

Executive Summary

The main goal of this paper is to back-test the magic investment formula developed by Joel Greenblatt in his book *The little book that beats the market* on the Swiss stock market. The Sharpe Ratio and the M2 measure are used to see whether or not the potential outperformance can be explained by a higher risk. As claimed by Greenblatt, this investment approach would have generated an annual return of ~30% from 1988 to 2004 on the US stock market.

The magic formula is a value investment approach which combines a quality measure and a value measure to evaluate stocks. The Return on Capital employed (ROC) is used as a proxy for quality, whereas the earning yield (EY) is used as an indication of value. The stock market universe is screened and each stock is ranked for these two measures. The two ranks are then combined to find stocks which rank high in both lists. The magic formula, then, invests in the top ranked stocks, to be hold for one year, after that the stock are sold and the selection process is beginning again.

In a first part I will briefly introduce the value investment approach of which the magic formula is part and present the efficient market hypothesis. In a second step I am going to explain in detail Greenblatt's investing method as described in *The little book that beats the market*. In a third part I will discuss how I applied the magic formula to the Swiss stock market and which adaptation I had to make. Further, I will lay out my hypothesis and analyse the results of my back-testing.

The back-testing of the magic investment formula on the Swiss stock market over a time frame of 15 years, from 2003 to 2017, seems to generate a higher return than the SPI and this also when transaction costs are considered. Thus, the outcome is consistent with the results provided by Greenblatt and shows that the magic formula is not only applicable on the US stock market, but can also be a valid investment approach for the Swiss stock market.

The higher returns delivered by the magic formula are only partially explained by the higher risk (expressed as a higher volatility compared to the benchmark). This means that the portfolio managed according to the criteria of the magic investment formula has a higher Sharpe ration than the market and should therefore be preferred by rational investors.