



A Guide to Beating the Market for All Ages

The Little Book That Beats The Market

THE SUMMARY IN BRIEF

You can achieve investment returns that beat the pants off even the best investment professionals and the top academics. In fact, you can learn how it's possible to more than double the annual returns of the stock market averages.

But there's more. You can do it all by yourself. You can do it with low risk. You can do it without making any predictions, and you can do it by following, step by step, a "magic formula" that uses only common sense and two simple concepts. Best of all, once convinced that it really works, you can choose to do it for the rest of your life.

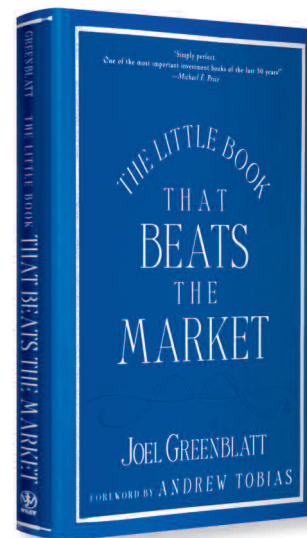
The formula has been tested over hundreds of different periods and thousands of stock picks, and has been proven extremely profitable for those who are willing to "stick with it."

While the concepts covered in this summary may seem simple — perhaps too simple for sophisticated investors — each step along the way is there for a reason. Stay with it, and the payoff for both beginning and experienced investors will be huge.

It's never too early or too late to start investing, and by following the simple steps and the Magic Formula that are clearly outlined and explained, you can achieve extraordinary long-term investment results with a very low level of risk. With this summary as your guide, you'll know exactly where to go and what to do — and it won't even take much time, just a little effort every few months.

IN THIS SUMMARY, YOU WILL LEARN:

- What options you have for saving and investing.
- What it means to invest in a company and buy stocks.
- How the stock market works.
- What the "magic formula" is and how you can use it to grow your money.
- How to find good companies at bargain prices.
- How you can beat the market all by yourself.



By Joel Greenblatt

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THE COMPLETE SUMMARY: THE LITTLE BOOK THAT BEATS THE MARKET

by Joel Greenblatt

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Part One: Saving Money

It takes a great amount of discipline to save any money. After all, no matter how much money you earn or receive from others, it's simply much easier and more immediately rewarding to find something to spend it on.

When author Joel Greenblatt was young, he decided that all of his money should go to Johnson Smith. Of course, he'd love to tell you that Johnson Smith was an orphan who just needed a little help. He'd love to tell you that the money given to Johnson Smith helped change his life. He'd love to tell you that, but it wouldn't be completely accurate. You see, Johnson Smith was a company that sold whoopee cushions, itching powder and imitation dog vomit through the mail.

Greenblatt didn't completely throw away all his money. He writes that he did buy some educational stuff, too. Once, the guys at Johnson Smith were able to sell him a weather balloon that was 10 feet tall and 30 feet around. He and his brother finally figured out how to blow it up by somehow reversing the airflow on the vacuum cleaner, but they ran into a big problem. The 10-foot balloon was quite a bit larger than their front door. Using a complicated formula that not even Einstein could fully comprehend, they decided that if they turned their backs and pushed really hard. The giant balloon could be squeezed out without bursting.

And it worked, except they forgot one thing. It seems that the air outside was colder than the air inside their house. That meant that they had filled their balloon with warm air. And since hot air rises, the balloon started to float away. The two of them were left

chasing a giant balloon down the street for about half a mile before it finally popped on a tree.

Investment Strategies

Luckily, Greenblatt learned a valuable lesson from the whole experience. Although he doesn't exactly remember what that was, he writes that he is pretty sure it had something to do with the importance of saving money for things that you might want or need in the future rather than wasting money buying the giant weather balloons that you get to chase down the block for all of three or four minutes.

Let's assume that we can all agree that it is important to save money for the future. Let's also assume that you have been able to resist the many temptations of the Johnson Smith people and the thousands of other places calling out for your money; that you have been able to provide for all of the necessities of life, including food, clothing and shelter; and that by being careful about how much you spend, you have somehow been able to put aside at least a small amount of money. Your challenge is to put that money — let's say \$1,000 — someplace where it can grow to be even more money.

Sure, you can just put it under your mattress or in your piggy bank, but when you come to get it, you'll still be left with the same \$1,000 you put there in the first place. It won't grow at all. In fact, if the prices of the things you were going to buy with that money go up during the time your money was just sitting there, your money will actually be worth less than it was worth the day you put it away. In short, the mattress plan kind of stinks.

Plan B has got to be better. And it is. Just take that \$1,000 over to the bank. Not only will the bank agree to



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hold your money, they'll pay you for the privilege. Each year, you'll collect interest from the bank and, in most cases, the longer you agree to let them hold your money, the higher the interest rate you'll get. If you agree to keep your \$1,000 with the bank for five years, you might collect something like 5 percent in interest payments per year. After five years, your \$1,000 will grow into \$1,276. Not bad and certainly better than the mattress plan.

Which brings us to Plan C. This plan is known as "who needs the bank?" There's an easy way to just skip the bank altogether and lend to businesses or to a group of individuals yourself. Often, businesses borrow money directly by selling bonds. If you purchase a \$1,000 bond from a large company, for example, that company might agree to pay you 8 percent each year and pay back your original \$1,000 after 10 years.

Investment Risks

There's one little problem. If you buy a bond from one of these companies and something goes wrong with the business, you may never get your interest or your money back. That's why riskier companies usually have to pay higher interest rates than more solid, established ones. That's why a company's bonds have to pay more than the bank. People need to make more money on their bond to make up for the risk that they may not receive the promised interest rate or their original money back.

If you're not comfortable taking any risk of losing your \$1,000, the U.S. government sells bonds too. For our purposes, the bond we'll be looking at is the one that matures after 10 years and compare that with our other long-term investment choices.

So if the annual interest rate on the 10-year government bond is 6 percent, that essentially means that people who are willing to lend their money out for 10 years, but are unwilling to take any risk of losing their original investment, can still expect to receive 6 percent each year on their money.

That means that if anyone asks you to loan them money or to invest with them over the long term, they better expect to pay you more than 6 percent a year. Why? Because you can get 6 percent a year without taking any risk.

The big picture is that we want to make sure we earn a lot more from our other investments than we could earn without taking any risk. Obviously, if long-term U.S. government bond rates rose to 7

percent or higher, we would use 7 percent or that higher number. ●

Part Two: Investing in a Company

Okay, what else can you do with your money? Let's face it: Putting money in the bank or lending it to the government is really boring. How about investing in a business?

A Case Study — Jason's Gum Shops

Let's say Jason wants a hefty \$6 million for half ownership of his business. Of course, 6 million bucks is more than most of us can afford, but, luckily, Jason isn't looking to sell half ownership of his business all to one person. In fact, he has decided to divide ownership of his business into a million equal pieces, or shares.

Jason's plan is to keep 500,000 shares for himself and sell the other 500,000 shares for \$12 apiece or \$6 million total. If you were to buy, for example, 10,000 shares costing \$120,000 you would then own 1 percent of Jason's Gum Shops (10,000 shares divided by the 1-million-share total). That doesn't mean that you would own the spearmint gum department or a small piece of one of Jason's stores. It means that you would be entitled to 1 percent of the future earnings of the entire business.

Now, of course, all you would have to do is figure out whether paying \$120,000 for 1 percent of Jason's future gum profits is a good deal. It seems that last year Jason sold a total of \$10 million worth of gum from the 10 stores in his chain. Unfortunately, \$10 million isn't how much profit Jason made. Obviously, Jason's stores ran up a few expenses along the way. There was the cost of the gum that Jason sold — that totaled \$6 million. That left him with \$4 million in profits. He also had to pay rent and those pesky employees. There were electricity and heating costs, trash removal and accounting and all kinds of administrative costs and that stuff adds up. In this case, another \$2 million, bringing Jason's business down to \$2 million in profits.

Jason's business had to pay 40 percent taxes of that \$2 million — or \$800,000 — leaving him with a net profit of \$1.2 million.

Actually, Jason provided us with all that information about last year's income in a very neat table, known as an income statement.

That means if the whole business earned \$1,200,000 each share earned one-millionth of that amount, or

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\$1.20 in earnings. If we invest \$12 for a piece of Jason's business and it earns us \$1.20 in the first year, our return on our investment would be \$1.20 divided by \$12 or 10 percent. The earnings from your share of the profits must give you more money than you would receive by placing that same amount of money in a risk-free, 10-year U.S. government bond.

But it's not quite that simple. First, the \$1.20 per share is what Jason's Gum Shops earned last year. Second, we have to come up with our estimate for how much he will earn next year and how confident we are in our prediction. The third little detail we haven't yet considered is that next year is only one year. Even if Jason's Gum Shops earns \$1.20 next year (or a lot more or a lot less), what about all the years after that? ●

Part Three: The Stock Market

Stock prices move around wildly over very short periods of time. Looking at the price for shares over a two- to three-year period would give us an even wider range.

Each day the newspaper lists the names of thousands of companies and the price at which people have been buying and selling an ownership share in each. The *trading* back and forth of these ownership shares takes place in a number of locations and over computer networks. These ownership shares are referred to as *shares of stock*, and collectively, this buying and selling activity is referred to as the *stock market*.

Interpreting Market Fluctuations

Why do share prices move around so much every year when it seems clear that the values of the underlying businesses do not? Who knows and who cares? They do!

Suppose you figured that a business was worth between \$10 and \$12 per share, and at varying times during the year, its shares could be purchased for between \$6 and \$11. If you were confident about your estimate of what the business was worth, then deciding whether to buy shares when they were trading near \$11 might be a difficult decision. But when shares in that same company during that same year were available at close to \$6, your decision might well become much easier.

You are never required to act. You alone can choose to act only when the price offered by Mr. Market appears very low (when you might decide to buy some shares) or extremely high (when you might consider selling any shares you own).

Discount Buying

It is a good idea to buy shares of a company at a big discount to your estimated value of those shares. Buying shares at a large discount to value will provide you with a large margin of safety and lead to safe and consistently profitable investments.

But there's still a problem here. How are you supposed to know what a business is worth? Second, if you could figure out the value of a business, how would you know you were right? Third, aren't there tons of smart, hard-working people trying to figure out all this stuff too?

Paying a bargain price when you purchase a share in a business is a good thing. One way to do this is to purchase a business that earns more relative to the price you are paying rather than less. In other words, a higher earnings yield (calculated by dividing the earnings per share for the year by the share price) is better than a lower one.

Return on Capital

Buying a share of a *good* business is better than buying a share of a *bad* business. One way to do this is to purchase a business that can invest its own money at high rates of return rather than purchasing a business that can only invest at lower ones. In other words, businesses that earn a high return on capital are better than businesses that earn a low return on capital. ●

Part Four: The Magic Formula

What do you think would happen if we simply decided to buy shares in companies that had *both* a high earnings yield and a high return on capital? In other words, what would happen if we decided to only buy shares in good businesses (ones with high returns on capital) but only when they were available at bargain prices (priced to give us a high earnings yield)?

We would make a lot of money!

Measuring the Results

Does it make sense that something this simple and obvious would actually work in the real world? Well, to answer that question, a logical first step might be to go back and see how a disciplined strategy of buying *good businesses at bargain prices* would have worked in the past.

Over the last 17 years, owning a portfolio of approximately 30 stocks that had the best combination of a high return on capital and a high earnings yield would have

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returned approximately 30.8 percent per year. Investing at that rate for 17 years, \$11,000 would have turned into well over \$1 million.

During those same 17 years, the overall market averaged a return of about 12.3 percent per year. At that rate, \$11,000 would still have turned into an impressive \$79,000. While that certainly is a lot, \$1 million is more.

Raising the Bar

Let's see what happens when we raise the bar a little bit. Let's look at just the largest 2,500 companies. Over the last 17 years (ending in December 2004), the magic formula worked remarkably well for this group. Owning a portfolio of 30 stocks chosen by the magic formula would have achieved an annual return of 23.7 percent. During that same period the market's average return for this group was 12.4 percent per year. In other words, the magic formula practically doubled the market's average annual return.

When we narrowed the group to just the largest 1,000 stocks, it appears that even the largest investors can practically double the market's compounded annual return simply by following the magic formula.

Throughout the 17 years of our study, we held a portfolio of roughly 30 stocks. Each stock was held for a period of one year. In all, over 1,500 different stock picks were made for each of the tests. When we combine all of our tests, they are the results of over 4,500 separate selections.

Starting with the largest 2,500 companies, what if we ranked them again using the magic formula from 1 to 2,500, from best to worst? That means the companies that appeared to be in good businesses and available at bargain prices would be ranked closer to number 1, while the companies losing lots of money that were offered at expensive prices would be ranked closer to 2,500.

We then divided those 2,500 companies into 10 equal groups based on their rankings, with group 1 being the 250 companies that the magic formula viewed as good companies at bargain prices and group 10 being the 250 stocks that the magic formula ranked as being poor companies at expensive prices.

What would happen if we did this every month for 17 years? What if we held each of those stock portfolios (each containing roughly 250 stocks) for one year and calculated the returns? The magic formula appears to work in order. The best-ranked stocks perform the best and as the ranking drops, so do the returns (see table).

Annualized Return (1988-2004)

Group 1	17.9%
Group 2	15.6%
Group 3	14.8%
Group 4	14.2%
Group 5	14.1%
Group 6	12.7%
Group 7	11.3%
Group 8	10.1%
Group 9	5.2%
Group 10	2.5%

A Magic Formula Warning

Unfortunately, looking at the statistics for only our very successful 17-year test period, it turns out there's actually plenty to worry about. The magic formula fared poorly relative to the market averages in five out of every 12 months tested. For full-year periods, the formula failed to beat the market averages once every four years. For one out of every six periods tested, the magic formula did poorly for more than two years in a row. There were even some periods when the formula did worse than the overall market for three years in a row.

The unpredictability of Mr. Market's moods and the pressures of competing with other money managers can make it really hard to stick with a strategy that hasn't worked for years.

So what's the point? The point is that if the magic formula worked all the time, everyone would probably use it. If everyone used it, it would probably stop working. So many people would be buying the shares of the bargain priced stocks selected by the magic formula that the prices of those shares would be pushed higher almost immediately. In other words, if everyone used the formula, the bargains would disappear and the magic formula would be ruined.

That's why we're so lucky the magic formula isn't that great. It doesn't work all the time, in fact, it might not work for years. Most people just won't wait that long. Their investment time horizon is too short. Even if a strategy works in the long run, most people won't stick with it. After a year or two of performing worse than the market averages (or earning lower returns than their friends), most people look for a new strategy.

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Identifying the Right Stuff

Most people and businesses can't find investments that will earn very high rates of return. A company that can earn a high return on capital is therefore very special.

Companies that earn a high return on capital may also have the opportunity to invest some or all of their profits at a high rate of return which can contribute to a high rate of earnings growth.

So how does the magic formula find us companies that are able to earn a high return on capital in the first place? To earn a high return on capital, even for one year, it's likely that, at least temporarily, there's something special about that company's business. Otherwise, competition would already have driven down returns on capital to lower levels.

It could be that the company has a relatively new business concept (like a candy store that sells only gum), or a new product (like a hot video game), or a better product (such as an iPod that's smaller and easier to use than competitors' products), a good brand name (people will happily pay more for Coke than for Joe's Cola, so Coke can charge more than Joe's and continue to earn a high return on capital despite having competition), or a company could have a very strong competitive position (eBay was one of the first auction Web sites and has more buyers and sellers than anyone else, so it's hard for new auction sites to offer the same benefits to customers).

Marketplace Advantages

In short, companies that achieve a high return on capital are likely to have a special advantage of some kind. That special advantage keeps competitors from destroying their ability to earn above-average profits. Businesses that don't have anything special going for them are likely to earn only average or below-average returns on capital. If there's nothing special about a company's business, then it's easy for someone to come in and start a competing business. If a business is earning a high return on capital and it's easy to compete, eventually someone will! They'll keep competing until returns on capital are driven down to average levels.

By eliminating companies that earn ordinary or poor returns on capital, the magic formula starts with a group of companies that have a high return on capital. Sure some of the companies chosen by the magic formula won't be able to maintain their high return on capital. But on average, the high-return-on-capital companies chosen by the magic formula are more likely to have the opportunity to reinvest a portion of their profits at high

rates of return. They are more likely to have the ability to achieve high rates of earnings growth. They are also more likely to have some special competitive advantage that will allow them to continue to earn an above-average return on capital. In other words, on average, the magic formula is finding us good companies. Then it tries to buy them at bargain prices.

More Impressive Results

The magic formula has a better track record than I've been letting on. I didn't reveal this good news earlier for a reason. A good track record is not why you should want to follow the magic formula. A good track record is not why you will have good results in the future. A good track record is not why you will keep following the magic formula even when results turn against you. The truth is that a good track record only helps once you understand why the track record is so good. Now that you do — simply put, the magic formula makes perfect sense — I can trust you not to get carried away with a little more good news.

Following the formula for any three-year period in a row, the magic formula beat the market averages 95 percent of the time (160 out of 169 three-year periods tested). That's not all. Over three-year periods, if you followed the magic formula, you would never have lost money. Sticking with the magic formula for any three-year period during those 17 years, you would have made money 100 percent of the time. The worst return for the magic formula was a gain of 11 percent, compared to a loss of 46 percent for the worst return over a three-year period for the market averages.

All of those numbers were based on the results achieved by choosing from only the largest 1,000 stocks. The results from choosing from the largest 3,500 stocks were even better. Every three-year period tested was positive for the magic formula portfolios and every three-year period beat the market averages.

Getting an Accurate Earnings Read

Most people have no business investing in individual stocks on their own. Choosing individual stocks without any idea of what you're looking for is like running through a dynamite factory with a burning match. You may live, but you're still an idiot.

But if you must ... and you can actually predict normalized earnings several years down the road, use those estimates to figure out earnings yield and return on capital. Then use the principles of the magic formula to look for good companies at bargain prices based

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on your estimates of normal earnings. The magic formula doesn't look at future earnings. That's too hard. The magic formula uses last year's earnings which can be very misleading.

In fact, often the near-term prospects for the companies selected by the magic formula don't look so good. In many cases, the outlook for the next year or two is downright ugly. If instead, estimates for this year's or next year's earnings were used, many of the companies selected by the magic formula might not look like such bargains at all.

So what should we be doing? Ideally, better than blindly plugging in last year's earnings to the formula, we should be plugging in estimates for earnings in a normal year. Of course, last year's earnings could be representative of a normal year, but last year may not have been typical for a number of reasons: earnings could be higher than normal due to extraordinarily favorable conditions that may not be repeated in most years. Alternatively, there may have been temporary problems with the company's operations and earnings may have been lower than in a normal year.

If you truly understand the business that you own and have a high degree of confidence in your normalized earnings estimates, owning five to eight bargain-priced stocks in different industries can be a safe and effective investment strategy.

How can owning just five to eight stocks possibly be a safe strategy? Think of it this way. You're a successful local businessman who has just sold off his business for \$1 million. You want to invest that money wisely so that you can safely earn a good return over time. You have the opportunity to reinvest the proceeds from the sale of your business by buying an ownership stake in some of the other businesses in town. You have some understanding of about 30 of those businesses, and your plan is to invest in companies that you understand well, that have a good future and that are available at a reasonable price.

For those companies about which you feel most confident in your ability to make predictions, you project what normal earnings should be several years down the road. You also look for companies that you believe will be able to continue in business for many years and for companies that should have the ability to grow their earnings over time. Then you calculate earnings yield and return on capital based on your estimates for each of those companies. Of course your goal is to find good businesses that can be purchased at bargain prices. On the basis of your analysis, you select your five favorites

and invest \$200,000 in each.

Risk

Does that sound like risky behavior? It would be if you had no idea how to read financial statements or evaluate individual businesses. But if you do have that ability, is buying a stake in your five favorite businesses enough? Would owning a stake in your eight favorites be better? I think most people, especially those who view stocks as long-term ownership stakes in actual businesses, would think that spreading that \$1 million among investment stakes in five to eight bargain-priced businesses in varying industries would qualify as prudent behavior.

At least, that's the view I take with my investment portfolio. The more confidence I have in each one of my stock prices, the fewer companies I need to own in my portfolio to feel comfortable. Most investors view stocks and the construction of stock portfolios differently however.

Somehow, when ownership interests are divided into shares that bounce around with the market's moods, individuals and professionals start to think about and measure risk in strange ways. When short-term thinking and overly complicated statistics get involved, owning many companies that you know very little about starts to sound safer than owning stakes in five to eight companies that have good businesses, predictable futures and bargain prices. In short, for the few who have the ability, knowledge and time to predict normal earnings and evaluate individual stocks, owning less can actually be more — more profits, more safety and more fun. ●

Part Five: Investing Fundamentals

On Wall Street, money won't magically appear under your pillow. There's no one to tuck you in, no one to take care of you and no one you can turn to for good advice. You're on your own.

To see why this is necessarily so, assume you have some money you would like to invest over the long term. Second, you would like to earn as much as possible from your investments, but you are unwilling to take unreasonable risks. Finally, the stock market offers the best possibility for high investment returns over time and this is where you would like to put your money.

- One typical stop is our friendly neighborhood stockbroker. This is an investment professional whose job is to hold your hand and help you invest

Magic Formula Investing

Step 1

Go to magicformulainvesting.com.

Step 2

Follow the instructions for choosing company size (e.g., companies with market capitalizations over \$50 million or over \$200 million). For most individuals, companies with market capitalizations above \$50 million or \$100 million should be of sufficient size.

Step 3

Follow the instructions to obtain a list of top-ranked magic formula companies.

Step 4

Buy five to seven top-ranked companies. To start, invest only 20-33 percent of the money you intend to invest during the first year.

Step 5

Repeat step 4 every two to three months until you have invested all the money you have chosen to allocate to your magic formula portfolio. After nine-10 months, this should result in a portfolio of 20-30 stocks.

Step 6

Sell each stock after holding it for one year. For taxable accounts, sell winners after holding them a few days more than one year and sell losers after holding them a few days less than one year. Use the proceeds from any sale and any additional investment money to replace the sold companies with an equal number of new magic formula selections.

Step 7

Continue this process for many years. You must be committed to continuing this process for a minimum of three to five years, regardless of the results. Otherwise you will most likely quit before the magic formula has a chance to work.

your money. Your stockbroker will help you choose between individual stocks, bonds, investment funds and other investment alternatives. If your stockbroker is like the vast majority, he or she has no idea how to help you. Most get paid a fee to sell you a stock or a bond or some other investment product. They don't get paid to make you money.

- You might as well just put your money in a *mutual fund*. Here's the perfect solution for the small

investor. A mutual fund is an investment fund managed by a professional money manager who selects a diverse group of stocks or bonds. This is a particularly efficient way for a small investor to spread his or her investments capital over a wide group of different investments. The problem is that it's tough to have specific insight into many different companies and investment securities. Then of course, there's the small matter of fees. Basic math says that average returns minus fees equals below-average returns.

- Instead, you might consider investing in a hedge fund. These are exclusive private investment funds usually reserved for very wealthy investors. Unfortunately, in most cases, unless you already have at least \$500,000 or so to invest, you probably won't even have this option. By law, most hedge funds can only accept investors who can afford to lose large amounts of money. Hedge funds are investment funds that have more flexibility than most mutual funds. Managers can use the fund's capital and borrowed money to buy a large variety of securities. They are able to place bets on whether stocks, other securities or entire market averages will move up or down. Most mutual funds are restricted to making money only when the securities they own go up. A hedge fund's ability to bet up or down over many different securities, often with the aid of borrowed money, is seen as a big advantage over most standard mutual funds. But most hedge funds charge huge fees — at least 1 percent of assets under management plus a 20 percent share of the profits.
- So that's why many people just choose to invest in an index fund. An index fund is a mutual fund that just tries to equal the overall market's return, less a very small fee. These funds pick a market index and buy all of the stocks in that particular index. Although this strategy won't help you beat the market, it will help you achieve returns that are at least close to the market averages.

The magic formula and the principles behind it to guide your future investment will remain one of your very best investment alternatives. I believe that if you are able to stick with the magic formula strategy through good periods and bad, you will handily beat the market averages over time. In short, I believe that, even after everyone knows the magic formula, your results will continue to be not only quite satisfactory, but with a little luck, extraordinary. ●