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Q&A

A Value Investor Defends Value Investing (Despite Its Recent Track Record)

Joel Greenblatt says if you do good valuation work, the market eventually will agree

By Chuck Jaffe

Joel Greenblatt laughs when asked if value investing—the struggling style of money management that he champions—is dead.

"Yes, no, maybe, and I don't care," he says. "That about covers it."

The co-founder of Gotham Asset Management—which runs both hedge funds and traditional mutual funds using Mr. Greenblatt's take on value investing—knows his Gotham Large Value fund (GVALX) proves that the investment style can work. The fund has a five-star rating from Morningstar Inc. and has ranked in the top 5% of its peer group since its inception at the start of 2016, according to the research firm.[1]

He also knows that investors often give up on any investment style when its performance lags behind that of others. While value investing has underperformed during the current bull market of more than a decade, it always pays off eventually for investors who stick with it, Mr. Greenblatt says; no style works, he says, for investors who give it up after periods of underperformance.

"Buying the cheapest stocks still works," says Mr. Greenblatt, who is 61. "Call it value if you want to, but to me it's the way I invest."

The author of several books—including "The Little Book That Beats the Market" and "The Big Secret for the Small Investor"—Mr. Greenblatt may be the best-known value investor this side of Warren Buffett, and is widely seen as the likely successor to him as the de facto spokesman for the buy-it-at-a-discount style of investing.

Here are edited excerpts from a recent interview with The Wall Street Journal.

WSJ: *Value investing means different things to different people. What does it mean to you?*

MR. GREENBLATT: It does not mean low price-to-book-value, low price-to-sales ratio investing, which is how most people define it.

Stocks aren't pieces of paper that bounce around, they're ownership shares of businesses that we value and try to buy at a discount. Thinking about it that way, value investing is self-defined: It is actually valuing businesses—the way a private investor values them based on cash flows and expected cash flows—and then trying to buy them at a discount to what those cash flows are worth.

WSJ: *Is there any secret sauce that goes with that?*

MR. GREENBLATT: We're looking to get more than our fair share of companies that are undervalued. Good companies in good businesses—meaning they get high returns on capital, they're growing sales and earnings, they're relatively cheap and more—are a good place to start hunting, but the key is in the analysis.

We do a lot of analytical work to make sure the numbers we use are correct. Reported numbers don't mean as much to us as drilling down and seeing real cash flows and the company's efficiency of investing money and spending money.

I have taught at Columbia for 23 years, and I make a promise to my students the first day of class that if they do good valuation work on a business, the market will agree with them. I never tell them when that will happen, but in 80% or 90% of the cases, two or three years is enough time for the market to recognize the value of a business if you've done a good job valuing it.

At the end of the day, what matters is that you get the right numbers.

WSJ: *With that focus on businesses and fundamentals, does it matter to you at all if the broad market is overvalued?*

MR. GREENBLATT: With Gotham Large Value, we have a fund that is 100% long. We're not taking our exposure down to 20% when we think the market's expensive or going to 100% invested when we think it's cheap. We buy—at all times—the cheapest stocks we can find.

Right now, the market is relatively expensive compared to the history we have looked at. We're in the 16th percentile toward expensive over the last 28 years, meaning the market has been cheaper 84% of the time and more expensive 16% of the time based on data for the S&P 500.

Because it's more expensive than normal doesn't mean that you wouldn't invest in the market, it means that if the market has averaged 10% returns over the last 28 years, we would expect lower than that. It works out to closer to 4% or 5%. That's still positive, and buying the cheapest stocks in the S&P 500, we would expect to do better than that.

WSJ: *Some people don't worry about the value in value investing, because they believe all active management is dead. How do you respond to that?*

MR. GREENBLATT: I started a talk at Google a number of years ago by saying, "Warren Buffett says most people should index, and I agree with him. But Warren Buffett doesn't index, and neither do I."

How come? Well, most people don't have the ability to value businesses at a discount and the discipline to hold them. When people can check their returns 30 times a minute on the internet, time horizons shrink, investors are impatient and sell at any sign of underperformance, so they fail to participate in periods of overperformance.

It's a great environment for value investors who do their work, but a bad environment for all active management—including what is traditionally classified as value investors—because of people's lack of patience. Patience is the thing in short supply.

Most people aren't very good at valuing a business, and they're not very good at picking managers—another hard art—so they're left between a rock and a hard place. That's why they're better off indexing.

Mr. Jaffe is a writer in Boston.

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[1] The Morningstar ranking for GVALX (the "Fund") quoted in the article was for the period since inception (12/31/2015) through 6/30/2019, among 1,119 Large Value funds in its Morningstar peer group.

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