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Re: January 2006 Client Letter (<http://www.brickfinancial.com/letters/200601clientletter.html>)

Dear Partners, Clients and Friends,

Our Core Portfolio Average came in slightly behind the Wilshire 5000 and just ahead of the S&P 500 this month. Our portfolios returned 3.1% to the Wilshire's 3.6% and the S&P's 2.7%. The returns for both model portfolios versus relevant stock market indices (including reinvested dividends) as of January 31, 2006 follow¹:

	Jan	YTD 2006	2005	2004	2003	2002	Since Inception
Relative Value ²	3.87%	3.87%	-1.49%	33.54%	44.09%	-2.09%	92.77%
Choice ³	1.05%	1.05%	-1.90%	15.31%	22.31%		39.81%
Portfolio Average⁴	3.02%	3.02%	-1.61%	28.07%	37.31%	-2.09%	74.52%
Wilshire 5000	3.56%	3.56%	6.38%	12.48%	31.64%	-5.54%	54.09%
S&P 500	2.65%	2.65%	4.91%	10.88%	28.68%	-5.88%	44.62%
Wilshire 4500	6.57%	6.57%	10.03%	18.10%	43.84%	-4.21%	90.81%
All U.S. Equity Mutual Funds	4.67%	4.67%	6.65%	11.96%	32.44%	-5.46%	56.49%

Happy New Year

Happy New Year! After a slightly disappointing 2005, we hope to get off to a good start in 2006. One way we hope to do that is by sticking to our goal of keeping these letters, well, succinct.

We sold Freddie Mac and Bank of America

The "big" news happening in our portfolios this month was that we sold some long time holdings while buying one that we have been waiting to get into for quite sometime. Our sells consisted of Freddie Mac and Bank of America (BoFA). Although we feel that both companies remain good companies and decent investments, we felt our funds were better leveraged elsewhere. (We talked about our sell criteria in our August 2005 client letter: <http://www.brickfinancial.com/letters/200508clientletter.pdf> .)

Uncertainty at Freddie

Freddie is still reeling from the accounting scandals that surfaced a few years ago. President Bush and former Fed chairman Alan Greenspan have each called for more government regulation of Freddie and its sister company Fannie Mae. Although the legislation suggested may actually allow these firms to take on *more* loans, we are just simply not fans of



government regulation. Freddie has benefited from the government's influence in the past, but we would just rather see the government stay out of their way.

With its complex situation (just coming off an accounting scandal) and the current unfavorable interest rate environment (a flat yield curve⁵), Freddie is difficult to pin a value on. From most indicators, Freddie is at an attractive valuation level. But we think there is enough uncertainty to give us pause. Usually we as value investors relish in uncertainty. That's usually where the opportunities lie. But we don't like undue risk. If we can find a situation where we see less risk with similar probabilities of return, we will take it.

Misgivings about BofA's management

The BofA sell was a little different. It too faced the daunting condition of a nearly flat yield curve. It, like most other large banks, is likely to see its net interest margins⁶ get worse before they get better. The recent earnings miss is a symptom of this. Although the company's management expects their acquisition of credit card issuer MBNA to begin adding to earnings as soon as 2007, we're skeptical.

Not that we think MBNA is a questionable business. Just the opposite. We think it's a fine business. It is more that we think the management of BofA, especially its CEO Ken Lewis, has an uncomfortably optimistic outlook (euphemism for "misleading") no matter the conditions of the economic climate. An example of what we mean is when management consistently reports *pro forma* figures rather than the more conservative GAAP⁷ figures. Pro forma figures have many assumptions or hypothetical conditions built in which allows for an alternative view of the financial statements. But that's just semantics. Usually companies use pro forma figures to hide all the bad stuff.

On a recent conference call Ken Lewis stated that the company was able to grow earnings by 31% over a two year period. The GAAP figures revealed something not quite in line with what Lewis's statement. Hedge fund manager Thom Brown (bankstocks.com) pointed out this discrepancy and recounted an email exchange he had with the company.

"This is what we refer to around here as 'Charlotte math. By the lights of my Bloomberg, BofA earned \$3.57 per share in 2003, \$3.86 in 2004, and \$4.15 in the year just ended. So over the past two years, earnings have risen by 16%, half the 31% growth that Lewis alleges. In response to my inquiry, a company spokesman emailed to say that the 2003 EPS Lewis was referring to are the pro forma numbers the company filed at the time of the Fleet deal in 2004. *Which is to say, Lewis's statement is nonsense.* [emphasis ours] The fact is that investors don't have a claim on retrospective pro forma numbers, nor do those numbers help build economic value over time. What matters are actual, here-and-now GAAP numbers. Lewis knows that, of course, but he threw out those phony numbers to make his performance look better than it really is. That's our Ken!"

Evaluating the management of companies is essential to our investment process. We look for capable management. We look for management groups that treat their shareholders (and customers) with high regard. We need to feel like management is speaking with us candidly

and honestly. We do not want management painting a rosy picture, were there really is none. We want management to “give it to us straight”. We just don’t get that feeling from the management of BofA.

All that said, we think that there is a good chance that from these levels, these companies will probably outpace the return of the S&P 500 over the next few years. But given our reservations about each of the companies, we thought we’d try to find a company that will give us similar returns with much lower *economic* risk and more capable and honest management.

The influence of Mr. Buffett

If you are a frequent reader of our letters, you have no doubt come to realize that Warren Buffett has been and will continue to be *the* primary influence in how we run your (and our) money. [Actually, we have also been influenced greatly by the wit and wisdom of Benjamin Franklin. Anyone interested in obtaining an intellectual base in the principles of wealth building should read Franklin’s *The Way to Wealth*.] In fact, many of the investments we have owned have also been owned by Buffett’s firm, Berkshire Hathaway. In no way were we copycatting his buys and sells. We have simply implemented an approach “taught” to us by Mr. Buffett (and his intellectual predecessor, Benjamin Graham) through years of studying him. If we apply what we’ve been taught correctly, we are bound to view some of the same companies as attractive purchases.

Berkshire Hathaway

The irony is that we had yet to own Buffett’s own company Berkshire Hathaway. Not that we haven’t wanted to. Applying Buffett’s own criteria to Berkshire led us to believe that there wasn’t much of a margin-of-safety in purchasing the stock. Even if there was a slight margin, after comparing it to what we owned in our own portfolio, we didn’t feel compelled to make a purchase. All we could do was wait. Finally, after years of waiting, we felt that the market had priced Mr. Buffet’s baby well below its intrinsic value so we purchased.

Berkshire is primarily an insurance company, operating GEICO, General Re, and National Indemnity. It also owns several other companies outright including Clayton Homes, NetJets, See’s Candies, Fruit of the Loom, International Dairy Queen, and The Buffalo News. Berkshire also own minority (but substantial) positions in some of the world’s most recognizable companies including American Express, Anheuser-Busch, Coca-Cola, Moody’s and Wal-Mart. In other words, Berkshire is huge.

Berkshire’s incredible growth

Since 1965, Berkshire’s per share book value⁸ has increased by an average annual gain of over 20%. We explained to you why the increase in book value is so important to us in our year end (December) 2005 client letter. To reiterate, we pointed out that the direction and trajectory of a company’s book value greatly influences the direction and trajectory of the company’s intrinsic value. And hopefully its *market* value. Since the end of 1996, Berkshire’s per share book value increased at a compounded annual rate of 13.5%. Berkshire’s price per share increased at a compounded annual rate of 11.2% over the same period.

In the case of Berkshire however, growth in book value is a misleading indicator of the potential growth in market price. Berkshire's intrinsic value should grow at a slightly higher pace than book value. One reason is that book value is continually reduced by the amortization of goodwill (an intangible asset) which decreases the asset side of the balance sheet. In Berkshire's 1999 shareholder letter, Buffett also added that he thought that his firm's operating results should outpace the gain in the S&P over the next decade. We believe him.

Berkshire's intrinsic value and potential return

We determined that Berkshire is undervalued using two approaches. A "simpleton" approach and Buffett's suggested approach. In the simpleton approach we used Berkshire's historic price multiples as gauge. Since 1990, Berkshire has traded in a range of 1.4 to 2.4 times book value. It has more recently been trading at a price to book value of 1.5 times. If we assume that Berkshire can continue to increase its book value by 10% annually over the next 5 years (a conservative estimate) and return to a "normal" multiple of 1.9 times book, then we are looking at a value for Berkshire's class A shares of \$182,000. From today's level of just under \$90,000 per share, we'd enjoy an annualized return on investment of 16%. At the very least, we think there is a high probability that Berkshire's market price will *at least* track the increase in the company's book value.

The second method (suggested by Buffett) of valuation requires us to break out Berkshire's business into two parts and add them. First is the per share value of its cash, equity and fixed income holdings. The second part of the equation is the per share value of pre-tax earnings excluding all gains and dividends from Berkshire's investments multiplied by a reasonable multiple (say 10-15x). At the end of the 3rd quarter for 2005, this calculation would have put Berkshire's intrinsic value somewhere around \$120,000 per share.

If we further assume that Berkshire's intrinsic value increases at a rate of 11% (slightly ahead of the projected rate of growth for the S&P 500 and its own book value), in 5 years the company should be worth \$193,000. This would give us a return on investment for the period of 17%.

Berkshire has "light" risks

Are there risks involved with Berkshire? Some. One is that Buffett may not be able to deploy Berkshire's \$40 billion in cash into profitable investments. In turn, yielding sub-par returns and diminishing the potential growth in book value. Another risk is the uncertainty surrounding Buffett's (and his partner, Charlie Munger's) age. These guys are not young. There remains some question as to how long they can keep it up. Another is the liquidity of its shares as they approach \$200,000 in the coming years. There isn't necessarily a ready market for them if a shareholder wants to unload. Another risk may be that the insurance business will see dramatic changes in the coming years.

But we feel that all these risks pale in comparison to the risks (and lack of comfort) we faced with Freddie Mac and BofA. Buffett has shown a long history of deploying capital rationally and to the benefit of shareholders. There is no reason to think this trend won't continue. And yes, the guy is no spring chicken but we trust that he and Munger will pick successors in their own mold, when the time comes for that. And finally, Berkshire is simply an extremely well

run organization with few worthy opponents. We feel we've strengthened our portfolio with addition of Berkshire Hathaway.

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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

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 If the “yield curve” is an alien term to you, it simply refers to the graphical representation of the relationship between yields and maturity dates for a set of similar bonds, usually Treasuries, at a given point in time. Normally, long maturity bonds have higher yields than short maturity bonds. A flat yield curve refers to the condition where there is very little difference in the yields of long and short term bonds. Financial institutions make money by borrowing short term bonds and selling long term bonds. They make money on the difference in the yields of the two. If the yields are “tight” very little money can be made.

⁶ Net interest margin is the dollar difference between interest income and interest expenses.

⁷ GAAP refers to Generally Accepted Accounting Principles. GAAP is a widely accepted set of rules, conventions, standards, and procedures for reporting financial information, as established by the Financial Accounting Standards Board.

⁸ Book value is a company's common stock equity as it appears on a balance sheet, equal to total assets minus liabilities, preferred stock, and intangible assets such as goodwill. This is how much the company would have left over in assets if it went out of business immediately.