Monday, August 6th – Butler National by VETLE FORSLAND

Tuesday, August 7th - Northfield Precision Instruments by LUKE ELLIOTT

"Pre-Judging a Stock"

August 12th, 2018

To Focused Compounding members:

This week, a Focused Compounding member sent me a link to a blog post about **Brighthouse Financial (BHF)**. Brighthouse Financial is the spun-off retail business of MetLife. Although websites often list Brighthouse Financial under the industry group "Life Insurers", the stock is really a seller of annuities. Many of these annuities are tied to the performance of the S&P 500 or other stock indexes. So, the company's investor presentation includes a slide where it shows how badly affected the company would be by various percentage declines in the S&P 500. Based on that slide, the writer of that blog post eliminated the stock from consideration. He had spent – perhaps – an hour or less looking at this company. That was enough to tell him no to invest. Should it be? What we are talking about here is literally prejudice. It is judging a business before you fully understand it. It is making a snap judgment based purely on your initial impressions. And especially on this stock's resemblance to other such stocks you've seen before. You think back to all the stocks you know that have some similarities to this one and you make a snap judgment – assigning this stock to the same group as those stocks. It's definitely a time saver. And for those who believe in Peter Lynch's motto that he who turns over the most rocks wins – it's an efficient approach. If you can quickly glance at a thousand stocks and find ten that really excite you on your first impression and buy those – maybe that's enough. A lot of investors follow the pre-judging approach. I tweeted about the KLX Energy Services business. This is technically going to be a spin-off. However, what is really happening is that Boeing is buying KLXI's aerospace business for cash and leaving KLX Energy Services for KLXI's current shareholders. This is the spin-off I've most been looking forward to this year. Someone on Twitter mentioned that *"…if I recall ESG is a collection of absolutely garbage businesses."* KLX Energy Services was formed as a super fast roll-up of a bunch of U.S. energy service providers that served "tight oil / tight gas" (shale oil) producers in the U.S. The price of oil dropped quickly around the time of KLX's acquisition spree (late 2013 through 2014). Some of these acquisitions were made when oil was around $100 a barrel. So, KLX paid high multiples of EBITDA for businesses where the EBITDA completely vanished in the oil price crash. This collection of businesses may be garbage. But, it's impossible to know they really are if you only have data going back about 5 years and those 5 years don't include anywhere near a full cycle in oil.

Brighthouse Financial and KLX Energy Services are both tempting stocks to pre-judge, because if you don't pre-judge them you have to do some heavy lifting. Brighthouse Financial is complicated. KLX Energy Services doesn't have the past financial performance data I'd want to see. In both cases, the analyst has to do the very hard and very speculative work of coming up with future estimates based on what they know of the business model. Snap judgments are a lot faster. And they allow you to focus on simpler, better understood businesses. Of course, if other investors happen to be making the same snap judgments you are about the same stocks you are – then the stocks you're quickly dismissing may be the least efficiently priced stocks out there.

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