
Greenblatt, Joel – The Big Secret For the Small Investor

Crown Business, 2011, [Equity Investing] Grade ★★★★★

This is according to his own admission the book that superstar investor and Columbia business professor Joel Greenblatt always wanted to but never previously succeeded to write. I'm glad he failed twice before finally nailing it. The two beta versions turned out to be among the best investing books authored the last decade. His writing has always had the purpose of helping individual investors to succeed in the stock market. The first book *You Can Be a Stock Market Genius* turned out to be much too technical and mostly aided a number of hedge fund managers, the second, *The Little Book That Beats the Market* was definitely less complex but assumed individuals wanted to devote more time to investing than was really the case. This third book is even lighter reading but builds on the same basic concept that it is better to buy cheap stocks in good companies than expensive stocks in bad companies.

The first four chapters basically builds the story of rational investing "*first figure out the value of something – and then pay a lot less*", but also the difficulty of that approach; that it's extremely hard to know what something actually is worth as the value is derived from an uncertain future. Valuation methods like DCFs, relative valuation using multiples, acquisition value, liquidation value or sum-of-the-parts give varying and imprecise estimates of value. Yet on average it seems reasonable that a stock with higher prospective return is preferable to one with a lower and that to be attractive, the expected return should be higher than that you could get on a government bond. Then follow two chapters that discuss the merits of being a private investor compared to a professional one. The small investor can venture into areas that the professional investor with huge amounts of capital, short term performance pressures and restrictive guidelines cannot go. And as Greenblatt points out "*Less competition and more choices are a real advantage*". The obvious area of advantage for the small investor is to invest in less researched small cap stocks but true to his first book the author also points to the merits of special

situations investing. Realizing that small caps and special situations are suitable only for the interested few, Greenblatt in the last three chapters starts to work his way towards a more easily digested solution.

With a detour over equal weighted indexes and fundamental weighted indexes (where the later get a partial approval) Greenblatt presents the solution of A) an indexation based on the combination of the relative size of the earnings yield of the stock and of the return on capital in the companies. Basically the same market beating solution as presented in the author's second book. Part B) consists of choosing an equity allocation in a total portfolio that you can live with and periodically rebalancing to that weight. Responsive to peoples need to feel that they can control their fate Greenblatt also allows for a narrow allocation interval for the investor to work with. This is against his better judgement but potentially hinders the investor from abandoning the whole program at the wrong time.

This is the book professional money managers should try to get their high school children to read. The book serves the authors purpose. If private investors invested like this they would probably beat the pros over the longer term. The book is very easy to read. You will complete it during a Sunday when the weather keeps you indoors. I think Greenblatt somewhat leaves the reader naked when it comes to the active asset allocation. This is an area filled with pitfalls and the risks of destroying value are high. Perhaps he could have worked more with the concept of hurdle rates (as he points to the government bond yield earlier in the book). If one would define the number of positions held, set an absolute requirement of how high earnings yield and how low ROC that would be allowed in the portfolio and then allocate to a money market fund if these rule created gaps, this could give a workable asset allocation rule. Cutting through complexity is a blessing. Most investors would be better off following these simple rules and never reading another business journal.

Mats Larsson, October 16, 2013