At the end of March, the institutional share class of famed value investor Joel Greenblatt?s Gotham Index Plus fund (GINDX) passed its three-year mark and garnered a 5-star rating from Morningstar. That means, over its first three years, the long-short stock fund landed in the top-20% of the large blend fund category for its volatility-adjusted return. Long-short funds have high fees because they pay dividends and margin costs on short positions, and this fund is no exception with an eye-watering 3.61% expense ratio. But it?s a good time to look under this fund?s hood to see if it still deserves a place in some portfolios.

Background on Greenblatt and the ?Magic Formula?

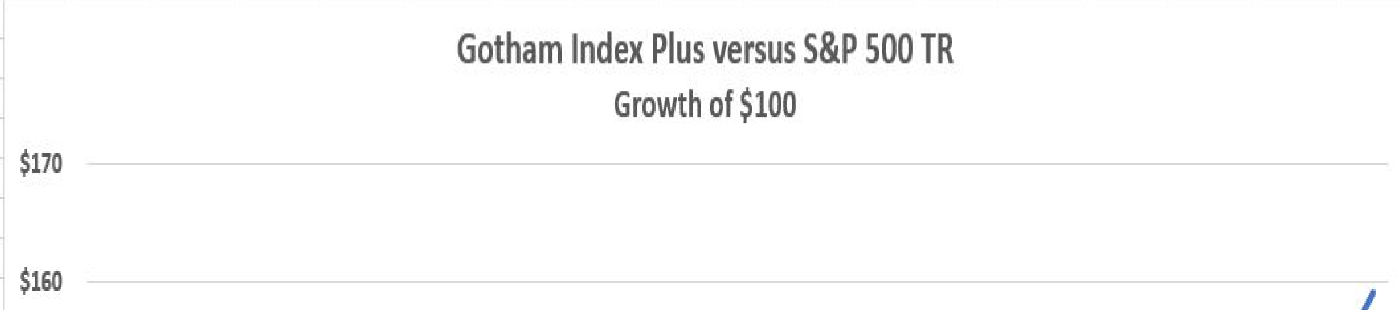
As I wrote in a previous article, Joel Greenblatt began his career has a hedge fund manager using a strategy that could be described as special situations. He looked for corporate restructurings including spinoffs and bankruptcies and managed to post a 50% annualized return for a decade, albeit with significant volatility as he tells it. Greenblatt likes to write and teach, including holding a position as an adjunct professor at Columbia Business School, and the book that emerged from that experience became a hedge fund cult classic, *You Can Be a Stock Market Genius*. After closing his fund, Greenblatt devised a strategy that could accommodate more assets called the ?Magic Formula.? The strategy is really a simple smart beta two-factor model, picking stocks with the best combination of EBIT yield and return on invested capital. Greenblatt ran a backtest and realized picking the stocks that scored best on these two factors at the start of each year would have beaten the index by 4 percentage points annualized over a quarter century. Three books came out of testing this strategy ? *The Little Book that Beats the Market*, *The Little Book that Still Beats the Market*, and *The Big Secret for the Small Investor.* When I was at•Morningstar•I calculated that the strategy beat the S&P 500 Index, including dividends, by 10 percentage points annualized from 1988 through September of 2009, based on Greenblatt?s back-tested numbers from his first book on the strategy and funds he was running at that time. That doesn?t mean the formula beat the index every single calendar year. In fact, it showed patterns of underperforming for as many as three straight years before recovering and overtaking the index again. Value investors must tolerate fallow periods. In fact, value strategies work over the long run precisely because they don't work over shorter periods. Everyone piles out when the strategy is faltering, leaving stocks poised for outperformance. The "magic" of the formula is really based on the human psychology or behavior that causes many of us to be bad investors.

Using the Magic Formula to Go Long & Short

Now Greenblatt and his partner Robert Goldstein have based a series of long-short funds on the strategy, which, to varying degrees, own the stocks that score best on his formula and short the stocks that score the worst on it. For each dollar invested, the Gotham Index Plus fund gains 100% exposure to the S&P 500 Index. It also selects long and short positions from the 500-700 larges U.S stocks that are that most expensive or cheapest on Gotham?s assessment of value or the Magic Formula. The resulting portfolio is 190% long and 90% short. So the fund combines full exposure to the index with active management. Part of the fund tracks the market, and another part of the fund uses a value strategy to own and short stocks. The benefit of having both market exposure and exposure to an active strategy is that investors who still want to beat the market don?t have to withstand such severe fallow periods that every value investor endures and that the fund would likely have if it were just invested in the magic formula strategy.

The Verdict

With such a high expense ratio, however, the fund must outperform significantly when the strategy is working ? and not underperform significantly when it?s not. The avoidance of underperformance versus the index is especially true since one of Greenblatt?s objectives is to provide an index-like experience for investors so that they won?t get shaken out when the active strategy is out of favor. That seems like a tall order. Nevertheless, for the 41 months the fund has been in existence it has outperformed the index. Over that period, the fund?s compounded annualized return is 14.54%, while the S&P 500 Index?s return is 12.75%.



Over long periods of time that difference ? 1.79 percentage points ? adds up to serious returns. For example a $100,000 investment earning 7% for 25 years would grow to around $540,000, while the same investment for the same period of time earning 8.79% would growth to around $820,000, Interestingly, the Gotham Index Plus fund has a 1.42% Sharpe Ratio for the past 36 months according to Morningstar, while the index has a Sharpe Ratio of 1.55%. This implies that the index has a slightly better volatility adjusted performance. But the Sharpe Ratio views all volatility (up and down) as the same, whereas investors obviously don?t. Indeed, the Sortino Ratio of the fund, which penalizes an investment only for downside volatility, is higher ? 3.42% -- than the index?s 3.30%. Additionally, the fund has captured 105% of the index?s upside moves and 77% of the downside moves. So far, despite its breathtaking expense ratio, the Gotham Index Plus fund has delivered on its promise ? outstripping the index by a decent amount over a 41-month period, while delivering a roughly similar volatility experience. Investors should consider that other long-short funds must pay dividends and margin costs too. It?s noteworthy though that if the stock market endured a steep decline, the fund would then be paying even higher fees assuming dividends weren?t cut too badly in that event. If the expense ratio on the fund reached, say, nearly 6% instead of nearly 4% now, the fund might do fine, but would it overcome the index as easily? Of course, such a big decline in the stock market itself, although painful in absolute terms, might be a relative boon for the fund as both its long and short magic formula components could outperform the index during a big drop. And stocks would be cheaper after such a decline, arguably favoring the fund's strategy.• But 6% or more seems like a rather high hurdle. It?s difficult to recommend a fund this expensive. But paying dividends and margin costs is part of shorting. And if you aim to find a mechanical, smart beta-like long-short fund that can beat the market over the longer haul, this fund?s strategy has a decent chance.