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An Interview With Joel Greenblatt
Co-Founder, Gotham Asset Management

Joel Greenblatt's Investing Secrets Revealed

by Leslie P. Norton

The following has been excerpted

The Columbia University professor and co-founder of Gotham Asset Management made the case for value investing in his best-selling *The Little Book That Beats the Market*, buying shares of businesses that were cheap relative to returns on invested capital and earnings yield. With Robert Goldstein, his longtime partner, Joel Greenblatt created a series of hedge funds and mutual funds that would go long cheap stocks and short expensive stocks. Last year, realizing that many investors preferred funds that stuck more closely to the index, Greenblatt's Gotham Asset Management launched Gotham Index Plus (ticker: GINDX), which has been beating the Standard & Poor's 500 index.[1] And after a bout of underperformance caused by investor disdain for value stocks, his funds are snapping back. Last week, Greenblatt, 58, chatted about his new fund and his outlook for the market.

In his spare time, he's also one of the guiding lights behind the charter-school movement in New York City, and shared with us his next great idea for improving society.

Read on to learn why he likes Apple (AAPL) and CVS Health (CVS) and is short Salesforce.com (CRM) and Caterpillar (CAT).

Gary Spector for *Barron's*

Joel Greenblatt's Gotham Asset Management launched Gotham Index Plus.

Barron's: **Gotham Index Plus is the latest generation of Gotham investing — dramatically different from your previous styles. It's like Dolly Parton going from country to disco. What's the idea?**

Greenblatt: That's such a bad image, really. The basic idea is that the best strategy for most people is not only one that makes sense, but also one they can also stick with. To beat the market, you have to zig and zag differently from the market. While value investing works over the long term, and in the vast majority of cases within two or three years, people's time horizons are shrinking, and they keep chasing returns. They don't generally know how to evaluate stocks.

Your book told them clearly how to do it.

The Little Book That Beats the Market gave you metrics to buy a group of companies. If you buy a group of them, on average

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you will end up with a good return. Stocks are not pieces of paper that bounce around, they are businesses that you value and try to buy at a discount. If you are going to buy individual stocks, you need to know how to value companies yourself. Most people don't know how to do that or don't want to do the work, so they get someone else to do it. Unfortunately, the only way they have to judge those managers is how they've done over the past one-, three-, and five-year periods. Multiple studies will tell you there is very little correlation between the past one, three, five and the next one, three, five. [2] So people should really look for managers that follow a process they can believe in and stick with over the long term. Unfortunately, it's just as hard to pick a good money manager as it is to pick an individual stock. Why? When the market goes up or an active investor outperforms, people pile in. When the market goes down or that investor lags behind, people pile out. They chase returns because that's all they really have.

Are you repudiating your other strategies?

No. I love our other strategies. We can make lots of money over time with them. But people don't stick with it. Most people have a difficult time sticking with strategies that underperform from time to time. Gotham Index Plus minimizes that time. It is a way to capture our ability to buy cheap stocks and short overvalued stocks and add that to the base S&P 500 index. We buy a dollar's worth of the S&P 500—the underlying stocks in the same proportions as they are in the index. Then we add 90 cents of our favorite S&P 500 stocks and short 90 cents of our least favorite S&P 500 stocks. With this strategy, you have a lot less tracking error—the divergence between a fund's return and that of its benchmark—and we can still take advantage of our stock-picking ability.

In 2011, I published a book called *The Big Secret for the Small Investor*. I always say it's still a big secret because no one bought it. It talked about a couple of studies, including the best-performing fund from 2000 to 2010, which was up 18% a year even when the market was flat. The average investor in that fund went in and out at the wrong times on a dollar-weighted basis to lose 11% per year.[3] Meanwhile, the statistics for the top-quartile managers for that decade were stunning: 97% of them spent at least three of those 10 years in the bottom half of performance, 79% spent at least three years in the bottom quartile, and 47% spent at least three years in the bottom decile.[4] So our fund would compromise: Reduce the tracking error but add the benefit of buying cheap stocks and shorting expensive stocks. In a more muted return environment for the S&P 500, that extra additional return should be very attractive to investors.

This long period of low interest rates has distorted markets. What do you see for stocks?

The market looks expensive. It's roughly in the 21st percentile toward expensive over the past 25 years, meaning 79% of the time during that period the market is less expensive. What usually happens the following year when we've been at this level? On average, the market is up between 2% and 7%, so figure a gain of 4% to 6% on average. During those 25 years, the market rose 9% to 10% a year. Another way to think about this is the market is 12% to 13% more expensive than it has been traditionally. Well, one scenario could be that it drops 12% to 13% tomorrow, and future returns would go back to 9% to 10%. Or you could underearn for three years at 4% to 6%. We're still expecting positive returns, just more muted. The intelligent strategy is to buy the cheapest things you can find and short the most expensive.

At $44 million in assets, your new fund is tiny. Yet it has much lower fees than your other funds. Are your other fees on the way down, too?

When we started taking outside money again in 2009, I made a few decisions. I've sat on many investment boards over the years, and most hedge funds don't justify their fees of 1.5% to 2% of assets and 20% of profits. We thought reasonable fees were 2% flat. People thought we were crazy to be so cheap, charging half or less what other hedge funds traditionally charge. We thought the money would be stickier because the lower fees would leave investors with more of the returns. Three years later, when we looked at introducing mutual funds, we realized we were among the few hedge funds that could launch mutual funds without diluting our strategy. So we charge our mutual fund clients what we charge our hedge fund clients. We have limited capacity because many of the names are so small. With Gotham Index Plus, because they're all large-caps, our management fee is 1% total.[5]

Your other three mutual funds have trailed their benchmarks. You've said to give an investment two to three years to work out. Is the period of underperformance over?

Like I say, value investing works like clockwork, but sometimes your clock has to be very slow. This year, we're pretty much in line with the market, adjusted for each fund's equity exposure. We continue with our same process. Last year, part of the issue was that the S&P 500 was up 1% and the equally weighted Russell 2000 was down 10%. We didn't have good spreads last year between the performance of our longs and shorts. Valuation is like gravity. Usually what happens is, [the stock price] is like a rubber band—it stretches away from value. If we're good at valuing businesses, the rubber band will snap back. Our expectations for our long portfolio are very high; we expect very poor returns from our short portfolio. Our strength is knowing what we are doing.

Value investing is back in vogue this year. For how long?

Neither Morningstar nor Russell classify us as value investors—they call us a blend of value and growth. The reason is that many people use low price-to-book or low price-to-sales metrics to define value. We're neither. We're cash-flow-oriented investors, valuing businesses and buying them at a discount. So by definition, if we're good at what we're doing, it doesn't stop working. If we were momentum investors and that's worked well for 30 or 40 years and didn't work for two or three years, I'd be questioning if it were a crowded trade, because it's not so hard to figure out if a stock used to be lower and now it's higher. I don't have strong opinions on so-called factor investing and which factors are in and out of favor. It's completely counterproductive to analyzing what's going on in the market.

Let's talk about what's in the long/short portfolio. Names please.

Apple is one of our four biggest positions on the long side. It has double-digit free-cash-flow yields, while the S&P 500 is less than half that. People worry that it's effectively a hardware company that will crash and burn. But it's also an ecosystem of products that play with one another and a brand people like. Coca-Cola sells sugar water and has done OK. The truth is probably a gray area in between those two arguments. But Apple earns huge free cash flow, huge returns on capital, has a great niche.

And we don't own just Apple. We own a "bucket" of Apples—companies that gush cash with huge returns on capital and nice market niches. Qualcomm [QCOM] is another. People worry about the semiconductor market for handsets slowing. OK, growth isn't what it once was, but it has huge market share, dominates a section of its industry, and has moves it can make through current technology or acquisitions: Smartcars and a lot of other things can use its technology.

CVS is another big position—again, gushing cash, but people worry about a new president, new health-care rules, and integrating some acquisitions. We think these are short-term concerns. The big

problem with most active managers is they avoid companies where clarity over a year or two is a little opaque.

How about on the short side?

Salesforce sells at 218 times pretax earnings and almost seven times sales. People think they'll earn more and more money, but even if you are generous with your assumptions, it is still trading at over 50 times earnings. In most of our short book, companies sell at 50, 100, 300 times pretax earnings and are losing money. We're also short Costco Wholesale [COST], a great retailer but still a retailer. It trades at 28 times earnings and is not growing. It has to compete with Amazon.com [AMZN]. Another one is Caterpillar, which people like for its 3.5% dividend yield. It's not earning enough money to pay that dividend right now. The expectation is they'll earn over $5 and justify their $87 stock price. It's really a bet on growth in the developing world. Even if they do better, they're very fully priced.

You've been a guiding light behind the Success Academy's charter schools. What is your next big idea to improve society?

Creating an environment that supports a job for every American who wants one should be one of the most important responsibilities of government. The 5% unemployment rate doesn't reflect the record-low participation rate, as well as those who are underemployed, earning less than $15 an hour. I think we should have a very generous job credit for hiring so that companies are incentivized to hire people who are not employed or earn under $15 an hour. It could build on a broad expansion of an existing framework in the Internal Revenue Code.

This would be the most direct and efficient method of creating employment opportunity and spurring economic growth. The costs could be low or even negative since unemployment payouts would be reduced and the new employee would contribute Social Security, federal, and state taxes to the government in each of the first two years of employment. And most would be eligible for employer health benefits, further reducing government obligations.

Thanks, Joel. ■

[1] As of date of interview. The S&P 500 Index is a commonly followed equity index and is generally considered a barometer of the U.S. equity market. The performance of an index does not reflect operating expenses that apply to a mutual fund. It is not possible to invest directly in an index.

[2] See, e.g., Stewart, Neuman, Knittel, and Heisler, Financial Analysts Journal, November/December 2009 "*Absence of Value: An Analysis of Investment Allocation by Institutional Plan Sponsors*"; Amit Goyal and Sunil Wahal, Journal of Finance, Vol.63, No. 4, August 2008 "*The Selection and Termination of Investment Management Firms by Plan Sponsors*"

[3] Morningstar study quoted in the Wall Street Journal, December 31, 2009, "*Best Stock Fund of the Decade*."

[4] Davis Advisors (1/1/00 – 12/31/09)

[5] Other expenses apply to an investment in the Gotham Index Plus Fund. Effective March 31, 2016, the fund's current expense ratio is 1.15% (exclusive of expenses related to dividend and interest expense on securities sold short, interest, extraordinary items, and brokerage commissions). The fund's net expense ratio is 3.28% (includes 2.13% for dividends and interest on securities sold short, but does not reflect dividends earned by the fund on its long positions of 3.35%). Both the current expense ratio and the net expense ratio reflect an expense limitation agreement by Gotham in effect until January 31, 2019. Shares redeemed within 30 days of purchase are subject to a redemption fee. Please see the prospectus for more information about the fund's fees and expenses.

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