The **First Cut**

Greenblatt's Magic Formula

The First Cut is designed as a starting point for investors. Each issue we list the top stocks that pass relatively simple screens of interest to individual stock pickers. AAII's Stock Investor Pro *screening software is used to generate the First Cut listing.*

Long-term success relies on both a sound strategy and the discipline to follow your approach during bull and bear markets. In "The Little Book That Still Beats the Market" (John Wiley & Sons, 2010), Joel Greenblatt shows that his "Magic Formula" approach holds up over the long term, but that you need to be prepared for brief runs when it underperforms the market. The approach seeks out good companies with a high return on invested capital that can be purchased at an attractive pretax earnings yield.

Greenblatt measures the strength of a business by examining its return on capital, which he defines as operating profit (EBIT, earnings before interest and taxes) divided by tangible investment capital (net working capital plus net fixed assets). If you do not have access to this variable, Greenblatt suggests that investors use return on assets (net income divided by assets) or visit his website (www.magicformulainvesting.com), which has a free magic formula screening tool.

To help value a business, Greenblatt takes the price-earnings ratio, inverts it and tweaks the variables slightly. Greenblatt calculates earnings yield by dividing EBIT by the enterprise value. The enterprise value tries to reflect the minimum value to purchase a company outright. It is calculated by adding market capitalization, preferred stock, and total debt and subtracting excess cash. Greenblatt notes that you can also look for low price-earnings ratios, but warns to avoid firms with extremely low ratios because earnings may be unusual in some way.

Stocks that made this issue's First Cut are domestic, exchange-listed stocks with a minimum price of $5.00 per share and a market cap of at least $50 million. Greenblatt also excludes financials and utilities because of their unique financial structures. To calculate the magic formula, the rank value of return on capital was combined with the rank value of the return on enterprise value. The 30 stocks with the lowest magic formula total passed the First Cut. Greenblatt suggests building a 20- to 30-stock portfolio by selecting five to seven stocks every two to three months.

—John Bajkowski, President of AAII

Magic Formula Stocks (Ranked by Magic Formula Total)

	Magic Formula Total	EBIT/ Enterprise Value (Ratio – Rank)	Return on Capital (Ratio – Rank)	P/E (X)	Return on Assets (%)	Market Cap ($ Mil)	Liab to Assets (%)	Price Change % Rank 13-Wk (%)	Price Change % Rank 52-Wk (%)	Share Price (11/11) ($)	Description
ITT Educational Svcs (ESI)	38	35% – 17	160% – 21	5.2	48.4	1,585	81.3	26	52	59.44	postsecondary educ'n
NL Industries, Inc. (NL)	72	24% – 42	132% – 30	5.6	18.3	661	48.0	56	85	13.58	component products
Bridgepoint Education (BPI)	82	29% – 26	88% – 56	7.2	32.7	1,130	42.9	43	91	22.02	postsecondary educ'n
Safeguard Scientifics (SFE)	97	158% – 3	68% – 94	2.2	49.2	334	13.5	76	72	16.12	business capital & resources
Veeco Instruments Inc. (VECO)	102	38% – 16	70% – 86	4.6	32.8	1,113	21.3	25	27	28.74	LED equip & solar panels
Capella Education Co. (CPLA)	113	19% – 87	143% – 26	9.5	23.1	499	28.7	56	26	34.50	postsecondary educ'n
ASA Gold & Precious Metals (ASA)	117	17% – 113	1321% – 4	5.9	15.7	596	0.2	65	44	30.67	prec metals closed-end fund
PDL BioPharma Inc. (PDLI)	128	18% – 99	134% – 29	8.5	48.5	875	189.9	76	80	6.26	humanized antibodies
Forest Laboratories, Inc. (FRX)	135	18% – 98	116% – 37	7.6	16.6	8,154	26.6	33	48	30.52	ethical drug products
USA Mobility, Inc. (USMO)	139	21% – 64	75% – 75	2.9	35.4	320	28.7	42	39	14.49	nutritional & care prods
AmSurg Corp. (AMSG)	144	19% – 86	87% – 58	15.6	3.8	799	59.0	86	89	25.50	ambulatory surgery centers
Momenta Pharmaceuticals (MNTA)	151	48% – 11	55% – 140	3.4	68.1	765	4.2	35	51	14.92	complex molecule engin'g
AMERIGROUP Corp. (AGP)	151	17% – 131	177% – 20	12.4	10.1	2,815	49.3	91	88	58.84	health care services
TeleNav, Inc. (TNAV)	156	17% – 115	102% – 41	11.1	15.7	390	22.9	63	88	9.45	voice-guided GPS
VAALCO Energy, Inc. (EGY)	174	47% – 12	51% – 162	10.6	13.7	356	16.5	40	42	6.24	crude oil & natural gas
Strayer Education, Inc. (STRA)	175	16% – 139	118% – 36	10.3	50.4	1,141	80.5	39	27	95.07	postsecondary educ'n
Invesco Mortgage Capital (IVR)	177	15% – 171	524% – 6	4.1	2.3	1,764	87.5	28	28	15.29	real estate investment trust
Visteon Corporation (VC)	181	53% – 9	50% – 172	4.9	23.1	2,940	73.8	77	42	57.07	auto systems
Almost Family, Inc. (AFAM)	187	31% – 24	51% – 163	6.6	9.7	149	18.0	32	18	15.91	health care services
Power-One, Inc. (PWER)	190	56% – 8	48% – 182	5.2	19.0	566	45.3	20	25	5.43	renewable energy inverters
C&J Energy Services Inc. (CJES)	193	19% – 83	64% – 110	9.1	36.4	1,082	26.9	24	56	20.86	hydraulic servs for wells
Aeropostale, Inc. (ARO)	196	21% – 61	57% – 135	9.4	21.6	1,373	50.5	94	30	17.01	casual apparel retailer
Terra Nitrogen Company LP (TNH)	210	14% – 192	192% – 18	12.4	83.8	3,242	9.3	60	92	175.22	nitrogen fertilizer prods
Leucadia National Corp. (LUK)	216	15% – 176	103% – 40	3.8	17.8	5,890	26.7	29	44	24.08	diversified holding co.
Hawaiian Telcom HoldCo (HCOM)	220	66% – 6	43% – 214	na	32.3	152	70.4	20	56	14.96	communications servs
Magellan Health Services (MGLN)	227	15% – 180	94% – 47	13	9.1	1,506	35.9	83	73	52.91	health care services
DeVry Inc. (DV)	227	22% – 56	50% – 171	8.1	16.2	2,453	30.5	27	35	36.46	educational services
Dolby Laboratories (DLB)	235	15% – 166	79% – 69	11.1	16.6	3,178	10.8	32	18	28.78	audio/video for entertain
Wayside Technology Grp (WSTG)	237	17% – 118	61% – 119	11.1	7.8	57	56.8	49	77	12.20	software/hardware reseller
Valassis Communications (VCI)	249	15% – 167	72% – 82	10.1	6.0	935	71.4	33	28	20.88	media & marketing servs

Source: AAII's Stock Investor Pro*, Thomson Reuters and I/B/E/S. Data as of 11/11/2011.*