# Brick Financial Management LLC

*Benjamin B. Taylor*
*Investment Manager*

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

January 10, 2005

Re: December 2005 Client Letter (http://www.brickfinancial.com/letters/200512clientletter.html)

Dear Partners, Clients and Friends,

**Our model portfolios were both near even in December.** The Relative Value model portfolio returned 1.0% and the Choice model portfolio returned -0.1%. The returns for both model portfolios versus relevant stock market indices (including reinvested dividends) as of December 31, 2005 follow[1]:

| | Dec | 2005 | 2004 | 2003 | 2002 | Since Inception |
|---|---|---|---|---|---|---|
| Relative Value[2] | 1.00% | -1.49% | 33.54% | 44.09% | -2.09% | 85.59% |
| Choice[3] | -0.13% | -1.90% | 15.31% | 22.31% | | 38.36% |
| **Core Portfolio Average[4]** | **0.66%** | **-1.61%** | **28.07%** | **37.31%** | **-2.09%** | **69.41%** |
| | | | | | | |
| Wilshire 5000 | 0.14% | 6.38% | 12.48% | 31.64% | -5.54% | 48.79% |
| S&P 500 | 0.03% | 4.91% | 10.88% | 28.68% | -5.88% | 40.89% |
| Wilshire 4500 | 0.48% | 10.03% | 18.10% | 43.84% | -4.21% | 79.03% |
| All U.S. Equity Mutual Funds | 0.43% | 6.65% | 11.96% | 32.44% | -5.46% | 49.51% |

**Our long-term performance**

Last month marked the moment that our oldest portfolio, the Relative Value, hit three years old. We are just now entering into a time where our performance becomes more meaningful in determining our skill as stock pickers. Of course, even three years is still a short amount of time. One would need five years or more to make a decent assessment of a stock picker's skill, 10 years would be better. The longer out you go, the less random chance is responsible for investment results.

| | 3-year Total Returns | Annualized 3-year Returns | Annualized Since Inception† | 3-year Sharpe Ratio |
|---|---|---|---|---|
| Relative Value | 89.55% | 23.76% | 22.32% | -- |
| Choice | NA | NA | 12.57%* | -- |
| **Core Portfolio Average** | **73.02%** | **20.05%** | **18.73%** | **0.95** |
| Wilshire 5000 | 57.51% | 16.35% | 13.75% | 1.13 |
| Avg. Equity Mutual Fund | 58.14% | 16.56% | 13.93% | 1.11 |

† Relative Value model portfolio and the Portfolio Average since inception returns are from 12/6/2002. Index and mutual fund since inception returns are from 12/1/2002. *Choice model portfolio since inception return is from 4/4/2003.

Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to "Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com." Otherwise written permission is required.

That said the 3-year mark may still be helpful in comparing our performance to date against our stated goals, which are to:

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

**Our long-term performance *expectations***
From the table above it's easy to see that over the last three years and since inception we have increased our capital. In addition, our portfolios (the Portfolio Average[5]) have beaten the Wilshire 5000 and the average domestic equity mutual fund over that time. However, just knowing that we increased our capital and beat the market is a little like knowing that we simply *passed* an exam. What we do not know is if our passing grade was an A, B, or C[6]. In order to determine our grade we think it helpful to compare our actual performance to our *expectation* of performance. We expect:

- An average annual return of 12-15% over rolling 5-year periods, and/or
- Annual average outperformance of the stock market (as measured by the Wilshire 5000) by 4-7% per year.

We did not arrive at these performance expectations arbitrarily. First, we wanted to provide returns of at least 10% plus the rate of inflation. We used the historical rate of inflation which is around 3% as a proxy. Additionally, we wanted to provide returns that exceeded the returns of the market by enough of a margin to make it worthwhile to invest with us. As we have stated in past letters, we think the market will return 7½-9% over the foreseeable future. We think our value-oriented approach, concentrated strategy, and long-term focus should provide a margin of at least 4-7% over the market.

Perhaps to some of you a 15% return doesn't sound like much. But the magic of compound interest transforms that 15% into something a little more appealing. Such a return will turn $1,000 into $2,000 in 5 years, $16,000 in 20 years and $1,000,000 in 50 years. Not to mention that earning 15% on your investments while saving a fifth of your income and keeping your spending increases limited to the rate of inflation will allow you to retire in 15 years. You may also be thinking that a 4-7% margin over the market may not be much. But over 20 years a 4% margin will yield you twice as much money while a 7% margin will get you four times as much money. Thus, those little differences mean a lot over time.

**Our performance "report card" and 2005 in review**
We would generally say that meeting either of our performance *expectations* would garner us a grade of B. With annualized returns of 19-20%, we've exceeded our performance expectations of 12-15% and outperformed the market since inception by about 5%. In other words, we think we have performed respectively over the last 3-plus years and we have earned a grade of B, possibly a B+.

However, this past year was a difficult one for the investments in our portfolio. For the first time since inception our portfolio, as defined by the Core Portfolio Average, failed to beat its primary index (Wilshire 5000). With a return of -1.6%, we lost to the market by 8.0%.





Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to "Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com." Otherwise written permission is required.

Right from the very beginning our portfolios faced pressure. The Choice model portfolio nosedived -8% (January) due almost entirely to the decline of our position in eBay. The Choice model portfolio spent the rest of the year fighting uphill to recover. At the time, we said that eBay's decline was a good thing. Of course we meant in the long-term as it gave us an opportunity to average down on the stock. But in the short-term, it hurt like hell. Although the Choice beat the S&P 500 the last 8 months of the year, the portfolio only recovered enough to yield a small loss of -1.9%.

We faired no better with the Relative Value model portfolio with a disappointing return for the year of -1.5%. Unlike the Choice, almost all of the positive return in the Relative Value occurred in the middle of the year. It was ahead of its benchmark up until the end of July. However, as we covered in a previous letter, investments in the real estate/housing sector hurt its performance the last "half" of the year.

You may recall that not too long ago, our annualized returns were *somewhat* higher.

| | Annualized Returns 2002 to 2004 | Total Returns 2005 |
|---|---|---|
| **Core Portfolio Average** | **30.03%** | **-1.61%** |
| Wilshire 5000 | 17.47% | 6.38% |
| S&P 500 | 15.20% | 4.91% |
| Avg. U.S. Equity Mutual Fund | 17.60% | 6.56% |
| *Average margin of victory/(defeat)* | *13.27%* | *-7.59%* |
| *Annualized return of 12-15%?* | *Yes* | *No* |
| *Outperformance of market by 4-7%?* | *Yes* | *No* |

Our "average" performance for the period spanning 2002 to 2004 would have certainly been worth an A or an A+. Unfortunately, we did not meet any of our performance objectives *or* expectations for 2005 – a showing worthy of a big fat F. However, we are less concerned about our year-to-year performance than we are our performance over several years. [We pointed out to you in a previous letter that even the most highly regarded and successful stock pickers occasionally lose to the market.] We would welcome suffering through the occasional F year if it meant multiple years of A+ performance. In the words of Warren Buffett:

> "I'd rather take a lumpy 15% than a smooth 12%."

**Smooth returns ain't possible**

It is worth pointing out that the inexperienced investor might read the above quote and assume that a "smooth 12%" is actually achievable. It ain't! Buffett would have been more accurate if he had said "a *less lumpy* 12%". Lumpiness in the stock market is simply a fact of life. This in no way means that we can not strive for the smooth. Our goal of providing returns "consistent with reasonable risk" is our pursuit of the smooth.

Unfortunately, it's a little difficult to determine whether or not our portfolios have performed consistent with reasonable risk. Risk is in the eyes of the beholder. There are so many ways



BRICK FINANCIAL MANAGEMENT, LLC
BUILDING WEALTH ONE BRICK AT A TIME

Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to "Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com." Otherwise written permission is required.

to define risk and as many ways to measure it. Even if there were agreement on what risk is and how to measure it, then there is the problem of coming to some consensus on *reasonable* risk.

**How the financial community defines risk**
Most in the financial community will define risk as nothing more than the volatility[7] of a portfolio. But we are unlike most investors and, although it may play a role, we do not define risk strictly as volatility. We are more comfortable defining risk as the "probability of permanent loss of capital".[8] You may recall our general view on risk:

> "…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 permanent loss of capital and not…volatility.
>
> 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… 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."

**The failure of the Sharpe Ratio and other so-called measures of "risk"**
The advantage of defining risk as simple volatility, however, is that it is mathematically accessible. Standard deviation[9], Sharpe ratio, alpha, beta, and the Treynor index to name a just few, have all been developed to measure different angles of volatility. Each of these measures provides limited benefits to investors like us who are less concerned with short-term volatility. (Of course that is not to say that they have *no* benefits.)

As an example of what we mean, let's look at the Sharpe ratio. The Sharpe ratio essentially measures how much extra return (above the risk-free rate of return[10]) a portfolio offers per unit of volatility (as measured by standard deviation). Said another way, two portfolios, A and B, may both offer returns of 10%. But if portfolio A is more volatile than portfolio B, portfolio B is said to offer the better risk-adjusted returns. The higher the Sharpe ratio the better.

We have listed our Sharpe ratio versus that of the market (see the previous chart). As you can see, on an annualized return of 20%, our Sharpe ratio was 0.95 while the market's annualized return of 16% produced a Sharpe of 1.13. Although not materially different, the market produced a higher Sharpe ratio albeit with lower returns. In other words, the market offered better risk-adjusted returns than our portfolios. Herein lies the major flaw of such measures as we see it. These measures *equate* the importance of volatility (risk) and return. We view return to be the more important component of the risk/reward tradeoff.

Mutual fund pioneer John C. Bogle addresses the issue of volatility risk versus reward in an essay called "The Four Dimensions of Investment Return"[11]:



BRICK FINANCIAL MANAGEMENT, LLC
BUILDING WEALTH ONE BRICK AT A TIME

Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to "Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com." Otherwise written permission is required.

"…let me turn to risk—the second dimension of return. What breadth is to length in spatial terms—the *lesser* of the two sides of the plane—so, in terms of investment strategy, is risk to reward. That is not to say that risk is unimportant. It is crucial. But I simply do not accept that it should be counted *equally* with reward in calculating what we have come to know as 'risk-adjusted return.'

…The consummate measure of risk-adjusted return is the Sharpe Ratio… The essence of this formula is that one unit of risk is counted as the equivalent of one unit of return. But the reality of investing, as I see it, is that an extra percentage point of standard deviation (a rough proxy indeed for the elusive concept of risk) is *meaningless,* while an extra percentage point of long-term return is *priceless.* To be sure, large differences in risk are extremely important—there is a difference between a stock portfolio and a bond portfolio—but the simple expedient of weighting them equally on a formulaic basis leaves much to be desired as a factor in setting long-term strategy."

**A better definition of risk**

There are other ways to mathematically measure volatility risk that are perhaps more suited to us. But even these depend on price movement as the major component. So instead of listing these (which we may do in a later letter), we think it more informative if we demonstrate how our process reduces risk (and increases returns). We will do this in a moment. Of course we mean risk in terms of the probability of the permanent loss of capital. According to Benjamin Graham,

"…the bona fide investor does not lose money merely because the market price of his holdings declines, and the fact that a decline may occur does not mean that he is running a true risk of loss . . . We apply the concept of risk solely to a loss which is either realized through actual sale, or is caused by a significant deterioration in the company's operations – or, more frequently perhaps, is the result of the payment of an excessive price in relation to the worth of the security."

**The importance of persistence**

An interesting point is although our portfolios wound up trailing their respective indices for the year, at certain points during the year they were ahead. It's no telling where our portfolios will be in relation to the market at any one moment, especially in the short-term. All we can do is plug along, finding good companies at bargain prices, concentrating on our best ideas and hoping for positive outcomes. The direction of the market and our portfolios is impossible to predict in the short-term. But, as we've said in a previous letter:

"Staying put has been critical…"

"Staying put" will prove to be critical in the future as well. Of course, we're disappointed that we didn't beat our benchmarks this year, but we won't abandon our approach. Our approach is principle based and intelligently crafted. It has proven itself over long periods of time and should once again lead us to positive market beating returns.



BRICK FINANCIAL MANAGEMENT, LLC
BUILDING WEALTH ONE BRICK AT A TIME

Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to "Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com." Otherwise written permission is required.

**The short-term *process* produces long-term results**
In our June client letter, we pointed out that assessing performance over short periods has inherent limitations.

> "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 absence of meaningful short-term performance yardsticks, you should rely on other methods to evaluate us. Since it is adherence to our *process* that will lead to market beating performance, the lion's share of your attention should be spent evaluating whether or not our *process is correct*. Proven time and again, the process we follow has produced exceptional results and should in the future.

**Our process supports our principles**
Based in part on this process, we developed a series of investment principles that if strictly followed, will likely lead to long-term superior performance. These principles are intended to guide us in our daily pursuit of serving you better. Thus, we encourage you to measure our behavior against these principles. 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?
- Does Brick Financial manage a concentrated portfolio of common stock positions of companies that it understands well? Do the companies in the portfolio generate high degrees cash and generate high returns on capital/equity?
- 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?

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. As we will demonstrate, following these principles has the dual benefit of increasing return while reducing risk (as we define it) in our portfolios over longer periods of time.



BRICK FINANCIAL MANAGEMENT, LLC
BUILDING WEALTH ONE BRICK AT A TIME

Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to "Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com." Otherwise written permission is required.

**Reducing risk while increasing return**
There are several ways in which following our principles helps us to reduce risk and increase returns. The following are just a few:

1. Purchasing good, if not great companies at bargain prices (margin-of-safety)
2. Concentrating on our best ideas
3. Making wise decisions in the absence of an immediate compelling opportunity

**1a. Good companies**
There are many ways to determine whether or not a business is "good". Some of the characteristics marking good businesses are high margins and/or high asset turnover, low debt, pricing power, consistent earnings growth and brand recognition among others things. But what we think is the most telling mark of a good business is the ability to earn high returns on equity (ROE) and invested capital (ROIC). Although slightly different calculations, we employ the use of both.

To best explain our preference for companies with high returns on equity and invested capital, it is best to go through an example. Since ROE is a slightly more straightforward calculation than ROIC, we will use it in our illustration. Essentially ROE is the net income of the firm divided by the firm's average book value (equity). Assume that Acme Corp has $150 in total assets and $50 in total liabilities. This leaves Acme with $100 in equity. What we want to know is how proficient Acme is at putting its $100 of equity to work. In other words, how much in net income can Acme generate "using" its $100 of equity.

Historically, American businesses have produced an average ROE of about 10-12%. If Acme where an average company, it would earn about $10 to $12 on its $100 in equity. Of course, we do not want an average business. We are looking for companies than can consistently produce ROEs in excess of 15%. Now, if Acme returns 15% on its equity and retains all of its earnings within the firm *and* it is able to continue its high ROE ways, the intrinsic value of the firm should in turn grow at the same 15%. Warren Buffett has often said that a company's intrinsic value should grow at the same rate as its equity base. If we invest only in companies that are able to grow their equity base at or above 15%, our investment should also grow at that pace.

**1.b Bargain prices**
Even the greatest company will not make a good investment if it is overpriced. Determining the correct price for an investment is difficult as it requires many assumptions. But it is essential to our investment process. Directly from our website:

> "In an attempt to determine the intrinsic value of companies…we will rely on factors such as, but not limited to, the discounted value of its projected future free cash flows, the company's ability to earn returns on capital in excess of its cost of capital, private market values of similar companies, the costs to replicate the business and of course traditional measures such as the price-to-earnings ratio and price-to-book ratio. Qualitative factors, such as an assessment of the company's products, competitive positioning, strategy,



BRICK FINANCIAL MANAGEMENT, LLC
BUILDING WEALTH ONE BRICK AT A TIME

Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to "Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com." Otherwise written permission is required.

industry economics and dynamics, regulatory frameworks and more, may also be considered."

The process detailed above is meant to lead us to investments that are currently selling for less than 60% of our estimate of the company's intrinsic value. Many in the finance field feel that a company being value at an extreme discount to its value must have imbedded flaws, thus making investment in those companies inherently risky. But we feel that buying dollars for 60¢ is an intelligent practice. Again, quoting Warren Buffett:

> "Finance departments teach that volatility equals risk. Now they want to measure risk. And they don't know any other way - they don't know how to do it, basically. So they say that volatility measures risk.
>
> I've often used the example of the Washington Post stock when we first bought it: In 1973, it had gone down almost 50% - from a valuation of the whole company of close to say $180 or $175 million down to maybe $80 million or $90 million. And because it happened very fast, the beta of the stock had actually increased. A professor would have told you that the stock of the company was more risky if you bought it for $80 million than if you bought it for $170 million - which is something that I've thought about ever since they told me that 25 years ago. And I still haven't figured it out."

**The marriage of good companies at bargain prices**

If we are successful in finding good companies (those that can produce high ROEs) at bargain prices (60¢ on every dollar of intrinsic value), then we should do well with our investments. As we have said earlier, we are looking for companies that can grow their equity base, and as a byproduct their intrinsic value, by at least 15% per year. If we buy these companies at a fair price, our underlying investment should also grow at 15%. But, if we are somehow able to get these "15%-plus" companies on the cheap, we have afforded ourselves some insurance. In that case, hopefully the extra cushion the discounted price affords us will also give us a little extra return above the 15% we are looking for. Of course this assumes that investors will eventually recognize the price-to-value discrepancy and close the gap by bidding up the price. If the price-to-value gap never closes, we should still be able to rely on the 15% growth in our underlying investment.

Compared to the market, our portfolios are built with companies that are better values with greater returns than the overall market. For example, the Relative Value portfolio has a favorably low P/E (price-to-earnings)[12] of 13.0 while the S&P 400 and the S&P 600[13] have P/E's of 19.7 and 18.4 respectively. Additionally, the ROE for the Relative Value portfolio is 19.4%. This compares well to the S&P 400 & 600 which have a ROEs of 15.2% and 15.3% respectively.

The Choice model portfolio's P/E of 17.0 is slightly lower than the P/E of the S&P 500 at 17.2. However, the Choice portfolio brings with it *meaningfully* higher ROE's than the market (27.3% vs. 20.0%). Normally, we'd like to see a larger difference between the P/E of our portfolios and the P/E of the market. But this will not always be the case. We are willing to pay up for a good business, with a strong franchise in the Choice portfolio. As Buffett has



BRICK FINANCIAL MANAGEMENT, LLC
BUILDING WEALTH ONE BRICK AT A TIME

Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to "Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com." Otherwise written permission is required.

often reminded us, companies that have strong franchises, that can produce exceptionally high ROEs, are often bargains even though there price multiples are also high.

| | Number of Securities | Price/ Earnings | Price/Book | Return on Equity | Dividend Yield | Beta |
|---|---|---|---|---|---|---|
| Relative Value | 17 | 13.04 | 2.31 | 19.37% | 1.23 | 1.06 |
| S&P 400 | 400 | 19.69 | 2.62 | 15.15% | 1.27 | 1.07 |
| S&P 600 | 600 | 18.35 | 2.37 | 15.34% | 1.00 | 1.07 |
| | | | | | | |
| Choice | 12 | 16.99 | 2.72 | 27.93% | 1.00 | 1.05 |
| S&P 500 | 500 | 17.23 | 2.85 | 19.95% | 1.99 | 1.00 |

Source: Folio*fn,* Barra

**2. Our Buffett-like preference for concentration**
In Berkshire Hathaway's 1993 annual letter, Warren Buffett elaborated on his preference for owning just a handful of stocks:

> "The strategy we've adopted precludes our following standard diversification dogma. Many pundits would therefore say the strategy must be riskier than that employed by more conventional investors. We disagree. We believe that a policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort-level he must feel with its economic characteristics before buying into it."

We adhere to a policy of investing in just a few businesses that we understand well. In practice, that means that at any one time we will own 10 to 35 companies. As of the end of the year we owned a total of 29 companies between both our model portfolios. In addition, we have owned most of those positions for over 2½ years. This is in sharp contrast to the typical mutual fund which owns over 120 positions and holds them for less than 10 months[14].

**Overdiversification in mutual funds**
We can not say for certain why mutual funds hold so many securities for so little time. We think it safe to speculate that the managers of these portfolios have been somewhat influenced by Modern Portfolio Theory (MPT) and the Efficient Market Hypothesis (EMH). Although popular among academics and large institutional investors, MPT and EMH hold very little relevance to most value investors.

MPT makes excessive diversification a central feature to proper portfolio development. Because, as the theory holds, an investor will not be compensated (return) for the high risk he takes in owning only one or a few securities. EMH – the idea that the market always incorporates the best estimate of the true value of a security – is embedded in this conception of risk and diversification; otherwise it might be possible for a clever investor to pick relatively few securities and be rewarded for those selections.



BRICK FINANCIAL MANAGEMENT, LLC
BUILDING WEALTH ONE BRICK AT A TIME

Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to "Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com." Otherwise written permission is required.

**Mutual funds fail conventionally**

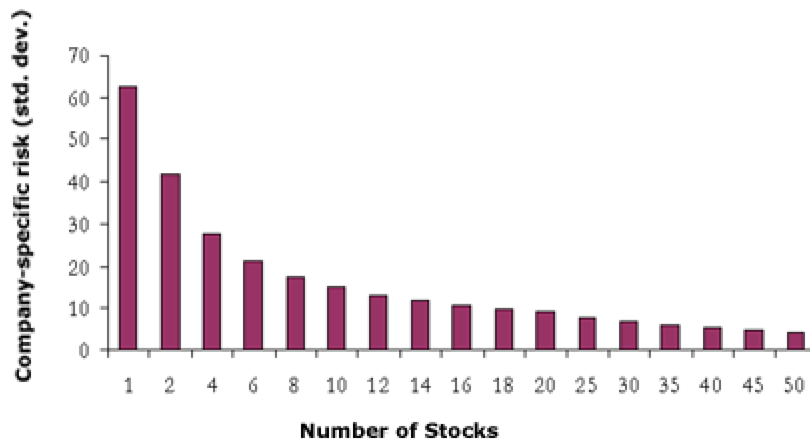
Something else to consider is that mutual fund managers are often compensated by how well they do against a stated index (i.e. the S&P 500) and their peers over extremely short periods of time like a month or a quarter. On the occasion when they do not outperform, it is best that they do not deviate greatly from the index or their peers as this will surely have grave consequences for their career. It is in the mutual fund manager's best interest to maintain a portfolio that acts much like the market so as not to deviate to greatly from the market as the downside of deviating from the benchmark (loss of assets, loss of clients, firing) is too great. In the words of John Maynard Keynes:

> "It is better to fail conventionally than to succeed unconventionally."

**It takes less than 25 stocks to be "fully" diversified**

We on the other hand think stock selection does matter, and as you know by now we do not accept the definition of risk as simply volatility. Additionally, we are not afraid to deviate from the market's return over short periods. In fact, we often remind you (and ourselves) that this is inevitable and simply a part of a good investing program. We also know that concentrated portfolios are not necessarily unduly volatile. One can see this clearly by comparing the betas of our portfolios against those of the market. (See the previous chart.)

Prof. Meir Statman[15] suggests that an investor can eliminate 91% of the company specific risk[16] in a portfolio with as little as 30 stocks, and 79% with just 10 stocks. He also found that the volatility of 50-stock portfolios is not much different than that of 500-stock portfolios. Other studies suggest an investor can eliminate over 90% of company specific risk with just 20 stocks. (See chart below.)[17]




**Extreme diversification *decreases* returns**

Thus, we generally run more concentrated portfolios. This is because the only securities that we select are those that we feel we understand well. We reduce risk, as we define it, by steering clear of permanently weak companies and avoiding overpriced firms, not by excessive diversification.



BRICK FINANCIAL MANAGEMENT, LLC
BUILDING WEALTH ONE BRICK AT A TIME

Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to "Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com." Otherwise written permission is required.

Increasing portfolio positions past 20 to 30 positions does very little to reduce volatility any further. Interestingly though, increasing positions past this point will continue to *reduce returns*. As we stated this past July, concentrated portfolios of 15 securities are 13 times *more likely* to outperform the market than portfolios of 250 securities.[18] In other words, excessive diversification fails to effectively reduce volatility risk yet greatly handicaps the investor's ability of beating the market.

**3. Actions in the absence of immediate investment opportunities**

Back in our August 2005 letter, we told you that we had been paring down our positions to a more manageable level over the year. We also pointed out that selling these positions put us in a position where we had plenty of "cash" to invest. We are ever on the lookout for places to invest that will provide us excellent rates of return. Right now there are a few names on our watch list, but have yet to pull the trigger on them as we assess each company's unique circumstances. But during the time in which we are looking, we need to do something with the funds we have available. What does an investor do in absence of an immediate compelling opportunity?

If you are a student of value investing and an observer of those that practice it you'll find that many practitioners choose to continue to hold cash in such a situation. A quick tour of the portfolios managed by some value investing stars in late 2003 until now found substantial cash positions of 20%, 30% and sometimes 50%. Now you might ask, "Why would a professional *stock* investor hold so much cash?" It's a reasonable question and one that is answered eloquently by investing legend Seth Klarman, manager of the $2 billion Baupost Group Hedge Fund, in his 2003 Annual Letter:

> "Perhaps some of you will soon be asking why you are paying us a management fee to hold so much cash. Let us preempt you by saying that you are not. You are paying us to decide when to hold onto cash and when to invest it, *to determine when the expected return from an investment justifies the risk involved and when it does not* [emphasis ours]...
>
> Cash... offers positive albeit very limited yield, complete safety of principal, and full and instant liquidity... *Our view is that investors should choose to hold cash in the absence of a compelling opportunity*, not because they are making a top-down asset allocation into cash, but based on the result of a bottom-up search for bargains… The investment should be made not because cash is bad, but because the investment is good. Exiting cash for any other reason involves dangerous thinking and greatly heightened risk."

Klarman goes on to say:

> "Cash is a way of safely doing nothing until a compelling investment opportunity arises."

**A difference in application, not philosophy**

At this point, we are going to tread some dangerous ground. At first glance it is going to seem like we are disagreeing with Klarman and many of the wizards of value investing. But let us



BRICK FINANCIAL MANAGEMENT, LLC
BUILDING WEALTH ONE BRICK AT A TIME

Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to "Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com." Otherwise written permission is required.

suggest that there may be a better way of “doing nothing” than by holding cash. We recognize that disagreeing with folks of Klarman’s stature on issues of finance is not necessarily the mark of an intelligent person. It is more likely representative of someone who is highly arrogant or very foolish. Hopefully we’re neither. Let us say that we are not disagreeing with Klarman per se. Our suggestion [that there is a better alternative than cash] is more a difference in *application* of philosophy than a disagreement in the philosophy itself. In any regard, we think that “safely doing nothing” might mean something more than investing in cash. We think it might mean investing directly in the market (or some combination of the market and cash). In other words, staying as fully invested in stocks as possible.

The irony is that we are following the same systemic approach of the value investing greats. Yet on the topic of where to put new money in the absence of particular compelling opportunity, we are led to a different outcome. Where Klarman and many others we admire feel that a value investor should “know that in the absence of opportunity (he) should hold cash”, we feel that the issue is not so cut and dry.

We believe that our deviation from some of our value investing brethren may have something to do with childhood experiences. Most, though not all, of the value investors in the hold-cash camp are usually “seasoned[19]” investors whose conservative nature is result of being children of the Great Depression era. They have learned to, *above all else*, fear the *absolute loss* of capital. We on the other hand, being children of the Great Inflation era of the 1970’s, are just as concerned with the *devaluation* of our capital as we are the absolute loss of it.[20] Thus we are compelled to take on a little more short term risk than our hold-cash value investing brethren.

**The decision process regarding new money**

When deciding how to employ our new funds, whether we got the funds from the sale of other holdings or it’s simply new money coming in from other sources, it is beneficial to keep in mind the objective of investing. According to Warren Buffett:

> “The objective [of investing is]…to end up with more dough than [you] start, with *a minimum of risk*.” [emphasis ours]

The first step in the approach in thinking about where to place new money is comparing any potential investment to the investments in our current portfolio. According to Charlie Munger:

> “…the best thing you already have should be your measuring stick…If the new thing isn’t better than what you already have available then it hasn’t met your threshold. That screens out 99% of what you see.”

We assume that all prudent investors, especially those that we admire, go through this mental exercise of comparing any potential investment with what is already owned. These investors may find that their new money should be reinvested in one or some of their current holdings, thus they will add to their position. In some instances they will find something more



BRICK FINANCIAL MANAGEMENT, LLC
BUILDING WEALTH ONE BRICK AT A TIME

Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to “Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com.” Otherwise written permission is required.

favorable than what they already own, thus in that case will invest there. Sometimes these investors won't do either of these things and instead allow their new money to sit in cash.

Now in the case where the investor has chosen to invest new money in cash above all other alternatives, even his own portfolio, he could argue (we'll do it for him) that cash is the best investment available. We think this is what Klarman and others holding substantial amounts of cash are saying. But this begs the question, if cash is the absolute best investment available, why not be 100% cash? Why not sell all your equity holdings? We must assume that the investor considered his own portfolio as an investment alternative, as Munger says we should do, but found the candidates for new money there inadequate. If that's the case why wouldn't that investor be *all* cash?

Of course we are being somewhat facetious here. It is impractical (and unnecessary) for many reasons for most investors to sell their entire portfolio in favor of cash. After all, the objective is to have more dough down the line. Holding good but not great investments will do that. But it does shed light on the fact that even the most conservative investors are willing to hold equities even when those equities are not necessarily the screaming values they would customarily invest in. What we are looking for is something other than cash to invest in. The question still remains, what do we do with our money while we wait for the *great* investments?

**Cash versus the market**

As we suggested earlier, we think investment in the general market (or some combination of cash and the market) is a viable thing to do while we wait for juicier investment opportunities. However, we must assure ourselves that doing so will provide us more dough (relative to all cash) down the line and that it meets the "minimum of risk" criteria.

According to the research conducted by Prof. Jeremy Siegel[21], author of *Stocks for the Long Run*, which covers the period of 1871 to 2001, stocks tended to beat cash most of the time over several holding periods:

| Investment Holding Period | Percentage of Time Stocks Outperform Cash |
|---|---|
| 1 Year | 64.1% |
| 5 Years | 77.1% |
| 10 Years | 84.7% |
| 20 Years | 99.2% |
| 30 Years | 100% |

There are a few ways we can determine the risk side of the equation. One way to determine risk is assessing the likelihood of *absolute* loss by investing in the market. We looked at the returns of the S&P 500 over the period from January 1975 to August 2005[22]. The following is what we found:

| Rolling periods[23] | 3 Months | 12 Months | 5 Years | 10 Years |
|---|---|---|---|---|
| Total periods | 366 | 357 | 309 | 252 |
| Periods w/ positive return | 260 | 289 | 278 | 252 |



BRICK FINANCIAL MANAGEMENT, LLC
BUILDING WEALTH ONE BRICK AT A TIME

Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to "Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com." Otherwise written permission is required.

| Rolling periods[23] | 3 Months | 12 Months | 5 Years | 10 Years |
|---|---|---|---|---|
| Percentage of periods w/ positive return | 71% | 81% | 90% | 100% |

Another way to assess the risk of investing in the market versus cash is determining the likelihood of capital devaluation. In other words, how does the market and cash perform versus inflation. Again, from Siegel's research, we can see the growth of $1 invested in several different securities types from 1802 to 2001:

| Security Type | Nominal Value of $1 |
|---|---|
| Stocks (market) | $8,800,000 |
| Bills (cash) | $4,455 |
| CPI (inflation) | $14.67 |

**The market beats cash in the long-term**
The above is convincing support for investing in equities as opposed to cash. In periods as short as 12 months, stocks beat cash 64% of the time and post positive gains 81% of the time. In periods of 10 years, stocks beat cash 85% of the time and post positive gains 100% of the time. We can also see clearly that over the long run, the market will perform better than cash *and* inflation.

Does this amount to a minimum of risk? Well, what we would need to do at this point is ask ourselves, what is the likelihood that stocks will beat cash and inflation NOW and will it beat cash by enough of a margin to make it worth taking on the extra risk? In other words is there a margin-of-safety?

**The proper margin-of-safety for the market versus cash**
Warren Buffett gave us a clue as to what margin is required to invest in the market versus cash: In Berkshire Hathaway's 2002 annual letter he states:

> "The aversion to equities that Charlie and I exhibit today is far from congenital. We love owning common stocks – if they can be purchased at attractive prices... Unless, however, we see a very high probability of at least 10% pre-tax returns (which translate to 6½-7% after corporate tax), we will sit on the sidelines. With short-term money returning less than 1% after-tax, sitting it out is no fun. But occasionally successful investing requires inactivity."

So Buffett is looking for an after tax margin between the market and cash of about 5%. We've stated in previous letters that we think, all things considered, the market will likely return between 7½-9% for the foreseeable future. This translates into about a 7% after tax return (for long term investors). The yield of the three month t-bill, a good proxy for cash, averaged just above 3% in 2005 which translates into a little more than 2% after tax. The current margin between the expected after tax market return and the after tax three month t-bill yield is close to Buffett's 5% margin-of-safety. So we feel comfortable.



BRICK FINANCIAL MANAGEMENT, LLC
BUILDING WEALTH ONE BRICK AT A TIME

Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to "Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com." Otherwise written permission is required.

**What other value investors think about investing in the market versus cash**
I think the above serves to support our view that investing directly in the market instead of cash can sometimes constitute a situation where "…*the expected return from an investment justifies the risk involved*". And that investing in the market may be "…*a way of safely doing nothing until a compelling investment opportunity arises*." Like we said earlier, although it may seem like we are disagreeing with Klarman and others of the hold-cash mindset, we are using the same mental approach and the same criteria for our new money. We are just lead to a different outcome. Although some value investors may take issue with our decision to hold the market[24] there are at least a few may that think our approach is sound.

From Berkshire Hathaway's 2004 Annual Letter:

> "Over the 35 years, American business has delivered terrific results. It should therefore have been easy for investors to earn juicy returns: All they had to do was piggyback Corporate America in a diversified, low-expense way. An index fund that they never touched would have done the job. Instead many investors have had experiences ranging from mediocre to disastrous.
>
> [One cause of disastrous experiences is] a start-and-stop approach to the market marked by untimely entries (after an advance has been long underway) and exits (after periods of stagnation or decline)…"

From value investing mutual fund company Tweedy Browne's, *10 Ways to Beat an Index*:

> "Empirical research has shown that 80%–90% of investment returns have occurred in spurts that amount to 2%–7% of the total length of time of the holding period. The rest of the time, stocks' returns have been small. With stocks, you have to be in to win. We believe that value-oriented stocks with extreme investment characteristics are likely to beat the returns from cash over the long run. Index funds stay fully invested with no cash. The long-run odds of having your portfolio generate returns in excess of returns from fully-invested index funds are enhanced by keeping cash to a minimum and staying as fully invested as possible. (Note: It is a little painful for us to write this section because, in our past, we often sat on our thumbs with too much cash in clients' portfolios… lower investment returns, were the residual of this process.)"[25]

**Mistakes and missteps in 2005**
It is always difficult to admit mistakes. Partly because we all want to be correct 100% of the time. Sometimes we are unaware of our mistakes. But as investors and stewards of your funds we have to be good at self-examination. We discussed what we thought may have been our biggest mistake in our October client letter. We explained to you that we reinvested into the real estate sector just as the sector started to tank. Our reasons for investing in real estate in the first place where spelled out then, but are worth repeating here. The firms we invested in all had extremely low P/Es, extremely high ROE's, consistently high earnings growth, high dividend yields and increasing net margins. We also assessed each company's ability to



BRICK FINANCIAL MANAGEMENT, LLC
BUILDING WEALTH ONE BRICK AT A TIME

Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to "Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com." Otherwise written permission is required.

continue producing and decided that although there was some pressure there, that the low valuations more than made up for any future difficulty.

However, the market sentiment at the time was that the real estate industry couldn't possibly continue to rise. Especially since it had been on a multi-year tear. For the 3 years ending in October real estate mutual funds had an annualized return of 27.8%. Talk of a real estate bubble permeated (and still does) the marketplace. In the end, market sentiment put tremendous pressure on the prices of these stocks. But our approach is based on company specific analysis, not macroeconomic speculation.

So where was our mistake? Like we said in October, we don't think our buying into the sector constitutes an error. (Although it may later prove to be so.) If there was any mistake on our part we think it was in overweighting the sector in our portfolio. Although we try to avoid being overly diversified in terms of number of positions, we try to be somewhat diversified in terms of the industries we are invested in. If we had it to do again, we would have cut our investment in the sector in half.

Perhaps you think it a little silly to say that knowing what we know, we would have invested in the sector again. But as you have heard us say before, we are going to trust our process as it is principle based and intelligently crafted and should lead us to market beating returns in the future. Doing so won't always work in our favor but over the long-term it should.

**Developments and accomplishments in 2005**

At the end of last year we set out to reduce our holdings in both the Relative Value and Choice model portfolios. Our goal was to eliminate a total of 15-20 positions from what was admittedly a bloated portfolio. We succeeded, reducing our total positions from 54 at the end of last year to 29 at the end of this year.  As we said last year,

> "…we would much prefer to own a portfolio of a small number of positions, each of which represent companies we know well and are highly confident are undervalued by the market than to be overdiversified".

We mentioned last year that we would be instituting diversified portfolios made up primarily of ETFs for those clients that are in the capital preservation stage of their investment lifecycle. We've been testing a few different allocations over the year, but have yet to officially launch a portfolio. However, we plan to do so this February.

We decided not to start a dedicated small/micro cap portfolio as we said we would. We abandoned the idea as we felt the Relative Value portfolio allows us enough flexibility in terms where in the market (size, industry) we can invest. Since the Relative Value portfolio is meant to opportunistic, a dedicated small cap portfolio would've been overkill.

Although we've made some strides in terms of disseminating articles and letters to you on numerous financial topics, we failed to do so with the consistency and volume we would have liked. We are still working on the right mix of information, frequency and delivery methods in our attempt to communicate with you.



BRICK FINANCIAL MANAGEMENT, LLC
BUILDING WEALTH ONE BRICK AT A TIME

Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to "Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com." Otherwise written permission is required.

**Plans for 2006**
There are a few things we would like to accomplish in 2006. One thing we are working on is establishing relationships with other financial service professionals. In line with one of our principles which is to focus on things which are in our circle of competence, we feel it best that we concentrate on the investment of your funds. However, many of you need and deserve more comprehensive services which include insurance planning, estate planning, college funding, legal and accounting assistance, concierge services and certainly comprehensive financial planning. So in an effort to serve you, we will be seeking and subsequently introducing you to professionals we feel will champion your effort to become wealthy and secure your financial well-being.

Our plans regarding your investments continue to be the same. We will continually look for good, if not great companies that we understand well and that are being traded in the market at bargain prices. We hope to concentrate our positions further. We want to own between 10 and 35 positions total, staying at the lower end of this range. Our primary concern however is that we adhere to our principles and do the things that will increase your (and our) capital with reasonable risk. And to do so by enough of a margin to make it worthwhile for you to work with us.

As we mentioned, we were not completely happy with how we delivered information to you during the year. Many of you have suggested that we shorten our client letters. While others asked for more articles on specific financial topics. Many of you praised our blog, but yearned for more frequent entries. After all the feedback and some thought on our part, we have come to the realization that there is no one answer on *how* to deliver information to you. But there is no debate in *what* to deliver to you. Thus we will continue to deliver the "*what*" which is information that is unfiltered, honest and in plain language.

In terms of "*how*" we get this information to you - it is a work in progress. But for 2006 we will make an effort to greatly shorten each of the client letters and post them to our website in a timely fashion. It is likely that the mid-year and year-end letters will continue to be a little longer. (Hopefully not 20 pages long.) We will also attempt to make frequent (about 1-3x per week) entries to *The Brick Blog* and disseminate those entries to you on a regular schedule. We will also encourage all of you to make comments and some of you to make actual entries. We are still working on developing our newsletter, *The Third Pig.* The newsletter is still a work in progress but we hope to have it operational by the second half 2006.

**Subscribe to our blog**
In the meantime, we encourage you to subscribe directly to *The Brick Blog* by clicking one of the links below. You can either subscribe through a blog reader (i.e. My Yahoo, Bloglines) or with an email delivery service (i.e. Feedblitz). All these services are free.

- For direct email delivery by Feedblitz: http://www.feedblitz.com/f/?Sub=6311
- For blog readers like My Yahoo: http://feeds.feedburner.com/brickfinancial



BRICK FINANCIAL MANAGEMENT, LLC
BUILDING WEALTH ONE BRICK AT A TIME

Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to "Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com." Otherwise written permission is required.

**We would like your referral**
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.

Sincerely,

Benjamin B. Taylor

*Endnotes*

---

[1] The gross returns of the Relative Value and Choice model portfolios and the Core 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 inception date for the Relative Value model portfolio is 12/6/2002.
[3] The inception date for the Choice model portfolio is 4/4/2003.
[4] The Core Portfolio Average is meant to represent the weighted average of the Relative Value and Choice model portfolios. Returns for the Core Portfolio 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 Core Portfolio Average is 12/6/2002.
[5] The Portfolio Average is meant to represent the weighted average of the Relative Value (70%) and Choice (30%) model portfolios.
[6] The idea of assigning a grade to our performance is not a unique concept. *Forbes* magazine runs a yearly feature on the top mutual funds and give each a letter grade. We all went to school and we all got a report card at some point. We are innately familiar with the letter grade method of assessing degree of performance. Thus, all of us immediately know the difference between an A+ and a D-.
[7] Volatility: The relative rate at which the price of a security moves up and down. Volatility is commonly found by calculating the annualized standard deviation of daily change in price. If the price of a stock moves up and down rapidly over short time periods, it has high volatility. If the price almost never changes, it has low volatility.
[8] …And to a lesser degree, the probability of the *devaluation* of capital.



BRICK FINANCIAL MANAGEMENT, LLC
BUILDING WEALTH ONE BRICK AT A TIME

Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to "Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com." Otherwise written permission is required.

[9] Standard deviation: A statistical measure of the historical volatility of a mutual fund or portfolio, usually computed using 36 monthly returns. More generally, a measure of the extent to which numbers are spread around their average.
[10] Risk free rate of return: A theoretical interest rate that would be returned on an investment which was completely free of risk. The 3-month Treasury Bill is a close approximation, since it is virtually risk-free.
[11] http://www.vanguard.com/bogle_site/lib/dimensions.html
[12] As we have said in a previous letter, 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 may be undervalued. In general price multiples do not define intrinsic value. They tell nothing of a company's competitive advantage, its growth potential, its capital 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 value 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.
[13] The S&P MidCap 400 is now the most widely used index for mid-sized companies. The S&P MidCap 400 covers approximately 7% of the U.S. equities market.

The S&P SmallCap 600 is fast becoming the preferred small-cap index in the U.S., covering approximately 3% of the U.S. equities market.
[14] Source: Morningstar.com
[15] Meir Statman is the Glenn Klimek Professor of Finance at the Leavey School of Business, Santa Clara University.
[16] Often referred to as non-systemic risk, it is the risk associated with the unique circumstances of a particular company, as they might affect the price of that company's securities. This is the risk that can be reduced by investing in several companies. Systemic risk on the other hand is the risk that affects an entire financial market or system, and not just specific participants. It is not possible to avoid systemic risk through any amount of diversification.
[17] Source: Campbell, John Y., Martin Lettau, Burton G. Malkiel, and Yexiao Xu. "Have Individual Stocks Become More Volatile?" Journal of Finance, February, 2001. Analysis Period: 1986-997
[18] *The Essential Buffett*, Robert Hagstrom, (John Wiley & Sons, Inc; New York; 2001), p. 176
[19] Euphemism for "old guys".
[20] The avoidance of absolute loss and the avoidance of devaluation are not mutually exclusive. We simply mean to point out how if one is emphasized over the other, how it can lead to different applications of the same investment philosophy (in this case value investing).
[21] Jeremy Siegel is the Russell E. Palmer Professor of Finance at the Wharton School, University of Pennsylvania.
[22] Source: Barra Research
[23] For example, the 5 year rolling period for 1995 covers January 1, 1991, through December 31, 1995. The next 5 year rolling period would be February 1, 1991 through January 31, 1996, etc.
[24] We actually do this by purchasing ETF's that mimic broad indexes like the S&P 500 or the Wilshire 5000.
[25] http://www.tweedybrowne.com



BRICK FINANCIAL MANAGEMENT, LLC
BUILDING WEALTH ONE BRICK AT A TIME

Copyright © 2005 Brick Financial Management, LLC, PhatKnot Media, LLC, Benjamin B. Taylor, all rights reserved. Readers may freely quote this document in part or in its entirety with the contingency that material is attributed to "Benjamin B. Taylor, President of Brick Financial Management, LLC, www.brickfinancial.com." Otherwise written permission is required.