

LONG & SHORT

By JESSE EISINGER



Magic Formula

Of Little Book

Just May Work

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As hard as it is to envision, hedge-fund titans and other masters of the universe soon will be tucking themselves into bed with a thin tome bearing a cutesy title: "The Little Book That Beats the Market."

Here's why: The author is Joel Greenblatt, a former hedge-fund manager. His first investment guide, published in 1997, also sported a hokey title, "You Can Be a Stock Market Genius (Even If You're Not Too Smart)," and sold about 38,000 hardcover and softcover copies.

Not bad as first books go, but it also became a cult hit in the insular world of hedge funds, passed like samizdat from manager to manager. A book of war stories and case studies written clearly and laced with jokes, it had two profound insights, say hedge-fund managers who have pressed the book on me.

One was that there are secret hiding places in the stock market, like spinoffs and restructurings, where bargains tend to lurk. The other was there wasn't any compelling reason to have a giant portfolio of dozens of stocks when a well-designed, concentrated portfolio could accomplish the same goal of achieving high returns without adding risk.

"His book on investing is by far the most valuable thing I have read," says David Einhorn, who manages a large, successful hedge fund, Greenlight Capital.

But hedge-fund managers "were not quite the underprivileged group I was shooting for when I wrote it," he says. So for his second book, Mr. Greenblatt says he wanted to write an even more basic and fundamental book on investing that would appeal beyond Wall Street. Think Benjamin Graham does Borscht Belt.

Mr. Greenblatt, 47 years old, says his goal was to provide advice that, while sophisticated, could be understood and followed by his five children, ages 6 to 15. They are in luck. His soon-to-be-released "Little Book" is one of the best, clearest guides to value investing out there. I have some minor quibbles, but in a world where individual-investor advice is dominated by jargon-filled short-termism on the one hand and oversimplified throw-up-your-hands indexing on the other, Mr. Greenblatt's

approach is valuable.

It is so simple and cute that an investor with a little bit of knowledge might mistakenly dismiss it. Mr. Greenblatt titles his investment approach a "magic formula." His tongue is in his cheek, but not entirely. He writes as if he were J.M. Barrie spinning a Peter Pan-esque fairy tale, but with the fervor of a true believer:

"You have to take the time to understand the story, and most important, you have to actually believe that the story is true. In fact, the story concludes with a magic formula that can make you rich over time. I kid you not."

What is the magic formula? Invest in good companies when they are cheap. As Mr. Greenblatt might say: See? We told you it sounded obvious. Yeah, so what's "good"? And what's "cheap"?

Good companies earn high returns on their investments, he explains, while cheap companies sport share prices that are low (based on past earnings). His proxies for these criteria are return on capital (operating profit as a percentage of net working capital and net fixed assets) and earnings yield (pretax operating earnings compared with enterprise value, which is the market value plus the net debt). To his credit, however, Mr. Greenblatt explains all that parenthetical jargon in terms that shouldn't insult his peers but that will ring a bell for the unschooled masses.

To make things simpler still, his free Web site, www.magicformulainvesting.com, screens companies using his criteria. He advises individual investors to buy a basket of top stocks and turn them over on a strict schedule, depending on how they perform. (For maximum tax advantage, sell losers just before a year's up, and winners just after a year.)

It sounds too easy. But in fact, his approach is difficult not because it is hard to understand, but because it requires patience and faith that you are right when the market is saying you're wrong.

This is based on Warren Buffett's investment principles. But they bear repeating. Even a die-hard value investor like Mr. Greenblatt says he didn't realize that trying to find cheap, good companies, rather than just cheap ones, was so important until the 1990s. While Mr. Graham, Mr. Buffett's mentor, was looking for starkly cheap companies, Mr. Buffett wants only the great ones.

"I didn't get Buffettized until the early 1990s," says Mr. Greenblatt. "I wish it happened earlier."

Looked at retroactively, the returns of the "magic formula" beat the market handily. From 1988 through 2004, according to Mr. Greenblatt's book, the high-return/low-price stocks of the largest 1,000 companies had returns of 22.9% annually, compared

with 12.4% for the S&P 500.

The most convincing part of Mr. Greenblatt's argument is that when 2,500 companies are ranked for price and returns (based on the formula), the top 10% outperformed the second 10%, which outperformed the third 10% and so on. "The darn thing works in order," he says.

There are some limitations to the approach. It seems prone to tossing up stocks whose high returns and growth may be in the past. Magic-formula stocks with more than \$1 billion in stock-market value include lots of fast-growing specialty retailers and niche pharmaceutical companies. Some of these will flame out.

That's why Mr. Greenblatt argues that novice investors buy at least 20 or 30 of them. For himself, he buys a smaller number that he can know deeply. But that requires something not easily taught in a book: good instincts and judgment to distinguish true cheap gems from one-hit wonders.

Though he always was a value investor, his hedge-fund firm, Gotham Capital, wasn't always run on his magic formula, especially in the early years, when he tended toward complex arbitrage. He started Gotham in 1985 and ran it for outside investors for 10 years, achieving compounded annual returns, before fees but after expenses, of 50%. He started with \$7 million, mostly raised through junk-bond king Michael Milken. After five years, he returned half the outside capital. He finished with more than \$350 million and returned all the remaining outside capital.

These days, he spends his time teaching at Columbia Business School and helping run a Web site for pros, the Value Investors Club. His wealth is mostly tied up in Gotham Capital, which manages \$1.6 billion, including some outside money in a fund of hedge funds he started a few years back.

His home cooking isn't just good enough for Mr. Greenblatt. He's got his kids eating it, too. His eldest son is doing well following the book's advice. A daughter, at it for two months, is having a rougher time. "I'm not sure if she didn't have me as her daddy she'd be hanging in there," he says.

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