The Outside — In Approach: Eliminating our Natural Bias

Written by
Jerry Alderman et al
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Achieving a disciplined approach to Customer Value Creation (CVC) requires adopting a number of ideas and philosophies that are new to many industrial companies. In Valkre’s experience, companies must incorporate a specific set of tools and ideas to move along the path towards profitable growth.

This paper focuses on the concept of Outside—In. The Outside—In approach is a short hand way of saying that far too often companies do not spend enough time thinking about business decisions from a perspective other than their own. Instead, companies continue to make business decisions using an approach that is more or less based on their internal knowledge and instincts...an inside-out approach. The result of this inside-out approach leads companies to losing touch with their customers, stagnating value propositions, and underperforming against financial expectations.

Figure 1: Customer Value Creation: A Disciplined Approach to Profitable Growth
So, one of the ingredients to achieving profitable growth is to take an Outside—In approach to business.

To accomplish this transition, companies must evaluate their decision making processes to ensure consistent and effective decision making across the organization. Why? Because significant scientific evidence and our own extensive experience suggest that despite most individuals’ best intentions, their decisions largely reflect internal viewpoints and myopic perspectives on customers’ needs. In practice, the decision-making process is heavily influenced by the assumptions and biases of the decision makers as opposed to the customer’s perspective.

Outside—In is based on Scientific Principles

During the past several years there have been significant advances in the field of behavioral economics that need to be incorporated into business. Many of these theories are being implemented in the capital markets but have yet to make their way into operating business practices. The most fundamental advancements in the behavioral economics field pertain directly to how we as humans make decisions and the flaws inherent in many of those decisions. This paper will discuss how by adopting an Outside—In perspective we can incorporate the latest behavioral economics science into our business decision processes and improve our performance.

Relating the Outside—In Approach to Decision Making

Decision behavior has received increased recognition with the award of the Nobel Prize in Economics in 2002 to Dr. Daniel Kahneman. Dr. Kahneman, a professor at Princeton University, was the first behaviorist in history to win the award. Kahneman was cited “for having integrated insights from psychological research into economic science, especially concerning human judgment and decision making under uncertainty.” Among other things, Kahneman’s efforts have shown that we all tend to be overconfident in our own ability and as such need to integrate an Outside—In perspective to improve our business decisions. Kahneman’s work, has laid the foundation for a new field of research by discovering how human judgment may take shortcuts that systematically depart from basic principles of probability. The award reflects the remarkable success of an approach known as behavioral economics, which merges psychology and economics in a way that enriches both academic theory and policy practice.

Why Is Decision Making So Difficult?

Why do so many people struggle with making decisions? To begin with, there are implications and outcomes that result directly from being a decision maker. This responsibility can hinder an individual’s ability to make rapid and confident decisions.

- Consequences. Sometimes decisions result in positive consequences and sometimes the results are negative. Since most everyone desires a positive consequence, the possibility of a negative consequence causes many to stall decisions or never make them at all.
- Accountability. How many times have you heard, “Whoever made this decision should be fired?” No one wants their name attached to a decision that may go wrong. Instead, people usually wait for a positive outcome and then work feverishly to take some part of the credit.
- Choices. There always seems to be too many choices. How do we know what choice should be chosen? In today’s world the number of choices seems to be growing without parallel growth in the number of right answers.

Why do we tend to look Inside—Out?

Once individuals overcome the difficulties preventing them from making decisions in the first place, how can we be certain that they make the proper decisions? Do they consider all factors and strive towards an objective, rationale decision? Dr. Kahneman’s findings have shown unequivocally that they rarely do. And there is good reason for this —most of us think we are smarter than everybody else and that the answer we develop in our own conference roots is actually right. Unfortunately, the research has demonstrated that humans do not decide rationally and in fact make predictable errors. We exhibit decision failures for a number of reasons, such as: biases in perception, fallacies in reasoning, and problems of groupthink. As a result, it is more often the case that our answers and ensuing decisions do not deliver on the financial returns we promised.

To highlight the importance of Outside—In, we have identified a number of well documented biases and heuristics that can sabotage decision making with an Inside—Out approach:
1. Overconfidence Bias

Our brains are programmed to make us feel overconfident. Behavioral economists often illustrate this point with simple quizzes: guess the weight of a fully laden jumbo jet or the length of the River Nile. Participants are asked to offer not a precise figure but rather a range in which they feel 90 percent confidence—for example the Nile is between 2,000 and 10,000 miles long. Time and again, participants walk into the same trap: rather than playing safe with a wide range, they give a narrow one and miss the right answer. Most of us are unwilling and unable to reveal our ignorance by specifying a very wide range. Most of us prefer to be precisely wrong rather than vaguely right.

We also tend to be overconfident of our own abilities. This is a particular problem for strategies based on assessments of core capabilities. Almost all financial institutions, for instance, believe their brands to be of “above average” value.

2. The Status Quo Bias

In one classic example, (William Samuelson and Richard Zeckhauser, “Status quo bias in decision making,” Journal of Risk and Uncertainty, March 1988) students were asked how they would invest a hypothetical inheritance. Some received several million dollars in low-risk, low-return bonds and typically chose to leave most of the money alone. The rest received higher risk securities—and also left most of the money alone. What determined the students’ allocation in this experiment was the initial allocation, not their risk preference. People would rather leave things as they are. One explanation for the status quo bias is aversion to loss—people are more concerned about the risk of loss that they are excited by the prospect of gain. The students’ fear of switching into securities that might end up losing value prevented them from making the rational choice: rebalancing their portfolios.

A similar bias, the endowment effect, gives people a strong desire to hang on to what they own; the very fact of owning sometime makes it more valuable to the owner. Richard Thaler tested this effect with coffee mugs imprinted with the Cornell University logo. Students given one of them wouldn’t part with it for less than $5.25, on average, but students without a mug wouldn’t pay more than $2.75 to acquire it. The gap implies an incremental value of $2.50 from owning the mug.

3. Anchoring

One of the more peculiar wiring flaws in the brain is called anchoring. Present the brain with a number and then ask it to make an estimate of something completely unrelated and it will anchor its estimate on that first number. The classic example is the Genghis Khan date test. Ask a group of people to write down the last three digits of their phone numbers, and then ask them to estimate the date of Genghis Khan’s death. Time and again, the results show a correlation between the two numbers; people assume that he lived in the first millennium, when in fact he lived from 1162 to 1227. Anchoring can be a powerful tool in negotiations. In negotiations, naming a high sale price for a business can help secure an attractive outcome for the seller, as the buyer’s offer will be anchored around that figure.

4. The Herding Instinct

The desire to conform to the behavior and opinions of others is a fundamental human trait and an accepted principle of psychology. Warren Buffett summarized this point when he wrote, “Failing conventionally is the route to go; as a group, lemmings may have a rotten image, but no individual lemming has ever received bad press.” For most CEO’s, only one thing is worse than making a huge strategic mistake: being the only person in the industry to make it. We all felt the tug of the herd during the dot-com era. At times of mass enthusiasm for a strategic trend, pressure to follow the herd rather than rely on one’s own information and analysis is almost irresistible. Yet the best strategies break away from the trend. Some actions may be necessary to match the competition—imagine a bank without an ATM. But these are not unique sources of strategic advantage, and finding such sources is what strategy is all about.

5. False Consensus

People tend to overestimate the extent to which others share their views, beliefs, and experiences—the false consensus effect. Research shows many causes, including:

- Confirmation bias, the tendency to seek out opinions and facts that support our own beliefs and hypotheses.
- Selective recall, the habit of remembering only facts and experiences that reinforce our assumptions.
- Biased evaluation, the quick acceptance of evidence that supports our hypotheses, while contradictory evidence is subjected to rigorous evaluation and almost certain rejection; we often, for example, impute hostile motives to critics or question their competence.
- Groupthink, the pressure to agree with others in team-based cultures.
Without the proper processes to mitigate these inherent human traits, organizations will generally gravitate towards maintaining their traditional Inside—Out approach to business decision making. The result often leads to poor understanding of how the outside world values the companies’ products and services.

Why do Companies Fail to Take an Outside—In Approach?
If you ask most executives if they have a customer focus, they will invariably answer yes. Focusing on your customer is not a new concept, and is critical to the success of any business. But do organizations truly understand what actions and behaviors are necessary to maximize the value exchange with their customers and their suppliers? For retailers, the answer may be yes. The proliferation of data summarizing consumer buying patterns, customer preferences, and demographics has helped retail companies tailor their business offerings to customers’ perceived values. Unfortunately, companies in the industrial world are less likely to understand how customers value one offering versus another. Ask any industrial company executive if they understand better than their competitors how these value tradeoff decisions are made and they will likely suggest that they do. But the reality is all of the biases and heuristics discussed in this paper are playing tricks on their business judgment. By understanding these biases and taking an aggressive Outside—In approach there is an opportunity to create competitive advantage and drive profitable growth.

How Do You Translate an Outside—In Perspective into Profitable Growth?
Valkre has developed a unique approach to helping industrial companies pursue profitable growth. Using our Customer Value Creation model, once a company has adopted an Outside—In perspective, we can leverage multiple tools (see Figure 3) to translate this fresh perspective into enhanced financial returns. By employing tools such as Demand Value Chain and Customer Economics, companies can apply the same rigor and discipline that has been traditionally reserved for operations to their market facing business processes. Effectively leveraging these tools to define and quantify how value is exchanged with customers is the critical bridge to translating Outside—In into profitable growth.

Case Study: Pepsi versus Coke
To highlight the importance of an Outside—In approach, consider the classic example of Pepsi’s attempts to challenge the dominant position of Coca-Cola during the 1970’s. Though these events are over 30 years old, they continue to provide timeless lessons of how to think about your customers. Furthermore, while most retailers have applied the lessons from Pepsi’s experience competing with Coca-Cola, industrial companies still have not grasped the power of these findings and their ability to transform their ability to deliver value to customers. At the time, Pepsi executives were certain that Coca-Cola’s distinctive, hour glass shaped bottle was Coke’s most important competitive advantage. Trying to compete with Coke’s bottle, Pepsi spent millions of dollars and many years studying new bottle designs, but the company’s efforts never achieved the recognition of the Coke bottle. In dealing with this John Sculley, better known as the former chairman of Apple Computer and Pepsi’s vice president of marketing at the time, decided to take a different
Approach by asking what the customer really wanted. In addition, Sculley realized that the company did not know enough about the consumers to identify what they really wanted, and therefore it could not conduct its marketing decision process properly. So before he even tried to assign the bottle question to a new task force, Sculley launched a test to study how families actually consumed Pepsi and other soft drinks in their homes. As a result of the study, Pepsi discovered what all marketers now recognize as a key fact about snack foods—however much you can persuade people to buy, that’s how much they’ll consume. This helped Sculley determine that Pepsi needed to design packages that made it easier for people to get more soft drinks into the home. Pepsi began a new intelligence gathering stage, decided to launch a new group of larger packages, and established new systems to learn from feedback in the stores to refine the packaging strategy still further. The results of Pepsi’s changes were dramatic: Coca-Cola couldn’t convert its famed hourglass silhouette bottle into a larger container. Pepsi’s market share not only expanded dramatically, it drove the long unassailable Coke bottle into extinction in the U.S. market.

Summarizing Outside—In
Taking an Outside—In approach is one of the fundamental concepts of achieving profitable growth under the customer value creation management philosophy. Companies that continue to focus on creating value by having meetings among themselves in their conference rooms have very little chance of creating differential value in the eyes of their customers. The learning to heed from Dr. Kahneman’s research is that we do not know as much about our business as we think and we are often afraid to ask too many ques-