Premature Closure - Have we done enough?

*While I was in New York in January 2011, Dr Alexander Elder introduced me to a common mistake in psychiatry called **premature closure**. He suggested that this mistake can also be found in investors and traders. I have done some thinking about this and researched it further, so that I have been able to turn what I have learned into this article on decision making.*

In psychiatry, premature closure is a mistake where the clinician has a tendency to enquire into a case only far enough to reach an initial diagnosis. The clinician then acts on the diagnosis, without continuing to examine the evidence to ascertain whether there are other possible diagnoses that may better fit all the available information. The mistake called premature closure may also involve proceeding on the basis of the first diagnosis arrived at without making any effort to carry out further tests, or further questioning of the patient to discover additional information. Clearly, if the initial diagnosis turns out to be correct, then the case will probably turn out well for the patient and the clinician. However, if the premature closure involves an incorrect diagnosis, and treatment proceeds on that basis, the result may not be so happy.

That is all the psychiatry I am going to talk about here. What I think is useful to explore now is how this applies to investing, because the idea of premature closure can be very relevant.

Depending on the markets in which we invest, there will be a large number of financial instruments in which we could take a position at any one time. What we have to do as investors is to make decisions about what we will do. These decisions will be at many levels.

Everything we do as investors will start with analysis. We will need to analyse the markets as a whole to decide as investors whether to buy, sell or stand aside. Let's say that we decide to buy stocks. Having analysed the overall market, we then need to find an appropriate stock or stocks to buy. This may be a top down search or it may be a bottom up or stock picking search. Having made a short list of candidates, we will then need to closely analyse each stock to decide which will be the best to buy.

As we think about it, it is surprising how many different decisions need to be made at several levels. Every step in our analysis will involve decisions that leave us open to premature closure as we simply identify one opportunity and take it rather than searching for other opportunities and then weighing up which are the best ones to act upon.

Where our investment style involves close analysis of both the technical and fundamental aspects of a stock, we are again prone to premature closure. It could occur if we see a few aspects that look good and on that alone, we go ahead and buy the stock. However, there may have been some other information that is very important to the stock, which was there to be checked, but we did not make the full gamut of checks. This means that we have been guilty of premature closure. We made a decision to buy on a faulty judgement because we stopped looking.

Some of the ways in which premature closure can occur in investing decision making include:

- *Failure to check with experts*. This involves not taking the time to look for and evaluate the views of broker or professional analysts' research on the stock which may introduce information that could cause us to revise our original decision. That would turn the original decision into a premature closure mistake.

- *Blind acceptance of the opinions of others, including experts*. However, we need to be careful here in that many stock research reports can be biased for many reasons. If the research report sounds great and we just act on that without making our own independent checks and then making our own evaluation of the opportunity, then that can also be the premature closure mistake.

- *Skipping ongoing reviews of the situation*. We might have invested in a stock that was a sound decision in the first place. However, we have then committed the premature closure error through neglecting to check the new information, fundamental or technical as it becomes available. It may have suggested to us that the situation had changed.

- *Omitting verification*. We often find that we have to make decisions on partial information for all kinds of reasons. These decisions become a premature closure error if we then omit the necessary steps to seek out other information that would verify or not verify the original decision.

- *Not validating findings*. This can be either fundamental or technical decisions. As more information or price data becomes available, if we do not continue to check whether it confirms or disconfirms our original decision, we may have made a premature closure mistake.

- *Confirmation bias*. This is a big one and very common. It occurs in three ways. First, we unconsciously filter out as irrelevant any further information or price data that does not confirm our original decision, creating a premature closure error. Second, we seek out only new information or other technical signals which confirm our original decision, creating premature closure. Third, we seek out all information or price data coming forward, but unconsciously interpret it in such a way that it supports our original decision, again making that decision into a premature closure mistake.

Another issue that can contribute to the premature closure error includes the strong bias in all of us to seek only a single explanation for something. This is our minds simplifying situations on partial evidence as soon as we have found a reasonable explanation. It can be very seductive and comforting to kid ourselves that we know with great certainty that something is correct, when that certainty is only because we grasped the first good-looking explanation. By failing to look for alternative confirming or disconfirming evidence or to think about whether there are alternatives to a decision turn that decision into premature closure.

Associated with this is another strong tendency in all of us which involves us underestimating the value and implications of additional information or price data. This is premature closure because we have failed to appreciate that there were other ways to have judged a situation and instead we blindly follow through on our originally mistaken decision.

Satisficing
This is a term used in decision making that was coined by Henry Simon in the 1950s. Satisficing is a jargon word created from the two words "satisfy" and "sufficing", hence

satisficing. The idea is that a good strategy to follow when making decisions in complex situations can be to develop a decision which is adequate and not go on to develop alternatives that may be optimal. Simon suggested that we are not very good at maximising for three reasons:

1. The probabilities of the various possible outcomes often cannot be accurately gauged, even if known.

2. It is rare that we can even identify all the possible outcomes with any precision.

3. Our memories are poor and not to be trusted because of hindsight bias among other things.

However, satisficing can be a legitimate strategy in making difficult decisions in complex situations. This is because if we were to factor in the full costs of establishing all the possible outcomes and collecting and assessing all the information about their probability, the satisficing strategy would have given us a close to optimal decision.

This is important because, while satisficing looks like the premature closure mistake: the selection of the first sound option which seems to meet all our requirements in a situation, it may in fact be as near as we can practically come to an optimal or maximising decision.

The key issue with satisficing is not to avoid it or to adopt it all the time, but to know when we should satisfice and when we should try to get as close as we can to an optimal decision. This is something that will come to us as we gain experience. We become consciously aware of the premature closure mistake and to start to recognise when satisficing is a sound strategy and when it is actually a premature closure mistake.

Interestingly, research suggests that premature closure is more prevalent in older people than in the young, so the older we are the more we should guard against premature closure. Also, there is evidence that the more experienced we become, we become more prone to premature closure than novices. This may simply be hubris from experience versus insecurity and therefore the urge to more thorough research in beginners.

Strategies to minimise premature closure
There are three main strategies to adopt in investing decision making to avoid premature closure mistakes:

1. Try to create a list of all the possibilities about an investing situation. Then use a process of elimination by testing each one against the available information to discount them until the best one remains. One problem can be that we eliminate all of our possibilities in this procedure. This may well be because the best possibility was not on our list. Then we have to try to develop some more possibilities to test and try to eliminate using strategies 2 and 3 below. Failing that, we should go with the most likely situation and continue to test it against further information or price data as it becomes available.

2. Even more powerful can be the so-called crystal ball technique. Even having arrived at a single possibility in a situation, we set out to find other possibilities. A good way to do this is to consciously say to ourselves: assume that our best possibility is wrong, what other possibilities are there. This should give us a list of possibilities to test against the

evidence and try to discount them, using the first strategy, until a single possibility remains. It may be our original possibility or it may be a different one. This can be a powerful way to avoid the premature closure mistake of not looking at all the possibilities in a situation.

3. Sometimes we are so committed to the first possibility we came up with in a situation that we just cannot bust out of it using the previous strategy. In this case we could try the *devil's advocate* strategy. This is where we ask someone who has some knowledge of the stock to suggest any other possibilities or scenarios. Then we try to test all the scenarios, eliminating the unlikely ones until we are left with the most likely one. This may of course be our original possibility. The gain is that now we can be more certain that we have not made the premature closure mistake.

Conclusion

Premature closure is a very common mistake in investing where we rush to act on the first likely analysis of a situation and fail to search for other explanations or other information that suggests alternative possibilities. A good mindset to adopt is to be a sceptic at all times and to be especially wary when all we can see is one possible explanation for something or only one appropriate decision that could be made. Any time that we are certain that we are right is a dangerous situation to be in. We should ask why someone would take the other side of our proposed transaction in the market. At these times we should try to be on our guard for the premature closure mistake and turn to the three strategies to try to avoid making it.