No, honoring sunk costs is not always irrational

Sticking with a past decision can be a way to create stability.



November 25, 2025

The sunk-cost effect has long been the poster child for human irrationality.

This business concept describes what happens when an individual or business continues to invest in a failing venture, motivated in part by the resources they have already spent on it.

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Famous examples include the massive decline of General Motors in the 2000s, when the company failed to embrace fuel-efficient cars. And then there's the development of the Concorde, when the United Kingdom and France threw good money after bad in the face of mounting evidence that the aircraft could never be profitable. This case is so iconic that honoring sunk costs is sometimes called "the Concorde fallacy."

Many less famous decisions are also attributed to a sunk-cost mindset, whether it be pharmaceuticals continuing to invest in trials of a minor drug, or a startup that hesitates to pivot when business stalls.

Why do people continue to stumble into this irrationality trap, when they should know better?

Johannes Müller-Trede of IESE Business School argues that we're thinking about it the wrong way. His own research suggests that honoring sunk costs isn't always irrational. And beyond that, he says, how we label things is important.

For example, any business student will tell you that honoring sunk costs is bad.

But many would also tell you that perseverance in the face of rejection and failure is essential.

When perseverance and commitment aren't a sunk cost

Artists and their champions have always known that it can be a long road to success. Take the writer John le Carré, whose first two books had modest sales, but whose third, *The Spy Who Came in From the Cold*, was a genre-defining international bestseller. Continuing with the same tools with only limited success might appear to be poor business acumen, but in the case of le Carré — and, critically, the editor who continued buying his work — continuing to invest until the skills and bestselling idea were perfectly aligned turned out to be a smart move.

It isn't only artists who labor for years before a breakthrough. Dr. Tu Youyou is a Nobel Prize-winning pharmaceutical chemist credited with saving millions of lives. Appointed to study treatments for malaria during the Vietnam War, she bucked medical trends of the 1960s by focusing her search on ancient Chinese medicine, combing through some 2,000 traditional recipes before identifying a compound in wormwood that proved effective. At a time when most scientists were experimenting with synthetic approaches, her path was considered

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eccentric and even superstitious. But her eventual discovery was revolutionary and continues to be the basis for most modern malaria treatments.

In many ways, continuing down a path that does not yield short-term payoffs can put more pressure on a leader than pivoting would — whether that's an editor propping up an underperforming writer or a researcher in charge of a team. Each bend in the road requires the leader to evaluate the situation again. Some situations, like the Concorde, call for a change of direction. But in other situations, staying on course can save leaders and their organizations from the costs and confusion associated with flip-flopping.

Another example of the same patterns of failure and *then* success holding true: Apple failed when it launched the Lisa, a prohibitively expensive $10,000 desktop computer in 1983.

The Lisa is widely considered Apple's most legendary and expensive failure, but was it? It paved the way to future success. The graphical user interface — user-friendly windows, menus, icons and mouse-based navigation — were incorporated into the Macintosh in 1984. The Mac itself wasn't an unqualified hit, as sales were sluggish in the first few years, and Steve Jobs was famously shown the door. But the two early computers paved the way to all that Apple became, and Jobs came back to reinvent the company with the iMac, the iPod, the iPhone … and the rest is history.

Would it have been more rational to kill the Lisa during development, or less? Was it perhaps better to create a culture of stability where today's lessons could be applied tomorrow?

Sometimes the real leadership challenge doesn't lie in racing to cut funding to failing projects. It lies in telling apart a Concorde from a Lisa.

The idea that sticking to your guns can be rational comes from the paper "Choices without preferences: principles of rational arbitrariness," by Shlomi Sher, Johannes Müller-Trede and Craig R.M. McKenzie, published in Psychological Review. *They suggest that people aren't necessarily irrational — sometimes their preferences are simply incomplete, and that after making a choice, people tend to stick with it for reasons that are rational: to allow internal consistency, and to turn uncertainty into stability.*

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Johannes Müller-Trede

Associate Professor of Managerial Decision Sciences at IESE. He is an expert on the psychology of decision-making, behavioral economics, decision theory, prediction and forecasting, and risk.

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