Ego Makes Entrepreneurs?

Researcher Brian Wu says they aren't unusually risk tolerant. It's "overconfidence in their ability" that allows them to take the leap

Just how much appetite for risk do entrepreneurs really have? That's the question Wharton doctoral student Brian Wu began asking himself while examining their behavioral patterns. He found the general assumption to be that entrepreneurs are risk seekers -- but the empirical evidence suggests that, surprisingly, they weren't. But if entrepreneurs are more cautious than everyone presumes, then what accounts for their risk-bearing behavior?

That question is at the crux of Entrepreneurial Risk and Market Entry, which received the annual Best Doctoral Paper award from the Small Business Administration's Office of Advocacy this month. Co-written with Professor Anne Marie Knott of the University of Maryland, the paper describes entrepreneurs as inherently overconfident, which helps cancel out their sensitivity to risk.

A native of Shandong province, China, Wu has also studied the influence of the euro on his country's foreign exchange reserve and the staged financing of entrepreneurs. He came to the U.S. three years ago, after earning degrees from Tsinghua University in China and the National University in Singapore. BusinessWeek Online reporter Stacy Perman recently spoke with Wu about uncovering a seemingly inherent contradiction on the nature of entrepreneurs. Edited excerpts of their conversation follow.

Q: The accepted understanding has been that entrepreneurs have a greater tolerance for risk than the rest of the population, and yet your study found the opposite to be true. How so?
A: While conventional wisdom assumes entrepreneurs have great risk tolerance compared to the rest of us, in controlled experiments that tracked attitudes to risk, we consistently found that they aren't really that different. In some cases, they're even more risk averse [than the norm], and yet they continue to bear risk.

Q: So you're debunking the conventional wisdom?
A: I wouldn't say that so much as I wanted to make clear that there are dimensions of uncertainty. This disparity confronts two dimensions of uncertainty: One, the uncontrollable risks or market uncertainty, and two, the uncertainty of ability. Entrepreneurs, like everybody else, hate uncontrollable risks, but on the other hand, they're overconfident in their own abilities -- they think they can control their abilities in a random drawing of people. It's like the Lake Wobegon effect in assessing their position among peers. They think they're above the average.

Q: That being the case, what then accounts for their willingness to bear risk?
A: It's their overconfidence in their ability. Their confidence is greater than their risk avoidance. It compensates for their aversion to risk.

Q: How does that influence their behavior?
A: Entrepreneurs appear to be risk seeking with respect to their ability. For example, if there are two industries and one has a high cost of ability uncertainty and the other has a low cost of ability uncertainty, the entrepreneur will choose the first case because of his overconfidence.

Even though the second industry has the same mean value, he would be considered just average [there]. While in the first, he thinks he can be Bill Gates. It's that overconfidence in their ability that encourages them to be entrepreneurs.

Q: Is this then the main differentiating factor between what makes an entrepreneur compared to the rest of the population?
A: There are many sources [of difference], like education, culture, social environment, and family tradition, but in the end, it's
their overconfidence that drives them to be entrepreneurs.

Q: What's the advantage to this approach?
A: I wouldn't say it's advantageous. These findings help us understand why entrepreneurs take risks. If, in fact, entrepreneurs with low capabilities and high overconfidence enter ventures, they're likely to fail in the end because they have overestimated their abilities.

For example, look at the airline industry. There's much uncertainty, and it's volatile. Still, we see a lot of entrants into it because they think they understand the industry. They think they have a higher ability than the other guys. They say, "I will be the next Southwest Airlines."

Q: Then is this an inherent disadvantage?
A: Of course, [the venture] is a failure for the entrepreneur, but the average person benefits. Overconfidence encourages [entrepreneurs] to enter an uncertain industry, and their low ability in it may lead to failure. But without that, the average person wouldn't enjoy the creativity of the entrepreneur and their innovations that lead to lower prices due to competition.

Q: What's the broader implication of this research?
A: It helps us to understand the entry-pattern behavior of entrepreneurs across industries. We can see the dynamic of entrepreneurial behavior. When there's a high degree of uncontrollable uncertainty but a low degree of ability uncertainty, we won't see a sufficient level of entry into an industry. But if there's a high degree of ability uncertainty, we will see a sufficient amount of entrants because their overconfidence compensates for the uncontrollable risks.

Q: As a native of China, how do you see the American entrepreneur in comparison to the Chinese entrepreneur?
A: I think mainly the difference is in culture, in terms of confidence and, in particular, overconfidence. I would characterize American entrepreneurs as confident. I wouldn't say they are overconfident, but they're confident, which is good.

Chinese entrepreneurs in some sense used to be constrained by all kinds of social, political, and cultural factors. Now, they're changing, as China enters the World Trade Organization, and they're becoming more and more confident.

The second thing is that, especially in technological startups, many Chinese entrepreneurs in the big cities are trying to learn from the Americans. More and more, there's a flow of information between the two economies. I'm not sure, but I feel there could be a convergence in entrepreneurial behaviors as China and the U.S. are becoming the two most important economies.

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Edited by Rod Kurtz