Greenblatt

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Off the Shelf

How to Invest, Times Three

By PAUL R. BROWN

PITY, please, the people who write personal finance books.

More than 150 years ago, Charles Dickens wrote in "David Copperfield": "Annual income twenty pounds, annual expenditure nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery."

Little has changed since.

Every January, publishers seem compelled to issue another round of personal finance books in the hope of capturing the millions of people who have vowed, "This is the year I finally do something about my finances."

In trying to put a new spin on things, publishers have placed the emphasis this time on books that make saving and investing not only simpler but also intriguing. Of the dozens of personal finance books coming to the market this month, here are three that deliver on the premise.

Lee Eisenberg, the former editor of Esquire, has created a template with "The Number" (Free Press, $26). In this book, your "number" is how much money you need to live the way you want, once you retire.

Clearly, it is a personal calculation, as the people who are interviewed by Mr. Eisenberg make clear. To some, accumulating as much money as possible is the only thing that matters; to others, the only goal is having enough money to make a difference in the world.

Mr. Eisenberg makes no moral judgments. Instead, he offers conventional investing advice: diversify your investments, keep transaction fees to a minimum and understand that you can safely draw down 4 percent of your savings every year during retirement with little risk of outliving your funds. But the book's real benefit is to force you to figure out what you are saving for.

When that is decided, you can determine how big your number needs to be.

For example, if your goal is "being comfortable," you will need $50,000 to $100,000 in annual income from your savings and investments once you stop work, according to one specialist who is interviewed. That puts your number in the range of $1 million to $2 million.

Mr. Eisenberg says one lesson to draw is this: "An unexamined life may or may not be worth living. But it is almost always more costly than an examined one."

In another new book, "Smart and Simple Financial Strategies for Busy People" (Simon & Schuster, $26), the longtime financial writer Jane Bryant Quinn advocates simplifying all your financial decisions and living by hard-and-fast rules. Although even relatively inexperienced investors may feel that large parts of the book are too basic - it spends an inordinate amount of space explaining the process of getting a mortgage and defining things like index funds - it is terrific in suggesting ways to automate your savings and how to invest in things like life-cycle funds - mutual funds that shift money to more conservative investments as you age.

For the undisciplined investor, there is something very appealing about the idea of following this book's hard-and-fast rules: If you are in your 20's, you should be saving 10 percent of your income for retirement, Ms. Quinn writes in no uncertain terms; if you are in your 30's and haven't started saving yet, that number is 15 percent.

By far the most entertaining of the offerings is "The Little Book That Beats the Market" (Wiley, $19.95), by Joel Greenblatt, who has a definite plan for how you can invest your savings.

Realistically, there is only one way for most of us to accumulate enough money so that we can stop working full time and still live the way we want: build a portfolio of stocks or mutual funds that perform well.

And Mr. Greenblatt, the founder of Gotham Capital, "an investment partnership that has averaged 40 percent annualized returns since its inception in 1985," according to his biography, is great at explaining where and how to invest. Using the mythical Jason's Gum Shops as a model, he explains in simple, straightforward language the fundamentals of valuing a business, often underscoring with a joke why you need to know all this: "Choosing individual stocks without any idea of what you're looking for is like running through a dynamite factory with a burning match. You may live, but you're still an idiot."

Armed with the fundamentals, Mr. Greenblatt presents his "magic formula" - his term for how you should invest.

His underlying concept, which is a variation on an idea that goes back to the days of "Security Analysis," by Benjamin Graham and David Dodd, first published by McGraw-Hill in 1934, is to "find above-average companies that we can buy at below-average prices."

Mr. Greenblatt's formula makes a lot of sense. He says we should invest in companies that have both a high earnings yield - determined by dividing a company's earnings per share by its stock price - and a high return on capital, which is nothing more than a measure of how well a company uses its money. That, too, is a ratio: net income divided by invested capital.

"What would happen," he asks, "if we decided to only buy shares in good businesses (ones with high returns on capital) but only when they were available at bargain prices (priced to provide a high earnings yield)? We would make a lot of money."

One note: Mr. Greenblatt's formula is based on how a company performed in the previous year. And investors have been told since the beginning of time that past performance is no guarantee of future results.

Mr. Greenblatt agrees. But he says that he has back-tested his formula repeatedly - and that it works.

"Over the last 17 years, owning a portfolio of approximately 30 stocks that had the best combination of a high return on capital and high earnings yield would have returned 30.8 percent per year," he writes. "During those same 17 years, the overall market averaged a return of about 12.3 percent a year."

And he provides a step-by-step path for putting his formula into practice.

Of course, you don't have to follow Mr. Greenblatt's formula - or anyone else's, in particular - in order to achieve financial success. But as these books make clear, you do need to know how much you'll need to live the way you want and have a clear plan for attaining that goal.

All three of these books can help you have a more prosperous new year - and longer-term future.

Greenblatt

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Can American Eagle Pull Out of Its Dive?

By Nat Worden

Get Jim Cramer's picks for 2006.

The retail sector has slogged through hurricanes, soaring gas prices, flagging consumer confidence and rising interest rates to tack on a small gain for 2005. So, how did longtime Wall Street darling American Eagle Outfitters (AEOS:Nasdaq) stumble?

While the S&P Retail Index boasts a 0.3% increase going into the last few days of December, American is down 6.4%. This from a highflying clothing chain whose ability to navigate teen fashion trends more than doubled its stock price in 2004 after a 20% jump in 2003.

Has American Eagle been replaced atop the teen taste food chain by Abercrombie & Fitch (ANF:NYSE)? Yes. Is it time to abandon its carcass in the fashion highway's breakdown lane? According to one newly popular model for value investing, no.

Snake Oil?

Investors don't like to rely on magic formulas when it comes to their hard-earned savings, but they may want to make an exception here. In his new stocking-stuffer hitting bookstores, The Little Book That Beats The Market, Joel Greenblatt uses the term "magic formula" to describe a strategy has yielded extraordinary returns and has nothing to do with magic.

Greenblatt, a managing partner with Gotham Capital and a professor at Columbia Business School, uses the classic tenets of value investing to derive a formula for managing a stock portfolio that has soundly beaten the averages for 17 years. That's a feat that proponents of the efficient-market theory -- best described in Burton G. Malkiel's book A Random Walk Down Wall Street -- claim is impossible, or at least unsustainable. Greenblatt, however, makes a convincing case that his formula will continue to beat the market, and his formula points to American Eagle Outfitters as a screaming buy.

To be sure, that doesn't mean that buying shares in the apparel retailer is a sure win. Aside from picking individual stocks, the success of Greenblatt's technique relies on diversification. By his recommendation, American Eagle would be one in a basket of 30 stocks that investors should buy for the best

chance of success. Any one stock in the basket could be a loser.

In fact, the entire basket of stocks could lose for years; the idea is to be patient and limit your risk.

Less Than Rosy

At first blush, buying shares of American Eagle Outfitters might seem like a strange way to limit risk. The company cut its fourth-quarter outlook by 3 cents a share in early December after missing Wall Street's estimates by a wide berth with a measly 1.7% gain in November comps.

Meanwhile, the company is touting big discounts in its stores this holiday season that could hurt profit margins, particularly in denim, where some analysts feel there is an inventory glut. Observers have long warned that American Eagle's grip on fashion tastes was tenuous. Now, with concerns that consumers are ratcheting back their spending swirling around Wall Street, it seems increasingly plausible that the stock has reached the end of its tether.

Greenblatt's formula, on the other hand, encourages investors to ignore these issues, along with all the rest of the informational hoopla emanating from Wall Street. Nobody can really predict the future. Therefore, Greenblatt recommends using the past to play the future. His formula focuses on two metrics only: a company's earnings yield, or its price in relation to its earnings, and its return on capital.

"The formula isn't looking for the company that ranks best on return on capital or the one with the highest earnings yield," Greenblatt writes. "Rather, the formula looks for the companies that have the best combination of those two factors."

To calculate a company's return on capital, Greenblatt takes earnings before interest and taxes, and divides it by its net working capital plus its net fixed assets. By this measure, with EBIT for the last four quarters on the books of about $480 million, American Eagle shows a return on capital for the last four quarters of 48%. That means the company has been enjoying returns on its investments that are far above the market average.

Its earnings yield is also not too shabby. Greenblatt calculates it by dividing a company's earnings before interest and taxes by its enterprise value, or its market cap minus cash, plus debt. By a back-of-the-napkin calculation (an analyst would factor in more intricate measurements of a company's financials), American Eagle has about $679 million in cash on its latest balance sheet (third quarter ended Oct. 29). That includes short- and long-term investments.

On the liability side, the retailer appears to have no interest-bearing debt. Take Friday's stock price of $21.65, multiply it by the most recent count of shares outstanding, 149 million, and its equity is valued at roughly $3.25 billion. Subtract the estimated $679 million in cash, and American Eagle has an enterprise value of around $2.57 billion.

Divide EBIT by that figure, and American Eagle has an earnings yield of roughly 19%. That means that if shareholders had bought its stock a year ago at Friday's stock price, the company would have returned profits (economic profits, that is, not stock market profits) on their shares with a 19% return. Compare that with the annual return investors could get from a 10-year Treasury bill on Friday, 4.4%, and American Eagle is starting to look pretty good.

Of course, there is no guarantee that these metrics will last. Also, despite the good metrics, the value of its shares still went down last year, reflecting Wall Street's darkening view of its future prospects. So, stock prices will always be subject to the shifting views of traders looking at monthly same-store sales. Over time, however, Greenblatt and others say that investors can benefit by sticking to the metrics.