

Value Investing (a long-term investment strategy)

Sharpen your mind with Isaac Newton:

Isaac Newton once said that “If I have seen further than others, it is by standing upon the shoulders of giants.”

Ok. So how about mixing the philosophy of Benjamin Graham, the success of Warren Buffett and the Magic Formula of Joel Greenblatt as an example?

Graham’s philosophy of value investing: **Know the fundamentals**

and

Do your own work, your homework. (research, investigation and analysis)

As an educator and a strong advocate of learning, Greenblatt believes in being open-minded to new ideas. He points out that Buffett’s success is due to his unique spin on Graham’s thinking and philosophy.

Time is the friend of the wonderful business, the enemy of the mediocre.

-Warren Buffett, 1989 Chairman's Letter

So what is a Wonderful Business? Investopedia has a nice [summary of Buffett's wonderful business](#) criteria:

Buffett's criteria for "wonderful businesses" include, among others, the following:

1. ***They have a good return on capital without a lot of debt.***
2. *They are understandable.*
3. *They see their profits in cash flow.*
4. ***They have strong franchises and, therefore, freedom to price. (MOAT)***
5. *They don't take a genius to run.*
6. ***Their earnings are predictable.***
7. *The management is owner-oriented.*



Joel Greenblatt's Magic Formula Approach – Keep it Simple

In his book, *The Little Book that Beats the Market*, Greenblatt explains his magic formula method on how to buy mispriced stocks with top earnings yield and high ROIC. (Return on Invested Capital)

The idea of the magic formula is to provide:

A long-term investment strategy designed to help investors buy a group of above-average companies but only when they are available at below-average prices.

If I plug my estimates into the Magic Formula, and it comes out cheap, that's good.

Joel Greenblatt – The Magic Super Investor

November 6, 2015, Written by Lanber

We are starting a series profiling super investors that have made a big impact in the value investing world.

Isaac Newton once said that “If I have seen further than others, it is by standing upon the shoulders of giants.” I hope that through this series you'll discover new super investors to learn from in order to further sharpen your own thinking.

Up first is Joel Greenblatt. He doesn't need much of an introduction.

The mastermind behind the simple and effective magic formula, holder of one of the best 10 year investment records at 40-50% CAGR.

Considering that Greenblatt describes himself as self-taught in the ways of value investing after reading Graham's quant based investing strategies, his results are even more impressive. Then throw in some additional accolades like being an adjunct professor at Columbia University and being classified as a super investors at such a young age.



We know all about the magic formula, but investors don't really know much about Greenblatt himself of Gotham funds.

Let's dive into some details and get to know Greenblatt a little better.

Lessons Joel Greenblatt after Gambling Money in a Dog Race

When Joel Greenblatt was 15 he had the chance to make some bets in a dog racing circuit.

He was confident in a dog named Lucky which had a 99-1 chance of winning. He was a sure bet because he was fast in all the previous races.

But Lucky was unlucky and lost.

However, Greenblatt realized that Lucky performed best in short races and this story provides a glimpse into Greenblatt's mechanical approach to investing.

At 15 years old Joel took this lesson to heart. Betting with just a good story and not knowing the facts will only cost money.

He argued that if you don't know the fundamentals you will lose.

This follows closely Graham's philosophy of value investing:

- **Do your own work**
- Don't trust anyone over 30
- Don't trust anyone 30 or under

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Joel Greenblatt's magic formula was previously tested on old school value with a heavy dose of scepticism, but numbers don't lie. See for yourself.

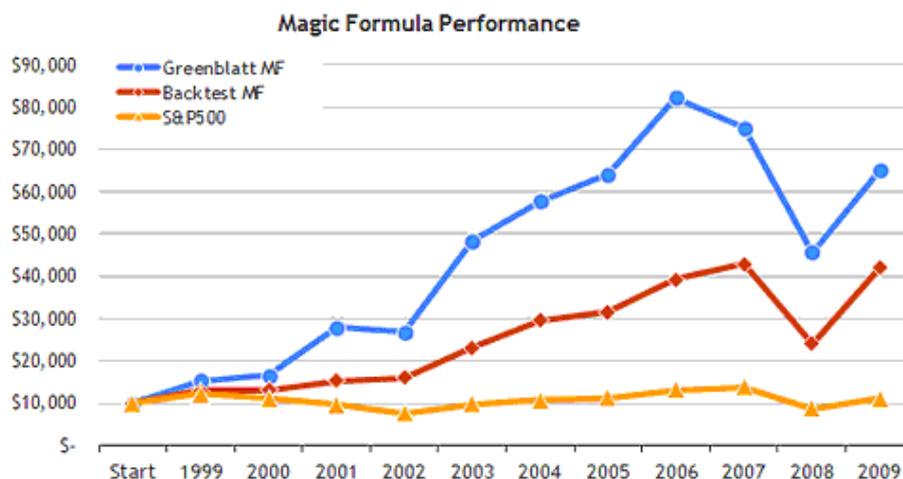
The original magic formula numbers first.

Year	Magic Formula		S&P500		Net %
	Performance	Dollar Amount	Performance	Dollar Amount	
		\$ 10,000.00		\$ 10,000.00	
1988	27.1%	\$ 12,710.00	16.6%	\$ 11,660.00	10.5%
1989	44.6%	\$ 18,378.66	31.7%	\$ 15,356.22	12.9%
1990	1.7%	\$ 18,691.10	-3.1%	\$ 14,880.18	4.8%
1991	70.6%	\$ 31,887.01	30.5%	\$ 19,418.63	40.1%
1992	32.4%	\$ 42,218.40	7.6%	\$ 20,894.45	24.8%
1993	17.2%	\$ 49,479.97	10.1%	\$ 23,004.79	7.1%
1994	22.0%	\$ 60,365.56	1.3%	\$ 23,303.85	20.7%
1995	34.0%	\$ 80,889.85	37.6%	\$ 32,066.10	-3.6%
1996	17.3%	\$ 94,883.80	23.0%	\$ 39,441.30	-5.7%
1997	40.4%	\$ 133,216.85	33.4%	\$ 52,614.69	7.0%
1998	25.5%	\$ 167,187.15	28.6%	\$ 67,662.49	-3.1%
1999	53.0%	\$ 255,796.34	21.0%	\$ 81,871.62	32.0%
2000	7.9%	\$ 276,004.25	-9.1%	\$ 74,421.30	17.0%
2001	69.6%	\$ 468,103.21	-11.9%	\$ 65,565.16	81.5%
2002	-4.0%	\$ 449,379.08	-22.1%	\$ 51,075.26	18.1%
2003	79.9%	\$ 808,432.97	28.7%	\$ 65,733.86	51.2%
2004	19.3%	\$ 964,460.53	10.9%	\$ 72,898.85	8.4%
2005	11.1%	\$ 1,071,515.65	4.9%	\$ 76,470.90	6.2%
2006	28.5%	\$ 1,376,897.61	15.8%	\$ 88,553.30	12.7%
2007	-8.8%	\$ 1,255,730.62	5.5%	\$ 93,423.73	-14.3%
2008	-39.3%	\$ 762,228.48	-37.0%	\$ 58,856.95	-2.3%
2009	42.9%	\$ 1,089,224.50	26.5%	\$ 74,454.04	16.4%
CAGR	23.76%		9.55%		



And old school value's variation of the magic formula compared with the original and the market.

Greenblatt Magic Formula			Backtested Version			S&P500		Net Return % vs	
Year	Performance	Dollar Amount	Performance	Dollar Amount	Performance	Dollar Amount	Greenblatt	Backtest Ver	
		\$ 10,000.00		\$10,000		\$ 10,000.00			
1999	53.0%	\$ 15,300.00	28.3%	\$ 12,825.00	21.0%	\$ 12,100.00	32.0%	7.3%	
2000	7.9%	\$ 16,508.70	1.3%	\$ 12,996.86	-9.1%	\$ 10,998.90	17.0%	10.4%	
2001	69.6%	\$ 27,998.76	17.2%	\$ 15,232.31	-11.9%	\$ 9,690.03	81.5%	29.1%	
2002	-4.0%	\$ 26,878.80	5.0%	\$ 15,989.36	-22.1%	\$ 7,548.53	18.1%	27.1%	
2003	79.9%	\$ 48,354.97	45.3%	\$ 23,237.34	28.7%	\$ 9,714.96	51.2%	16.6%	
2004	19.3%	\$ 57,687.48	27.0%	\$ 29,516.07	10.9%	\$ 10,773.89	8.4%	16.1%	
2005	11.1%	\$ 64,090.79	6.7%	\$ 31,493.64	4.9%	\$ 11,301.82	6.2%	1.8%	
2006	28.5%	\$ 82,356.66	24.6%	\$ 39,225.33	15.8%	\$ 13,087.50	12.7%	8.8%	
2007	-8.8%	\$ 75,109.28	9.3%	\$ 42,877.21	5.5%	\$ 13,807.31	-14.3%	3.8%	
2008	-39.3%	\$ 45,591.33	-44.0%	\$ 24,019.81	-37.0%	\$ 8,698.61	-2.3%	-7.0%	
2009	42.9%	\$ 65,150.01	75.0%	\$ 42,034.67	26.5%	\$ 11,003.74	16.4%	48.5%	
CAGR	18.57%		13.74%		0.87%				



	Total Return	Annualized Return	Max Drawdown	Sharpe Ratio	Sortino Ratio	Standard Deviation	Correlation with Bench	R-Squared	Beta	Alpha
Screen	311.4%	13.74%	-59.3%	0.39	0.53	23.71%	70.0%	0.5	0.78	11.60%
S&P 500	9.3%	0.81%	-54.6%	-0.18	-0.24	21.30%	-	-	-	-

It's not the 30% claimed in the book or the 18.57% return. However, the old school variation produced a 13.74% CAGR which easily beats the market return of 0.9% over the same period.



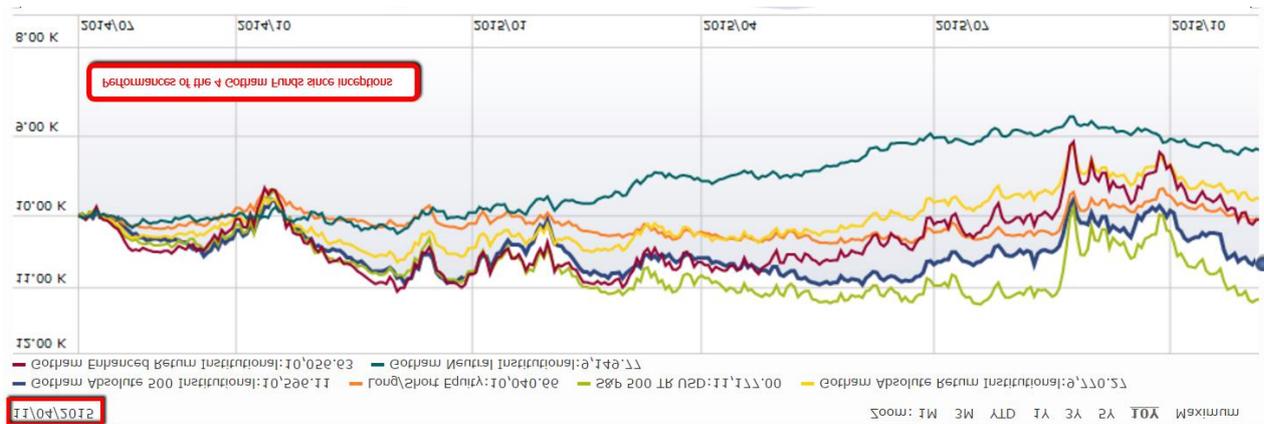
How Long Will the Magic Formula Work?

There's been a lot of discussion about whether the magic formula has lost its touch. The argument is that because the book became a best seller, more people know about it and it is now a crowded strategy now.

But when you consider that value investing itself isn't popular with mainstream investing and the magic formula is just a subset of value investing, there is plenty of room before it ever gets crowded.

Even if the magic formula has lost some of its glimmer, the truth is that no investing strategy will work 100% of the time.

Investors need to believe in their system even if it's not working in the short term. "Short term" isn't 1-6 months. As of today, [Gotham funds have been underperforming](#) the market for a few years, but it's still too short to claim whether a system is working or not. Especially when the system has been proven before and backtested evidence shows that it works.



Monthly Returns as of 10/31/2015

FUND NAME	TICKER	MONTH	TRAILING 3 MONTHS	YTD	1 YEAR	SINCE INCEPTION ANNUALIZED	SINCE INCEPTION CUMULATIVE	INCEPTION DATE
Gotham Absolute Return	GARIX	3.45%	-0.39%	-7.12%	-5.28%	10.70%	37.99%	August 31, 2012
Gotham Absolute 500 Fund	GFIVX	5.51%	0.19%	-2.08%	1.40%	4.49%	5.65%	July 31, 2014
Gotham Enhanced Return	GENIX	5.95%	-1.09%	-7.91%	-4.66%	12.13%	31.90%	May 31, 2013
Gotham Neutral	GONIX	0.80%	2.34%	-8.20%	-8.19%	1.50%	3.29%	August 30, 2013

Greenblatt believes that **consistency** is key to his fund's success and if you look at the quotes section below, you'll notice his emphasis on sticking with the long term and not getting pushed out of a strategy due to short term underperformance.

Investment Strategies of Joel Greenblatt

Joel Greenblatt isn't just known for the magic formula. He is likely the one that really brought special situations to value investors. Sure Buffett wrote about workouts in his letters before Greenblatt even got started, but when it comes to teaching about **special situations, Greenblatt is the best.**

Most value investors have read his [special situation book, You Can be a Stock Market Genius.](#)

In fact, you can download and read notes to [Greenblatt's Columbia Business School special situation class](#) from a decade ago thanks to John Chow from [CS Investing](#) who was the auditor of his lectures.

Also, here's another [good link](#) that provides notes to a 2006 lecture from Greenblatt's value investing class video going over some of his previous stocks.



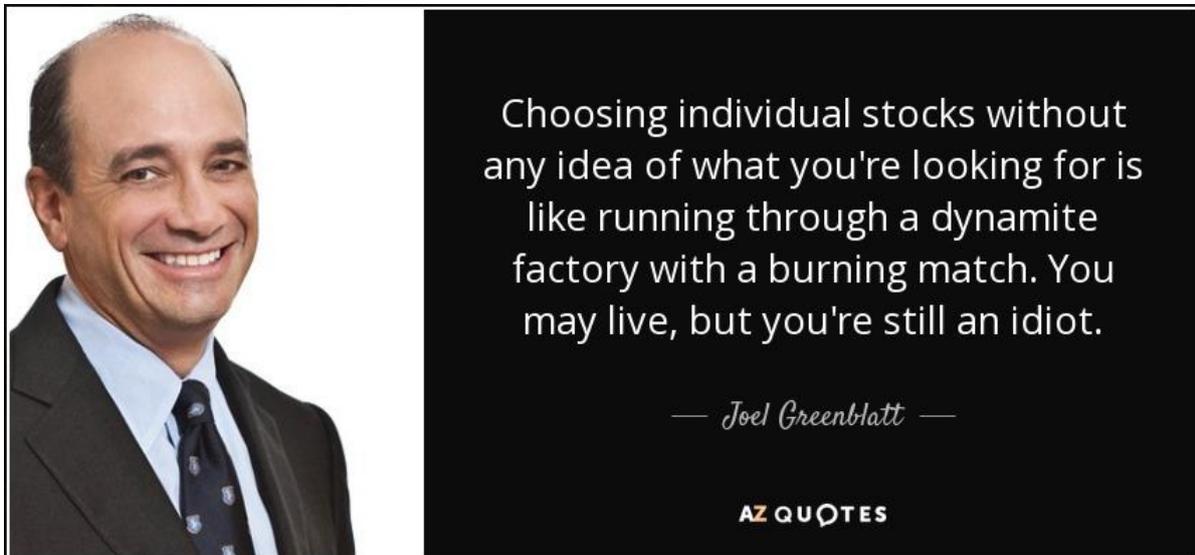
Now when selling stocks, Joel Greenblatt takes the same objective and simple approach.

Consistency is key right?

I usually try to sell before my investment reaches a conservative estimate of fair value. In other words, I usually sell too early. In addition, I may sell before an investment reaches even that discount to conservative fair value if I find something else a lot cheaper and it makes sense to make the exchange after looking at my overall portfolio.

This quote ties in very much with the magic formula where stocks are sold after one year.

Joel Greenblatt Famous Quotes



Here is part of the trade off with diversification. You must be diversified enough to survive bad times or bad luck so that skill and good process can have the chance to pay off over the long term.

Many studies over the years have confirmed that value-oriented strategies beat the market over longer time horizons. Several different measures of value have been shown to work. These strategies include, but are not limited to, selecting stocks based upon low ratios of price to book value, price to earnings, price to cash flow, price to dividends... these simple value strategies do not always work.



However, measured over longer periods, they do. Though these strategies have been well documented over many years, most individual and professional investors do not have the patience to use them. Apparently the periods of underperformance makes them difficult – and, for some professionals, impractical to implement.

If your goal is to beat the market, an MBA or a Ph.D. from a top business school will be of virtually no help.

If you spend your energies looking for and analysing situations not closely followed by other informed investors, your chance of finding bargains greatly increases.

Look down, not up, when making your initial investment decision. If you don't lose money, most of the remaining alternatives are good ones.

There's a virtuous cycle when people have to defend challenges to their ideas.

Any gaps in thinking or analysis become clear pretty quickly when smart people ask good, logical questions. You can't be a good value investor without being an independent thinker – you're seeing valuations that the market is not appreciating. But it's critical that you understand why the market isn't seeing the value you do. The back and forth that goes on in the investment process helps you get at that.

You do have to do your homework.

You do have to have the right framework.

You have to screw up a bunch and learn from it.

Each mistake leads to better insights and subtleties.

I think business school is a very personal decision. I love Columbia and I think they have a great value investing program but there is nothing that is taught there that you can't learn on your own.

Becoming a good investor is about reading, learning and practicing and then practicing some more.



Magic Formula Screen

Joel Greenblatt's Magic Formula Screen

Download results:

<http://www.oldschoolvalue.com/stock-screener/magic-formula-screen.php>

Quick Screen Summary

In the book "The Little Book that Beats the Market", Joel Greenblatt came up with a simple way to screen and invest in stocks.

The Magic Formula screener methodology he outlined is as follows:

1. Establish a minimum market capitalization (usually greater than \$50 million)
2. Exclude utility and financial stocks
3. Exclude foreign companies (American Depositary Receipts)
4. Determine company's earnings yield = EBIT / enterprise value
5. Determine company's return on capital = EBIT / (net fixed assets + working capital)
6. Rank all companies above chosen market capitalization by highest earnings yield and highest return on capital (ranked as percentages)
7. Invest in 20–30 highest ranked companies, accumulating 2–3 positions per month over a 12-month period
8. Re-balance portfolio once per year, selling losers one week before the year-mark and winners one week after the year mark
9. Continue over a long-term (3–5+ year) period

The two key points of the Magic Formula stock screen is based on:

Earnings Yield = EBIT / Enterprise Value > 10%

Return on Capital = EBIT / (Net Fixed Assets + Working Capital) min. 25%

www.magicformulainvesting.com/Screening/StockScreening



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