

Brick Financial Management LLC

Benjamin B. Taylor
 Investment Manager
 phone: 973 313 1220
 fax: 973 313 1230
 www.brickfinancial.com

January 31, 2005

Re: Year End/December 2004 Letter to Clients

Dear Clients and Friends,

Brick Financial's model portfolios - the Relative Value and the Choice - had an excellent year rising 33.54% and 15.31% respectively.

The Relative Value portfolio beat its closest benchmark, the Russell Midcap Index which returned 20.22% in 2004. The Choice portfolio had similar success, besting its closest benchmark, the S&P 500 Index which returned 10.88%. The returns for both model portfolios versus relevant stock market indices (including reinvested dividends) follow³:

	Inception Date	2003	2004	Total Return Since Inception	Annualized Since Inception
Relative Value ¹	12/6/2002	44.09%	33.54%	88.39%	35.80%
Russell Midcap ¹		40.06%	20.22%	66.46%	27.92%
S&P 400 ¹		35.62%	16.48%	51.48%	22.06%
Choice ²	4/4/2003	22.31%	15.31%	41.04%	21.83%
S&P 500 ²		32.87%	10.88%	47.33%	24.78%
Russell 1000 ²		29.65%	11.40%	44.43%	23.50%
Dow 30		28.26%	5.31%		
Nasdaq		50.77%	9.15%		

1. The inception date for the Relative Value model portfolio is 12/6/2002. For comparison purposes the S&P 400 is assumed to have an inception date of 12/1/2002 and the Russell Midcap is assumed to have an inception date of 12/6/2002.
2. The inception date for the Choice model portfolio is 4/4/2003. For comparison purposes the S&P 500 is assumed to have an inception date of 4/1/2003 and the Russell 1000 is assumed to have an inception date of 4/4/2003.
3. Notes: The returns of the Relative Value and Choice portfolios represent models each with an initial investment of \$10,000. They do not represent actual trades of client portfolios although client portfolios are based on the model portfolios. The model portfolios are for informational purposes only. Although Brick Financial believes the information and data in this report were obtained from sources considered reliable and correct, we cannot guarantee their accuracy or completeness. Neither this commentary, nor any opinions expressed herein, should be construed as an offer to sell or a solicitation of an offer to acquire any securities or other investments mentioned herein. Persons associated with this firm may own or have an interest in securities or investments mentioned in this presentation. Their positions may change from time to time and they may buy or sell such securities or investments. Past returns are no guarantee of future performance. Model portfolios and charts are maintained at Foliofn.com. The index data comes from several sources including Standard & Poor's, Russell, Barra and Bloomberg.

Fun with percentages

A fun, if only slightly useful, exercise is to calculate how a particular percentage return will grow money. The effects of compounding are magical over long periods of time. One way of completing this exercise is to measure how long it would take to turn a one-time \$10,000 investment into a \$1,000,000 nestegg. For instance, if we were able to invest our money in the Relative Value portfolio, and continue to receive a 35.8% annualized return indefinitely (highly unlikely mind you), a one-time \$10,000 investment would become a million dollars in about 15 years.

Anyone over the age of 30 knows that 15 years goes by impressively fast. Comparatively, an investment in the S&P 500 at the annualized rate of return the index has provided the last two years, 19.45%, would turn that \$10,000 into one million in 26 years. An investment in Apartment buildings (NCREIF Apartment Index), which had a two year annualized return of 11.04%, would accomplish that money increasing feat in a measly 44 years. And an investment in bonds (4.22% annualized over the last two years), as measured by the Lehman Brothers Aggregate Bond index, would do it in short 111 years.

Looked at another way, we can see how slight differences in return will result in extreme differences in the amount of money that is accumulated at the end of an investment period. For example, that 35.8% annualized return we received by investing in the Relative Value portfolio, would turn our \$10,000 investment into \$213,000 in 10 years, \$4.5 million in 20 years and \$44 billion in 50 years. An 11% annualized return, like the one you'd have gotten in Apartment building investing over the last two years, would turn \$10,000 into \$28,000 in 10 years, \$81,000 in 20 years and \$1.8 million in 50 years. Now, \$1.8 million is a lot of dough, but I'll take the \$44 billion please... to go.

	Annualized Rate of Return	Years to turn \$10,000 into \$1,000,000	In <u>10</u> Years, \$10,000 becomes:	In <u>20</u> Years, \$10,000 becomes:	In <u>50</u> Years, \$10,000 becomes:
Relative Value	35.8%	15.0	\$213,303	\$4,549,832	\$44,155,875,202
	30%	17.6	\$137,858	\$1,900,496	\$4,979,292,230
	25%	20.6	\$93,132	\$867,362	\$700,649,232
S&P 500	19.45%	25.9	\$59,132	\$349,657	\$72,294,746
	15%	33.0	\$40,456	\$163,665	\$10,836,574
NCREIF Apartment Idx	11.04%	44.0	\$28,497	\$81,206	\$1,879,198
Lehman Bros. Agg. Idx	4.22%	111.4	\$15,118	\$22,857	\$78,984

Of course, as we said at the beginning of this section, this is only a slightly useful exercise. Sadly, we can say with extreme confidence that there is no way we will generate +35% annualized returns indefinitely. In fact, an investor should not expect more than the historical return norms for the stock, real estate and bond markets and the returns we've seen over the past two years are well above average. But what we can take away from this is that an investor can do extremely well by beating the market return by only a few percentage points. The S&P 500's long term average return is about 10%-11%. If an investor can average a 15% return, over an investment lifetime of 50 years, he/she will have earned over 9x more money than he/she would have in the S&P.

Positions of note

Stocks of particular note in the Choice portfolio were eBay which rose +80% and Republic Services which rose +34% in 2004, including dividends. The Relative Value portfolio performed even better, partly due to the general outperformance of the mid-cap sector of the stock market. Standout performers in the portfolio were Berry Pete, Toll Brothers and American Eagle Outfitters, up +142%, +73% and +189% respectively in 2004, including dividends.

Gains and losses in perspective

Each portfolio had very few losing positions for the year. For the Relative Value portfolio, the average return for *all* losing stocks was -13%. The value of these stocks represented 22% of the total value of the Relative Value portfolio. By contrast, the average return for “top performers” was +99% in 2004, representing 23% of the portfolio. For the Choice portfolio, the average return for all losing stocks for the year was -15%. Losing stocks represented 24% of the Choice portfolio at year end. By contrast, the average return for “top performers” was +45% in 2004, representing 22% of the portfolio.

	Avg. Price Return of Top Gainers	% of Portfolio	Avg. Price Return of <u>ALL</u> Losers	% of Portfolio
Relative Value	+99%	23%	-13%	22%
Choice	+45%	22%	-15%	24%
S&P 500	+42%	23%	-17%	35%

Overall, our portfolios had relatively fewer losers than the market (22% and 24% vs. 35%), had average losses that weren't as significant (-13% and -15% vs. -17%) and had higher gains among the top “25%” of gainers in the portfolio (+99% and +45% vs. +42%).

Vital portfolio statistics

Our portfolios are built with value in mind. But we do not ignore growth. Compared to the market, our portfolios are built with companies that are better values with greater growth prospects than the overall market. For example, the Relative Value portfolio has a favorably low P/E (price-to-earnings) of 15.2 while the Russell Midcap and the S&P 400 have P/E's of 20.1 and 19.9 respectively. Additionally, the ROE (return on equity) and forecasted earnings growth for the Relative Value portfolio are 21.1% and 13.6% respectively. This compares well to the S&P 400 which has a ROE of 14.9% and forecasted earnings growth of 11.6%.

The Choice portfolio has a P/E (20.15) that is only slightly higher than the P/E of the S&P 500 (19.16). However, the Choice portfolio brings with it *substantially* higher ROE's than the market (37.3% vs. 19.6%) and greater long term growth prospects than the market (16.5% vs. 12.8%).

Even though our portfolios are concentrated, they are not extremely volatile. The Relative Value portfolio has a beta, which is a measure of volatility, of only 1.13 and the

Choice portfolio has a beta that is actually *less* than the market at 0.96. This serves to support the notion that excessive diversification isn't necessary to diminish portfolio volatility.

	Price/ Earnings	Price/Book	Return on Equity	Dividend Yield	Long Term Growth Forecast	Beta
Relative Value ⁴	15.19	3.10	21.12%	0.77	13.57%	1.13
Russell Midcap ⁵	20.07	2.64		1.37	12.39%	0.98
S&P 400 ⁶	19.85	2.56	14.89%	1.24	11.61%	0.98
Choice ⁴	20.15	3.09	37.32%	1.02	16.45%	0.96
S&P 500 ⁶	19.16	3.02	19.60%	1.88	12.83%	1.00
Russell 1000 ⁵	19.09	2.95		1.69	12.06%	1.00

4. Source: Foliofn

5. Source: Russell Investment Research

6. Source: Barra Investment Research

Positioning and Outlook

It continues to be a difficult, though not an impossible market for investors seeking deep value stocks, as many stocks are fairly valued. Despite this environment, we are pleased to report that most of the stocks in our portfolios were so deeply discounted at the time of purchase, that they remain undervalued and have room for further expansion. We have not had to substantially change our allocation (we only eliminated one position during the year) and we did not initiate any new positions in 2004.

To be fair part of our success over the past two years was due to the market's *overcorrection* of the 90's bull market. Stocks had been beaten down to a point that made finding undervalued securities relatively easy. Today's market offers fewer opportunities and this will present a challenge to us going forward. Although we try not to make predictions about the future, we do not expect to enjoy the outsized returns we've had for the past two years. We do expect that we will be competitive with the market, whose returns should be near historic norms. We will be taking a defensive position in the coming months, moving slowly (as usual) in attempt to preserve the gains we've made and be ready for opportunities as they arise.

As we've said, we do not like to make predictions about the future, but there is support of our position that the market may continue at least modest returns in the coming year. The following is from S&P's 2005 Annual Forecast:

The good profits posted in the current economic expansion have left corporate America with a bundle of available cash. The balance sheets of S&P 500 companies contained close to \$600 billion in cash and equivalents with less than a month to go in 2004. That compares with \$499 billion at the end of 2003 and a mere \$260 billion at yearend 1999. We expect that at least some of this cash will be put to work in the coming year.

One potential use of the funds is for mergers and acquisitions. Recent major mergers in health care, financial services, media, and telecom services suggest to us that cash-rich corporations will continue to fill in their business portfolios in 2005. That could help

boost stocks as speculators scoop up shares of potential targets. Dividend increases are another use for that cash. With taxes on qualified payments to shareholders at a low 15% maximum, we see more companies raising their payouts. That move could improve the market's long-term total return.

Share buybacks are another possible use for excess corporate cash. As long as they don't simply offset shares issued in connection with the exercise of options, buybacks often improve per share earnings by reducing shares outstanding. That can cause investors to bid up the company's shares. Companies can also use their cash for capital spending. Standard & Poor's economists estimate that spending on equipment will rise 10.8%, year over year, in 2005. Although that doesn't directly affect share prices, the purchase of new equipment should make a company more efficient, which can improve its profitability.

All that said, the market still trades at a P/E multiple of about 20 according to Barra Research at the end of 2004 based on trailing twelve month earnings. That is above the 70 year average P/E for the S&P 500 of 16. In addition, a weakening dollar (which raises the prices of imported goods) could cause inflation to rise. Should that happen the Federal Reserve may raise interest rates. These factors, taken together, may trigger a fall in stock prices despite the positive economic and corporate indicators mentioned above. Should there be a fall in market prices it would prove a boon for us and our style of investing. In that environment we would expect that we would have minimal losses and, more importantly, have the opportunity to invest at far more attractive prices.

Mistakes

Our biggest mistake during the past year had to have been our failure to eliminate some positions. After review of our portfolios over the past two years, and as outside evidence suggests, concentrated portfolios are more likely to outpace the market. The Relative Value portfolio contained 35 positions and the Choice portfolio contained 19. Bottom line our portfolios contained far too many positions. Our performance would have been much better over the past two years had we eliminated the positions that were showing small signs of deterioration, were redundant, fairly valued or not as deeply valued as we would have liked at the time of purchase. We would much prefer to own a portfolio of a small number of positions, each of which represent companies we know well and are highly confident are undervalued by the market than to be overdiversified.

Plans for 2005

Brick Financial intends to streamline the Relative Value and Choice portfolios. Each portfolio will contain fewer positions, increasing the likelihood of market outperformance. Our goal is to eliminate 10-12 positions from the Relative Value portfolio during the year. In addition, we hope to eliminate about 5-8 positions in the Choice portfolio. Although this may increase the volatility of these portfolios, we manage these portfolios with the long term in mind. So we will sacrifice volatility over the short term for superior long term gains. And evidence suggests (see Vital Portfolio Statistics) that given our style of investing – value oriented – the volatility of our portfolios may actually be *less* than market. Even if this were not the case, we plan on adding to our investment mix, portfolios that address the “volatility problem” directly through use of ETF (exchange traded fund) index positions.

ETFs are diversified portfolios of stocks and bonds that trade as a single stock. Most are akin to index mutual funds, but offer distinct advantages.

- Lower Expenses - typically offer lower expenses and they are always no-load.
- Tax Efficiency - ETFs are typically based on broad indices, and there is no active management within them.
- Flexibility - ETFs trade at any time during the trading day, unlike mutual funds that trade at the end of the day based on only one price level per day.
- ETFs are not constrained to a "minimum order" and can employ the use of stop and/or limit orders, as well being able to be sold short.
- ETF purchases are not subject to round-lot orders.

The ETF strategy will entail style-rotation and sector-rotation methodologies designed to create prospective outperformance versus the broad market. We will primarily use these securities to decrease the volatility in the portfolios of clients that are in the 'withdrawal' stage of their investment life. Because of the diversified nature of ETFs, one can eliminate single-stock risk and the risks inherent in the concentrated portfolios that we employ.

We will also be adding a portfolio, likely to be constructed as the Relative Value portfolio is, with emphasis on small cap positions. For lack of a better name, we will call it the Relative Value Smallcap model portfolio. History has shown that a portfolio concentrated in small cap issues, has outperformed the general market (represented by the S&P 500). Thus we want to help our investors take advantage of this sector of the market.

Finally, our firm will more consistently distribute writings on a myriad of financial topics in the coming year. This will include commentary on issues relating to the general market, our portfolios, specific companies, our philosophy, personal financial issues and general musings on life. We hope you will enjoy our upcoming letters.

Articles of interest

Please check Brick Financial's website in the coming weeks for the following writings:

- In *The 529 Dis-advantage*, we discuss why College Savings Plans (529 Plans) are an inferior vehicle for your investment dollars.
- In *What Can You Really Afford*, we stress how very few consumers understand what "afford" really means and we discuss ways to determine what you can really afford.
- In *Value Investing in Real Estate: A Rebuttal*, we review Dr. Gary Eldred's book and rebut many of his conclusions on the superiority of small property real estate investing vs. stock market investing.

Thank you for your continued confidence in us and our portfolios. As always, we welcome your comments or suggestions so please don't hesitate to call us at (973) 313-1220 or email us at info@brickfinancial.com.

Sincerely yours,
Benjamin B. Taylor