

# Sunk Costs: An invisible, pervasive peril

by Jason Cohen on February 15, 2010

Many of my mistakes can be traced back to a failure to recognize and appreciate “sunk cost.”



Just because you've spend time and money doesn't mean you should keep at it.

The term comes from economics: **“Sunk Cost” is money you've already spent and cannot get back.** A “rational actor,” as economists say, will *completely ignore* sunk costs when making decisions because the money is gone no matter what action is taken next.

Of course we carbon-based life forms can rarely be described as “rational,” especially when it comes to ignoring sunk costs. It's hard to abandon projects in which you've poured time and money, especially when you've also attached your ego and reputation.

Sometimes it's easy to do the right thing. For example, let's say you designed a banner ad for a certain website (cost: \$1000) and paid to run the ad for three months (cost: \$2000). At the end of the three months, you look at the results and they're *horrible*—barely anyone clicked the ad and none of those people made a purchase.

Clearly you won't spend any more time or money on that ad. Yes you spent \$3000, but that's a “sunk cost”—you cannot get that money back. Whether you had spent \$30

or \$30,000, it still wouldn't be worth continuing this project. Obvious!

And yet, throwing good money after bad is *exactly* what we do in many other situations. Here's a typical business example. A company is building a new \$20 million manufacturing plant. They burn through the \$20m, but it now it's clear that it will take another \$10m to complete the project. In the meantime, an opportunity has appeared where they could take over and retrofit a different manufacturing plant for only \$2m.

From a completely rational perspective, they should abandon the original project. The \$20m they've spent can't be recovered (let's say), so it's now just a choice between spending \$2m or \$10m. Duh.

Of course the correct decision probably won't be made. You can imagine the internal politics of someone standing up and staying “I'm responsible for this hugely wasteful endeavor, and now I want you to trust my judgment as I pull the plug and do something completely different.”

Here's where you expect me to say how stupid big-business is and how little startups are smart and agile and never make mistakes like that, but that's crap.

**It's not just politics, it's human nature.** Depending on which way you approach it, the term is “Loss Aversion” or the “Endowment Effect,” subtly different but close enough for our purposes.

In short: **We place excessive value on that which we own, or which we perceive we own.** There's all sorts of fun experiments demonstrating this:

- At Duke University there are far more students wanting to attend games than there are tickets, so a complex lottery system determines who gets the

precious few. Experimenters posing as scalpers determined that those who lost the lottery would on average pay \$170 for a ticket. When they approached students who won the lottery, they were willing to part with the ticket for an average \$2,400. Both students went through the same effort to get tickets, but those who own these (randomly-assigned) tickets ascribed a much larger value to them.

- Horse bettors who have already placed their bets (a sunk cost, “owning” a particular outcome) are more optimistic about their chances of winning than those who are still in line to place bets.
- Most people will not walk out of a movie they hate, because that would “waste money,” even though the money cannot be recovered and they could be doing something more enjoyable.
- Just *touching* an item in a store makes you more likely to purchase it.

It's one of those things so deeply ingrained that it's hard to change your gut reaction even when you're aware of the problem. But that's exactly why you have to be especially vigilant.

**So where in my life of startups has this crept up and bit me?** And possibly you too?

- You've created an awesome feature. It was hard to implement and you're proud of it. Problem is, it turns out your customers don't care about it, and it's starting to create confusion and cause bugs. It's hard to kill your pet feature, especially after all this effort, and after all customer XYZ agrees that it's super neat-o. But that effort is sunk whether or not it's the right fit for your product; kill the feature.
- After hours of brainstorming, arguing, and banana daiquiris, you've finally come up with a clever, fun, catchy marketing slogan. Problem is, it doesn't quite fit the business. You don't want to “waste” this great concept; surely you can use it somehow, somewhere? No. As with all writing, you have to learn how to throw things out.

- Your newest hire isn't working out. You did everything you could during the interview; they passed all the tests. Still, they're not a culture fit, they're not picking things up as fast as you'd like, and everyone else is having to pick up the slack, which they resent. But, you think, it was so much work finding them and we've put all this effort into training them; maybe they'll change? But they won't, and deep down you know that. You can't get that time back, and yes this is one of the most expensive mistakes you can make, but even worse is prolonging the inevitable. (It's bad for the employee too—they deserves a chance to find a job where they *can* be successful.)
- You try a marketing effort and it doesn't work. That's OK, that's what A/B tests are for! So you test a pair, and the second one is a *little* better but not much. And then you iterate again, and again, and .... again .... When will you stop and realize that sometimes incremental iteration isn't enough, and sometimes repeated experimentation leads to false-positives?
- You're trying to land a 500-seat sale with a big-name company. The trial has taken 9 months. They keep finding reasons they can't buy—“deal-breaker” features they need, “critical” bugs they can't work around, budget allocations that never materialize. But that sale would mean so much, and besides you've already spent hundreds of hours with them and added all these special features so surely they'll buy from you eventually! But in my experience they often won't, or they'll buy just 10 seats so you can't claim they're “still trialing.” All this is just an indicator that you don't have a good fit; this time-suck isn't going to vanish once they buy. Let it go. You need *profitable* customers, and advocates, not only mere customers.
- You went to school for Biology, so clearly you have to have a career in Biology! Nevermind that you made that career choice when you were a teenager and hadn't really discovered who you were, what makes you happy, or where your talents lie. Your friends and family expect you to get a job as a lab rat and regale

them with stories about diseased bovine spleens while everyone's eating meatloaf. Should you really throw away all that work and all those expectations to follow your true dream of becoming a caterer?

It's perfectly natural to feel attached to your sunk costs. It sucks to acknowledge that you've wasted time, money, energy, and reputation.

**But it's even worse to irrationally prolong the waste.**

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