Value Investing Guru Joel Greenblatt Sees Shift to "High Quality" Stocks

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Beauty is in the eye of the beholder and that's especially true for value investors. True value investors are typically attracted to stocks that most other investors wouldn't touch.

In his 2005 best-seller, "The Little Book that Beats the Market," money manager Joel Greenblatt described his "magic formula" for picking stocks: a combination of high return on capital and low valuations, based on the past year's earnings.

"What you'll find is that [the formula] comes up with companies people always think there's a problem with - that's why you have to buy a basket of 20 or 30," says Greenblatt, co-founder of Formula Investing and managing partner of Gotham Capital.

Generally speaking, Greenblatt says the value today is predominantly in "higher quality business that didn't get hurt as badly in the recession" vs. the low-quality names like AIG and Fannie Mae which led the rally off the March lows.

Among the "beaten up stocks" currently ranked highly by Greenblatt's are construction companies, select retailers and McGraw-Hill.

The parent of Standard & Poor's, McGraw-Hill shares have been battered - along with top rival Moody's - since the bursting of the subprime bubble amid fears the firms' will be exposed to additional legal liability, or simply less robust profits going forward.

But McGraw-Hill trades with a trailing P/E below 13 and boasts return on capital above 22% for the past five years.

In sum, it's the kind of name a value investor willing to look beyond the headline risk can love.