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How do you prevent investors from buying and selling at the wrong time? Financial innovator and successful value investor, Gotham Funds' Joel Greenblatt explains his new hybrid approach combining indexing and his active long/short strategies.

JOEL GREENBLATT
Co-Founder, Co-Manager
Gotham Index Plus Fund

CONSUELO MACK: This week on WEALTHTRACK, why has great value investor Joel Greenblatt created a mutual fund combining a passive index with his traditional and very successful actively managed long/short strategies. Gotham Asset Management's Joel Greenblatt explains next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack. Ever since we launched WEALTHTRACK in 2005 we have covered the agonizing question of why investors underperform the very funds they invest in. We call it the underperformance trap.

One of the most dramatic examples involves a study *Morningstar* did of the top performing mutual fund of the decade from 2000 to 2009. The fund delivered impressive 18% plus annualized returns in an essentially flat market. But the distressing reality was that the average investor in the fund during the same decade experienced <u>negative</u> annualized returns of 11%! Why the huge discrepancy? The investors chased the fund when it was outperforming the market, buying high, and bailed out of the fund when it underperformed, selling low thus missing out on the decade's gains.

The reality is that even the best active managers have years of underperformance which is a major reason so many investors are flocking to index funds instead. According to another study of the same decade, 97% of the top 25% of funds spent at least three of the ten years in the bottom half of performance, 79% of them spent at least three years in the bottom quartile and 47% of the decade's top 25% spent at least three years in the bottom decile.

You can understand why so many investors bail. No matter how much we say we are long term investors most of us lack patience. By the second or third year of trailing the market we are ready to switch to the funds that have been beating the market, and so it goes.

This week's guest has decided that rather than fight human nature he will work with it. He is both a great value investor and a financial innovator. Joel Greenblatt is Managing Principal and Co-Chief Investment Officer of Gotham Asset Management, a firm he founded in 2009 with his long time business partner and fellow investor Rob Goldstein.

He co-manages the Gotham Funds, long/short mutual funds, run like hedge funds but with much lower fees, that go long several hundred stocks the firm deems to be extremely undervalued and shorts hundreds of stocks it determines are very expensive. His predecessor firm Gotham Capital ran a very concentrated hedge fund, with only 6-8 holdings. After a ten year run delivering 34% annualized returns he and Goldstein decided to close it to outside investors. Greenblatt realized early on that most investors cannot emotionally tolerate years of market underperformance.

In early 2015 his firm launched a new fund, the Gotham Index Plus fund combining index investing with their actively managed long/short strategies. I asked him why.

JOEL GREENBLATT: Well, there's a lot of ways to make money, but for people who are interested in active investors who are trying to beat the market, one of the truisms is that to beat the market you have to do something different from the market. That means your fund will zig and zag differently than the market. Often that comes with periods of outperformance and periods of underperformance. One of the problems for people who allocate to active investors is they don't like the periods of underperformance. Most investors aren't very patient. They often don't understand the reasons for that underperformance and, therefore, they're not very sticky. They're not very patient to collect the periods of outperformance. So it's very tough. It's a challenge for both retail investors. It's a challenge for active investors. It's also a challenge for institutional investors because they have agency problems and behavioral problems, and they're judged as well over shorter time periods. So we were trying to come up with a solution that would take advantage of the ability that we believe we have to actively choose stocks that will do well on the long side and stocks that will do less well than the market on the short side, but we also need patience. So the question is, how do you bridge that gap? How do you bridge the gap between the fact that you need patience, and there are often times when you're activity by necessity that you're going to have periods of underperformance? So how can you minimize that problem? I started a fund, and I wrote an essay about it, and I said that I started it this way. I said the strategy that's best for you is not only one that makes sense but one you can stick with, and if there's too long periods of underperformance which is a necessity usually for value investors which we are, I'm not really helping the people I'm trying to help. So how can we bridge that gap? So we took it upon ourselves to look at the problem and try to figure out a solution, and we came up with Gotham Index Plus.

CONSUELO MACK: So how does Gotham Index Plus work? How does it fix the problem, number one, that you've got to understand the strategy and you've got to have the patience to stick with it?

JOEL GREENBLATT: So there's a few things we did to create it. Number one, we said that most people use the S&P 500 as a benchmark for performance. So they're really comparing how they did. It doesn't matter if they're doing small cap stocks or all cap stocks or S&P 500 stocks. They use the S&P 500 as a benchmark. So when they're measuring underperformance, that's generally what we're using. So we started there, and what we do with our fund is you give us a dollar. We actually go out and recreate the stocks in the S&P 500 and the weights in the S&P 500. So we take your dollar and we buy a dollar of the S&P 500 effectively. We don't charge for this portion. It's not so hard to go do that, but then we have an active overlay on top of just that investment in the S&P 500 in which we buy 90 cents more of our favorite S&P stocks, and we short 90 cents of our least favorite. So we have a 90 by 90 long-short overlay on top of the index where we're hoping that our long picks beat our short picks, and that's additive over time to the performance of the S&P 500, but because the base is the S&P 500, you minimize tracking error, so that's good, and the 90-90 portion hopefully in most periods will be additive. When we've looked at testing this going backwards, it was very encouraging.

CONSUELO MACK: So what's interesting is that in the past when you and I have talked, you basically said that you thought it was not a smart idea to invest in a market cap-weighted index fund, for instance, because you were constantly paying up. I think you figured out it cost you two percent a year in performance too because you're constantly paying up for the most expensive stocks. Did you kind of throw in the towel and say, look, if everybody's going to use the S&P 500 as the benchmark, then we've got to kind of have that as a core to the Gotham Index Plus. The index has got to be the S&P 500, so we'll take the cap-weighted market with all of its flaws.

JOEL GREENBLATT: Well, so there was an article written in *The Wall Street Journal* that Jonathan Clements wrote it.

CONSUELO MACK: Who's been a guest on WEALTHTRACK many times.

JOEL GREENBLATT: So he really hit it on the head. He said index investors end up doing better than active investors not because they're smarter. It's basically because they make less mistakes. When you have an index fund, people make mistakes. When the market goes up, they pile into it. When the market goes down, they pile out. Those are mistakes, but for an active fund they pile in when the fund does well. They pile in when it outperforms. When the market goes down, they pile out. When the fund underperforms they pile out, so they make twice as many mistakes. They have twice as many mistakes to make because of the under and outperformance, and so index fund investors make half as many mistakes. So, obviously if you're trying to beat the market, you have to have some tracking error. We're trying to make that mostly positive tracking error which no one minds, meaning you make more money. They only mind when you underperform. So our long-short strategies tend to do well in poor markets, not always a guarantee but certainly that's our goal.

CONSUELO MACK: Explain your long-short approach for people who are not familiar with Gotham and your work. I know we interviewed you a couple of years ago, and that interview is available on wealthtrack.com, but for those people who haven't seen it, just explain that overlay, how that overlay works so that we can understand that as well.

JOEL GREENBLATT: Sure, absolutely. So we take a look at the 500 stocks for this particular strategy in the S&P 500, and we rank them from one to 500 based on their discount to our assessment of value. We value them with metrics that we've always used to value business. How much cash flow am I getting from that business? How cheap is it relative to all the other businesses that I could buy and other similar businesses? How cheap is it historically? It's the only way we really know how to value things. We rank them from one to 500. Value investing to us is not low price to book, low price sales investing. It's actually valuing a business and buying it at a discount, trying to leave a large margin of safety between those two. Here's fair value. Here's price. Ben Graham said leave a large distance between those two.

CONSUELO MACK: So you're still doing the traditional value analysis that you've always done, and in this case you're doing it for the S&P 500 companies.

JOEL GREENBLATT: Correct.

CONSUELO MACK: So that's fundamental value analysis. You're still doing your homework with these 500 companies.

JOEL GREENBLATT: Exactly. So we're buying a few hundred in the 90-90 overlay portion, the few hundred we think are cheapest. We rank them according to their cheapest and buy more of the cheapest and the second cheapest and more of the third, but there are a couple hundred companies, so a lot of diversity. We want to be right on average, and we short close to 200 of the most expensive. So we're trying to take advantage of that disparity but, because these are all large cap companies, most of them are in pretty good businesses generally. We're trying to stick to shorting the ones that are trading at 50 and 100 times free cash flow which are priced really for perfection in our opinion. So on average that's not a good strategy, and usually those companies we are hoping and believe will not perform as well as the average.

CONSUELO MACK: Why so many? I mean I'm thinking about with your other funds, the Absolute Return Fund for instance. Your universe is 2000, is the Russell 2000, and you're doing this same discipline, but you're taking I think it's 200 or 300 of those companies that are selling to the biggest discount to what your valuation is. Then you're shorting the 200 or 300 companies that are the most expensive according to your evaluation again, but with the S&P 500 which is a much smaller universe, why are you investing in so many of the S&P 500 companies both on a long and a short basis? Why not make it a smaller universe?

JOEL GREENBLATT: So one of the things we're trying to do in index plus is minimize tracking error. So we want to be right on average. It's like why insurance companies don't insure five people. If God forbid one of them steps off the curb, it doesn't matter what kind of underwriting you did. It's very hard to get all those right. You'll have very often aberrational returns. So we want to be right on average. We want to minimize that time where we're missing by too much with a few poor picks. So we do think we can create a very nice disparity between the ones that are cheapest within the S&P 500 and the ones that are most expensive, and there will be a very nice spread there that we can add to the returns of the S&P 500, but we don't want to have those periods that are too drastic because then people won't be able to stick with us. So that's one of the things we're looking at. In this particular strategy, we're designing it so that it's easier for people to stay with us because we're not going to have huge periods of underperformance as our goal.

CONSUELO MACK: So right now, Joel, if you're looking at the S&P 500, give me a couple of companies that are the most undervalued according to your analysis and a couple of companies that are the most overvalued, that you'd be shorting at this point.

JOEL GREENBLATT: For well-valued, in other words cheap companies ...

CONSUELO MACK: Cheap companies.

JOEL GREENBLATT: I can give you a couple right now. Apple is one of our biggest holdings still. Some people think Apple is just another hardware company that's going to crash and burn like all of them do. All of us had Blackberries a number of years ago, and other people think, no, it's a network and it's an ecosystem of products that play off one another and that it's really not just a typical hardware company.

CONSUELO MACK: You're in that camp.

JOEL GREENBLATT: Well, the answer is probably gray, meaning somewhere in between is probably the right, but the stock is priced with double-digit free cash flow yields, meaning in a one or two percent interest rate environment and as a company like Apple that earns huge returns on capital has a great niche, the answer is probably gray, but the key is that I always say we don't own just Apple. We own a bucket of Apples. We own a bunch of companies with similar characteristics. Gushing cash flow, huge returns on capital, nice market niche, and we don't know if Apple specifically is going to work out, but we do know and believe that our bucket of Apples is going to work very well.

CONSUELO MACK: So Joel, on the short side, what are some of the most expensive companies that you're shorting in the Index Plus Fund?

JOEL GREENBLATT: So Salesforce is one, selling at 300 times pretax earnings. It's a very good company. It hasn't earned a lot of money. Over its history they are building market share. It's a very good company but at 300 times pretax earnings that's pretty darn expensive. Another name is Costco. It's a wonderful retailer. It's trading at 30 times earnings though. With the competition from Amazon and the fact that it's not growing, we think that's pretty extreme valuation as well.

CONSUELO MACK: It's so interesting that as a value investor, price really matters. I mean you want to buy good businesses. If Costco were a lot cheaper, for instance, or Salesforce were, it might be one of your longs, but right now they're just way overvalued.

JOEL GREENBLATT: The way to think about this is I don't live in Manhattan, but if I did and I owned a beautiful three-bedroom apartment on Central Park and it was selling for $250,000, well, that would be a steal. At 50 million it would be ridiculous, but the apartment hasn't changed. Its price is driven whether it's a good investment or not, so a strategy that says, hey, let me just go out and buy apartments with good views is not really an investment strategy because I didn't tell you what I'm going to pay for them, so price really drives everything in investing.

CONSUELO MACK: Where does Index Plus fit into a portfolio? You've got other long-short funds. This is a hybrid. This is new. It's something different. No one else has done it before. Where does it fit into my portfolio?

JOEL GREENBLATT: So number one, Index Plus is 100 percent net long. So most people when they're putting together a portfolio, most advisors, even most individuals are comfortable with a certain amount of market exposure. If you had 100 percent of your money in the market and the S&P could fall as we learned in 2008 40 percent or even more in any particular year, and if you're going to panic out when that happens, you're not a candidate to be 100 percent long because that could happen at any time. So you would take a lower exposure, but let's say you chose that I'm comfortable with 60 percent net long. So really what we're trying to answer is for that portion of your portfolio that you plan to be long, what's the smartest way to do that? So we think Index Plus plays a part in that part of the portfolio that's 100 percent long.

CONSUELO MACK: So your other funds, for instance the Gotham Absolute Return Fund, is your experience that people aren't sticky? They're not sticking with your other funds as well, so you're actually experiencing a problem that you're trying to solve.

JOEL GREENBLATT: Well, we have a similar experience, possibly a little better than many other active funds. When we opened the Absolute Return Fund, we came out of the box when we first opened.

CONSUELO MACK: In 2012.

JOEL GREENBLATT: Right, in 2012. We had great returns. People saw that. It was a fairly unique fund when we opened it to have the ability to invest in a real hedge fund in the mutual fund space. People saw the results and piled in. Last year was not a great year for us, and we lost some of our investors. We had much better experience than most, but still if I'm trying to help people stay with us, it points out the fact that no matter what kind of education job we do and how important we explain patience is and stick with it, advisors most of who we are talking to for these mutual funds have clients. Whether the advisor has a long time horizon or not, most clients don't, and so they have to deal with that as well, and it's just part of the issue. So in Index Plus really what we were trying to do is come up with something that would sort of mark the middle ground. There's been a big move to index or passive investing, and it's cheap and you get the average and I support it very much, but there are a portion of investors who still want to beat the market, and there's a portion, and it's a relatively small portion, of active investors who can actually do that.

CONSUELO MACK: Who can do it.

JOEL GREENBLATT: Of course we believe we're one of those. I've been doing this for 35 years, and we think we're good at what we do. So for those who want to be active but still can't take the tracking error problems of being fully active, we're sort of trying to bridge that gap by staying in large cap stocks, by making the base the S&P 500 so you still participate with that. You still get the tax benefits of doing that but to add an active overlay so you don't have to give up on trying to outperform the market.

CONSUELO MACK: But the active strategy that you're talking about of course, when you and I have talked before, from 1985 to 1995 you did run a very tightly focused hedge fund which you then closed in 1995 and returned the money to investors. It had 34 percent annualized returns, but you said it was just too difficult to ... and just explain to me why. When I look at you as a great value investor and that kind of pure hedge fund that you had early on was exactly what I would expect from you, but it was just too difficult to maintain for a whole number of reasons. So is that kind of focused value approach that you and your partner, Rob Goldstein, were so successful at, is that just a dying breed now? Is that something that we're going to see less and less attempt to do because of all of the things that we've been talking about, lack of patience and just the huge deviation from the market that you have with a strategy like that?

JOEL GREENBLATT: There are a lot of reasons why we returned outside capital. We didn't close the fund. We continued to run our internal ...

CONSUELO MACK: Yourselves.

JOEL GREENBLATT: ... our capital thereafter. One of the issues…and Warren Buffett always says, "A fat wallet is the enemy of high investment returns," and with a very concentrated portfolio and in that portfolio 80 percent of our portfolio was generally in six to eight names we were finding our favorite things, but that's also very volatile when one or two of those names aren't doing well for a short period of time either because we were wrong or because our hypothesis just needed a little more time to play out, and there were periods of sharp drops even though the long-term record was excellent. But as we were successful that period of time, we collected more money, and we thought we could continue to get very high returns with less money, so we did that. Another way to ...

CONSUELO MACK: Joel, have you continued that with Rob Goldstein? Are you still doing that very focused ... ?

JOEL GREENBLATT: We did that for over a decade after we returned money, and we developed these more diversified strategies that we found both enjoyable to run our own money, and most of our money is invested in these more diversified strategies, but in contrast to a very select portfolio we're using our valuation skills in a more diverse universe, and we have a lot less issues with two or three days where one or two names are particularly hurting us. It's easier for people to stay with, and I would just guess Index Plus would be another iteration of that. Even a more diversified strategy when you're really picking the cheapest which are out of favor and the most expensive which are truly in favor, some of those divergences last longer than most people's patience lasts, and so this was our way of really narrowing that weighting to come close to the index. It doesn't make one better than the other. It doesn't mean concentrated investing is better than diversified investing which is better than what we're doing in Index Plus which is something that's going to hug the index a little bit more than the fully active part of our strategy. There are different ways to skin the cat, and so what I started saying when I put together the piece that I wrote to introduce Index Plus was the strategy that's best for you is not only one that makes sense but one you can stick with.

CONSUELO MACK: A strategy that makes sense and that you can stick with, a lot of people have decided that that strategy is going to be index funds, and a lot of people are invested in just the S&P 500 index fund, but again in the past in a past interview with me, you were critical of the market capitalization-weighted index fund. Is there a better strategy? I mean there are equal weight index funds for the S&P 500 for instance. There are fundamentally-weighted index funds now. Are those a better way to go so that we're not again paying up for the most expensive companies all the time?

JOEL GREENBLATT: Sure. Long term there's been plenty of studies, and we've done the studies ourselves. What happens in a market cap-weighted – just to review – is that if a company is overpriced because you're basing it on price, you buy definition own too much of that company. If a company is bargain priced because you're investing by price, you by definition own too little. In a market cap-weighted index, you sort of step on every crack and you make every mistake possible even if you don't know which are overpriced, which are underpriced. You know if it's overpriced, you own too much. If it's underpriced, you own too little. That's what you do know. So one way to avoid that is to make random errors, so random errors would be an equally-weighted index. Sometimes you own too expensive ones, sometimes cheap ones, but on average you're making random errors. You get the two percent back it costs you to make mistakes every single time, and some of the fundamental weighted index, if they charge low enough prices, also avoid that in another way. Both over time will outperform the market cap-weighted index. On the other hand, they do zig and zag differently than the market cap-weighted index, and there will be periods where the market cap-weighted index – even three, four-year periods – where that outperforms. So they still have tracking error less, but if I were advising my mother or my sister or someone like that, I would tell them to use either an equally-weighted or some of the fundamentally-weighted indexes. If they wanted to follow a relatively passive strategy, I like those a little bit more than the market cap-weighted indexes. Also, if you do it in the form of an ETF you get tax benefits a little bit more where you don't have to pay interim taxes other than for dividends, just only when you buy and sell, and if you use an ETF properly in my mind, you're a long-term holder.

CONSUELO MACK: One investment for a long-term diversified portfolio. What would you have all of us own some of? The last time actually you did recommend an indexed ETF, and hopefully a fundamental value one or an equal weighted one because of the tax advantages and also you're participating in the market.

JOEL GREENBLATT: So there's a Guggenheim Equally-Weight S&P 500 Index that's both cheap and liquid, and so that would be one of my favorites.

CONSUELO MACK: Joel Greenblatt, it's so great to have you back on WEALTHTRACK. Thanks so much for joining us today.

JOEL GREENBLATT: Thanks again for having me.

CONSUELO MACK: At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term.
This week's Action Point is: if you are going to invest in an index fund take Greenblatt's advice and: Consider an equally weighted index ETF**,** which gives equal dollar weight to all of the stocks in the S&P500. As *Morningstar* explains "equal-weighting's primary advantage compared with market –cap-weighting comes from its massive underweighting of potentially expensive mega-cap stocks and overweighting of smaller cap stocks…. It may also offer a slight improvement in return by systematically selling recent winners and buying recent losers when it rebalances."

ETF fees are being cut across the board so it pays to shop around for the best deals from reputable firms.

Next week, leading strategist Jason Trennert and noted historian Richard Sylla join us to assess the election's impact on the markets and economy. Will it be back to normal or something else?

In the meantime, in the EXTRA feature of our website Joel Greenblatt will give us his take on the elections and a progress report on the children attending Success Academy, the charter schools he has been supporting for years.

Thank you so much for watching, please make the effort and vote. The decision on the country's future direction is ours to make. Have a great weekend and make the week ahead a profitable and a productive one.