

Brick Financial Management LLC

Benjamin B. Taylor
Investment Manager

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

December 6, 2005

Re: November 2005 Client Letter

Dear Partners, Clients and Friends,

Our Portfolio Average advanced 4.4% in November due to strong performance in the Choice model portfolio. The Relative Value model portfolio returned 2.5% and the Choice model portfolio returned 8.9%. The gross returns for both model portfolios versus relevant stock market indices (including reinvested dividends) as of November 30, 2005 follow¹:

	Nov	YTD 2005	2004	2003	2002	Since Inception
Portfolio Average²	4.37%	-2.26%	28.07%	37.31%	-2.09%	68.29%
Wilshire 5000	3.99%	6.23%	12.48%	31.64%	-5.54%	48.59%
All U.S. Equity Funds	4.02%	6.20%	11.96%	32.44%	-5.46%	48.88%
Relative Value³	2.54%	-2.47%	33.54%	44.09%	-2.09%	83.74%
Wilshire 4500	4.67%	9.50%	18.10%	43.84%	-4.21%	78.17%
Multi-Cap Core Funds	3.51%	5.72%	11.05%	29.89%	-5.39%	44.27%
Choice⁴	8.86%	-1.77%	15.31%	22.31%		38.54%
S&P 500	3.78%	4.88%	10.88%	32.87%		54.51%
Large-Cap Core Funds	3.75%	4.70%	7.79%	25.59%		41.74%

¹ The gross 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).

² 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.

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

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



It was a good month

The market had one of its best months of the year in November. Our portfolios benefited from this rise as well. In the Choice model portfolio our largest positions performed extremely well. eBay rose 13.1%, Amazon rose 21.6%, Autozone rose 10.1% and Radian rose 8.6%. Even Anheuser-Busch which has been flat most of the year rose 6.7%.

The Little Book

Instead of getting into the details of our portfolios this month, we thought we'd change things up a bit with this letter. Recently, a neat little book hit bookstores. Written by hedge fund manager, Joel Greenblatt, *The Little Book That Beats the Market* explains value investing in (mostly) layman's terms. The book touts a "magic formula" that Greenblatt says will help any investor beat the returns of the market. A review from the University of Western Michigan Library states:

"Using basic math skills and simple concepts, Greenblatt shows you how to achieve investment returns that beat the pants off even the best investment professionals and the top academics... Through entertaining anecdotes and practical pearls of wisdom, the book explores the basic principles of successful stock market investing and reveals the secrets to buying good companies at bargain prices automatic... The (magic) formula has been tested over hundreds of different periods and thousands of stock picks and has been proven extremely profitable for those who are willing to stick with it..."⁵

Good companies at bargain prices

The book is of particular interest to us and the clients of Brick Financial because it so clearly lays out basic value investing principles that we follow every day. Basically the book is about how to find superior companies at bargain prices. Greenblatt's magic formula helps investors identify those companies.

Following the formula requires caution

Greenblatt goes to great lengths to explain to the reader that the magic formula is not a panacea. The formula is bound to lead to some years of underperformance. [Even proven investors have down years.] Those that don't have the conviction or where-with-all to stick with it are bound to abandon the approach. Thus, following the formula requires faith in the underlying principles of value investing. It requires the ability to endure the long-term. And it requires, as Warren Buffett has stated, a "quality of temperament...not a high IQ".

He is also adamant in saying that you should not be investing directly in stocks if you do not know the principles of accounting, forecasting, and basic financial principles. If you can not confidently work your way around a company's financial statement then, according to Greenblatt,

"You have no business investing in individual stocks on your own!"

⁵ url: <http://www.wmich.edu/~ulib/news/2006/ebook022006.php>

He goes on to say,

“Choosing individual stocks without any idea of what you’re looking for is like running through a dynamite factory with a burning match. You may live, but you’re still an idiot.”

The Little Book highlights

Some of the main points of the book, and those that are most relevant to clients of Brick Financial, follow:

- There is a place where they sell businesses for half price all the time. And it doesn’t take a genius to figure out where to find them. The trick to finding these one dollar bills for 50 cents is that you as the investor must believe that these “dollars-on-discount” exist.
- Everyone should endeavor to save money. There are places an investor can put his money – under a mattress, in the bank, in government bonds or in corporate bonds. Some investments are better than others though.
- Buying a stock means buying a percentage share in a business which entitles you to your proportional share of that company’s future earnings. Estimating the current value of the business requires *guessing* what the future earnings of the business will be. Your investment in any company should offer you more of a return than you might get in “safer” alternatives like the mattress, bank, or bonds.
- Most stock investors are irrational and speculative which is one reason why the prices of stocks swing wildly in short periods of time. For instance, GM’s stock price can go from \$30 to \$60 in just a few months. It is improbable that the *value* of the GM would double in that time. Does this phenomenon make any sense? No! But all we as investors need to know is *that* it occurs and attempt to exploit it. We don’t need to know *why* it occurs.
- Even though it is difficult to value business, we must make our best guess. And when we do decide to invest, we are best served to wait for the moment when the stock price of the company is below our guess of the business’ intrinsic value. Benjamin Graham coined this action as buying with a *margin of safety*.
- It is better to buy a company that earns more money relative to the amount you paid for it. In other words, if company A earns \$2.40 per share per year and company B earns \$1.20 per share per year, yet both companies cost you \$12 to purchase, which is the better buy? Company A of course. You’re getting more earnings for your money. Company A’s *earnings yield* is 20%, while company B’s is only 10%.
- An investor would also be keen if he bought only good business. How do you tell which are the good business? As an example, let’s say it cost both company A and B \$400,000 to build each of their widget stores and get up and running. Let’s further

say that company A earns \$200,000 but company B only earns \$10,000. Which is the better business? Company A once again. Company A's *return on invested capital* (ROIC) is 50% while company B's ROIC is a paltry 2.5%.

- If an investor stuck to buying good business (high ROIC) at cheap prices (high earnings yields) he'd do well with his investments.
- Buying good businesses at bargain prices works as an investment strategy. Not only has it worked in the past but because its principles are sound, it will work in the future. There will always be better business than others and there will always be better values than others. But the investor must have faith in the principles.
- The “magic formula” as well as any well reasoned investment strategy will occasionally fail to do well in the short-term. The short-term can often mean *years*, not days or months. It is extremely hard to stick with a strategy that may not work for several years in a row. Which is a *good* thing. If the formula worked all the time, everyone would use it and it would eventually cease to work. The trick is to have a *long-term* mindset. Long-term in this case means three, four, or even five years *or more!*
- Although you want an investment strategy that has worked in the past, a good track record will not ensure results in the future. A good track record will not keep you following if the results are not as good. A good track record is not why you follow it. You should follow an investment strategy if the principles are sound. Buying good businesses at bargain prices is a sound principle and is the definition of value investing.
- If an investment strategy is sound, the longer the time horizon, the better the chances for success. Time horizons of 5, 10 or 20 years are ideal. Such a time horizon will give an investor a large advantage over most other investors.
- As much as 95% of the trading that occurs in the stock market is completely unnecessary and meaningless.
- The stock market offers the best possibility for high investment returns over time. However, most people that should invest should *not* invest on their own. So it is difficult to know where to start. Stockbrokers generally have NO idea how to help investors. They're only trained to sell products at the investor's expense. Mutual funds would be fine but the vast majority of mutual never beat the market. A hedge fund may be a viable option but their high fees are usually not justified by their performance.
- Since there are so few good avenues for investors to participate in the stock market, the best choice is most often an index fund. Or he may use an easy to use “magic formula” like the one in the book.

We have our *own* magic formula

We think that is a pretty thorough summary of an excellent book.⁶ The book describes a process that is very similar to the one we go through when selecting investments for our portfolios at Brick Financial.

We have our own magic formula in the form of an approach that is grounded in the value investing philosophy first espoused by Benjamin Graham and practiced by many other great investors. We too are looking for good companies at bargain prices. We rely heavily on computer based models, but we inject our own judgment as well. We realize that our approach will not always work in the short-term, which is why we maintain a long-term mindset. And, although our approach has produced exceptional results in the past, this is not why we continue to use it. We continue to use it because the underlying principles are sound.

You (can) benefit from Brick Financial's magic formula

One other point we would like to address is Greenblatt's dismal picture of the investment alternatives most investors are left with. He says that most investors have two viable choices for investing in the stock market – an index fund or *his* magic formula. Well, let us suggest that there is a better alternative than either of the choices he touts.

An investor would be well served by placing their funds with an investment manager that follows value investing principles, charges a low fee, and does so in separate accounts. Such a manager has many inherent advantages over most other options. Brick Financial just happens to be one of those investment managers.

Be sure to get the book

Finally, we encourage you to read this book. You can click the link below to pick up a copy:

http://www.amazon.com/exec/obidos/redirect?link_code=ur2&tag=brickfinancia-20&camp=1789&creative=9325&path=http%3A%2F%2Fwww.amazon.com%2Fgp%2Fproduct%2F0471733067%2Fsr%3D8-1%2Fqid%3D1141160727%2Fref%3Dpd_bbs_1%3F%255Fencoding%3DUTF8

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

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LONG & SHORT

By JESSE EISINGER



Magic Formula

Of Little Book

Just May Work

November 9, 2005; Page C1

As hard as it is to envision, hedge-fund titans and other masters of the universe soon will be tucking themselves into bed with a thin tome bearing a cutesy title: "The Little Book That Beats the Market."

Here's why: The author is Joel Greenblatt, a former hedge-fund manager. His first investment guide, published in 1997, also sported a hokey title, "You Can Be a Stock Market Genius (Even If You're Not Too Smart)," and sold about 38,000 hardcover and softcover copies.

Not bad as first books go, but it also became a cult hit in the insular world of hedge funds, passed like samizdat from manager to manager. A book of war stories and case studies written clearly and laced with jokes, it had two profound insights, say hedge-fund managers who have pressed the book on me.

One was that there are secret hiding places in the stock market, like spinoffs and restructurings, where bargains tend to lurk. The other was there wasn't any compelling reason to have a giant portfolio of dozens of stocks when a well-designed, concentrated portfolio could accomplish the same goal of achieving high returns without adding risk.

"His book on investing is by far the most valuable thing I have read," says David Einhorn, who manages a large, successful hedge fund, Greenlight Capital.

But hedge-fund managers "were not quite the underprivileged group I was shooting for when I wrote it," he says. So for his second book, Mr. Greenblatt says he wanted to write an even more basic and fundamental book on investing that would appeal beyond Wall Street. Think Benjamin Graham does Borscht Belt.

Mr. Greenblatt, 47 years old, says his goal was to provide advice that, while sophisticated, could be understood and followed by his five children, ages 6 to 15. They are in luck. His soon-to-be-released "Little Book" is one of the best, clearest guides to value investing out there. I have some minor quibbles, but in a world where individual-investor advice is dominated by jargon-filled short-termism on the one hand and oversimplified throw-up-your-hands indexing on the other, Mr. Greenblatt's

approach is valuable.

It is so simple and cute that an investor with a little bit of knowledge might mistakenly dismiss it. Mr. Greenblatt titles his investment approach a "magic formula." His tongue is in his cheek, but not entirely. He writes as if he were J.M. Barrie spinning a Peter Pan-esque fairy tale, but with the fervor of a true believer:

"You have to take the time to understand the story, and most important, you have to actually believe that the story is true. In fact, the story concludes with a magic formula that can make you rich over time. I kid you not."

What is the magic formula? Invest in good companies when they are cheap. As Mr. Greenblatt might say: See? We told you it sounded obvious. Yeah, so what's "good"? And what's "cheap"?

Good companies earn high returns on their investments, he explains, while cheap companies sport share prices that are low (based on past earnings). His proxies for these criteria are return on capital (operating profit as a percentage of net working capital and net fixed assets) and earnings yield (pretax operating earnings compared with enterprise value, which is the market value plus the net debt). To his credit, however, Mr. Greenblatt explains all that parenthetical jargon in terms that shouldn't insult his peers but that will ring a bell for the unschooled masses.

To make things simpler still, his free Web site, www.magicformulainvesting.com, screens companies using his criteria. He advises individual investors to buy a basket of top stocks and turn them over on a strict schedule, depending on how they perform. (For maximum tax advantage, sell losers just before a year's up, and winners just after a year.)

It sounds too easy. But in fact, his approach is difficult not because it is hard to understand, but because it requires patience and faith that you are right when the market is saying you're wrong.

This is based on Warren Buffett's investment principles. But they bear repeating. Even a die-hard value investor like Mr. Greenblatt says he didn't realize that trying to find cheap, good companies, rather than just cheap ones, was so important until the 1990s. While Mr. Graham, Mr. Buffett's mentor, was looking for starkly cheap companies, Mr. Buffett wants only the great ones.

"I didn't get Buffettized until the early 1990s," says Mr. Greenblatt. "I wish it happened earlier."

Looked at retroactively, the returns of the "magic formula" beat the market handily. From 1988 through 2004, according to Mr. Greenblatt's book, the high-return/low-price stocks of the largest 1,000 companies had returns of 22.9% annually, compared

with 12.4% for the S&P 500.

The most convincing part of Mr. Greenblatt's argument is that when 2,500 companies are ranked for price and returns (based on the formula), the top 10% outperformed the second 10%, which outperformed the third 10% and so on. "The darn thing works in order," he says.

There are some limitations to the approach. It seems prone to tossing up stocks whose high returns and growth may be in the past. Magic-formula stocks with more than \$1 billion in stock-market value include lots of fast-growing specialty retailers and niche pharmaceutical companies. Some of these will flame out.

That's why Mr. Greenblatt argues that novice investors buy at least 20 or 30 of them. For himself, he buys a smaller number that he can know deeply. But that requires something not easily taught in a book: good instincts and judgment to distinguish true cheap gems from one-hit wonders.

Though he always was a value investor, his hedge-fund firm, Gotham Capital, wasn't always run on his magic formula, especially in the early years, when he tended toward complex arbitrage. He started Gotham in 1985 and ran it for outside investors for 10 years, achieving compounded annual returns, before fees but after expenses, of 50%. He started with \$7 million, mostly raised through junk-bond king Michael Milken. After five years, he returned half the outside capital. He finished with more than \$350 million and returned all the remaining outside capital.

These days, he spends his time teaching at Columbia Business School and helping run a Web site for pros, the Value Investors Club. His wealth is mostly tied up in Gotham Capital, which manages \$1.6 billion, including some outside money in a fund of hedge funds he started a few years back.

His home cooking isn't just good enough for Mr. Greenblatt. He's got his kids eating it, too. His eldest son is doing well following the book's advice. A daughter, at it for two months, is having a rougher time. "I'm not sure if she didn't have me as her daddy she'd be hanging in there," he says.

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<http://online.wsj.com/article/SB113149105486391586.html>

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