





FIRESIDE

Rockefeller Center 1230 Avenue of the Americas New York, NY 10020

Copyright © 1997 by Joel Greenblatt
All rights reserved, including the right of reproduction in whole or in part in any form.

"Florida Gardens Restaurant Falls into Sinkhole" reprinted by permission of *The Wall Street Journal*, copyright © 1985 Dow, Jones & Company, Inc. All rights reserved worldwide.

First Fireside Edition 1999

FIRESIDE and colophon are registered trademarks of Simon & Schuster Inc.

Designed by Jeanette Olender Manufactured in the United States of America

19 20 18

The Library of Congress has cataloged the Simon & Schuster edition as follows:

Greenblatt, Joel.

You can be a stock market genius (even if you're not too smart): uncover the secret hiding places of stock market profits / Joel Greenblatt

p. cm.

Includes index.

- 1. Stocks—United States—Handbooks, manuals, etc.
- 2. Investments—United States—Handbooks, manuals, etc. I. Title.

HG4921.G718 1997

332.63'22—dc21 96-50310 CIP

ISBN-13: 978-0-684-83213-5

ISBN-10: 0-684-83213-5

ISBN-13: 978-0-684-84007-9 (Pbk)

ISBN-10: 0-684-84007-3 (Pbk)

ACKNOWLEDGMENTS

As with any work of this kind, many people deserve the blame. Of course, the ultimate responsibility for errors, omissions, misstatements, or misguided advice rests with some guy from Cleveland who no one can seem to find. As a consequence, I have no choice but to point the finger at the following suspects:

The entire cast and crew at Gotham Capital. This includes my partner in crime, Daniel Nir, who I had the good fortune of plucking from the jaws of Harvard Business School at the inception of Gotham Capital—he is one of the primary reasons for Gotham's success, a major contributor and supporter of this project, and still one of my all time best picks; my partner, Robert Goldstein, whose brutally honest (and, unfortunately, fair and insightful) comments made this book far better than it would have been—also special thanks for his unparalleled contributions to many of the examples found on these pages (and to the profits that went with them), including the discovery of Charter Medical and his exceptional work on Host Marriott and Liberty Media;

A C K N O W L E D G M E N T S

my partner, Edward (Ned) Grier, for both his helpful comments and superior research efforts on many of the case studies found herein, including General Dynamics and Strattec. While each of these extraordinary investors could have compiled a spectacular investment record without the aid of any partners, I feel privileged to have had the opportunity to work with such a talented group of friends.

Speaking of talent and friends, I would also like to give special thanks to Gotham's dedicated and fearless head (and only) trader, Lisa Alpert; our chief financial officer and all around nice guy, Bruce Berkowitz (no relation to the Wells Fargo investor by the same name); and our special and multi-talented office manager, Alison Jarret.

Two more people deserve special mention as members of the Gotham family. The first, Bruce Newberg, has truly been a full partner in Gotham's success. He is not only responsible for raising the start-up capital that made Gotham possible, but for contributing a never-ending stream of sage advice, exceptional investment ideas, and overwhelming friendship as well. Everyone should be lucky enough to have such a loyal and good friend. The second Gotham family member also happens to double as my sister. Linda Greenblatt has been the primary sounding board and constructive contributor to this book. It's amazing that even after fifteen readings, she still managed to laugh in all the right places and found the time to make her new investment partnership, Saddle Rock Partners, a major success. Her infinite patience, dedication, and intelligence has had a dra-

matic effect on the final result. I absolutely couldn't have finished this project without Linda's help.

Other likely suspects, owing to their significant contributions and friendship, include: John Scully of Hamilton Partners and Columbia Business School, a mentor and friend from my Halcyon days; Eric Rosenfeld, Managing Director of Oppenheimer & Co.; Jeffrey Schwarz, Managing Partner of Metropolitan Capital Advisors; Richard Pzena, Pzena Investment Management; Mitch Julis, Managing Partner of Canyon Partners; Seth Klarman, President of the Baupost Group; Joseph Mazzella, my attorney and a partner at Lane, Altman & Owens; Robert Kushel, my broker at Smith Barney; Mark Gimpel, Esq., for my glorious Apache Relay memories; Major Gary E. Warren, U.S.M.C. for his counting humor; and Rabbi Label Lam, for his invaluable directions towards the stake in the sand, and specifically, for his "currency of life" thoughts in the final chapter.

Special thanks also to Bob Rosenkranz, chairman of Delphi Financial Group and managing partner of Acorn Partners, for his unrivaled support of Gotham throughout the years; Ezra Merkin, our partner at Gotham for two and a half years during the 1980s; and Stan Kaplan, Gotham's head trader for our first five years.

Thank you also to Bob Mecoy, my editor at Simon & Schuster; Sandra Dijkstra, my agent; and Guy Kettelhack, for his assistance with the original book proposal.

Extra special thanks for the love, support and encouragement of my entire family, each of whom pitched in to add

A C K N O W L E D G M E N T S

significantly to the final result (me *and* the book): my wonderful parents, Allan and Muriel Greenblatt; Richard and Amy Greenblatt; Drs. Gary and Sharon Curhan; and my inlaws (*the* in-laws) Dr. George and Cecile Teebor.

Grateful appreciation also to my son, whose searing question, "So, what are you, Dad? Policeman? Fireman? What?" served as a major inspiration for the completion of this book. At least, now I can respond, "You know what Dr. Seuss does, right?"

Finally, to Julie, the love of my life (and my wife), and our four unbelievable children, thank you for the gift of each precious day together.

TO MY WONDERFUL WIFE, JULIE,

AND OUR FOUR MAGNIFICENT SPINOFFS

CONTENTS

- Follow the Yellow Brick Road—Then Hang a Right • 13
- 2. Some Basics—Don't Leave Home Without Them 25
- **3.** Chips Off the Old Stock: Spinoffs, Partial Spinoffs, and Rights Offerings 53
- Don't Try This at Home: Risk Arbitrage and Merger Securities • 129
- Blood in the Streets (Hopefully, Not Yours):Bankruptcy and Restructuring 163
- 6. "Baby Needs New Shoes" Meets "Other People's Money": Recapitalizations and Stub Stocks, LEAPS, Warrants, and Options ■ 201
- **7.** Seeing the Trees Through the Forest 237
- **8.** All the Fun's in Getting There 263

Appendix: Gotham Capital • 271

Glossary • 273

Index • 287

YOU CAN BE A STOCK MARKET GENIUS

0000000000000 Chapter 1 FOLLOW THE YELLOW BRICK ROAD-THEN HANG A RIGHT 66666 000000000000

It doesn't make sense that a book can teach you how to make a fortune in the stock market. After all, what chance do you have for success when you're up against an army of billion-dollar portfolio managers or a horde of freshly trained MBAs? A contest between you, the proud owner of a \$24 "how to" book, and these guys hardly seems fair.

The truth is, it isn't fair. The well-heeled Wall Street money managers and the hotshot MBA's don't have a chance against you and this book. No, you won't find any magic formula in chapter 8, and this isn't a sequel to *How to Succeed in Business Without Really Trying*, but if you're willing to invest a reasonable amount of time and effort, stock market profits, and even a fortune, await.

Okay: What's the catch? If it's so easy, why can't the MBAs and the pros beat your pants off? Clearly, they put in their share of time and effort, and while they may not all be rocket scientists, there aren't many village idiots among them either.

As strange as it may seem, there is no catch. The answer

JOEL GREENBLATT

to this apparent paradox—why you potentially have the power to beat the pants off the so-called market "experts"—lies in a study of academic thinking, the inner workings of Wall Street, and the weekend habits of my in-laws.

We start with some good news about your education: simply put, if your goal is to beat the market, an MBA or a Ph.D. from a top business school will be of virtually no help. Well, it's good news, that is, if you haven't yet squandered tons of time and money at a business school in the single-minded quest for stock market success. In fact, the basic premise of most academic theory is this: It is not possible to beat the market consistently other than by luck.

This theory, usually referred to as the efficient-market or "random-walk" theory, suggests that thousands of investors and analysts take in all the publicly available information on a particular company, and through their decisions to buy and sell that company's stock establish the "correct" trading price. In effect, since stocks are more or less efficiently priced (and therefore, you can't consistently find bargain-priced stocks), it is not possible to outperform the market averages over long periods of time. Although exceptions (e.g., the January effect, small size effects and low price/earnings strategies) are covered briefly by the academics, most of these "market-beating" strategies are dismissed as trivial, transient, or difficult to achieve after factoring in taxes and transaction costs.

Since beating the market is out of the question, finance

professors spend a lot of time teaching things like quadratic parametric programming—which, loosely translates to how to pick diversified stock portfolios in three-dimensional space. In other words, if you muddle through complex mathematical formulas and throw in a little calculus and statistical theory along the way, you stand a pretty good chance of matching the performance of the popular market averages. Wow! While there are plenty of other bells and whistles, the message is clear: You can't beat the market, so don't even try. Thousands of MBA's and Ph.D.'s have paid good money for this lousy advice.

There are two reasons not to accept the basic teachings of the professors. First, there are some fundamental flaws in the assumptions and methodology used by the academics—flaws we'll look at briefly later on, but which are not the central focus of this book. Second, and more important, even if the professors are generally correct and the market for stocks is more or less efficient, their studies and conclusions do not apply to *you*.

Obviously, most of Wall Street must also ignore the academics because the whole concept of getting paid for your investment advice, whether through commissions or investment advisory fees, doesn't square too well with the idea that the advice really isn't worth anything. Unfortunately for the professionals, the facts would seem to support the conclusions of the academics. If academic theory held true, you would expect the long-term record of pension and

JOEL GREENBLATT

mutual-fund managers to equal the performance of the market averages reduced by the amount of the advisory fee. In a slight deviation from efficient-market theory, the professionals actually do approximately 1 percent worse per year than the relevant market averages, even before deducting their management fees. Does the theory that markets are "more or less" efficient explain this disappointing performance on the part of professionals, or are there other factors at work that lead to these lackluster results?

THE PROFESSIONAL'S CHALLENGE

I spoke with a professional whom I consider one of the best in the business, a friend I'll call Bob (even though his real name is Rich). Bob is in charge of \$12 billion of U.S. equity funds at a major investment firm. For some perspective, if you went to the racetrack and placed a bet with \$100 bills, \$12 billion would stack twenty World Trade Centers high (needless to say, a bet that would almost certainly kill the odds on your horse). According to Bob, the bottom line and the measure of his success is this: How does the return on his portfolio stack up against the return of the Standard & Poor's 500 average? In fact, Bob's record is phenomenal: over the past ten years his average annual return has exceeded the return of the S&P 500 by between 2 and 3 percent.

At first blush, the word "phenomenal" and an increased annual yield of 2 or 3 percent seem somewhat incongruous. Though it is true that after twenty years of compounding even 2 percent extra per year creates a 50 percent larger nest egg, this is not why Bob's returns are phenomenal. Bob's performance is impressive because in the world of billion-dollar portfolios, this level of excess return is incredibly hard to come by on a consistent basis. Some quick calculations help expose the limitations imposed on Bob by the sheer size of his portfolio. Imagine the dollar investment in each stock position when Bob sets out to divvy up \$12 billion. To create a 50-stock portfolio, the average investment in each individual stock would have to be approximately \$240 million; for 100 stocks, \$120 million.

There are approximately 9,000 stocks listed on the New York Stock Exchange, the American Stock Exchange, and the NASDAQ over-the-counter market combined. Of this number, about 800 stocks have a market capitalization over \$2.5 billion and approximately 1,500 have market values over \$1 billion. If we assume Bob does not care to own more than 10 percent of any company's outstanding shares (for legal and liquidity reasons), it's likely that the minimum number of different stocks Bob will end up with in his portfolio will fall somewhere between 50 and 100. If he chooses to expand the universe from which he chooses potential purchase candidates to those companies with market capitalizations below \$1 billion, perhaps to take advantage of

some lesser followed and possibly undiscovered bargain stocks, his minimum number could easily expand to over 200 different stocks.

Intuitively, you would probably agree that there is an advantage to holding a diversified portfolio so that one or two unfortunate (read "bonehead") stock picks do not unduly impair your confidence and pocketbook. On the other hand, is the correct number of different stocks to own in a "properly" diversified portfolio 50, 100, or even 200?

It turns out that diversification addresses only a portion (and not the major portion) of the overall risk of investing in the stock market. Even if you took the precaution of owning 9,000 stocks, you would still be at risk for the up and down movement of the entire market. This risk, known as market risk, would not have been eliminated by your "perfect" diversification.

While simply buying more stocks can't help you avoid market risk, it *can* help you avoid another kind of risk—"nonmarket risk." Nonmarket risk is the portion of a stock's risk that is not related to the stock market's overall movements. This type of risk can arise when a company's factory burns down or when a new product doesn't sell as well as expected. By not placing all your eggs in a buggy-whip, breast-implant, pet-rock, or huckapoo-sweater company, you *can* diversify away that portion of your risk that comes from the misfortunes of any individual company.

Statistics say that owning just two stocks eliminates 46 percent of the nonmarket risk of owning just one stock. This

type of risk is supposedly reduced by 72 percent with a fourstock portfolio, by 81 percent with eight stocks, 93 percent with 16 stocks, 96 percent with 32 stocks, and 99 percent with 500 stocks. Without quibbling over the accuracy of these particular statistics, two things should be remembered:

- 1. After purchasing six or eight stocks in different industries, the benefit of adding even more stocks to your portfolio in an effort to decrease risk is small, and
- 2. Overall market risk will not be eliminated merely by adding more stocks to your portfolio.

From a practical standpoint, when Bob chooses his favorite stocks and is on pick number twenty, thirty, or eighty, he is pursuing a strategy imposed on him by the dollar size of his portfolio, legal issues, and fiduciary considerations, not because he feels his last picks are as good as his first or because he needs to own all those stocks for optimum portfolio diversification.

In short, poor Bob has to come up with scores of great stock ideas, choose from a limited universe of the most widely followed stocks, buy and sell large amounts of individual stocks without affecting their share prices, and perform in a fish bowl where his returns are judged quarterly and even monthly.

Luckily, you don't.

THE SECRET TO YOUR FORTUNE

Since Bob clearly has his hands full, where can an investor turn for insight into making a fortune in the stock market? For better or worse, all roads appear to leave us at the doorstep of my in-laws. (Don't worry, I said mine—not yours.)

A typical weekend will find them scouting out a country auction, antique store, or estate sale looking for art or antiques that catch their fancy. As avid collectors, they seek out works that will give them joy to own and live with on a daily basis. As closet capitalists, they look for undiscovered or unrecognized works of art or antiques that they can buy at prices far below true value.

When in capitalist mode, the in-laws follow a very simple strategy. Whether they find a beautiful specimen of antique furniture at Podunk Fine Antiques & Tractor Parts or an impressionist painting from Grandma Bagodonuts' attic, they ask themselves only one question before buying. Are there comparable pieces of furniture or paintings that have recently sold at auction (or to dealers) at prices far above the potential purchase price?

It's truly that simple, although we can probably learn more from the questions they don't ask. They don't ask, "Is this painter going to be the next Picasso?" or "Is eighteenth-century French furniture going to skyrocket in value?" While it would be nice and perhaps more lucrative to be able to predict those types of future developments, few people can combine the ability, knowledge, and timing to fore-

see and profit consistently from future events. Whether the in-laws can or cannot predict the future is beside the point; they don't have to—they already know how to profit from studying the present.

That doesn't mean their knowledge of art and antiques doesn't help them to make money, but many people can acquire that same knowledge. Their edge comes from taking this knowledge and applying it in places off the beaten path. While these places are tougher to find, once found, less competition from other informed collectors creates an opportunity for them to find "inefficiently" priced bargains.

Finding bargain stocks works much the same way. If you spend your energies looking for and analyzing situations not closely followed by other informed investors, your chance of finding bargains greatly increases. The trick is locating those opportunities.

It's like the old story about the plumber who comes to your house, bangs on the pipes once, and says, "That'll be a hundred dollars."

"A hundred dollars!" you say. "All you did was bang on the pipes once!"

"Oh no," the plumber responds. "Banging on the pipes is only five dollars. Knowing where to bang—that's ninety-five dollars."

In the stock market, knowing where to "bang" is the secret to your fortune. With that in mind, let's uncover some of the secret hiding places of stock-market profits.

0000000000000 Chapter 2 SOME BASICS-DON'T LEAVE HOME WITHOUT THEM -000000000000-

When I was fifteen, the only gambling establishment that would let me sneak in was the Hollywood Dog Track. This was a great thing because, during my first illicit visit, I discovered a sure-fire route to big greyhound riches. In the third race, there was a dog who had run each of his previous six races in only thirty-two seconds. The odds on this dog—we'll call him "Lucky"—were 99–1. None of the dogs up against Lucky in the third race had managed a time better than forty-four seconds in any previous race.

Of course, I bet what passed for a small fortune at the time on Lucky to WIN. If all those fools who bet on the other dogs wanted to give me their money, so be it. However, as Lucky straggled down the home stretch in last place, my opinion of the other gamblers slowly began to change.

This was Lucky's first race at a longer distance. Apparently, as everyone else already knew, Lucky's spectacularly fast times in his previous races were achieved at much shorter distances. All the other dogs were experienced long-

JOEL GREENBLATT

distance runners. My 99–1 sure thing was a mirage that quickly evaporated along with my money.

On the bright side, in less than a minute I learned a valuable lesson. Without a basic level of knowledge and understanding, you can't tell a great investment from a real dog. So before you start hunting in the stock market's back alleys for hidden investment jewels, here are some basics that should help in the search.

A FEW BASICS

1. Do your own work

There are really two reasons to do your own work. The first is pretty simple. You have no choice. If you are truly looking at situations that others are ignoring, there will rarely be much media or Wall Street coverage. While there is usually plenty of industry or company information available, some of it quite helpful, almost none will focus on the special attributes that make your investment opportunity attractive. This should be fine with you; "the more the merrier" is not your credo.

The other reason to do your own work is closely related. As much as possible, you don't want to be well paid merely for taking big risks. Anyone can manage that. You want to be well paid because you did your homework. If you are one of the few people to analyze a particular investment opportunity, it follows that you are in the best position to assess the