

# How I Dodged a -69.3% Bullet With a Checklist and 3 Important Lessons to Takeaway

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Phew.

By learning from past mistakes, sticking with experience and following solid advice from books and gurus, it all helped me dodge a -69.2% bullet.

Here's what I mean.

At the end of June, I wrote about a [special situation involving SFX Entertainment \(SFXE\)](#) where the founder was aiming to take his company private.

And here's what happened.



The spread when I first looked at it was a very decent 14%. A spread greater than 10% shows that the market doesn't fully in the deal.

I know from a few painful experiences where I focused too much on the upside and bit off a big position, only to see the deal get canceled at the last moment.

The deal for SFXE hasn't been canceled. However, the go shop period has been extended, the buyout offer is to likely to be lowered and the company doesn't provide enough information to investors.

*The special committee and its advisors will entertain offers for the entire Company as well as assets not central to the Company's core business through at least October 2, 2015. Sillerman has agreed to cooperate with the special committee to obtain the best available offer for the Company's shareholders.*

*The October 2 date was chosen to allow potential bidders and their financing sources to have visibility into the Company's performance during its peak festival season, thus providing a full and accurate picture of the Company's results and prospects. To facilitate potential offers during this period, all "no-shop" restrictions and the related breakup fees provisions applicable to the Company under the merger agreement will no longer apply, enabling potential bidders to freely evaluate the Company in light of the recent substantial decline in its share price. Any new transaction will be evidenced by a new definitive agreement as the existing merger agreement is no longer effective. – [source](#)*

They don't all end up like this though. There have been plenty of going private acquisitions with a wide spread that went through successfully.

Buffett has said that missing out on opportunities was been one of his biggest mistakes.

If that's the case, then dodging blowups like this is equally important.

But how?

Simple.

Using a checklist like this is saved my bacon.

1. Make sure both parties have done their due diligence – Pass
2. Financing and regulator approval is complete – Pass (now a Fail)
3. Get preliminary shareholder sentiment or controlling shareholder approval – Uncertain
4. Obtain regulator (SEC, FCC, any and all) approval – N/A
5. Get final shareholder approval at a meeting called for that purpose – TBD
6. Check to see that insiders are continually vesting or buying shares – Pass

On the surface, there are more passes than fails, but because the importance increases

as I move down the checklist, number 6 was the big hold up. Without a clear green light by all shareholders, management and the special committee, it's risky to put money down.

## **Additional Criteria to be Added to the Checklist**

Based on the events that has taken place, I'm adding a couple of new checks to my checklist.

- Is management trustworthy?
- Is the upside and downside risk asymmetric?

## **Is Management Trustworthy?**

There are plenty of managers that execute like a surgeon. But with SFXE, there are warning flags visible in the way the company is managed and how it communicates to investors. Plus, when a CEO [publicly flips a bird and grabs his crotch](#), I tend lose trust in their actions and judgement.

Management should also have a history of doing what they say. A lot of managers are showman. After all, they are the face of the company and it is their job to sell.

A method to do is by comparing a few annual letters. Go through and highlight what they said they will do, and check in the next years letter to see whether it was accomplished, or whether it shows in the numbers. The numbers won't lie.

## **Is the Upside Downside Risk Asymmetric?**

Special situations operate on a timeline, usually within a year.

Due to a short timeframe, the tradeoff is that your profit potential is small. So it makes it even more important to go after the high certainty opportunities and ignore the ones with bad odds.

It's a lot safer and easier to go after a very highly certain 1-2% returns with a large amount of money that will close in a month, versus using a small amount of money for the 10% uncertain ones.

When Google announced that it was buying Motorola Mobility, the spread was a little under 2% at the time.

I was able to put down a large amount of cash to make up for the small return and short timeframe.

Keep doing this for the good ones and you'll build up your returns.

Buffett didn't achieve 30% annually during his prime by simply assigning a massive portion of this portfolio to Coca Cola and American Express and then sitting on it.

No.

He spent a lot of his time on special situations and other active areas and increased his returns one brick at a time.

## **The Updated Special Situations Checklist**

Add those the two new checks and here's the updated checklist I'll be using for special situations.

1. Make sure both parties have done their due diligence
2. Check management of both parties are trustworthy (NEW)
3. Financing and regulator approval is complete
4. Get preliminary shareholder sentiment or controlling shareholder approval
5. Obtain regulator (SEC, FCC, any and all) approval
6. Get final shareholder approval at a meeting called for that purpose
7. Check to see that insiders are continually vesting or buying shares
8. Verify upside and downside risk is asymmetric by assigning potential upside to downside returns (NEW)

## **3 Important Lessons to Take Away**

This year, it seems like I'm parroting the same thing, but the lessons I got SFXE is clear.

### **1. It's more important to focus on protecting the downside**

I didn't like the 14% upside versus 24% downside. Seeing the stock price now, you can see how the downside was actually larger.

### **2. Don't get greedy**

Even if you did go long with SFXE, if you kept it to a small position, less than 1% of your portfolio, it isn't going to damage your returns and compoundability. Losing money is bad because it makes it harder for your money to work because you're chopping it off at its knees.

I said earlier that I put a large amount into the Motorola merger, but that was because it was a highly certain transaction with very little possibility of failure. But I didn't sell my other positions to free up cash to go all in. I used what was available.

### **3. Manage risk**

The best investors and traders have one thing in common.

They are obsessed with minimizing risk by going after asymmetric bets and taking advantage of inefficiencies. This may sound similar to points 1 and 2, but managing risk involves position sizing, seeing how things fit in your portfolio, being emotionless, not falling for obvious behavioral fallacies, being able to cut losses, admitting faults and more.

But for the purpose of this article, adjust your sizing based on the odds and don't overdo it.