

College of Business Book Review by Robert Carton

Title: "The Little Book that Beats the Market"  
Author: Joel Greenblatt  
Publisher: Wiley  
Length: 155 pages  
Price: \$19.95  
Reading time: 2-3 hours  
Reading rating: 9 (1 = very difficult; 10 = very easy)  
Overall rating: 3 (1 = average; 4 = outstanding)

"The Little Book that Beats the Market" is a quick read that proposes a simple formula for picking a portfolio of stocks that beats market averages over the long-term. In his book, Joel Greenblatt discloses the magic formula that his investment firm has used to yield average annual returns of 40% for over 20 years.

One consistent theme that all of my finance professors taught me was that it is very hard to beat the market rate of return. In fact, research has shown that fewer than 20% of actively managed funds beat the market return. Therefore, I was taught to simply buy an index fund and spend the time I would have spent searching for individual stocks pursuing other hobbies. However, the results of Greenblatt's magic formula could make you rethink that advice.

The magic formula is based upon two investing criteria. First, only buy companies that earn the highest return on their invested capital. In other words, invest in companies that make good investment decisions themselves. Second, of the companies with high returns on invested capital, only buy companies that generate the greatest returns on your investment. In other words, buy the best companies in the market at the cheapest prices.

Greenblatt suggests that 20 to 30 companies selected using his formula will provide adequate diversification for your portfolio. In building this portfolio, he presents a system of buying your initial portfolio over the course of a year, not all at once. Further, the book suggests that once you have held a stock for one year (just under a year for losers and just over a year for winners to minimize your taxes), sell it and replace it with a new high performing, cheap stock. Consequently, you only have to worry about your portfolio three or four times a year.

Greenblatt tested his formula for the 3,500 largest companies on the US stock exchanges for the 17 years from 1988 to 2004. He found that his formula beat the market for any three-year period, but not necessarily in a single year (although it beat the market most years). Therefore, Greenblatt recommends that the faint of heart investor that cannot stand to watch his portfolio fluctuate, invest in index funds.

Just to see how the formula might work for me, I used the magic formula investing website to select the top 25 companies on April 18, 2006 to include in a portfolio. This portfolio had a loss of 10% over the 73 days compared with a loss of 1% loss in the Dow Jones Industrial Average. The best company in the portfolio had a 30% gain while the worst company had a 55% loss. Of the top 25 companies recommended on April 18, 13 were still recommended on June 30. Yikes! I guess Greenblatt was not kidding when he advises that the formula works in the long-term, but not necessarily the short-term.

Overall, I would say that "The Little Book that Beats the Market" is an easy and interesting read for new and experienced investors alike. The "Magic Formula" is very logical in its approach and easy to apply. However, I would caution readers not to take the recommendations of the magic formula without looking closely at the future prospects of the businesses it recommends. The formula is based upon past performance, which is not always a great proxy for the future.

Bob Carton is an Assistant Professor of Entrepreneurship in the College of Business at Western Carolina University. For previously reviewed books, visit our Web site at [www.wcu.edu/cob/](http://www.wcu.edu/cob/).