A professor at the Columbia University, he is also the founder of hedge fund Gotham Capital which he set up in 1985. Greenblatt is well known for his two books: *You Can Be a Stock Market Genius: Uncover the Secret Hiding Places of Stock Market Profits* and *The Little Book That Beats the Market*.
Joel Greenblatt, set up hedge fund Gotham Capital in 1985. The reason you should learn about Greenblatt’s techniques is because his Gotham Capital returned 40 per cent annually for 20 years!

Buying good, profitable companies at cheap prices is not exactly a revolutionary idea; this is what Warren Buffett has successfully done for decades. But Greenblatt has created a systematic way to do it, and most of the heavily lifting of number crunching is done by his Magic Formula. The magic formula is a stock screener, which ranks stocks by two factors: Profitability, based on Greenblatt’s chosen metric, Return on Capital and Earnings yield, the inverse of the PE ratio, defined here by him as EBIT/Enterprise Value.

Greenblatt called these inputs ‘Good’ and ‘Cheap’ factors, looked for companies that were both good and cheap. This formula had, and continues to have, extraordinary out performance and Greenblatt still feels that a focused approach to investing will yield higher returns, but a formula approach, that is buying a more diversified basket of quantitatively undervalued stocks is an approach he now prefers due to it’s simplicity and diversification, yet still above average return potential.

Although his philosophy is Graham, his strategy was much more focused. The Magic Formula is simply a combined ranking of Return on Invested Capital and Enterprise Value/EBIT (a variation of the more well known PE ratio). For casual investors, Greenblatt recommends buying a portfolio of 20-30 Magic Formula stocks, holding for one year, and then re-running the process annually.

### Greenblatt’ filter

The Magic Formula is a modification of Graham’s Simplest Way to select bargain stocks. Greenblatt combines companies with high earnings yield with high return on capital to come up with a list of high quality companies trading cheaply. He made some of his own adjustments to how to come up with his screen. We eliminated banks, financial institutions and utilities to try the Greenblatt filter and calculated Earnings Yield by dividing Ebit by Enterprise value.

1. Earnings yield compares the profit generated with the market’s valuation of the company (EBIT/enterprise value)
2. These were then ranked. The highest EY was ranked 1 and so on
3. Next came the ROCE which was derived by dividing Ebit with the sum of net fixed assets and working capital
4. Return on capital = Ebit/(net fixed assets + working capital). These were ranked. The highest ROCE was ranked 1 and so on
5. The two ranks were combined with the lowest ranks coming first
6. The top 30 stocks were selected. After due research into each of them, these stocks should be held for a period of three to five years

### Timeless principles

Greenblatt stresses discipline and his research shows that while beating the market is hard, it doesn’t have to be complicated. The hard part comes not in developing a complex strategy, but instead in finding a proven approach and sticking with it through good times and bad.