

## Talking With Joel Greenblatt

Author and Investor, Gotham Asset Management

# Joel Greenblatt Mixes Active and Passive In the Same Fund

By Gabe Alpert

Investment strategies are a lot like diets: They work only if you stick with them. Unfortunately, also like diets, most people don't. Investors tend to overestimate their tolerance for risk, then dump their funds as the market falls, subsequently missing out on the rebound. This has been particularly true in actively managed funds, as investors have yanked their money out of even successful funds in favor of index products.

Joel Greenblatt wants to change all that. The Columbia University professor and founder of Gotham Asset Management is the author of *The Little Book That Beats the Market*, a best seller that offers metrics and strategies for beginner and established value investors. Greenblatt is a venerated value investor himself; he founded Gotham<sup>1</sup> in 1985. The Gotham Index Plus fund (tickers: GNNDX/GINDX<sup>2</sup>) is Greenblatt's effort to marry the steadiness of index investing with the potential market-beating advantage of active management—which, in this case, means both stock-picking and shorting<sup>3</sup>. The fund marked its three-year anniversary in March, and has returned 15.7% annually over the past three years, ahead of the S&P 500's 13% and 99% of its peers in Morningstar's large blend category<sup>4,5</sup>.

The \$558 million fund is invested in the S&P 500 index with an overlay of active management. Greenblatt buys the most undervalued stocks in the index, and shorts the most overvalued—a strategy he believes will outperform by a greater margin



Joel Greenblatt of Gotham Asset Management

as the bull market slows down. For the past 28 years, he notes, the S&P 500 has been more highly valued than now only 15% of the time. In the past, when stocks were at those elevated valuations, the market returned from 2% to 4% in the next 12 months.

Greenblatt's approach to value is a bit more growthy, as he doesn't rigidly hew to the price-to-book and price-to-sales metrics that characterize most indexes. Indeed, Morningstar dubs it a large-blend fund. Like Warren Buffett, Greenblatt says that growth and value are "joined at the hip." Stocks are shares of a business,

rather than a collection of factors or balance-sheet items, and the best way to value stocks is to look at the value of a business as whole. The way to assess a business is based on the present value of its future cash flows.

Factor strategies like momentum investing can fail due to overcrowding, he says. However, valuing a stock's underlying businesses will always work. It was Greenblatt's father, a shoe manufacturer, who taught him this lesson, he says. "I learned quite a bit from him, about understanding the challenges of running a business and what you have to do [to succeed]," he recalls. "When

(over please)

## Gotham Index Plus

	Total Return*		
	YTD	1-Yr	3-Yr
<b>GNNDX</b>	4.2%	22.5%	15.7%
S&P 500	6.8%	17.8%	13.0%

TOP 10 HOLDINGS Company / Ticker	% of Portfolio
<b>Apple / AAPL</b>	6.0%
<b>Johnson &amp; Johnson / JNJ</b>	3.9
<b>Pfizer / PFE</b>	3.1
<b>AbbVie / ABBV</b>	3.1
<b>Alphabet / GOOGL</b>	3.0
<b>Microsoft / MSFT</b>	2.9
<b>Boeing / BA</b>	2.8
<b>Procter &amp; Gamble / PG</b>	2.7
<b>BlackRock / BLK</b>	2.6
<b>Texas Instruments / TXN</b>	2.5
<b>TOTAL</b>	<b>32.6%</b>

\*Returns through 8/13; three-year returns are annualized.  
Holdings as of 3/31 Sources: Morningstar;  
Gotham Asset Management

people learn investing, they forget ‘Hey, this is just an actual business.’”

Consider Apple (AAPL), the fund’s largest holding. By Greenblatt’s assessment, it trades at a 60% discount to its true value, and its sales-growth, return-on-capital, and earnings-growth prospects are all higher than the S&P 500’s average. An investor must decide whether Apple is a hardware business, or a consumer business with a heavy brand premium. In the former assessment, Apple’s growth and margins are bound to shrink. In the latter, Apple

is an “ecosystem” whose products’ brand strength will reinforce one another and lead to continued growth based on a strong niche. The truth is somewhere in the middle, but for Greenblatt, the latter argument is stronger.

The fund owns what Greenblatt calls his “bucket of Apples,” which he finds with a research team of 12 other people, including his partner Rob Goldstein, who joined the firm in 1989. These are companies with strong cash flow and good market niches, trading at a discount to their real value. Not every pick needs to work out, he says, as long as the whole bucket does.

Another holding is industrial conglomerate Honeywell International (HON)<sup>6</sup>, which has been transforming into what Greenblatt calls a “software-industrial company.” Specifically, sales of software products that connect the Internet of Things have boomed. As a result, he observes, “Honeywell’s cash flow has grown 50% over the past five years, while competitor General Electric’s [GE]<sup>6</sup> cash flow is down 80%. This speaks to execution and growth without having to rely on a financial division or accounting chicanery to meet quarterly numbers.” As Honeywell spins off less profitable automotive and home-products businesses and targets more-profitable units like aerospace, “they’ll be able to focus on further increasing profitability.”

One example of a short is Coty (COTY)<sup>6</sup>, the beauty company known for brands like CoverGirl or Clairol. It’s priced at just under 50 times cash flow, a valuation “more akin

to a disruptive technology company than an acquisition-driven consumer-products company undergoing significant restructuring.” The company’s cash flows have also declined. By contrast, faster-growing, more profitable peers Estée Lauder (EL)<sup>6</sup> and L’Oréal (OR.France)<sup>5</sup> fetch 22 and 29 times cash flow. Says Greenblatt: “I have trouble understanding why Coty merits roughly double the multiple.”

Greenblatt isn’t just a fund manager and author. He’s also one of the primary backers of the Success Academies, the well-known charter school network that has been a thorn in the side of the New York City Department of Education but has repeatedly reported strong test results. For fans of *The Little Book That Beats the Market*, Greenblatt is hard at work on another book.

It isn’t about investing, however. In it, the public-spirited investor will proffer policy solutions for the major challenges facing the U.S., such as inequality, education, immigration, and taxes. For example, he wants to introduce job credits to help push up a labor-participation rate that remains “historically low” despite a tight job market. “There are a lot of people on the sidelines who are not actively looking for jobs,” says Greenblatt. “It’s a big waste. It leads to attrition, loss of job skills.” Education could also expand to include re-education for people wanting to bolster their job skills.

“There’s still a lot to be done,” the money manager says.

<sup>1</sup> Gotham Asset Management is the successor to the advisory business of Gotham Capital, which was founded in 1985.

<sup>2</sup> The inception date of GNNDX, the fund’s investor share class, is 12/29/2017. The inception date of GINDX, the fund’s institutional share class, is 3/31/2015.

<sup>3</sup> The fund will invest a portion of the assets in securities intended to track the performance of the S&P 500 Index and additional exposure to a long/short portfolio consisting of long and short positions generally selected from the largest 500 to 700 U.S. companies by market capitalization.

<sup>4</sup> The total expense ratios for GNNDX and GINDX are 3.87% and 3.62% and the expense ratios excluding short dividend and interest expense and after waivers are 1.40% and 1.15% respectively.

<sup>5</sup> Morningstar percentile ranking is that of GINDX. GINDX ranked in the 2<sup>nd</sup> percentile based on total return among 1,223 Large Blend funds in its Morningstar peer group for the period since inception (3/31/2015) through 7/31/2018. For the trailing 1-year time period through 7/31/2018, GINDX ranked in the 2<sup>nd</sup> percentile based on total return among 1,307 Large Blend funds in its Morningstar peer group. Past performance is no guarantee of future results.

<sup>6</sup> As of 3/31/2018, the securities mentioned represented the following percentage of the fund: Honeywell was 2.20%, General Electric was 0.49%, Coty was -0.30%, Estee Lauder was 1.68% and L’Oréal was 0%.

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