make a major decision. For instance, your car’s
transmission goes out, and you have to decide whether to spend $1,500 to repair it or to go looking for a new car. The person you’ve been dating wants you to give up your apartment and move in together. Your employer is making cutbacks, your boss advises you that your position is being eliminated, and suddenly you’ve got to find a new job.

There are few activities more encompassing and characteristic of mankind than making decisions. None of us have the option to live a life void of making choices. In fact, one of the primary tasks parents have in raising children is preparing them to make decisions on their own.

**Who you are and what you’ll become (or have become) are largely determined by your decision choices.**

Decision making covers a wide territory. It encompasses everything from major decisions, such as accepting a marriage proposal, to the routine choices of everyday life like selecting among food items at the grocery store. Interestingly, most people think of decision making in the context of the big choices—marriage, children, college, jobs, home purchases. Yet the dozens of day-to-day decisions we all make can be powerful forces in shaping our lives. The person who has trouble scheduling his or her time often ends up being chronically late to work, to meetings, and to social events. It begins to interfere with job performance ratings and personal relationships. What appears on the surface to be minor decisions—what time do I get up in the morning or leave for a date—leads to losing a job or alienating a friend. In many cases, a person “down on his luck” is really just a person who has made some bad choices. He dropped out of school; tried drugs, believing he couldn’t become addicted; made some foolish investments; failed to develop marketable job skills or to keep those skills current; procrastinated too long and missed out on a great business opportunity; failed to show up at work on time; chose to save money by
not buying health insurance; didn’t think it necessary to read the “small print” in the contract; or thought there was nothing wrong with drinking and driving. The choices we make—the small ones as well as the large ones—shouldn’t be taken lightly. To do so places our future in the hands of fate.

A lot of us overlook the obvious fact that the choices we make shape our lives. Who you are and what you’ll become (or have become) are largely determined by your decision choices. It’s not luck that Oprah Winfrey, Rudy Giuliani, Bill Gates, and Tiger Woods excel in their professions. And it’s not chance that smokers significantly increase the likelihood that they’ll die of lung cancer or that people who save money on a regular basis are less likely to be destitute in their old age than people who don’t. A lot of well-educated people, with talent and connections, have screwed up their lives because they’ve made bad choices. And a lot of people with very average talent and minimal opportunities have lived full and rich lives because they have learned how to make smart decisions. In actuality, what we often attribute to luck is nothing more than making the right choice at the right time. A large component of luck is good decision making. The point is: For the most part, the quality of your life is a result of the quality of your decisions.

The good news is that you can improve your decision skills. Even though these skills are critical for success in life, and most of us have had little or no formal training in how to make decisions, you’re not captive to learn only through experience. The basic knowledge you need to have to become more effective at decision making can be condensed and summarized into a short, easy-to-read book, and here it is! In the following pages, you’ll learn the steps for making optimum decisions and the roadblocks you need to be aware of that can detour this goal.

One caveat before you begin your journey. Perfecting your decision skills doesn’t guarantee that all your decisions will come out the way you had hoped. Good decision skills focus on the means you use to reach a decision, not on the ends. You can’t control outcomes. You can only control
the process for arriving at those outcomes. As the old adage goes, however, the race doesn’t always go to the swift nor the battle to the strong, but that’s the way to bet. Improving your decision skills just increases your chances of winning life’s races and battles.

**Decision Tips**

- Decision making is one of life’s most important skills.
- You can improve your decision skills.
- You can control only the decision process, not the outcomes.
Brian and Rhonda had been looking for a home for several months. Then they came across the perfect place. The seller was asking $295,000 for it. Brian, always the smart negotiator, began doing his homework. He got a report listing all recent home sales in the area. He found ones that were similar to the one he wanted. He compared them on lot size, number of rooms, square footage, quality of construction, age, condition, and similar factors. After this careful analysis, Brian concluded that the fair market value for this house was $255,000. Now came the challenge. If Brian allowed the seller to focus on the $295,000 asking price, Brian was on the defensive. He would have to explain why he was offering $40,000 less. However, if Brian could get the seller to focus on Brian’s $255,000 offer—that is, to get the seller to justify why the house isn’t correctly priced at $255,000 when compared with other recent sales—he’d have a much better chance of buying the house for something close to $255,000. In essence, Brian was attempting to switch the point of negotiation from the asking price to his offer price.
Brian understood the anchoring effect. He realized that the initial starting point of a negotiation plays a major part in determining the final outcome. In this chapter, you’ll see how the anchoring effect shapes a number of decisions—from negotiations to jury verdicts—and what you can do to lessen its influence.

The anchoring effect is a tendency to fixate on initial information as a starting point. Once set, we then fail to adequately adjust for subsequent information. Why does this occur? Our mind appears to give a disproportionate amount of emphasis to the first information it receives. So initial impressions, ideas, prices, and estimates carry undue weight relative to information received later.

Anchors are widely used by people in the persuasion professions such as advertisers, politicians, real estate agents, and lawyers. For instance, in a mock jury trial, one set of jurors was asked by the plaintiff’s attorney to make an award in the range of $15 million to $50 million. Another set of jurors was asked for an award in the range of $50 million to $150 million. Consistent with the anchoring effect, the median awards were $15 million versus $50 million in the two conditions.

Negotiations aren’t limited to the persuasion professions, however. All of us are involved in bargaining. We buy a new car. We buy or sell a home or business. We create a prenuptial contract or negotiate a starting salary. And any time a negotiation takes place, so does anchoring. As soon as someone states a number, your ability to objectively ignore that number has been compromised. For instance, when a prospective employer asks how much you were making in your prior job, your answer typically anchors the employer’s offer. Most of us understand this and upwardly “adjust” our previous salary in the hope that it will encourage our new employer to offer us more.
Let’s look again at home prices because, for most us, buying or selling a home is one of the biggest financial decisions we make. The evidence indicates that not only is the typical buyer anchored by a property’s initial price, so are the “experts.” An experiment with experienced real estate agents in Tucson, Arizona, illustrates this point. The agents were given a detailed 10-page packet describing a number of homes and then taken on a tour of these properties. The packet contained standard Multiple Listing Service listing sheets, recent housing sales data for the city and the neighborhoods, and data about current homes for sale on the market. The agents were then asked to assess “fair market values” and to predict selling prices for these homes. The catch in this experiment was that the listed selling price on the summary sheets was manipulated. The homes had been independently valued by appraisers, but different agents were given different listing prices—ranging from 12 percent higher than the actual appraisal to 12 percent lower. Consistent with the power of anchors, the higher the listing price, the higher the agents’ valuation and estimated selling price.

The anchoring effect is most potent when there is a lack of objective information to compare against. Why is a new Patek Philippe watch “worth” $25,000? Because its manufacturer says so? Have you ever gone shopping for a diamond? Did you buy one? How do you know if you got a good deal? Is a wonderful painting by an unknown artist worth $50 or $5,000? Purchases of jewelry and art are particularly vulnerable to anchoring effects because most of us have a great deal of difficulty assessing true value. We are heavily influenced by the initial price set by the seller.

In ambiguous situations, we need to be particularly cautious of trivial factors because they can have a profound effect on anchoring us to an
initial position that is hard to deviate from. And implausible anchors can produce large effects. For instance, a television infomercial that promises that you could make $300,000 in the first year of selling a certain product is more likely to motivate you to sign up than one that offered a more realistic $25,000. Because we’re unlikely to have any valid reference point to challenge the $300,000 claim, it’s easy for shady entrepreneurs to suck in people with outrageous statements.

You can do a couple of things to make yourself less susceptible to anchoring effects. First, be aware of the anchoring bias. Recognize that we’re all vulnerable to first impressions, so we have to be vigilant when we receive initial information. You need to particularly scrutinize initial values that seem unusually high or low. Also, you should be cautious when confronted with best- or worst-case scenarios. This is because extreme anchor values produce the largest anchoring effects. “For instance, after considering the probability of a business venture under ideal conditions, it is difficult to arrive at a realistic projection.” Finally, use your knowledge of the anchoring effect to improve your negotiation skills. As a buyer, pay little attention to initial offers. Although everyone must have a starting position, these initial offers tend to be extreme and idealistic. Don’t let them limit your focus or narrow your options. Conversely, as a seller, you want to do just the opposite. Try to take the initiative by defining an initial price and focus the negotiations around that initial number.

**Decision Tips**

- Be aware that initial values bias subsequent information.
- Be vigilant to initial values that appear unusually high or low as well as best- and worst-case scenarios.
- As a buyer, pay little attention to initial offers.
- As a seller, try to take the initiative by defining an initial price.
Chapter Twenty-Two

Gone Is Not Always Forgotten: Understanding Sunk Costs

Consistency requires you to be as ignorant today as you were a year ago.
—B. Berenson

Nancy Segal, a New York City resident, bought a ticket to the ballet. An hour before she was to leave for the performance, she felt tired and a bit sick. She didn’t feel like walking eight blocks to Lincoln Center or sitting for three hours. What she really wanted to do was put her feet up on the couch and spend the evening reading a book, but she forced herself to go to the ballet. Her explanation? “I spent $80 for that ticket, and I wasn’t about to waste my money.”

Nancy made an irrational decision. She got taken in by the concept of sunk costs. If Nancy had been rational, she would have based her decision only on future consequences. So the amount she paid for the ticket shouldn’t have affected her future decisions. However, she treated the nonrefundable expenditure as equivalent to a current investment. And it’s not. Like Nancy, you’ll make more effective decisions if you consider only future benefits and costs rather than those already incurred." Why?

97
Because the decisions you make today can only influence the future. No current decision can correct the past.

A lot of us get sucked in by sunk costs when making decisions. For instance, do you know anyone who just can’t leave food on a plate in a restaurant? I have a friend who, when we eat out, always forces herself to clean her plate even when she’s absolutely full. The fact that the food is already paid for—eaten or not—is irrelevant to her. Have you ever had anyone tell you they’re unhappy in their relationship? If you asked that person why he or she doesn’t move on, the answer is something like “Because I’ve already put so much time into it.” Or have you ever stayed through a movie you hate, rather than walk out, because you paid $8 to see it?

In a classic study, one group of subjects was told to imagine themselves as the head of a firm that manufactured military defense aircraft. The company has already invested $10 million in research to try to build a plane that would not be detected by conventional radar. However, when the project is 90 percent complete, a competitor begins marketing a plane that can go undetected by radar and is much faster and far less costly than the plane your company is developing. As head of the company, subjects were asked if they would invest the last 10 percent of the research funds to finish the project. Then a second group was given the same scenario, but no mention was made of the prior investment. Although 85 percent of the first group said they would complete the project, only 17 percent of the second group said they would spend the additional money. Clearly, the previous expenditure of $10 million influenced the first group’s decision whether to continue or to drop this project.

A more recent study of playing time by NBA basketball players found that coaches are influenced by sunk costs. In this instance, sunk costs were defined in terms of selection order in the annual college draft. Although you’d expect rational coaches to play and keep their most productive players, draft order irrationally influenced those decisions. Coaches gave more playing time to their most highly drafted players and retained them
longer, even after adjusting for factors such as on-court performance, injuries, and the like.

The common thread through these examples is the consideration of sunk costs. But why do so many of us act irrationally when it comes to ignoring past expenditures of time, money, or effort? Why do we fixate on the past rather than on the future? Because ignoring sunk costs can make us look indecisive, inconsistent, and wasteful.\textsuperscript{4} We want to save face and avoid admitting, especially in public, that an earlier decision was a mistake. “I’ve got too much invested to quit now” is a phrase many of us have used too often. We also want to appear consistent. This is because consistency is a key element of rationality. Because most advanced societies value consistency and persistence, we want to look good to others, and we can do this by “staying the course.” Finally, many of us desire to avoid appearing wasteful because, in most circles, wastefulness is seen as an undesirable trait.

So how can a knowledge of sunk costs help you to make better decisions? First, the decisions you make today influence only the future, not the past. So don’t pay attention to past losses and costs when making decisions.\textsuperscript{5} That is, ignore sunk costs. In terms of continuing a relationship, for instance, ask yourself, “If I were going out on a date with this person for the first time today, would I want to see them again?”

Second, it’s OK to admit mistakes. If you have trouble conceding errors, ask yourself this: Why does admitting to an earlier mistake distress me? The idea here is to know when to say stop. You want to be able to distinguish those situations where persistence in pursuing a previously set course will pay off and when it’s just redirected.

\textit{The decisions you make today influence only the future, not the past. So don’t pay attention to past losses and costs when making decisions.}
Third, consistency isn’t always a desirable trait. Flexibility can also be an asset. It’s all right to be inconsistent if you can objectively justify it. A past decision, made under a certain set of conditions, may no longer be appropriate if those conditions have changed. Your previous decision wasn’t necessarily wrong; it just no longer fits the prior conditions it was made under.

**Decision Tips**

- Ignore sunk costs.
- It’s OK to admit mistakes.
- You don’t always have to be consistent.