

# Brick Financial Management LLC

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November 8, 2005

Re: October 2005 Client Letter

Dear Partners, Clients and Friends,

**Our Portfolio Average declined 4.3% in October due to a precipitous fall in housing stocks.** The Relative Value model portfolio returned -5.4% and the Choice model portfolio returned -1.6%. The returns for both model portfolios versus relevant stock market indices (including reinvested dividends) as of October 31, 2005 follow<sup>1</sup>:

	October	YTD 2005	2004	2003	2002	Since Inception
<b>Portfolio Average<sup>2</sup></b>	<b>-4.30%</b>	<b>-6.35%</b>	<b>28.07%</b>	<b>37.31%</b>	<b>-2.09%</b>	<b>61.24%</b>
Wilshire 5000	-1.84%	2.15%	12.48%	31.64%	-5.54%	42.88%
All U.S. Equity Funds	-2.22%	2.07%	11.96%	32.44%	-5.46%	43.09%
<b>Relative Value<sup>3</sup></b>	<b>-5.36%</b>	<b>-4.89%</b>	<b>33.54%</b>	<b>44.09%</b>	<b>-2.09%</b>	<b>79.19%</b>
Wilshire 4500	-2.35%	4.62%	18.10%	43.84%	-4.21%	70.23%
Multi-Cap Core Funds	-2.01%	2.06%	11.05%	29.89%	-5.39%	39.28%
<b>Choice<sup>4</sup></b>	<b>-1.58%</b>	<b>-9.77%</b>	<b>15.31%</b>	<b>22.31%</b>		<b>27.27%</b>
S&P 500	-1.67%	1.05%	10.88%	32.87%		48.88%
Large-Cap Core Funds	-1.57%	0.86%	7.79%	25.59%		36.54%

<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.



## **The housing boom**

In case you haven't noticed, this country has experienced a housing boom in the last few years. Real estate sector mutual funds have had an annualized return of 27.8% over the last three years while the average equity mutual fund has only returned 14.9%.<sup>5</sup> Of course, if you had the foresight (or the luck) to invest in the sector, you would have reaped the rewards over the last few years. As you know, the Relative Value portfolio has been invested in a few of the homebuilders over its life so we've benefited from the run-up in the sector. Perhaps we were lucky.

## **The housing bust?**

It seems our luck may have run out in this sector. Over the last few months we have had to endure a plethora of information that has suggested that the party in the housing market may be coming to an abrupt close. After record growth at many home builders, new housing starts have slowed and the sales price of the average home has leveled off<sup>6</sup>. It seems that market has reacted (we think overreacted) negatively to this information. The prices of many firms in the housing/real estate sector, our investments included, have plunged. This happened just as we increased our investment in some of these firms. As a result, the Relative Value portfolio has returned -12.2% over the last three months.

## **Our approach with the Relative Value model portfolio**

Did we make a mistake by placing our funds here? Well, before we answer that, allow us to describe how we came to the decision to place our funds in this sector in the first place. Our approach in managing the Relative Value portfolio is to rely heavily on the economic results of the companies we are analyzing. Each company's performance is analyzed and compared to its own past performance *as well as* the performance of other companies in the market. If that company "scores" well versus its own history and the history of other firms, that company is considered for investment. At that point we try to determine the likelihood that the company in question will be able to continue its good performance. In that light, we analyzed many of the home builders and found that they all scored highly when tested against our criteria. Thus despite the news (and clues) of a so-called housing bubble, we decided to place (more of) our funds in the sector.

## **The characteristics of our housing/real estate investments**

At the time we increased our investment in a few of these firms, they had the characteristics we usually look for. In aggregate, these stocks exhibited the following characteristics:

- A price-to-earnings (P/E) ratio of less than 10x, which was lower than their 5 year average P/E
- Return-on-equity of 33% and rising
- Earnings growth of over 40% over the previous 5 years and increasing
- A dividend yield that was twice that of the average company in the S&P 500
- Net margins of 10% or greater and increasing

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<sup>5</sup> Source: *The Wall Street Journal*

<sup>6</sup> Source: National Association of Realtors

### **Low multiples in the housing/real estate sector**

With these figures we made the assessment that even if the housing/real estate market slowed, and earnings and sales slowed with it, these companies' extremely low valuation would more than make up for it. Of course, housing stocks have always appeared very cheap. Our view is that the sector should yield higher multiples. A technology company with the same characteristics would fetch a substantially higher P/E ratio. Unfortunately, we can't explain this phenomenon other than to say that perhaps it is because housing/real estate isn't as sexy as tech. Or it could be that housing/real estate is cyclical (albeit extremely long cycles) and cyclical industries generally yield lower P/Es.

### **The long-term trend in housing/real estate**

Our feeling is that the long-term trend in housing/real estate is up. Much of the concern over the housing/real estate sector is that with its extended period of growth, that the sector has reached capacity. The old "Land – they aren't making any more of it" sentiment. But we think this concern is overstated. About 95% of U.S. land is undeveloped. This view is supported by a report written by Florida State professor, Randall G. Holcombe:

“Americans often overestimate the amount of developed land... Only about four percent of the nation's land area is developed, and even states that are thought of as very urbanized are mostly undeveloped. States with the highest percentage of developed area are New Jersey, which is 34.6 percent developed, Massachusetts, which is 27.4 percent developed, Connecticut, which is 25.8 percent developed... In total, four states have land areas that are more than 20 percent developed, while 39 are less than 10 percent developed, and 27 are less than 5 percent developed.<sup>7</sup>”

Additionally, the nation's growth in population seems to be going strong as well. Infant mortality rates are down, people are living longer and more and more people are looking to become Americans. According the U.S. Census, we have:

- One birth occur every 8 seconds
- One death every 12 seconds
- One international migrant (net) every 28 seconds
- Net gain of one person every 13 seconds

### **We must maintain a long-term mindset**

So did we make a mistake? If we made any mistake it was in allocating *too much* of our funds to the housing/real estate sector. We could have benefited from the sector without overexposing ourselves to it. (In the natural course of managing the fund, this has condition has since been "corrected".) But that's the short-term mindset answer. If you are using a long-term mindset to answer this question, as we do (and so should you), then we have to say that the jury is still out. We won't definitively know the answer for at least five years. In the

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<sup>7</sup> "The New Urbanism from a Market-Oriented Perspective", Randall G. Holcombe; DeVoe L. Moore Professor of Economics, DeVoe L. Moore Center, Florida State University

meantime we have to trust our analysis and our judgment. Our actions won't always lead to positive results in the short term, but in the long term it should.

You should know that we always approach the management of your money with caution. We are always concerned about the risk as well as the return our investments bring us. We try to manage the risk portion of this concern by investing in sound companies with a margin of safety. This approach has proved itself over decades and should yield superior results in the future.

**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