Joel Greenblatt Speaking At NYSSA

December-28-2005

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In the freezing cold evening of December 7th, 2005, Joel Greenblatt of Gotham Capital, armed with delightful jokes and a magic formula, warmed the hearts and souls of about 200 security analysts in a seminar organized by New York Society of Security Analysts (NYSSA.org). We are pleased to bring you the financial enlightenments captured from that event:

Crunching Data, Searching Magic Formula

- During his years at Wharton, Joel Greenblatt manually entered stock data based on 9 years worth of S&P Stock Guides and created their own database for research.
- Cleaned up the data by eliminating certain things. Now they use Compustat database.
- Richard Pzena figured out how to enter those data into the mainframe computers at Wharton Business School. At that time, the computers were about the size of two conference rooms.
- Sometimes, the market throws off bargains because it is unreasonable about the prospects of certain companies.

Buying Cheap Stocks Works Over Time

- In the 70's, they tested Benjamin Graham's Net-net Formula and found that picking stocks below liquidation value worked well. (Liquidation value = Current Assets - All Liabilities.)
- Not every cheap stock performed well individually, but as a basket they did well.
- However, these types of opportunities are practically extinct in today's market.
- Many other studies have shown the strategy of buying cheap companies works over time.

Buffettized: Buying "Cheap" and "Good"

- Starting out as a die-hard value investor, Greenblatt became "Buffettized" in early 90's. Why not look for the good ones amongst the cheap companies?!
- Greenblatt says that he didn't realize that trying to find cheap and good companies, rather than just the cheap ones, was so important until the 1990s. While Graham was looking for starkly cheap companies, Buffett wants only the good ones.
- Greenblatt's friend, Richard Pzena, remains committed to buying troubled companies at dirt cheap prices, the cigar butt approach. You see this saggy cigar butt on a dirty corner of Wall Street. You pick it up and get one last puff out of it. The puff not very tasty. The act is not very elegant. But it's free (Laugh).

The Magic Formula Was Born

- By combining Graham and Buffett, Joel Greenblatt's magic formula is a computerized system to invest in good companies whose stocks are cheap.
- Good companies = High return on capital (ROC defined as operating profit divided by net working capital plus net fixed assets.)
  Cheap stocks = High earnings yield (Earnings yield defined as pre-tax operating earnings divided by enterprise value.)
- ROC = EBIT/(Net working capital + Net fixed assets)
- Earnings yield = EBIT/(Enterprise Value)
- If net working capital is negative, use zero.
- Here, EBIT is last 12-month's earnings before interests and taxes (EBIT).
- Two key issues addressed by his magic formulas: (1) What is the return on the price you paid? (2) What is the return on the capital the company is investing?

Ranking the "Cheapness" and "Goodness"

- Greenblatt turned to his computers to rank companies by two factors, good (high ROC) and cheap (high earnings yield). Ranking Method: If company XYZ ranked 10 out of 3,500 companies in terms return on capital, and it ranked 20 in terms of earnings yield, the combined ranking of XYZ would be 10 + 20 = 30.
- Greenblatt's "Not-Trying-Very-Hard" Model Buy the top 30 of the highest ranked companies. Hold them for one year. Turnover the portfolio at year end to buy a new list of 30 highest ranked stocks based on one-year's worth of new financial data.
  Sell losers right before a year is up, and sell winners right after 12 months for tax benefits.

Why the One-Year Holding Period?

- It is interesting to note that more stocks worked out over one-year rolling periods, rather than two-year periods. Maybe the time window that a value stock stays undiscovered is being shortened towards one year as more and more people start searching for values.
- Besides, after one year, you get a complete set of new earnings data. It would be a good time to run the rankings again.
- Selling has always been difficult. The other day, Greenblatt and his partners went on and on talking about the stocks that made a huge move after they sold at intrinsic value. To remove the uncertainties and difficulties of selling, a one-year holding period was picked. "I call it the Not-Trying-Very-Hard Model (Laugh). My mantra is to keep things simple," said Greenblatt.
- Besides, trading cost is cheap now.

Sell Rules

- Sell close to intrinsic value.
- Sell if something even cheaper is found.
- "We never mastered the art of selling. We are semi-bubbling idiots at it," confessed Joel.

The Magic 30.8% Per Year for 17 Years

- Magic formula works! Using stocks of all sizes, it produced a 17 year annual return of 30.8%. Using only the largest 1,000 stocks, the annual return was 22.9%.
- When ranked by 10 deciles (250 stocks in each, higher deciles consistently outperformed those below them from top to bottom.
- The cheap portfolio tends to have less volatility also.
- The magic formula beats the market 96% of the time.

Magic Formula Investing:

The Operating Steps

In his new bestseller: "The little Book that Beats the Market", Joel Greenblatt also discussed in detail the operating steps of the magic formula investing:

1. Go to magicformulainvesting.com (Nice plug!)
2. Specify your criteria for minimum company size.
3. Get a list top-ranked companies based on high return on capital and high earnings yield.
4. Invest 1/3 or 1/5 of your money into 5 to 7 top-ranked companies every 2 to 3 months. (Dollar-cost-average into the "good and cheap".)
5. After 9 to 10 months, construct a portfolio of 20 to 30 stocks.
6. Sell each stock after holding it for one year. For tax purposes, sell winners a few days after the one-year holding period. Sell losers a few days before the one-year holding period.
7. Reinvest the proceeds into new top-ranked companies. Stick to this simple and mechanical system for at lease 3 to 5 years to give the magic formula a chance to work.

Greenblatt's Personal Investment Process

- Looks for value with a catalyst, so nice things happen sooner. Special situations are just value investing with a catalyst. They are simply different places to find cheap stocks.
- In his own hedge fund, Greenblatt uses the basic principals in the magic formula: Look for high ROC and high earnings yield.
  Tries to figure out what "normalized earnings" will be 3-4 years into the future.
- Makes sure the stock is very cheap based on normalized earnings.
- 5 to 8 securities can make up 80% of his portfolio. One position could be up to 30%.
- Having a concentrated portfolio works well for lazy people. Not that many stocks to track.
- Thinks about how much he could lose if he's disastrously wrong.
- No formal process or time frame for purchase decisions. Usually spend one month or so to do research. In difficult situations for which he and his partners have time, research could take months.
- If there is a great opportunity which, in their opinion, won't last, and if they feel they understand it, they sometimes use the approach of "Ready, Fire, Aim!"
- Has financials and utilities in the portfolio.

EBITDA Minus Maintenance CapEx

- For his own investment practice, Greenblatt uses a different input for earnings.
- He thinks that "EBITDA - Maintenance Capital Expenditure" would be a better measure of earnings power, but it can be difficult to calculate.

No Edge in Foreign Markets

- Greenblatt prefers to invest domestically because it's within his circle of competence and he hasn't run out of opportunities.
- He does acknowledge that you could probably find cheaper companies internationally and it is a good idea if it is within your area of expertise.
- If he was younger, he may do more with international investing.

On Long-Short Strategies

- Q: "How about long the top deciles of cheap stocks and short the bottom deciles of expensive stocks?"
- A: "I am not a fan of shorting. The long-short guys blow up every eight years. I call it the 'I got it! I got it! I ain't got it!' Strategy."

Fair Bet Yet Unfair Investing

- Look for a big mess that seems too complicated, not well understood, not well followed, and requires too much work. People don't want to do the work, but once you do the research, you will be at an advantage.
- Look for semi-complicated situations. The key is to identify what cuts to the core.

Numbers Are More Important than People

- First look at the numbers as they don't lie. You can learn a lot about the management by looking at what they've done though the numbers.
- Meeting the management in person and determining their abilities is not easy. "I used to meet a CEO and say to myself: 'This guy is smart.' Next day I meet another CEO and say to myself: 'This guy is smart, too.' (Laugh) In the end, I feel meeting CEO is not very important because I am not good at reading people," said Greenblatt.
- What is more important is: (1) What the management has done with the cash? (2) What are the incentives? (3) Is the salary too high? (4) Is there heavy insider selling? (5) What is their trackrecord?
- Compare "what they do" with "what they say".
- Bad signs: high salaries and insider sellings.

The Macro Picture Is a Distraction

- In 1999 and 2000, there were plenty of non-internet values out there. If you were worried that the burst of the internet bubble would have dragged those values further down, you would have made a big mistake. "Fortunately, we ignore the macro picture," said Greenblatt.
- In 2002 and 2003, there were plenty opportunities in small caps. If you were concerned that the bear market could go on further, you would make another mistake.
- "Now the value is in big caps. But if you look at the macro picture, the consumers could drop dead, the housing bubble could drag everybody down?- We ignore those. We have no macro view," said Greenblatt.
- Everything is cyclical. Values can always be found somewhere.

Ignore Volatility and Stock Prices

- Taking your clue from the stock prices is crazy. If you could value companies, you should ignore the noises from volatility and stock prices.
- Things such as volatility have nothing to do with buying a good, cheap company for the long run. Greenblatt said, "It is kind of ironic that, the older I get, the longer time horizon I look at." (Laugh)
- The Efficient Market Theory is a crazy way to look at the market. "Pick and choose. You can beat the market. It is worth the work."

The Vogue of Return on Capital

- There seems to be a movement towards high return on capital.
- The low P/B stocks haven't work very well in the past 10 years.
- Don't know if or when this trend will reverse.

One More Trick

- Greenblatt disclosed: "We have one more trick. When we have gains, we look at before-tax numbers. When we have losses, we look at after-tax numbers. (Blank stare?-pause.) That was trying to be funny. (Laugh)"