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The Entrepreneur's Dilemma: How Do You Know When It's Hopeless?

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Many entrepreneurs launch a venture with great certainty, passion, and grand hopes for the future. However, at some point the dream begins to dim. They might receive negative feedback about their venture, or realize that their hard work is not generating enough income for them to live comfortably. Should they double down in their commitment to the venture, make major changes to it, or pull the plug?

International financier Dr. Vincent deFilippo has studied this problem closely. He is a professor in the School of Accounting and Business at Monroe College. Previously he was CEO of a private equity fund in Hong Kong and raised several billion dollars in venture capital for entrepreneurs and publicly traded companies throughout Asia Pacific. He is also a member of the Writers Guild and holds an MBA and a Doctorate in Business Administration with a concentration in behavior, decision-making, and leadership.

In this interview with EIX, deFilippo draws from his new book to explain how entrepreneurs put themselves in peril when they fail to recognize that their idea or venture has problems or may not pan out, and choose to redouble their efforts instead of charting a new path.

An Intense Focus on Decision-Making

EIX: You were a venture investor before going back to study for a PhD. Please tell us a little about your investing experience and how that informed your academic curiosity.

I started working in the financial services industry when I was 18 years old. I was curious about how successful people built their wealth and businesses. After cold calling 27 different job offerings I was able to find an opportunity to start working on Wall Street.

My career in investing transitioned from financial advisor to institutional sales, investment banking, then venture capital and private equity. I was fortunate to be around during the Internet buildup of the 1990s, and the rise of emerging global markets in the 2000s. I have been an angel investor, entrepreneur, and real estate developer since my early 20s. I brought my investment bank to Singapore in March of 2013, and began building my private equity firm at that point. I assisted Asia Pacific region businesses with corporate strategies and capital-raising initiatives, raising them more than $2.5 billion.

From the beginning of my career through my travels through the Asia Pacific region, I was always curious about investor behavior and decision-making. I made some mistakes early on in my career, and wanted to understand why some decisions went well and others poorly. As I researched decision-making, I was fortunate to be introduced to great academics: Shaw, Kahneman and Tversky. This opened my mind to topics like loss aversion, escalation of commitment, and behavioral finance.

I decided to pursue my Doctorate in Business Administration with an emphasis on behavioral finance, decision-making and leadership. I wanted to first learn how to make better decisions and then how I can teach other entrepreneurs the same skill, while also teaching them how to avoid some of the mistakes I made in the past.

Explaining Escalation of Commitment

EIX: The "Escalation of Commitment" (EoC) is a process that you're especially interested in. Can you tell us what that term means, and give us a short history of the idea?

This theory was developed by Barry Staw through a psychology paper. In his paper, he argues that a decision-makers increase their total investment after receiving negative feedback in order to self-justify their initial decision. Logically, they continue hoping to ultimately prove their original investment, risking the incurring future negative feedback. Such assumptions were based on cognitive dissonance literature.

Escalation of commitment (EoC) is a situation when a person continues to invest into a “failing course of action” because he/she has already invested effort, time or money. In other words, escalation of commitment is a behavior when people continue to make the same choice, even though they’ve received negative feedback initially. Some researchers referred to EoC as sunk cost fallacy. Further, often in time, EoC leads to an individual delaying his or her exit decision. Staw and Ross (1987) found that that EoC means “predicaments where costs are suffered in a course of action, where there is an opportunity to withdraw or persist, and where the consequences of persistence and withdrawal are uncertain.”

Individuals who are faced with an escalation situation are essentially finding themselves in the place that they initially received negative feedback, and then must choose if they would like to continue with the same outcome or to exit. Whether it’s in government, politics, economy, business, or wherever that escalation of commitment takes place, decision-makers will be faced with an uncertain scenario in which they have to make a decision after hearing negative feedback.

How Dogged Commitment Hurts Entrepreneurs and Investors

EIX: EoC sounds especially relevant to entrepreneurs and investors, who are often so passionate about their ideas. How does EoC end up hurting their efforts?

EoC is one of the biggest reasons entrepreneurs must recognize that it is time to quit or revise their business model. Entrepreneurs start a business with strong passion and commitment. They put their effort, time, and resources into their companies. The entrepreneur's business environment can also change quickly in a rapidly changing world. The entrepreneur must adapt when an environment changes and when data shows a different picture.

Suppose the business has consistently lost money and failed to pay an income for a long time. In that case, the entrepreneurs must ask themselves whether it is a good investment of time, money, and effort. Rationally speaking, they should at least revise their business model. In the worst case, they should stop and close the business or acquisition if the investment is not profitable.

Most entrepreneurs would continue to invest more time, money, and effort, even taking on additional debt. Self-justification theory suggests that these entrepreneurs escalate their commitment to a hopeless cause to save face and justify their choices. By continuing with the same behaviors and course of action, they hope that ultimate success will justify their decisions. If the outcome proves that they were right all along, they feel vindicated.

Another example would be in the context of investors. Emotions significantly affect an individual's decision-making process, causing people to process information illogically. In investment situations, individuals tend to base their decision-making process on something other than rational decisions or choices. Instead, they think about their prior gains and losses. They fixate on a previous high price as an anchor, assuming the stock will rebound back to that price soon. They may even invest more funds into a losing situation, escalating a poor investment decision. In their minds, they tell themselves that the price will rebound. They escalate their commitment by holding on to the losing stock, ultimately causing them to lose more money. In a rational world, they should have cut their losses and sold stock when the price decreased past their risk management threshold, for example, 5% - 7%.

Grit, or Foolhardy Persistence?

EIX: Some entrepreneurs would say that to be successful you have to be willing to push through even when the odds look poor. What’s the difference between EoC and good forms of persistence, like grit or diligence?

Before knowing that you have fallen into the trap of EoC, first you need to understand the cause of it.

According to Staw and Ross (1978), self-justification theory explains that when a people receive a negative outcome that is a result of their decisions, they will try to mentally justify the actions in order to protect their self-esteem. To put it differently, through escalating their

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commitment into the initial course of action, the decision-makers try to tell themselves that the previous selection is the right one, disregarding the negative outcome. This can be seen as a defensive mechanism that humans have in place to protect themselves mentally from any type of distress of possible failures or mistakes.

Another cause of EoC is prospect theory, which emphasizes an individual's attitude toward loss and gain prospect. The theory explains that a person starts in a situation at one reference point but as they experience loss or gain, the reference point changes, thus causing the person to perceive the scenario differently.

Escalation of commitment theory could offer a rational explanation for many "irrational" behaviors. For example, have you ever wondered why some people wait at a bus stop for more than 30 minutes to take them somewhere, when they could have just walked to the same destination in 15 minutes? Have you ever seen some organizations stick with a failing business, instead of letting it go? It seems like it was just yesterday when the USA had found itself "knee-deep in the big muddy" in a tension with Vietnam. Why didn't the USA stop the war?

Questions to Ask Yourself

EIX: What kind of soul-searching should entrepreneurs be doing when they receive negative feedback about their venture or suspect it is not working out? How can they think critically about whether to continue on their course, change course, or pull the plug?

Here are some things for entrepreneurs to think about to know whether to continue or quit:

1. Continually monitor the business environment you are operating in to see if conditions have changed.
2. Evaluate whether any scenario has changed from when you first started the business, your previous year, and most current quarter (90 days) of results. Evaluate how these changes may have impacted your previously planned business objectives and goals. How have these changes impacted your values and what is important to you for your business to be successful?
3. Think about how the effects of these impacts have changed your business plan, your partnerships or joint ventures, and future growth prospects. Spot areas of your business that have fallen behind your expectations and research why this has happened.
4. Why should you continue with the business? List your reasons, then cross-check your answer with the next four questions.
5. Are you trying to justify your decision based on your responsibility?
6. Are you continuing because you do not want to admit that sometimes it is okay to quit?
7. Are you continuing because you want to compensate for past loss?
8. Are you escalating your commitment because you simply do not want to lose face?

How to Break Free

EIX: What else can entrepreneurs or investors do to break out of the dangerous spirals EOC can pose?

How can we avoid these pitfalls in decision-making? How can we consistently see the forest *and* the trees while avoiding repeated commitments to losing positions? And how do we accomplish this efficiently through facts and logic rather than gut instincts? In a word, *convergency*—a form of top-down decision-making.

Convergency, as a decision-making framework, allows us to better identify what's most important through a process that progressively narrows our focus. Convergence is visually illustrated by the way tributaries flow together until they converge into a single river. As a decision-making tool, convergency encourages us to focus on the river—our single best choice—by selectively eliminating fewer desirable options and leaving only the best for our consideration.

Simply put, we take the big picture and narrow it down, step by step, until there is a single outcome that is clear to us. Much like pouring water into a funnel.

Prof. deFilippo's new book is Braking Point: How Escalation of Commitment Is Destroying the World (and How You Can Save Yourself) (https://www.amazon.com/Braking-Point-Escalation-Commitment-Destroying-ebook/dp/B0C4CTPKF1/) . For more about him, visit his web site (https://www.vincentdefilippo.com/) *.*

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