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Entrepreneurial actions and optimistic overconfidence: The role of motivated reasoning in new product introductions

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ABSTRACT

Optimistic overconfidence (OO), that is, being certain of success only to end up disappointed, represents a potentially catastrophic error. However, few studies have identified which entrepreneurial actions are associated with it. To explore this issue, we examined 55 small companies and found that OO of product success was positively related to introducing products that required more resources and were more pioneering. Furthermore, satisfaction with company performance had a curvilinear (U-shaped) relationship with overconfidence. Both high and low levels of satisfaction were associated with greater OO in product introductions. In addition, the bias was positively correlated with entering hostile environments; that is, environments that are characterized by intense competition that threatens a firm and its introductions. Contrary to expectations, however, OO was negatively associated with environmental dynamism; defined as environments that embody frequent and large changes. The research also compared general knowledge overconfidence to OO, concluding that each represents a distinct bias with distinct effects.

Entrepreneurship encompasses a wide variety of firm actions occurring in different decision contexts, ranging from starting a new venture (Gartner, 1985) to introducing a product into a dynamic environment (Miller and Friesen, 1982), all of which are by definition risky, aggressive, innovative, and/or proactive (Lumpkin and Dess, 1996). Quite often, individuals initiating these actions (i.e., entrepreneurs) expect, with almost absolute confidence, that their actions will succeed (Cooper et al., 1988). Entrepreneurs, for example, are more often 100% certain their pioneering products will prosper than are managers introducing products that are more mainstream (Simon and Houghton, 2003). Furthermore, an astonishing 33% of venture founders are absolutely convinced that their ventures have zero chance of failure (Cooper et al., 1988). In fact, arguably one of the few qualities that differentiate entrepreneurs from others is the certainty with which they expect their actions to generate positive outcomes (Palich and Bagby, 1995).

This confidence can potentially produce many positive results, including generating the enthusiasm and the persistence needed to act and to succeed in risky situations. Alternatively, the certainty may represent optimistic overconfidence (OO), the topic of this paper. OO occurs when people overestimate the likelihood that their favored outcome will occur (Griffin and Varey, 1996), causing them to fail to realize their expectations and to end up disappointed.[2] The bias is not only common, but also potentially the single most catastrophic judgment error one can make (Griffin and Varey, 1996). OO may be especially important

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[2] This paper makes a distinction between OO and optimism and between general knowledge overconfidence and overconfidence in skills because they have different underlying dynamics, different rates of occurrence, and/or different performance ramifications (Griffin and Varey, 1996).

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to entrepreneurship, possibly explaining why people initiate entrepreneurial actions and why the actions often fail (Gartner, 2005; Hayward et al., 2006).

An exceptionally robust research finding is that specific decision contexts associated with certain types of actions are much more likely to generate overconfidence (Klayman et al., 1999; Lichtenstein et al., 1982). Still, while researchers suspect that several types of entrepreneurial actions and their accompanying decision contexts may be associated with OO, there is a dearth of studies directly identifying which specific entrepreneurial actions and the relative strength of the relationships (Camerer and Lovallo, 1999). The few empirical entrepreneurship studies that do touch on the topic frequently only examine one type of entrepreneurial action and often only use indirect measures of overconfidence (e.g., Lowe and Ziedonis, 2006), failing to explicitly compare an entrepreneur's prediction to its specific outcome. Cooper et al. (1988), for example, determined that many venture founders are quite certain their new ventures will succeed, but the authors did not compare each prediction to an outcome, nor to predictions made about less entrepreneurial actions. Thus one does not know if an entrepreneur's highly certain predictions are likely to be wrong or if making incorrect predictions differentiated entrepreneurs from others.

We seek to fill the gap left by these studies by identifying several entrepreneurial actions associated with an entrepreneur's failure to realize his or her favorable expectations and by explicitly comparing these actions with their less entrepreneurial counterparts. In so doing, we provide insights into why entrepreneurial initiatives often run into trouble, and we suggest actions to achieve more satisfactory results.

Whetten's (1989) suggestion that early research focused on where the phenomenon of interest was most likely to occur influenced our choice of sample. We studied small businesses, as they are unlikely to contain formal processes that allow for systematic risk assessment. We also focused on a company's new product launch because "new" indicates that a manager may lack the history needed to accurately forecast its outcome (Jain, 2003). This in turn allows for the possibility of overconfidence (Simon and Houghton, 2003).

1. Entrepreneurial actions and optimistic overconfidence

1.1. Prior research

Scholarly works in entrepreneurship have begun to study OO and closely related constructs. However, this research is, arguably, in its infancy. With the exception of a single study (Simon and Houghton, 2003) which examined only one entrepreneurial action (namely first moving), entrepreneurship research has not explicitly empirically compared a given success prediction with its associated outcome. Instead, the few existing studies often used indirect measures and/or missed critical components of OO, such as the performance outcome associated with one's expectation. Townsend et al. (2010), for example, explored whether or not a venture founder was confident of venture success, finding that he or she often was, but the authors never directly examined how the venture fared. Similarly, Palich and Bagby (1995) found that entrepreneurs, compared to managers, emphasize strengths and opportunities while largely ignoring weaknesses and threats, but their study did not answer the following question: Were the entrepreneurs' assessments justified?

Three other studies (Gartner, 2005; Hayward et al., 2006; Hmieleski and Baron, 2009) did discuss performance outcomes. They asserted that initial certainty of success and/or high optimism may ironically actually hinder subsequent performance by leading to inadequate research, inappropriate resource deployment, and inflexibility. Gartner's (2005) and Hayward et al.'s (2006) papers, however, were theoretical and need to be empirically verified. Hmieleski and Baron's (2009) study, while empirical, only examined the link between a venture's performance and the entrepreneur's general optimism. It did not measure the entrepreneur's specific predictions, yet predictions about success may play a role in deciding to proceed.

Overconfidence research also examined corporate acquisitions, a field arguably related to entrepreneurship. The studies used recent superior company performance (Hambrick and Hayward, 1997), media praise for the CEO (Hambrick and Hayward, 1997; Malmendier and Tate, 2008), and CEO overinvestment in their firms (Malmendier and Tate, 2008) to capture the CEOs' OO or closely related constructs. The studies, however, only captured OO indirectly at best, never looking at specific predictions.

Two overconfidence studies examining inventors face similar constraints. Astebro et al.'s (1997)study implicitly assumed that investors were confident of a positive outcome if they were generally optimistic and assumed that their confidence was inappropriate if they were willing to continue their efforts when faced with negative "expert" feedback. Lowe and Ziedonis (2006) assumed confidence if inventors attempted to commercialize their inventions and assumed overconfidence if their inventions fared worse than those of more established firms. Lowe and Ziedonis (2006) acknowledged, however, that both studies allowed for several explanations and suggested that future research use direct measures to generate more precise findings.

Lastly, a study by Camerer and Lovallo (1999) used an experimental design to determine that their subjects predicted that they could profit when entering a new market, even though the subjects expected the overall industry to suffer a net loss. The participants believed they had better than average skills but failed to account for the fact that they would be competing with a reference group with similar beliefs. The authors recognized that "more field research is surely worthwhile," explaining, "experimental data are hardly conclusive evidence that overconfidence plays a role in actual entry decisions by firms." Furthermore, the experiment equated market entry with confidence in success, making it difficult to rule out alternative explanations such as willingness to risk a high probability of failure for a small chance at a large return. Also, like Lowe and Ziedonis's (2006) measure, willingness to compete does not capture a precise level of OO. Even so, determining whether one is moderately or highly optimistic is a crucial distinction, given that moderate optimism may enhance performance, whereas high optimism may decrease it (Hmieleski and Baron, 2009).