

# Brick Financial Management LLC

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October 4, 2005

Re: September 2005 Client Letter

Dear Partners, Clients and Friends,

**Our model portfolios both decreased 2.1% in aggregate in September.** The Relative Value model portfolio returned -2.5% and the Choice model portfolio returned -1.1%. The returns for both model portfolios versus relevant stock market indices (including reinvested dividends) as of September 30, 2005 follow<sup>1</sup>:

	Sep	YTD 2005	2004	2003	2002	Since Inception
<b>Portfolio Average<sup>2</sup></b>	<b>-2.13%</b>	<b>-2.14%</b>	<b>28.07%</b>	<b>37.31%</b>	<b>-2.09%</b>	<b>68.49%</b>
Wilshire 5000	0.80%	4.07%	12.48%	31.64%	-5.54%	45.57%
All U.S. Equity Funds	0.97%	4.41%	11.96%	32.44%	-5.46%	46.37%
<b>Relative Value<sup>3</sup></b>	<b>-2.51%</b>	<b>0.50%</b>	<b>33.54%</b>	<b>44.09%</b>	<b>-2.09%</b>	<b>89.34%</b>
Wilshire 4500	0.76%	7.13%	18.10%	43.84%	-4.21%	74.32%
Multi Cap Core Funds	0.94%	4.24%	11.05%	29.89%	-5.39%	42.25%
<b>Choice<sup>4</sup></b>	<b>-1.14%</b>	<b>-8.33%</b>	<b>15.31%</b>	<b>22.31%</b>		<b>29.32%</b>
S&P 500	0.81%	2.77%	10.88%	32.87%		51.40%
Large Cap Core Funds	0.92%	2.49%	7.79%	25.59%		38.74%

<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 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.

<sup>3</sup> The inception date for the Relative Value model portfolio is 12/6/2002.

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



### **We've changed our benchmarks**

As you have noticed in our past few letters to you, we have changed the benchmarks in our return presentation. In the past we benchmarked the Choice portfolio against the Russell 1000 and the Relative Value portfolio against the Russell Mid-cap and the S&P 400. Over time however, we realized that those indices may not be the best benchmarks for our portfolios. We felt that on some level we were not making an apple (our portfolios) to apple (proper market index) comparison. In other words, we felt that by using these particular indices, we were impairing your ability to (as stated in our [June 2005 letter](#)),

“...better form an opinion regarding the likelihood of our meeting our stated dual investment objective (which is to), (1) increase your (and our) invested capital, consistent with reasonable risk, and (2) outperform the market indexes over long periods of time”

### **We think benchmarking is important**

You read in our [July 2005 letter](#) that we think benchmarking is of utmost importance in any investment program.

“(An investor) must go through this exercise (of benchmarking) if he is to ascertain if he is making the most of his effort. If he is not adding value, then why bother. Brick Financial seeks to provide investment returns net of costs superior to returns that might be achieved in an index mutual fund of similar characteristics as our portfolios. By doing this, you will know if we are adding value over the long term to your investment program.”

### **Apples to apples**

But for such an exercise to be informative, we need to make certain that we are making that apples to apples comparison. As an illustration, if a general manager of a baseball team were trying to assess whether or not to add a particular professional baseball player to his roster, he would use measurable statistics like, RBIs, stolen bases, errors or batting average. Though he would have these figures, alone they would mean nothing to him. The stats wouldn't exhibit any relevance until compared to the stats of other baseball players *of similar caliber or characteristics*. Meaning, the general manager would have to compare the performance of the professional player in question to the performance of other professional players. What he would *not* do is compare that player's performance to say a high school player's performance.

### **Characteristics of the Choice and Relative Value model portfolios**

In seeking the proper index(es) it is imperative that we understand *our* portfolios' characteristics first. As stated on our [website](#):

“The Choice model portfolio invests in the common stocks of *U.S. based companies* of all sizes but is concentrated in *large and medium capitalization* stocks... While these companies may be considered

traditional ‘value stock’ companies... *they may not necessarily be so... (value and growth)*”

“The Relative Value model portfolio invests in the common stocks of *U.S. based companies* of all sizes but is concentrated in *medium and small capitalization* stocks... The resulting portfolio will have price-to-earnings ratio that is lower than its benchmark index (*value*) and a return on equity that is higher than the index (*growth*)...”

### Components of a good benchmark

With the characteristics of our portfolios laid out, we have a better idea of what we need from our benchmark index(es). We need an index that:

- measures the performance of U.S. based companies, from all industries
- has, in aggregate, both value and growth characteristics
- includes stocks of the appropriate size - large/medium for the Choice, medium/small for the Relative Value portfolio and finally a broad index for the combination of the two portfolios

Other features we want in our benchmark index are:

- an index that is passively managed
- an index that is value-weighted<sup>5</sup> as opposed to price-weighted or equal-weighted
- a widely recognized and easily accessed index
- an index that has been duplicated by a mutual fund or ETF allowing investors to participate in that portion of the market

To keep this letter as short as possible (we realize it is already long) we will not go into the details of why we dropped each index. Just know that each index we no longer use was either redundant (the Russell 1000 and the Russell Mid-Cap overlapped) or did not quite fit the criteria above. Although, no benchmark is perfect<sup>6</sup>, we feel that the ones we’ve chosen to use going forward will inform you to a greater degree about the ultimate success or failure of your investment program.

### The S&P 500 and The Lipper Large-cap Mutual Fund Average

We chose to keep the S&P 500 as a benchmark for the Choice model portfolio primarily because it is the most recognized large-cap index in the world (excluding the Dow Jones). In many ways the Russell 1000 index is more appropriate as a benchmark for the Choice but we chose the 500 as it is more often quoted, more

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<sup>5</sup> A value-weighted index is a stock index in which each stock affects the index in proportion to its market value. A price-weighted index is a stock index in which each stock affects the index in proportion to its price per share. An equal-weighted index is a stock index in which each stock affects the index equally.

<sup>6</sup> A true apples (portfolio) to apples (benchmark index) comparison is impossible to achieve. The best we can hope for is possibly a *red* apples to *green* apples comparison.

often indexed, and more highly recognized. One “flaw” of the 500 is that it is not a true passive index. The stocks are selected for inclusion in the index by a committee. But it stands up well to all our other criteria.

Our other large-cap benchmark is the Lipper<sup>7</sup> Large-Cap Mutual Fund Average. We chose this benchmark because we see mutual funds in general as our competition so to speak. And we feel it informative for you to see first hand what your funds may have done if invested elsewhere.

### **The Wilshire 4500 and The Lipper Multi-cap Mutual Fund Average**

For the Relative Value model portfolio we chose the Wilshire 4500 as the primary benchmark. We feel the 4500 is a good representation of the pond we’ll be fishing in for the investments we will include in the Relative Value. Additionally, the 4500 works well for us as it includes all the stocks of the Wilshire 5000 (which we will discuss in a moment) but excludes all the stocks of the S&P 500. So the redundancy we had with our former benchmarks is avoided. The secondary benchmark for the Relative Value portfolio is the Lipper Multi-cap Mutual Fund Average. We use this index for the same reasons we use the Large-cap Average for the Choice. We want to compare our performance to our competition.

### **We manage ONE all-cap portfolio**

Here is something worth mentioning. You should realize is that we do not think of the Choice and Relative Value model portfolios as separate portfolios *per se*. We mentally approach the management of your (and our) funds as if we house them in one unified all-cap portfolio. In practice, we will probably usher the larger stocks to the Choice portfolio while the smaller stocks will most likely be placed in the Relative Value portfolio. There are a few reasons we do this but the main reasons are that we feel that large and small company stocks present unique challenges and demand distinctive analysis, thus should be managed accordingly.

### **The advantage of segmenting our ONE all-cap portfolio**

This segmentation of the Choice and Relative Value model portfolios also has the byproduct of creating two portfolios with distinctive risk and return profiles. The benefit is that we are able to offer our clients various allocation choices. While one client may be 30% Choice and 70% Relative Value, another client may be closer to 50%-50%. In reality, most of you will be more heavily weighted in the Relative Value portfolio as we think this portfolio will provide superior returns to the Choice, albeit with a just slightly more risk.

### **The Wilshire 5000 and The Lipper All U.S. Mutual Fund Average**

This brings us to the benchmark that we are truly aiming to outperform. The Wilshire 5000<sup>8</sup> is a value-weighted index and measures all the stocks traded on the major U.S. exchanges as long as they are U.S. headquartered. It only excludes

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<sup>7</sup> Lipper is a research company specializing in the mutual fund industry.

<sup>8</sup> Unlike the S&P 500 or the Russell 1000, which hold the number of stocks in the index that it has in its name, the Wilshire 5000 actually holds many more stocks than 5000.

stocks traded via the Bulletin Board system where most penny stocks of extremely small companies are listed. The major drawback of the index is that the 500 largest companies comprise more than 70% of the index's value, so total performance is weighted toward the top few (relatively speaking) companies. That said the Wilshire 5000 is probably the best measure of U.S. stock market performance available - which is why it is our benchmark to beat.

Keeping consistent, we also wanted a mutual fund benchmark that would be meaningful for the combination of the Choice and Relative Value portfolios. Thus, we feel the best measure here is the Lipper All U.S. Domestic Equity Mutual Funds Average (whew!). As the name suggests, this average measure the performance of all U.S. based stock mutual funds.

### **Our portfolios may experience “style-drift”**

You should keep in mind that we have no mandates concerning things like the size of the company we should invest in or how many stocks to hold in a portfolio or the like. We are free to invest where we want, when we want and how much we want. We are able to invest in every nook-and-cranny of the market. Thus, in pursuit of superior investments, our portfolios may experience what is commonly referred to as “style drift”. For example, our Choice portfolio has traditionally held large-cap stocks, but our freedom may lead us to place smaller and smaller stocks in that portfolio. In other words, the indices we’ve chosen as our benchmarks may be more or less relevant depending on our investment bias at the time. Like we said, no benchmark (or investment program for that matter) is perfect.

### **Articles on benchmarking**

As always, we strive to better inform you and we hope that this letter serves as clarification regarding our chosen benchmarks. We’ll leave you with an excerpt from an article we wrote entitled “Benchmarking Your Portfolio’s Performance”. The entire article can be viewed on our website [here](#):

“An important point to consider is making certain the benchmark you or your advisor uses is an apples to apples comparison. Many investment professionals are guilty of making apples to oranges comparisons all the time - many times for their own benefit. A manager may be primarily invested in small-cap stocks when small-caps in general are performing well and compare his performance to a large-cap index. Typically investment professionals who have a large-cap mandate will delve off into smaller equities in hopes of increasing portfolio returns and beating their stated index. Thus, in reality the comparison to a large-cap index such as the S&P 500 is not really relevant and gives you little information into whether not the manager is adding value to your investment program.”

We would also like to lead you to an excerpt from an article by the CFA Institute entitled “How to Evaluate Investment Portfolio Performance”. The article can be read in its entirety by clicking [here](#):

“Relative Returns: While the absolute return of a portfolio is important investors must also look at portfolio performance on a relative basis. To do this, compare your results to a relevant market index as well as to a peer group. A peer group is a group of managers who invest with a similar style and who have similar objectives. For example, if you invest with a large capitalization growth equity manager, compare his or her returns with similar managers as opposed to, say, a group of domestic high-yield managers. At the outset of the investment relationship, you and your advisor should agree upon the peer group and the index (for example, the Standard and Poor’s 500) that best reflect the goals of the account. Use these as a baseline to determine how well you are doing on a relative basis. To provide an accurate assessment of performance, take the overall investment climate for the specific asset class into consideration when looking at portfolio returns.”

**In closing**

And lastly, 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

# Benchmarking Your Portfolio's Performance

by Benjamin B. Taylor

August 8, 2005

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## Benchmark Your Portfolio Against the Appropriate Index

Benchmarking your portfolio's performance against a stock market index is a vital exercise. With the proliferation of passively managed index mutual funds at low costs, it makes sense to know whether or not you or your investment manager is adding value by picking individual stocks or actively managed mutual funds. If you find that you or he is *not* adding value then it makes little sense to move beyond investing in index mutual funds.

When benchmarking a portfolio investors have multiple indexes from which they can use. Although all measure the movement of the stock market or specific portions of the stock market, each does so in a slightly different way. Indexes are usually created by research organizations such as Standard & Poor's, Dow Jones, Wilshire & Associates, MSCI, Lehman Brothers, Russell & Co. and many more. The major indexes created by these companies include:

- The Dow Jones Industrial Average (DJIA) created by the Dow Jones Company
- The S&P 500 created by Standard and Poor's
- The Russell 2000 created by Frank Russell Company
- The Wilshire 5000 created by Wilshire Associates

What individuals may not realize is that out performance or under performance of any index may have little to do with stock selection and more to do with the index the investor chooses to benchmark his performance against.

## Dow Jones Industrial Average (DJIA)

The DJIA is the oldest continuing U.S. stock market index. It is comprised of 30 large company stocks that are meant to reflect most sectors of the U.S. economy. The DJIA is the best-known market indicator in the world, partly because it was the first of its kind.

The "average" is in the title because the index's performance was originally computed by adding up stock prices and dividing by the number of stocks. The DJIA is a price-weighted index calculated daily based on the price of each company without any regard to the relative size of each component. In other words if McDonald's is trading at \$75 and Microsoft is trading at \$25, McDonald's would hold more weight in the index's average even though Microsoft is a much larger company.

There in lies the major flaw of the DJIA. It is not really representative of how most stock market investments are fairing. If more money is invested in Microsoft than McDonald's it seems axiomatic that Microsoft should make up more of any particular index. Another flaw is the DJIA's size of just 30 mega-sized companies. Because the

index is not diverse and it only consists of extremely large companies, it may not accurately reflect the performance of vast swaths of the U.S. or global marketplace.

Although the DJIA is the most quoted and best known of all the indexes, it is probably the least relevant as a benchmark.

### **S&P 500**

The Standard & Poor's 500 Index is the preferred benchmark for most investment professionals as it has the triple benefit of representing a substantial portion of the U.S. stock market (about 75%), being market weighted (as opposed to price weighted like the DJIA) and it is well known.

The S&P 500 consists of a basket of 500 companies from a diverse range of industries. The companies that comprise the index are not the simply the *largest* 500 U.S.-based companies, but the companies chosen by the S&P Index Committee for market size, liquidity, and sector representation. The S&P 500 is a market-capitalization weighted index. In other words Microsoft would make up more the index than McDonald's since its market capitalization is much larger.

There are two major drawbacks of using the S&P 500 as an index. One drawback is that it has significant liquidity requirements for its components, so some large, thinly traded companies are ineligible for inclusion. Warren Buffett's company Berkshire Hathaway is not included in the index for this very reason even though it is one of the largest companies in the world. Another drawback is that since the index gives more weight to larger companies, it tends to reflect the price movement of a just a few large company stocks. It does not accurately measure smaller companies.

### **Russell 2000**

The Russell 2000 is the best-known of a series of market-capitalization weighted indices published by the Frank Russell Company. The index measures the performance of the smallest 2,000 companies in the Russell 3000 Index. The Russell 3000 is made up of the 3,000 largest U.S. companies in terms of market capitalization and represents 98% of the stock market. Unlike the S&P 500, it does not cherry pick the companies that make up the index by requiring substantial liquidity or that the index represent certain sectors of the economy. It is a truly passive index.

The Russell 2000 is most appropriate for benchmarking the performance of U.S. small capitalization stocks. But these aren't the smallest of the small. The Russell 2000 makes up only about 7% of the total market capitalization of the stock market. The two drawbacks of the index is that it does not measure the performance of large-cap stocks and micro-cap stocks. In other words, stocks that are among the largest 1000 and those that are smaller than the 3000 companies in the Russell 3000, do not get measured by this index.

### **Wilshire 5000**

The Wilshire 5000, a market-capitalization weighted index, measures all the stocks traded on the major U.S. exchanges as long as they are U.S. headquartered. It only

excludes stocks traded via the Bulletin Board system where most penny stocks of extremely small companies are listed. Unlike the other indexes that carry the number of stocks it holds in its name, the Wilshire 5000 actually has close to 7,000 companies. The number included in the index fluctuates as companies are listed and de-listed from the major exchanges. Although this index is less well known than the others, it is in fact the largest index by market value and most comprehensive of all the major U.S. indexes.

The major drawback of the index is that the 500 largest companies comprise more than 70% of the index's value, so total performance is weighted toward the top few (relatively speaking) companies.

All that said, the Wilshire 5000 is probably the best measure of U.S. stock market performance available.

Certainly the indexes mentioned here do not comprise the entire landscape of all indexes available for benchmarking. In addition to these broad U.S. market indexes, there are hundreds of indexes measuring various market sectors in the U.S. and around the world.

## **Summary**

Measuring index performance or benchmarking a portfolio does not have to be an extremely difficult task. When choosing an index to invest in or benchmark a portfolio against make sure the structure of the index is applicable to the portfolio you are trying to build. If you are investing in primarily well known large company stocks, perhaps the S&P 500 is an appropriate benchmark. If you are investing in stocks regardless of size, perhaps the Wilshire 5000 is better.

An important point to consider is making certain the benchmark you or your advisor uses is an apples to apples comparison. Many investment professionals are guilty of making apples to oranges comparisons all the time – many times for their own benefit. A manager may be primarily invested in small cap stocks when small caps in general are performing well and compare his performance to a large cap index. Typically investment professionals who have a large cap mandate will delve off into smaller equities in hopes of increasing portfolio returns and beating their stated index. Thus, in reality the comparison to a large cap index such as the S&P 500 is not really relevant and gives you little information into whether not the manager is adding value to your investment program.

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