MFI Stock Study Update

I have been contacted by a gentleman in Belgium who has expressed interest in working with me on my MFI stock study. I am very excited about this new relationship, as he is of similar analytical persuasion and should be quite an asset when it comes to performing statistical analysis on the data I am collecting. I will probably have more to say on this as he and I continue our dialog on this project.

On a related note, I am going to start collecting Quadrix ratings from Horizon Publishing Company, the publisher of Dow Theory Forecasts. I am excited about the prospect of utilizing these ratings as potential predictors of MFI stock performance. With the addition of these ratings, I am now collecting the following "point-in-time" data points for each weekly MFI portfolio I am tracking:

- Market Capitalization (MFI web site)
- MFI Earnings Yield (MFI web site)
- MFI ROC Range (MFI web site)
- Standard & Poor's STAR Rating (my brokerage's web site)
- StockScouter Rating (MSN Money web site)
- StockScouter Fundamental Grade (MSN Money web site)
- StockScouter Valuation Grade (MSN Money web site)
- StockScouter Technical Grade (MSN Money web site)
- StockScouter Ownership Grade (MSN Money web site)
- StockScouter Return Expectation (MSN Money web site)
- TheStreet.com Rating (TheStreet.com web site)
- Quadrix Overall Score (Dow Theory Forecasts web site)
- Quadrix Momentum Score (Dow Theory Forecasts web site)
- Quadrix Value Score (Dow Theory Forecasts web site)
- Quadrix Quality Score (Dow Theory Forecasts web site)
- Quadrix Financial Strength Score (Dow Theory Forecasts web site)
- Quadrix Earnings Estimate Score (Dow Theory Forecasts web site)
• Quadrix Performance Score (Dow Theory Forecasts web site)
• Quadrix Volume-Metrics Score (Dow Theory Forecasts web site)
• Trailing P/E Ratio (AAII StockInvestor Pro)
• Trailing P/E Percentile (AAII StockInvestor Pro)
• Price/Book Ratio (AAII StockInvestor Pro)
• Price/Book Percentile (AAII StockInvestor Pro)
• Price/Sales Ratio (AAII StockInvestor Pro)
• Price/Sales Percentile (AAII StockInvestor Pro)
• Price/CashFlow Ratio (AAII StockInvestor Pro)
• Price/CashFlow Percentile (AAII StockInvestor Pro)
• Price/FreeCashFlow Ratio (AAII StockInvestor Pro)
• Price/FreeCashFlow Percentile (AAII StockInvestor Pro)
• Price as Percentage of 52-week High (AAII StockInvestor Pro)
• 4-week Relative Strength (AAII StockInvestor Pro)
• 13-week Relative Strength (AAII StockInvestor Pro)
• 26-week Relative Strength (AAII StockInvestor Pro)
• 52-week Relative Strength (AAII StockInvestor Pro)
• Weighted 4-quarter Relative Strength (AAII StockInvestor Pro)
• Piotroski F Score (AAII StockInvestor Pro)
• Short Interest as Percentage of Float (Reuters.com)
• Short Interest Ratio (Reuters.com)
• Short Interest Ratio: Prior Month (Reuters.com)

While this looks like a daunting list, it actually doesn't take that long to pull the data. I feel like I still have some "bandwidth" to add more data points as I see fit.

Stay tuned for further updates as developments warrant …

Prior posts on this subject:

• 2/19/07 -- Seeking Assistance with New Study
• 2/25/07 -- New MFI Study Underway
• 6/3/07 -- MFI Stock Study Update
Psst! Hey, buddy! You wanna buy a stock? I got 'em cheap. Here, take a look.

Joel Greenblatt's *The Little Book That Beats the Market* is just about the oddest book on investing I've ever read. It doesn't present an investing philosophy, complete with stories about how following that strategy helped the author beat the market, as Peter Lynch's *One Up on Wall Street* does. It doesn't discuss how to dig deeper into a company's financials to catch those early warning signs, like O'Glove's *Quality of Earnings*. And I'm pretty sure Greenblatt doesn't mention Warren Buffett, though he does introduce Benjamin Graham and his ideas about Mr. Market and the margin of safety.

Instead, Greenblatt presents a strategy for picking companies to invest in, and shows how following that strategy resulted in 30% annual returns over the past 17 years. Sounds too good to be true, huh? But the formula seems to be based on two very solid pillars of value investing: Invest in companies with high returns, and make sure they're selling at a large discount.

The book opens with a discussion between Greenblatt and his son about a friend's gum-selling business. Greenblatt uses the idea of Jason's Gum Shops to illustrate several aspects of business and company evaluation, such as earnings yield -- the inverse of the P/E ratio -- and return on invested capital.

**Crazy Mr. Market? So what?**
Along the way, he points out the craziness of the stock market. To prove this point, you can see many recent examples of the market's volatility -- it priced *General Motors* (NYSE: ) at $19 per share last April, and then nearly 100% higher, at more than $36 per share, a mere six months later. What's up with that? The same thing happened with *Motley Fool Stock Advisor* recommendation *American Eagle Outfitters* (NYSE: ), which doubled in only a year's time from its January 2006 low. The companies were the same before and after the big movements, so why did Mr. Market give two wildly different prices for each at different times?

The answer, according to Greenblatt, is that it doesn't matter. The investor's job is just to find companies that do well, demonstrated by a high return on capital, and are selling cheaply, shown by a low P/E. Right out of the value investor's bible.
The magic formula
The strategy he outlines, which gives that fantastic return, is to buy about 20 to 30 of these companies, hold for a year, then sell. Rinse and repeat. That's it. He calls this the magic formula.

Greenblatt spends about half of this short, very easy-to-read book touting the results of the 17-year back-testing of his formula. Annual returns from 1988 through 2004 ranged from (4.4%) to 79.9%, compared to the S&P 500 index's returns of (22.1%) to 37.6%. The average returns were 30.8% and 12.4%, respectively. Those averages would turn $10,000 into $960,000 or $73,000, respectively, over the course of those 17 years. Note that this time frame covers both the Internet stock bubble and the market crash of 2000-2002. Greenblatt does point out that the formula does not beat the index in every yearlong period tested, but that in any period lasting three consecutive years or longer, his formula does win.

Whether General Motors would have been found by the magic formula last spring, I don't know. However, current companies on his list include communications giant Motorola (NYSE: MOT), whose share price has tumbled 33% over the last six months or so, and the small Pinnacle Airlines (Nasdaq: PNCL), whose shares are up 200% since last summer.

Mixed feelings
I'm a bit torn about this book. On the one hand, Greenblatt repeats over and over how great the magic formula is, which makes it seem like he's trying to sell me something. This triggers my sense of "If it sounds too good to be true, it probably is." On the other hand, the basis of the formula is found in strict value investing ideas, which I find highly appealing.

The book came out in 2006, so nobody has had a chance to test it for the three- to five-year period he recommends as a minimum (which is another point in its favor). However, he does make it very easy to find companies meeting his criteria with a website devoted to the idea. If one were to try the technique described in the book, it might be smart to do it on paper for a couple of years, to see if the magic formula holds up going forward as well as it did when back-tested.

American Eagle is a recommendation. To see what else is in this market-crushing portfolio, take a of the newsletter service today.

Fool contributor keeps stock certificates under his trench coat, hawking them to unsuspecting passersby. Those certificates don't include any from companies mentioned in this review, though. We consider the Fool's to be magical in its own right.