

Greenblatt, Joel – The Little Book That Beats the Market

John Wiley & Sons, 2006, [Equity Investing] Grade ★★★★★

During the summer InvestingByTheBooks will review some older books that we never got around to writing about although we think they are important. Joel Greenblatt's *The Little Book That Beats the Market* had an immediate and vast impact when it was published in 2006. Greenblatt is through his hedge fund Gotham Capital and later ventures clearly one of the most successful investors of all times judged by the size and the longevity of his outperformance. This book was written to his children trying to give them "a gift that would keep giving" by presenting a sound investment strategy to beat the stock market over time and calling it the magic formula.

The author starts off by showing that most investment strategies fail since they are built on the premise of forecasting the future and this is something investors have a hard time doing. Instead Greenblatt proposes that the investor should focus on what he does know and build the strategy on this. The core of the magic formula is that over time it will be profitable to invest in cheap and good stocks and avoid the expensive and bad ones. Fortunately the investor knows what the current valuation multiples are and they can be used as a proxy for "cheap" and he knows what the quality is as estimated by the level of return on capital (ROC). No forecasting is needed and on average investing in companies that combine low multiples with high ROC will expose the investor to enough undervalued stocks to outperform the market. High ROC is important as it signals that the company has a competitive advantage and profits that are reinvested at a high ROC will over time compound and grow earnings at a high rate. Even though some companies inevitably will fall from grace ROC is still a good proxy for quality.

To prove the magic formula's worth Greenblatt in the book tests how the strategy would have fared between 1988 and 2004. He takes the 3500 largest US companies ex financials, utilities and stocks with an earnings yield below 5 and ranks them on

earnings yield measured as last full year's EBIT/current EV, giving the cheapest a score of 1 and the most expensive a score of 3500. Then he ranks the same stocks on ROC measured as EBIT/(Net Working Capital + Net Fixed Assets), giving the company with the highest ROC a 1 and again using last full years' numbers. Finally, the two scores are added together to a total score. With yearly rebalancing a portfolio of the 30 stocks with the lowest combined score would have had a return more than twice as high as the S&P 500 and the equal weighted return of the 3500 stocks. Since it's a relative ranking you can always form a portfolio using the formula and looking to the risks the portfolio actually didn't have any three-year period with absolute losses – which Greenblatt explains with the fact that it on average takes 2 – 3 years for price and value to align. Further, the reason why the strategy keeps working over time is according to the author that it doesn't work all the time! The tested portfolio underperformed 5 months of 12, it underperformed 1 year of 4 and once during the 17 years it underperformed 3 years in a row. *"The point is that if the magic formula worked all the time, everyone would probably use it. If everyone used it, it would probably stop working."* People's investment horizons are too short to stay with a good strategy.

Greenblatt shows that a book can be very plaintext and still have depth and common sense enough to provide the magic to beat the market. The book doesn't take long to read but it had a huge impact on me through its clear reasoning. After starting off his career investing in special situations Greenblatt actually used a strategy most similar to the magic formula although he and his associates tried to estimate the normalized earnings instead of simply using last year's numbers and with this added security regarding which stocks that really combined quality with low price they had a more concentrated portfolio than 30 holdings.

The "Little Books" are always good and this is one of the best they have published.

Mats Larsson, Aug 16, 2015