

Friday, January 25th, 2019

"How to Pre-Judge a Stock"

To Focused Compounding Free Members:

Premium members get a weekly watchlist from me. That watchlist has 12 stocks on it. Those 12 stocks are the ones I plan to research next. Obviously, 12 stocks are a lot to get through. And new, interesting stocks pop up all the time. This means I will almost certainly get to stock #1 on the list and almost certainly not get to stock #12 on the list. So, ordering that list becomes important. But, how can you order a list of stocks you haven't "met" yet?

You have to pre-judge them.

Prejudice in stock picking – as in the rest of life – is a double-edged sword. On the one hand, it's very useful to make a snap judgment that assigns a category to each stock you meet. You quickly put this one in the "value" bucket, this one in the "growth" bucket, this one is a "dot com" stock, this one sounds a lot like fads you've seen, this one sounds a lot like a fraud, and so on. Snap judgments – pre-judgments – save you time. But, they also increase the risk you've mis-categorized a stock. You've leaped to a false stereotype. If the first thing you learn about a stock is that it's a net-net – because you find it on a net-net screen – then you will assume this is an unsafe, low-quality, and low-durability business because those are the traits you associate with the category of net-nets. But, if you were to find this same stock through a high ROC "magic formula" type screen, you would assume it is a good business – because you met the stock in an environment – a bucket of other high ROC stocks – that you've come to associate with good businesses. The same stock can make two different first impressions depending on the circumstances in which you meet that stock.

Is this such a big deal, though? If a stock is interesting enough on any desirable trait – it's cheap enough, it's good enough, it's safe enough, etc. – won't you eventually spend the time to dig into it? You might. But, there are two things worth considering about first impressions that differ from second, third, and fourth impressions. One, is that your first impression will be harder to shake than your third impression. If the first word you ever assigned a stock in your mind was the word "cheap" instead of the word "good", you'll tend to always look at this stock as coming from Ben Graham's hunting grounds rather than Phil Fisher's hunting grounds. Two: there's a second level issue at play here too. Far more market participants – that is, the people bidding for your shares in this stock and asking a price to sell you more shares in this stock – have a clearly formed first impression of this stock than a second, third, or fourth. Everyone has a first impression. Very few people ever form a fifth impression. So, if your snap judgment of a stock – your pre-judgment of a stock – is apt to be wrong, it's apt to be wrong in exactly the same way as the other people looking at this stock.

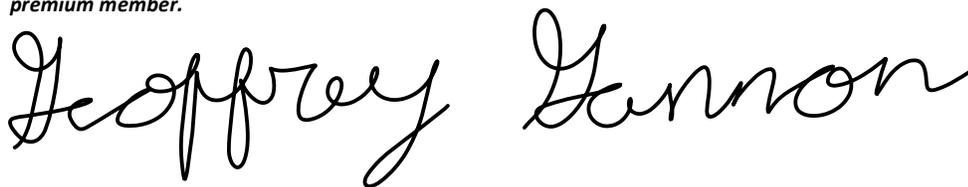
So, how do I try to overcome this issue? I can't just spend more time with all 12 stocks on my list. If I dig deeper into each stock individually, I'll have to cast a narrower net when looking for stocks in the first place. You only have so much attention to go around. The deeper you dig, the narrower your net must be. While the wider your net is, the shallower your dig must be. There's always a trade-off between breadth of knowledge and depth of knowledge.

The answer I've adopted is to make 5 snap judgments about a stock instead of just 1. I still pre-judge each stock based on my very limited knowledge. Each week, I learn a little more about the stock on the list and re-order my priorities accordingly.

I create a grid with the ticker of each of the 12 stocks I'm currently considering. There are 5 columns to the right of that ticker. The columns read: 1) Overlooked? 2) Understand?, 3) Safe?, 4) Good?, and 5) Cheap? I put down a negative one if I think the answer is "no", this isn't an overlooked stock. I put down a zero if I think the answer is "maybe" this stock is one I understand, or one that's safe, or good, or so on. And I put a plus one if I feel sure that the answer to the question is yes. Then, I total up the five columns. The stocks that score the highest – usually around a +3 – go to the top of my list. Meanwhile, the stocks that score the lowest – usually around a -3 – drop to the bottom of the list. Each week, I take fifteen minutes to sit down with the full list and re-score every stock. As I learn a little more about each stock, my initial impressions change – and that stock rises or falls in the rankings.

It's still a prejudiced first impression. But, now I'm prejudiced across 5 points instead of just 1.

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A handwritten signature in black ink that reads "Geoffrey Gannon". The signature is written in a cursive, flowing style with large, connected letters.