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July 15, 2005

Re: June 2005 Client Letter / Mid-Year Review

Dear Partners, Clients and Friends,

After last month's strong performance, our model portfolios had mixed results in June. The Relative Value model portfolio advanced 5.5% while the Choice model portfolio declined 2.4%. The returns for both model portfolios versus relevant stock market indices (including reinvested dividends) as of June 30, 2005 follow¹:

	June	YTD 2005	2004	2003	2002	Since Inception
Relative Value²	5.47%	2.00%	33.54%	44.09%	-2.09%	92.15%
Russell Midcap	2.69%	3.92%	20.22%	40.06%	-1.10%	73.01%
S&P 400	2.32%	3.85%	16.48%	35.62%	-4.10%	57.31%
Choice³	-2.37%	-12.18%	15.31%	22.31%		23.88%
S&P 500	0.14%	-0.81%	10.88%	32.87%		46.13%
Russell 1000	0.41%	0.11%	11.40%	29.65%		44.53%
Russell 3000	0.70%	-0.01%	11.95%	31.06%		
Dow 30	-1.69%	-3.65%	5.31%	28.26%		
Nasdaq	-0.5%	-5.12%	9.15%	50.77%		

¹ 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, Dow Jones, Nasdaq and Bloomberg.

² 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. All returns are total returns.

³ 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. All returns are total returns.



A mixed bag

The economy continues to expand at its historic real rate of about 3½%, inflation has been low at about 2½%, and interest rates continue to remain at reasonable levels given our low inflation environment. The price-to-earnings ratio (P/E) on the S&P 500 is about 17.7 and the dividend yield stands just above 2%.⁴ In other words we are in a favorable economic environment for long-run compound returns of 7½ - 9%.⁵

So much for favorable economic conditions. Investor pessimism in the form of fears over inflation, rising energy prices and rising interest rates seems to be depressing equity returns. Although our assessment of economic conditions leads us to expect compound returns north of 7%, year-to-date returns are essentially flat (-0.81%). In an environment where actual returns lag expected returns, one would think that the market is offering a plethora of undervalued companies. The irony here is that we see much of the investment landscape as fairly, if not over-valued. While some of the largest companies in the market are trading below historical norms we think that much of the market is expensive [the real estate sector, mid- and small-cap stocks].

The short-term does not tell us much

In the short-term⁶ however, it is extremely difficult to draw any meaningful relationship between events in the economy and the action of the stock market. This inability to draw relationships between recent events and price movements also applies to the stocks of individual companies. Over a month, or even several years, price movement of stocks in general and of individual companies specifically are at best random. That randomness is most times unexpected and unexplainable and has the potential to both frustrate and exhilarate. Our job as prudent investors is to find some emotional middle ground. Hopefully, by exercising our *emotional* intelligence, we may be able to ascertain whether

⁴ Source: Barra, Bureau of Economic Analysis (BEA).

⁵ An easy way to estimate the long-run expected compound return (ER) of the stock market is to take the earnings yield (EY) of market, which is the inverse of the price-earnings ratio (P/E), and add the current rate of inflation. For example, according to Barra the earnings yield for the S&P 500 (a proxy for the stock market) at the end of June was 5.7% (the inverse of the P/E of 17.7) and inflation has been about 2.5%. This gives us an ER for the market of 8.2%. Another formula is the Gordon equation which states that $ER = (DY + g)$, where DY is the dividend yield of the stock market and g is the nominal growth rate of GDP. The Gordon equation gives an ER in excess of 8% as well. We prefer the Phillips formula which relates book value to the expected return of the market. [The formula incorporates both dividends and earnings.] The formula is $ER = g + (ROE - g) * B/P$, where ROE is the return-on-equity of the market and B/P is the total book value of equities divided by total market value. In the current environment this formula would give us an ER in excess of 10%. See Thomas K. Phillips, "Why Do Valuation Ratios Forecast Long-Run Equity Returns?" *Journal of Portfolio Management* (Spring 1999): 39-44.

⁶ We view the short-term as any investment time horizon that is less than a year. By contrast we view a long-term investment time horizon as 5 years or more. Ideally, we'd say that the long-term time horizon in the equity market should be more than 10 years. Ten years is more in line with natural business cycles. [Warren Buffett is said to only consider investing in companies that have at least a 10 year history.] But this of course is in conflict with our natural human tendency toward immediate gratification. Taking our humanness into account, we've determined 5 years as the compromise. The intermediate term (1 to 5 years) is dangerous as it will give us just enough time to *think* we have all the information we need, when in fact we do not.

those price movements are justified by the news. This somewhat detached approach will allow us to either capitalize or protect ourselves when either action is appropriate.

How recent news has affected the stocks we own

June represented a light month in terms of news about our companies. The news that was reported had, in our opinion, little effect on the long-term *operational* outlook of the companies we own. In other words, our original investment thesis and our estimate of the intrinsic value of each of these companies remain largely unchanged. However, the *stock prices* of some of these companies proved extremely sensitive to what, if anything, was reported.

In the Choice model portfolio...

- eBay declined by 13.1% this month due mostly to Google's announcement that it would introduce a competing online payment service which would rival eBay's PayPal. Tech industry analysts (as opposed to stock analysts) believe that Google's payment service poses little threat to PayPal.
- Lincare declined almost 7.0% most likely due to concerns over Medicare cuts even though that information had been known since April.
- Amazon.com sank 6.8% on almost no significant news. We'll chalk that one up to random movement.
- Jet Blue was down 5.9% due to the ever increasing cost of oil.

In the Relative Value model portfolio...

- Barr Pharmaceutical was down about 4.1% due to lawsuits for alleged patent violations of the drug Razadyne, a treatment for Alzheimer's dementia

A long-term mindset gives us an advantage

We can not say for certain the importance we should allot to any of the above events or if those event are even the cause of the price changes. We are making an educated guess. In any case, this news is but one more piece of information in a mosaic of other pieces of information we must consider. But we can not ignore it. It is imperative that we make some probabilistic judgment of how this information affects our investment thesis for each of these companies. [We've already stated that on our initial review, we do not think the recent news changes to any great degree our original investment thesis.] As we suggested earlier, making long-term judgments is difficult to do in the short-term. So how do we get around this paradox – having to make long-term judgments given small amounts of (and possibly inconsequential) information? We lengthen our investment horizon.

Short-term investors, by the very nature of being short-term, are compelled to draw immediate conclusions using only small pieces of information. This is akin to determining the subject of a 1,000 piece puzzle when all you have is the corner piece at your disposal. We, as long-term investors, have the benefit of delaying such a

determination. We can sit and wait for the other 999 pieces to come into our possession before drawing any conclusions.

We've outperformed the "competition" (so far)

We credit our adherence to a value-oriented approach and our focus on the long-term for the overall success of our portfolios. We've been able to meet our two investment goals: to increase your (and our) capital and to outperform in aggregate relevant market indices. We've also been able to outperform our "competition" in the form of mutual funds. For example using data from Lipper Research and the Wall Street Journal⁷ we find that:

- had the Choice model portfolio been a mutual fund in 2004, it would have ranked 5th among the 925 Large-Cap Core Equity mutual funds with a return of 15.3%,
- had the Relative Value model portfolio been a mutual fund in 2004, it would have ranked 1st among the 303 Mid-Cap Core Equity mutual funds with a return of 33.5%,
- had the Relative Value model portfolio been a mutual fund for the 12 months ending June 30th, it would have ranked 2nd among 302 Mid-Cap Core Equity mutual funds with a return of 23.7%,
- for the years 2003 to 2004 the Choice model portfolio had a total return of 41.0% while the average total return for Large-Cap Core Equity mutual funds was 39.9%,
- for the years 2003 to 2004, the Relative Value model portfolio had total return of 92.4% while the average total return for Mid-Cap Core Equity mutual funds was 57.2%.

One unfortunate consequence of long-term (concentrated, value-oriented) investing

To recap, we have pointed out that,

- it is hard to ascertain the degree of importance of recent news,
- accurate conclusions can not be drawn from small amounts of information,
- price movements are at best random, unexpected and unexplainable in the short-term,
- price movements may greatly diverge from expectations in the short-term,
- our portfolios have outperformed relevant indices and mutual funds in the long-term.

Although we're pleased with how we've progressed with our investments, the picture is not all rosy. Despite our long-term⁸ success, our short-term results have disappointed as year-to-date, both of our model portfolios trail their respective indices. However, we should keep in mind that (at the risk of being redundant) stock price movements, both

⁷ Mutual fund data was obtained from the Wall Street Journal's Quarterly Mutual Fund Review which can be viewed at <http://www.wsj.com>. Lipper is a research firm specializing in the mutual fund industry.

⁸ "Long-term" is relative here given that all our portfolios are less than 5 years old. Our oldest portfolio is 31 months old (~2.5 years).

positive and negative, are random, unexpected and unexplainable in the short-term. Given this truth, we do not feel that six months is an adequate time frame to judge how we are performing on your behalf, especially, using price movement as the only gauge. Our short-term *underperformance* could simply be random.

That said, trailing the market is not something we like but it is something we will endure. The one unfortunate consequence of our style of investing is that we will lag the market from time to time, sometimes substantially, sometimes for several years in a row. This is inevitable.⁹ We often times invest in companies that are out of favor, misunderstood or are going through some turmoil. Most of the time we feel there has been an exaggerated negative reaction to the company depressing its stock price unjustifiably. It may take years (hopefully not decades) for the market to recognize our companies' inherent intrinsic value. During those interim years, when our companies' value goes unrecognized or is misjudged by the market, we may have to live through rough (hopefully temporary) periods of low relative returns.

But you should, as we do, take solace in the fact that in the long-run the "market is a weighing machine".¹⁰ Given enough time and enough information the market will in most instances afford companies their due fair market price. You should also be comforted by the fact that our value-oriented approach provides us investment "insurance" in the form of a margin-of-safety. We will only expend your (and our) hard earned dollars when market prices of securities are far below our estimate of their intrinsic value. Utilizing the margin-of-safety principle is analogous to a truck driver with a 10,000 pound load making sure that the bridge he is crossing has a 30,000 pound capacity – he is leaving considerable room for error.

Even the "Greats" have down years

Some of the world's greatest (and some modern day greats) investors have had periods where their portfolios underperformed. In Table 1¹¹, we point out how investors like John Maynard Keynes, Charles Munger, Bill Miller and James Gipson all at some point trailed the market. As a group these great investors have underperformed the market averages 34% of the time. [That's about once every three years for the mathematically challenged.] You will also notice that all of these investors with the exception of Warren Buffett¹² had extended periods where their portfolios lagged the market by as much as 50% [Hawkins]. Yet every single one of these investors has outperformed the market over long periods of time, most by a significantly wide margin.

⁹ You should not take this commentary as an admission or a prediction that we will loose to the market in this year or in any.

¹⁰ Attributed to Benjamin Graham, this refers to his assessment that in the short-term the market is nonsensical in the pricing of securities [a voting machine], but in the long-run the market tends to reward companies with appropriate market prices [a weighing machine].

¹¹ Source: Robert Hagstrom, *The Warren Buffett Portfolio*, (New York: John Wiley & Sons, Inc. 1999) pp. 69-70; Longleaf Partners Funds; Legg Mason Funds; Oakmark Funds; Clipper Funds; Ariel Funds.

¹² At the risk of being accused of blasphemy, let me suggest that had Buffett's partnership had a longer history, he too would have suffered years where his portfolios trailed the market. It is possible that his undefeated record is partly due to luck. (No letters please.)

Table 1. Value-oriented, focus investors and years/degree of underperforming the market

Manager (Fund/Company) ¹³	Total Years	Years Underperformed	Years Underperformed (as percentage)	Worst Relative Performance During Period of Underperformance
Keynes (Chest Fund)	18	6	33%	-18%
Buffett (Buffett Partnership)	13	0	0%	N/A
Munger (Munger Partnership)	14	5	36%	-37%
Ruane (Sequoia)	27	10	37%	-36%
Simpson (GEICO)	17	4	24%	-15%
Miller (Legg Mason Value)	23	4	17%	-25%
Hawkins (Longleaf Partners)	17	8	47%	-50%
Nygren (Oakmark Select)	8	3	38%	-19%
Gipson (Clipper)	20	11	55%	-39%
Hagstrom (Legg Mason Growth)	10	6	60%	-35%
McKissack (Ariel Appreciation) ¹⁴	15	5	33%	-34%
Totals for group	183	62	34%	

Buffett's rules of money management

The above analysis begs the question, “Are losses acceptable?” This question is not as straight forward as it may seem on the surface. In fact the question begs yet another question. Namely, “What kind of losses do we mean?” Do we mean the kind of losses that are temporary which can usually be attributed to the normal, albeit sometimes irrational and extreme, volatility of the market? Or are we talking about the kind of losses that result in the permanent loss of capital? When Warren Buffett laid out his rules of money management, the first of which is “Don’t lose money” and the second of which is “Don’t forget the first rule”, he was talking about the latter (read permanent loss of capital) and not the former.

It is important for us as long-term investors to differentiate between temporary losses and that of the permanent ilk. Volatility in stock prices is just part of the investment game. It is something that can not be completely managed away. In order for us to have the confidence to continue with our investment program, we can not allow ourselves to be scared off by a temporary drop in our portfolio. We must constantly remind ourselves that such a period “too shall pass”. Mind you we do not *accept* losses of any kind, but we should be prepared for the temporary kind in the short-term and avoid the permanent kind in the long-term.

¹³ The market proxy for the Keynes portfolio is the U.K. market; the proxy for the Buffett and Munger portfolios is the Dow Jones Industrial Average; the proxy for all other portfolios is the S&P 500.

¹⁴ Eric McKissack managed the Ariel Appreciation fund until the end of 2002. The fund is currently managed by John Rogers.

The *major* problem with short-term performance measurement¹⁵

One major problem of apportioning too much relevance to short-term performance is that on occasion bad decisions with favorable outcomes are often well received while good decisions with temporarily unfavorable outcomes are met with fervent objection.

Variance from expected and intended results are just as “wrong” when the apparent result is above expectation as when the result is below expectation. Of course it is nice when we are “wrong” yet our returns are outstanding. However it would be improper for us, and an error on your part, to assign us some superior investment skill in such an instance. It would be equally improper for us (or you) to label us handicapped in our investment skill simply because our short-term performance is poor, when in fact our process and judgment may have been “correct”. In the words of Benjamin Graham,

“You are neither right nor wrong because the crowd [the stock market] disagrees with you. You are right because your data and reasoning are right.”

If returns don’t tell us much in the short-term, then why measure/report them?

The main reason for measuring performance is to improve communication between you and us. The purpose of performance measurement is not to provide answers *per se*, but rather to identify questions that you as a client (or potential client) may have. Those questions should be explored together with us so that you have an understanding of our investment approach and philosophy. Armed with that knowledge, you will be able to better identify what may be detracting from or contributing to the performance of our portfolios.

The most effective and informative use of these Client Letters is to determine *not* whether our portfolio performance is superior or inferior. But to give you a tool so that you can better form an opinion regarding the likelihood of our meeting our stated dual investment objective which we’ve already mentioned but is worth repeating. Our dual investment objective is to,

- Increase your (and our) invested capital, consistent with reasonable risk, and
- Outperform the market indexes over long periods of time.

If not returns, how should you judge our performance in the short-term?

We have set up a series of investment and business principles which will have a direct and indirect effect respectively on our long-term performance. These principles are intended to guide us in our daily pursuit of serving you better. By closely following these principles we have faith that we will be in the high probability position of achieving our

¹⁵ The following two sections are liberally paraphrased from and greatly influenced by Charles D. Ellis’ excellent book, *Winning the Loser’s Game*, (New York: McGraw-Hill 1998) Ch. 14, Performance Measurement, pp. 71 – 81.

dual investment objective. Thus, we encourage you to measure our behavior against these principles.¹⁶

You should make a practice of regularly asking and answering the following questions related to our investment approach:

- Has Brick Financial demonstrated behavior that is in line with its commitment to a long-term investment philosophy?
- Has Brick Financial deviated from its preference for owning a concentrated portfolio of common stock positions of companies that it understands well? If so, why? Do the companies generate high degrees cash and generate high returns on capital/equity? If not, why not?
- Is Brick Financial adhering to a value-oriented approach to investing?
- Is Brick Financial concentrating on what it knows best - stock investing - or is it delving into areas that are not likely to bring positive future results?

You should also make a practice of regularly asking and answering the following questions related to our approach to running our business:

- Has Brick Financial exhibited a partner-centric approach to its business?
- Are the principals of Brick Financial “eating their own cooking” by placing their personal funds in the same investments it recommends to its clients?
- Has Brick Financial made efforts to make the investment process easier for investors of all sophistications to understand?
- What, if anything, has Brick Financial done to make investing more accessible to more people?
- Is Brick Financial being candid and forthright in its communications with its clients? Is the firm encouraging an open dialogue?
- Is Brick Financial encouraging diversity in its clientele and the companies in which it invests?

This is admittedly a qualitative pursuit but not a trivial one. Asking and answering these questions will allow you to determine whether we’ve made good decisions on your behalf even when the short-term quantitative measures of performance are disappointing.

Two examples

To reiterate, we want you to measure us against our stated principles. But how do you do this practically? We offer you the following two illustrative examples:

Do the companies that Brick Financial invest in generate high degrees of cash and generate high returns on capital/equity?

¹⁶ Brick Financial Management, LLC’s business and investment principles can be viewed along with its vision and mission statement by clicking the following link: (http://www.brickfinancial.com/about_us/mission.pdf).

In our December 2004 Client Letter

(<http://www.brickfinancial.com/letters/200412clientletter.html#stats>) we pointed out that the companies we invest in have demonstrated the ability to generate high relative returns on equity¹⁷ (ROE). At the end of 2004 the companies in the Choice model portfolio had a collective ROE in excess of 37% while the S&P 500, the Choice portfolio's closest benchmark, had a ROE of just over 19%. The companies in the Relative Value model portfolio had a similarly high ROE of 21% while the S&P 400, an index of mid-cap companies, had a ROE of just below 15%. As of June of this year, the companies in our portfolios continue to produce higher ROE's than the market in general.

Is Brick Financial adhering to a value-oriented approach to investing by insisting on a margin-of-safety?

Cash is king - free cash flow that is. Free cash flow which we define as a company's cash from operations¹⁸ minus its capital expenditures¹⁹ is the lifeblood of a company. It is the amount of cash that a company has left over after it has paid all of its expenses. We continually search for companies that produce high degrees of free cash flow. But we will *not* pay any price for the privilege of owning those companies. We will always invest with a margin-of-safety in place.

For example, the average market price-to-free-cash-flow (P/FCF) of the 25 largest non-banking companies of the S&P 500 was about 25x at the end of June. [These companies represent 31% of the total market capitalization of the S&P 500, thus serving as an appropriate proxy for this analysis.] In stark contrast, the average P/FCF of the non-banking companies in the Choice portfolio stood at about 20x. More importantly, our average *purchase* P/FCF of the companies in the Choice portfolio was more like 17x, a substantial discount to the market. These figures strongly suggest that we have adhered to a value-oriented approach to investing by always insisting on a margin-of-safety in our purchases.

[A caveat: We believe that low price multiples (price-to-cash, price-to-earnings and price-to-book) are not *proof* that a company is undervalued but rather an *indicator* that a company is undervalued. In general price multiples do not define intrinsic value. They tell nothing of a company's competitive advantage, its growth potential, its capital

¹⁷ Return on equity: A measure of how well a company used reinvested earnings to generate additional earnings, equal to net income divided by book value, expressed as a percentage. It is used as a general indication of the company's efficiency; in other words, how much profit it is able to generate given the resources provided by its stockholders.

¹⁸ Cash from operations: An accounting of funds related to the company's operations, reported on the cash flow statement of a company's annual report. This figure is calculated by adjusting net income to reflect depreciation expenses, deferred taxes, accounts payable, accounts receivable, and any extraordinary items. It shows how much money the company received from its actual business operations. This does not include cash received from other sources, such as investments.

¹⁹ Capital expenditures: Money spent to acquire or upgrade physical assets such as buildings and machinery – items usually needed for the ongoing operations of the company.

allocation process or its personnel (management) capabilities. Yet, all these factors matter.

A company's intrinsic value is however determined (estimated) by discounting to the present its future free cash flows (DCF method). Although we use a multifactor process in estimating a company's intrinsic value, including the use of price multiples, the DCF method is what we rely on most. Though undervalued companies and low price multiples frequently occur together, using the DCF method to estimate the value of companies reveals that this occurrence is not a requisite. This is the very reason we can purchase with confidence high price multiple companies and still adhere to the value-oriented investing philosophy.]

Communication is key to serving you well

You should take note that we are constantly trying to improve our level of service. In that vein, we often reflect on the information we think is important and the best way for us to deliver it to you so that you will in turn become a more knowledgeable, better informed investor. We want to avoid the scenario where we are speaking French yet what you hear is Spanish and you are further frustrated because the only language you speak is Japanese. Communication fails when both parties do not speak and understand the "same language".

One way we may have failed in our communication with you is in possibly giving you the false impression that short-term returns are important and/or significant in foretelling long-term returns. We may have unwittingly done this by starting off each Client Letter with a monthly synopsis of how our portfolios performed over the previous month. Let us say now that this was and is not our intent. This is one, though certainly not the only, reason we have dedicated the lion's share of this letter to the topic of allotting the proper significance to short-term results. The decision to place this synopsis at the beginning of each letter was simply a decision in formatting.

Upon further reflection, it is possible that this decision was partly influenced by our human tendency toward wanting to brag. Perhaps we formatted these letters this way because we were having good results with our portfolios and we wanted this to be something you noticed. Of course, we are only offering this as a possibility. If it was/is indeed true, rest assured that this was/is not a *conscious* part of our decision.

Some of you might remark that this whole exercise of worrying about formatting is pointless. You might say it amounts to a sort of visual semantics. But as your wealth building concierge we are not only responsible for directing your investment strategy on your behalf but we have a duty to inspire you with the proper mindset for successful long-term investing as well. Something seemingly as insignificant as formatting our Client Letter may be one tool we can use to help us serve you better.

In the future we will resist the urge to "pop our collar" when we have good results. But we will also resist the urge to skirt the issue when we have poor results. And it will be

and has been our aim to deliver to you a reasonable explanation should either result occur.

Another way we hope to improve our communication with you is by actively asking and answering in each Client Letter at least one of the principle based questions we presented to you. We expect that by doing so it will have the double benefit of getting you in the practice of doing the same and focusing our efforts on the things that matter most. We hope this letter is a good start.

Some final thoughts

As some of you are already aware, we are now officially a part of the blogging culture. We have started a blog at <http://www.brickfinancial.com/brickblog.html> where we elaborate on “Anything money and many things not”. More of you will recognize this as just a way for us to rant about some money issue. We’ll gladly accept that assessment. But we hope that our so-called rants will be at least entertaining and informative to you. So we welcome you to check our website from time to time for updates to our blog space and we invite your comments.

And lastly, we would like to ask for your referral. As we said in our May 2005 Client Letter, (<http://www.brickfinancial.com/letters/200505clientletter.html#refer>) nothing has as much cache or is as important to Brick Financial Management’s business success as your seal of approval.

As always, thanks for your confidence in us. Please don’t hesitate to call us at (973) 313-1220 or 1-888-BRICK-10 or email us at info@brickfinancial.com.

Sincerely,



Benjamin B. Taylor