Entrepreneurs aren't overconfident gamblers

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Leaving one's job to become an entrepreneur is inarguably risky. But it may not be the fear of risk that makes entrepreneurs more determined to succeed. A new study finds entrepreneurs are also concerned about what they might lose in the transition from steady employment to startup.

In Entrepreneurship and Loss-Aversion in a Winner-Take-All Society, Professor John Morgan at UC Berkeley's Haas School of Business and co-author Dana Sisak, assistant professor at the Erasmus University Rotterdam, focused on the powerful impact of loss aversion.

Loss aversion, or the fear of losing one's salary at a full-time job, along with its prestige, is directly linked to the amount of effort an entrepreneur puts into a startup. Loss aversion, the researchers found, is what drives most entrepreneurs, not a love of risk.

"There is a view that entrepreneurs are often overconfident gamblers, who thrive on risk, yet there is little evidence to support this view," says Morgan, who studies competition in online markets at the University of California, Berkeley's Haas School of Business. "Entrepreneurs aren't Steve Jobs. They're just ordinary people who want to start a business. I wanted to try to understand a little better what motivated those individuals."

Many studies focus on what makes a successful entrepreneur different than the rest of us. Morgan sought to learn what motivates individuals to sacrifice a secure job, and what determines an entrepreneur's effort to succeed.

The study is based on a theoretical model the researchers developed and was inspired by the dramatic stories people like to tell about risk-taking entrepreneurs.

All entrepreneurs have a "reference point," which defines how they feel about their salary or, say, happiness level, compared to others, Morgan says. That reference point is not connected to profits and losses, but is directly linked to how much or little the entrepreneurs are willing to lose when starting a company.

Morgan and Sisak found an entrepreneur's level of ongoing concern about loss aversion correlates with entrepreneurial effort. In other words, entrepreneurs who put a high stake on avoiding loss – more so than acquiring new gains – worked harder.

Morgan used a winner-take-all framework, which is common within the Internet startup environment, for his study of entrepreneurs. Startups such as Facebook or Twitter might not offer the best platforms, but still dominate their markets. In markets such as real estate, where there is no clear single winner, this model would be less appropriate, Morgan says. "For every Facebook, there were hundreds of failed ventures," he says. "We model this aspect of entrepreneurial markets explicitly." This research can help entrepreneurs gain self-knowledge so they make better decisions and have a clear understanding of "why they're doing what they're doing," Morgan says.

"One of the most important traps entrepreneurs fall into is when they're not experiencing success and they become increasingly willing to take risks because of where they are psychologically," he says. "One lesson from the research is to be careful when you are behind. It's not necessarily the best decision to double down."

In other words, risk aversion can be a good thing.

More information: See the paper here: faculty.haas.berkeley.edu/rjmo … gan/LossAversion.pdf

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