

## **Stick with the simple, if scary, solution**

By Whitney Tilson

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There's certainly no dearth of advice on investment. The bestseller lists are full of books on how to be a successful investor "in only 15 minutes a week", on how to become an "automatic" millionaire, and about how to invest if you're "young, fabulous and broke".

The best book on the subject in years is value investor Joel Greenblatt's *The Little Book That Beats the Market*, which is still a top seller months after its release. Beyond the credibility that comes from someone whose private investment partnership, Gotham Capital, has produced 40 per cent a year returns over the past 20 years, Greenblatt also brings an elegant and simple writing style to what can be a complicated subject.

He outlines a "magic formula", based on how he himself invests, that anyone can use. The formula has only two inputs, a company's earnings yield and its return on capital. The rationale is straightforward: buy shares in good businesses, measured by returns on capital, only when they're available at bargain prices, defined as a high earnings yield.

The magic formula looks for companies that have the best combination of earnings yield and return on capital, with each input weighed equally. An outstanding company with an expensive stock ranked, say, first for return on capital but 1,999th on earnings yield, would have the same combined ranking of 2,000 as a low return on capital company with inexpensively priced shares, ranking 1,999<sup>th</sup> in return on capital but first on earnings yield.

Using this approach to create a regularly updated portfolio of about 30 stocks with the highest combined rankings, Greenblatt tested his formula between 1988 and 2004. The results were remarkable: with only one down year, the magic portfolio would have returned 30.8 per cent a year, against a 12.4 per cent annual return for the S&P 500.

Rather than using the latest 12 months' earnings to calculate earnings yield and return on capital, Greenblatt and his analysts try to improve on the rote application of this formula by using earnings estimates in a "normal" year, one in which nothing unusual is happening within the company, its industry or the overall economy.

Greenblatt has created a free website for screening stocks based on his approach ([www.magicformulainvesting.com](http://www.magicformulainvesting.com)). In a recent screen I carried out there of the top 100 magic formula companies with market capitalisations above \$2bn, the top 10 companies ranked by market cap were Exxon Mobil [XOM], Microsoft [MSFT], Pfizer [PFE], Johnson & Johnson [JNJ], IBM [IBM], Intel [INTC], ConocoPhillips [COP], Dell

[DELL], 3M [MMM] and Motorola [MOT]. Now that's an impressive group of companies!

I own one of them (Microsoft) in my portfolio. Given how sceptical I am about the tech sector, owning this is a real leap for me but this is a fantastic business and the stock is attractively priced. Microsoft has a dominant franchise, some of the most jaw-dropping economic characteristics ever achieved, capable, honest, shareholder-friendly management and, unlike most technology companies, reasonably predictable future prospects.

I am optimistic about Microsoft's future prospects for a number of reasons. Most important, the company will be releasing in the next year significant upgrades of its two cash cows, Windows and Office. Historically, these events have been big and highly profitable events for Microsoft, and there is no reason to believe otherwise this time.

Yes, Microsoft's days of ultra-high growth are over, inevitable for a company with \$40bn in annual revenues. But it is highly likely the company will grow substantially faster than the S&P 500 for many years to come and that its fabulous economic characteristics will remain largely intact.

At a recent price around \$27, Microsoft, after adjusting for the company's cash hoard, is trading at under 17 times earnings estimates for this calendar year.

I don't claim this is screaming cheap but it is close to the lowest p/e multiple the stock has ever traded at and is, I believe, a very attractive price for a company of its quality and bright future.

You might wonder if Greenblatt is concerned that popularising his strategy will mean it will stop working. "Traditional value investing strategies have worked for years and years and everyone's known about them," he says. "They continue to work because it is hard for people to do, for two main reasons. First, the companies that show up on the screens can be scary and not doing so well, so people find them difficult to buy. Second, there can be one-, two- or three-year periods when a strategy such as this doesn't work. Most people aren't capable of sticking it out through that."

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