

# Brick Financial Management LLC

Benjamin B. Taylor  
Investment Manager

phone: 973-313-1220  
toll free: 888-BRICK-10  
<http://www.brickfinancial.com>

September 15, 2005

Re: August 2005 Client Letter

Dear Partners, Clients and Friends,

**Our model portfolios both took a downward slide in August.** The Relative Value model portfolio returned -4.8% and the Choice model portfolio returned -2.5%. The returns for both model portfolios versus relevant stock market indices (including reinvested dividends) as of August 31, 2005 follow<sup>1</sup>:

	August	YTD 2005	2004	2003	2002	Since Inception
<b>Relative Value<sup>2</sup></b>	<b>-4.78%</b>	<b>3.09%</b>	<b>33.54%</b>	<b>44.09%</b>	<b>-2.09%</b>	<b>94.22%</b>
Wilshire 4500	-1.15%	6.33%	18.10%	43.84%	-4.21%	73.01%
Multi Cap Mutual Funds	-0.55%	3.15%	11.05%	29.89%	-5.39%	40.77%
<b>Choice<sup>3</sup></b>	<b>-2.50%</b>	<b>-7.27%</b>	<b>15.31%</b>	<b>22.31%</b>		<b>30.81%</b>
S&P 500	-0.91%	1.94%	10.88%	32.87%		50.19%
Large Cap Mutual Funds	-0.93%	1.53%	7.79%	25.59%		37.44%
<b>Portfolio Average<sup>4</sup></b>	<b>-4.16%</b>	<b>-0.02%</b>	<b>28.07%</b>	<b>37.31%</b>	<b>-2.09%</b>	<b>72.15%</b>
Wilshire 5000	-0.90%	3.24%	12.48%	31.64%	-5.54%	44.41%
All U.S. Mutual Funds	-0.81%	3.38%	11.96%	32.44%	-5.46%	44.92%

<sup>1</sup> The returns of the Relative Value and Choice model portfolios and the Portfolio Average are determined using a technique known as "time-weighted return on investment" and include all capital gains and reinvested dividends. They do not represent actual trades or returns of client portfolios although client portfolios are based on the model portfolios. Client portfolio returns may be higher or lower than the model portfolios' returns. The model portfolios are presented here 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. The Relative Value and Choice model portfolio data is maintained at Foliofn.com. The index and mutual fund data comes from several sources including Wilshire, Standard and Poor's and The Wall Street Journal (Lipper Mutual Fund Averages).

<sup>2</sup> The inception date for the Relative Value model portfolio is 12/6/2002.

<sup>3</sup> The inception date for the Choice model portfolio is 4/4/2003.

<sup>4</sup> The Portfolio Average is meant to represent the weighted average of the Relative Value and Choice model portfolios. Returns for the Average are determined as follows: A split investment (70% in the Relative Value, 30% in the Choice) is assumed to be made at the beginning of each calendar year and rebalanced every subsequent calendar year. Inception date for the Average is 12/6/2002.



## **Paring down our positions**

Over the last few months we have been paring down our positions. If you recall, in our [December 2004 letter](#), we said that our biggest mistake of the year had been that we were *overdiversified*. To correct that mistake, we have spent a lot of time trying to concentrate our portfolios in our best ideas.

## **Our sell criteria**

With each position we have sold, we applied our sell criteria. Circumstances requiring such action include:

- The company has reached full valuation or has reached a level where future returns would be sub-par,
- Current price multiples are well above long-term historical average price multiples,
- The economics of the company are deteriorating,
- Management proves to be inept or irresponsible,
- We have found a superior investment alternative,
- When we have made a mistake in calculation or judgment.

In each case, the companies we sold met at least one of these criteria. In the case of a few of the companies, although we found reason to sell them, they remain great companies. Thus, it is possible that these companies will continue to provide great returns in the future and we will regret our decision to sell them. But given our goal of “concentrating on our best ideas” we had to make some tough decisions.

In the following paragraphs we discuss briefly a few of the companies we sold and our rationale for selling them. We hope that by sharing our thought process on each you will better understand how we manage your money (and ours).

## **Time Warner, the entertainment juggernaut**

Time Warner is one of the largest media and entertainment companies in the world. With businesses in five fundamental areas including the internet (America Online), cable, digital phone services, movies (Matrix Trilogy) and television (WB Network) and publishing (Fortune magazine), consisting principally of magazine and book publishing, it is a company that is far reaching. The company produces several billion dollars of free cash flow each year and earnings should continue to grow in the high single to low double digits.

## **Time Warner: a catalyst dependent investment**

Time Warner had been in the Choice portfolio since its inauguration yet we recently sold our position. We bought into Time Warner at about \$13 sold at \$18 representing an annualized return of just over 16% for the period we owned the stock. This performance edged out the price return of the S&P for the same period by a margin of about 4%. We still consider the company a stellar enterprise with assets that will allow it to continue to grow organically. But we felt that the company has become somewhat bloated. In order for it to realize some of its underlying value we felt that the company would have to sell some of its businesses which management has thus far seemed reluctant to do. We don't want the companies we own to be catalyst driven for us to earn superior returns. Thus we felt we could get more immediate gratification by taking our money out and placing it elsewhere.

### **Moody's wide moat business**

Moody's is a wonderful example of a company with a wide moat around its business. The company provides credit ratings, research and analysis covering debt instruments and securities. Government requirements for admission into the business have left only a few players (including McGraw-Hill's Standard & Poors). Approximately 80% of Moody's revenues are derived from providing ratings on firms issuing debt. Although the level of those revenues is highly dependent on the number of debt issues by corporate America and government in any given year, this revenue stream is quite secure. The marketability of debt is highly dependent upon favorable ratings from Moody's.

Moody's turned in another excellent quarter at the beginning of 2005 by producing stronger-than-expected results. First-quarter earnings climbed 15% on revenues that increased 18% to \$390.5 million. We have confidence that the company is likely to continue its winning ways. This notion is supported by Warren Buffett as the company remains one of Berkshire Hathaway's largest holdings.

### **Why we sold Moody's**

Nevertheless, we humble investors at Brick Financial have chosen to sell the stock. Our decision to sell was primarily based on the fact that Moody's is in the midst of a period that has seen its price multiple expand to historically high levels (~35x earnings). Widespread slowdowns in debt issuance, on which Moody's fees are highly dependent, are likely to depress earnings growth making the stock vulnerable to downward pressure. We however doubled our investment in stock over the period we held it. Should the price multiples come down to a more reasonable level, say 20x to 25x, you will likely see Moody's return to our portfolio.

### **JetBlue, the gem of the airline industry**

Over the past few years, JetBlue has been the gem of the airline industry. It has executed to a degree that far exceeds any competitor in terms of operating margins, revenue growth and labor costs. If JetBlue continues to execute as it has, there's a good chance that it will grow at compound rates that should significantly exceed the returns of the S&P 500.

We were cautious when we bought the stock back in the spring of 2003. (The stock never exceeded more the 2.5% of the portfolio.) At the time it was trading at about 35x earnings which we thought was expensive. But given the company's upside we thought the investment worth the risk. What we did not fully appreciate were some of the challenges that JetBlue faces. One was its vulnerability to rising oil prices. Although all transportation businesses were affected, airlines seemed to be especially so, and JetBlue was no exception. The other issue was the realization that although JetBlue's operating and labor costs are presently low - as planes age, as employees become unionized, as new markets become more scarce - the company's costs are bound to rise.

### **Our mistakes with JetBlue**

We made several mistakes on this purchase. First, we did not have a full understanding of all the factors that could affect the business and the stock. Further, we did not provide ourselves a wide enough margin of safety. We should have weighed JetBlue's rich valuation more

heavily in our analysis. Third, although acting slowly benefits us in most cases, in this case it hurt us. We missed an opportunity to sell JetBlue as the stock skyrocketed, nearly doubling in a short period of time after our initial purchase. As it turned out we broke about even on our investment. And finally, JetBlue is probably (at least right now) not the type of investment we want to own in the Choice portfolio. We would rather own companies where their competitive advantages are more established and apparent. This company, being an upstart in the industry, had only shown the *potential* to be dominant. It had not yet *demonstrated* that dominance.

### **We are cash flush**

Our reasons for selling these three stocks are representative of how we apply our sell criteria. We think by selling these investments we've improved our odds of outpacing the market (over the long term). Something to note is that by selling these investments we've put ourselves in a position where we now have to decide what best to do with the proceeds of each sell. What to do with our "cash" so to speak. We will address this in a future letter.

### **Refer us**

As usual, we would like to ask for your referral. As we said in our [May 2005 Client Letter](#), 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](mailto:info@brickfinancial.com).

Sincerely,



Benjamin B. Taylor