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Joel Greenblatt, author of "The Little Book That Beats the Market," discusses his magic formula for investing

ANCHORS: MARIA BARTIROMO

MARIA BARTIROMO, host:

Welcome back. Every investor aims to get rich by outperforming the market. Few people do. My next guest, however, has more than double the performance of the S&P 500 over the past 18 years. Value investor Joel Greenblatt is with us. He gained a cult following among pros with his first investment guide. And now he's out with a new best seller, "The Little Book That Beats the Market." He joins us here in the studio.

Nice to have you with us, Joel.

Mr. JOEL GREENBLATT (Founder, Gotham Capital): Thanks for having me.

BARTIROMO: Joel, you start the book by talking about how you spent money as a kid and--and talking about the fact that your children were an inspiration for this book, right?

Mr. GREENBLATT: Right. Well, I wanted to make it as easy as possible for everyone to understand, and kids don't really understand about savings. I mean, when I was a kid, I blew all my money with a company called Johnson Smith that sent me all kinds of joke books and gizmos and things. And one time they even got me to buy a giant weather balloon. And that lasted about two minutes because I blew it up inside the house and when my brother and I pushed it outside, kind of floated away. So we were chasing a giant 10-foot balloon for about four blocks and lasted about 20 minutes, and my money was gone that quickly.

BARTIROMO: Oh, God!

Mr. GREENBLATT: So I wanted to teach my kids, you know, maybe to save a little bit before that happens.

BARTIROMO: Let's talk about your strategy. The first thing you look for in a company, a high return on investment, right?

Mr. GREENBLATT: Yes. Well, we--actually we--I broke down what we--we have done for 20 years at Gotham Capital, the firm I run, into two really important things. One is what kind of business are you buying? Are you buying a good business and then how cheap are you buying it. So the first thing to decide what's a good business is to look at

return on capital. So we--you can think about return on capital. It sounds complicated, but it's really kind of easy. If you think of it as--in the book, I described a store called Jason's Gum Store.

BARTIROMO: Imaginary businesses.

Mr. GREENBLATT: Exactly right. And so let's say it costs \$400,000 to open one of these stores. And those stores actually earn \$200,000 a year. That's a 50 percent return on capital. Now take another store. Let's call it Just Broccoli.

BARTIROMO: OK.

Mr. GREENBLATT: Not a particularly successful store. Costs about \$400,000 to build, but let's say that store only makes \$10,000 a year. That's a 2.5 percent return on capital. We simply said that 50 percent's better than 2.5 percent.

BARTIROMO: Yeah.

Mr. GREENBLATT: And we ranked all companies based on return on capital from highest to lowest.

BARTIROMO: And--and the other criteria is they have to be cheap.

Mr. GREENBLATT: Exactly right. So the ow--how do we measure cheap? We said the more money a store earns relative to the--the price you pay for it, the cheaper it is. So we--we ranked all stocks based on cheapness. It's really like the inverse--we--we called it earnings yield, but it's really the inverse of the PE ratio. Instead of looking at price to earnings, we looked at earnings to price. The higher the earnings you get for the price you pay, the cheaper it is. And we ranked all companies based on cheapness in that way.

BARTIROMO: Um--hmm.

Mr. GREENBLATT: Then we just combined the ranks.

BARTIROMO: And--and used a computer screen to--to look for the companies that fit the bill. You say that people should pick 20 to 30 stocks a year.

Mr. GREENBLATT: Right, well, this is--we just said, let's try this--the not-trying-very-hard method.

BARTIROMO: Ah-hah.

Mr. GREENBLATT: The not-trying-ve--very-hard method was to pick the stocks that were the cheapest, best combined rankings of cheapness and also with the highest returns on capital. And if you combine those two and just pick the

top 20 or 30 stocks, it turned out that you made over 30 percent a year over the last 17 years, and even if you looked at even the largest stocks, the top 1,000 stocks, and just picked out of those, you made more than double the market's return, about 22.9 percent.

BARTIROMO: So use that strategy for us today and tell us the companies that you came up with that look good to you.

Mr. GREENBLATT: Oh, well, it's--it's pretty funny right now. It's the first time in 25 years that I've been doing this that large caps are actually the cheapest and--and a lot of companies coming up on the screen are large caps. Some of them...

BARTIROMO: Large cap technology, you were talking Microsoft, companies like Dell, right? Real quality names.

Mr. GREENBLATT: Right. Well, Microsoft is not a difficult technology. In other words, they have a pretty dominant share of their business, and even though their growth rate might not be as--as large as it has been in the past, it's--it's selling in a very low multiple. Maybe after subtracting cash, maybe 15 times next year's earnings. Tough to get a business of that quality at that low price. Dell is...

BARTIROMO: Because--because the S&P 500 is trading at like above--above 19 times earnings. Right? So when you compare that S&P 500 to companies like Microsoft at 15 times earnings, that's pretty good.

Mr. GREENBLATT: The whole idea of the magic formula, as we called it in the book, good companies at cheap prices, is that when you buy 20 or 30 of them, on average, what you're doing is buying above average companies at below average prices. It's pretty simple.

BARTIROMO: And--and you mentioned Microsoft and Dell. AutoZone is another one. Americal--American Eagle Outfitters was another one you liked.

Mr. GREENBLATT: Right. AutoZone, for instance, if you look out a year or two is g--it's trading about 10 times earnings. They have close to 4,000 stores, but they could probably still open another 3,000. So there's a lot of room for growth. So that's another cheap one. And--and we ow--we actually own some of that.

BARTIROMO: And you're providing screens free, right?

Mr. GREENBLATT: Right. We set up Web site. We just want to make this as easy as possible...

businesses, we think it's important to remind yourself to view investing in this way. Doing so might well keep you from making the mistake of chasing hot-performing investments at precisely the wrong time. Additionally, you can benefit from this approach by applying it to your fund managers and judging them against it. By doing so, you can better understand why they might be faltering during a particular period of time, because, as Greenblatt says, the high earnings yield, high return on capital approach doesn't win every year.

If buying good businesses at reasonable prices hasn't even worked in every year that Greenblatt backtested, will it work in the future, and will it give you a reasonable basis on which to judge your fund managers? Yes and no. In any given year the formula won't work because so many short-term minded investors won't have the patience to stick with the strategy. But for fund managers who are adept at executing their strategy, such periods can provide an opportunity to buy good businesses cheaply, which should help fuel strong long-term performance. Consequently, fund investors frustrated by poor performance should ask whether their funds are employing a style that cannot achieve repeatable success over the longer haul, or whether it is a temporary period when buying good businesses at reasonable prices isn't working. Our fund analyses are always sensitive to those issues and help investors "get beyond the numbers" in that sense.

There is one aspect of Greenblatt's strategy that we disagree with. He wants investors to purchase the top 30 or so stocks that are at the top of the list for earnings yield and return on capital, but he also wants investors to sell them after a year and purchase the new stocks that populate that list. Our preference, once we buy great businesses, is to hold them. That's the way we run our equity newsletter portfolios, and that's what we prefer to see in the mutual funds that we cover. Fewer trades reduce or at least defer the tax bill and lead to lower costs. Also, the whole point of looking for superior businesses instead of mediocre ones trading cheaply is that once you can snag a profitable company at a good price, its ability to sustain profits precludes your having to sell it anytime soon.

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BYLINE: By John Coumarianos

BODY:

Successful hedge fund manager Joel Greenblatt's latest book, "The Little Book that Beats the Market," focuses on finding good businesses and paying reasonable prices to own them. This is not a new concept, and Greenblatt's "magic formula" for beating the market is based on two simple ideas. First, Greenblatt advises investors to buy companies with high returns on capital, suggesting a company is a good business. (Click here for an in-depth article by Morningstar stock analyst Elizabeth Collins on this measure.) Second, Greenblatt advises investors to focus on companies with high earnings yields. A high earnings yield is just another way of saying that a company's shares are selling cheaply relative to its earnings. Still, Greenblatt's message is one that fund investors would do well to heed.

What makes Greenblatt's message valuable is its focus on investing as opposed to speculating. Investing involves risk, but it is not buying something with the hope that you'll be able to sell it to someone else for a greater price later. Investing is financing the operations of a business, and it involves trying to understand if that business is healthy enough and profitable enough to give you an adequate return on your capital from its operations, based on the price you've paid for your interest in those operations. This is what Warren Buffett has called a "business" approach to investing, and it's the one we favor at Morningstar both when we analyze stocks and when we evaluate the investment processes of mutual fund managers. Our stock analysts prefer free cash flow yield instead of earnings, as they believe free cash flow is a more accurate measure of the amount of cash that can be lifted out of a business without disturbing its operations. They also use something called a discounted cash flow analysis to value the stocks they cover, but the principles are the same as Greenblatt's.

Similarly, my fellow mutual fund analysts and I also tend to prefer managers who employ some variation of this "business" approach. For example, we excused a lot of funds we like for underperforming in 2003, when lower-quality companies surged. Also we've been leery of funds that outperformed in 2005 because they loaded up on oil stocks, whose returns on capital are driven by the price of the commodity they sell and are, therefore, out of their control. Even if you invest exclusively in mutual funds and never look at the annual reports of individual

believe in it deep down in your bones."

Even if you don't drink the Kool-Aid, you will learn about the technique of value investing from a pro. Greenblatt boils investment jargon down to what you need to know as succinctly and humorously as possible. Along the way -- and it won't take you more than two hours tops -- you're given a tutorial on bonds, stock shares and prices, earnings yields, return on capital and more. The appendix, which is "not required reading," adds a more detailed, strategic commentary.

It might be hard for less-schooled investors to understand why the "magic" formula makes sense and to stay with it when things get bleak, but the hard part is just getting started, he counsels. That's true for investing, period.

The Little Book That Beats the Market

By Joel Greenblatt

John Wiley & Sons

155 pages; \$19.95

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HEADLINE: 'Little Book' sums up stock strategy;
'Magic' formula relies on faith, patience

BYLINE: Kerry Hannon

BODY:

The Little Book That Beats the Market
By Joel Greenblatt
John Wiley & Sons
155 pages; \$19.95

Joel Greenblatt's The Little Book That Beats the Market is pitched not to the swells of Wall Street but to the novice individual investor.

Greenblatt, the founder of hedge fund firm Gotham Capital, has taken what he has learned about investing and written this skinny, pocket-size book.

His goal: to explain how to make money in terms that even his five kids could understand. "I figured if I could teach them how to make money for themselves, then I would be giving them a great gift."

Greenblatt, a Columbia Business School professor and an investor for 25 years, says, "I believe I can teach you (and each of my children) to be one of them" -- meaning, a successful investor.

The Little Book That Beats the Market is simple and sincere; Andrew Tobias, author of The Only Investment Guide You'll Ever Need, writes the introduction.

The formula works if you have faith and are patient enough to follow his

BARTIROMO: Yeah.

Mr. GREENBLATT: ...for people to do. So we set up a Web site called magicformulainvesting.com, and you just put in what size companies you're looking for, and it will give you the top 25 or 50 companies that rank that way, and you get to choose out of those. And all those companies do incredibly well, based on the screens.

BARTIROMO: Doesn't--doesn't work every year though, right?

Mr. GREENBLATT: Well, that's the great thing about the magic formula is it's not that great. There are one, two and even sometimes three-year periods where the magic formula doesn't work. If it always worked, everyone would follow it, and it would kind of ruin everything.

BARTIROMO: Right.

Mr. GREENBLATT: And--and, you know, I'd really be a kind of a blabbermouth telling everyone about this. But the big picture is it doesn't work every year, and unless you understand what you're doing, which is buying above average companies at below average prices, you won't stick with it. So I spend a lot of time in the book explaining to people what you're actually doing so that when it doesn't work for a year or two, you still stick with it because what you're doing is smart.

BARTIROMO: Really, really great strategy and--and so well done. Thanks so much, Joel.

Mr. GREENBLATT: Thanks for having me, Maria.

BARTIROMO: We appreciate you coming on the program. Joel Greenblatt, author of "The Little Book That Beats the Market." Great read.

Up next, we'll talk about some of the stocks that got hit hard this past few days. And still to come, my visit with Oprah this past week, answering questions like this one:

LAURA: (From "Oprah") What I want to know is who is FICA and why do they take so much money out of my paycheck every week?