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March 7, 2006

Re: February 2006 Client Letter (<http://www.brickfinancial.com/letters/200602clientletter.html>)

Dear Partners, Clients and Friends,

Our Core Portfolio Average came in slightly behind the Wilshire 5000 and the S&P 500 in February. Our portfolios returned -0.6% to the Wilshire's breakeven performance and the S&P's 0.3%. The returns for both model portfolios versus relevant stock market indices (including reinvested dividends) as of February 28, 2006 follow¹:

	Feb	YTD 2006	2005	2004	2003	2002	Since Inception
Relative Value ²	0.59%	4.48%	-1.49%	33.54%	44.09%	-2.09%	93.91%
Choice ³	-3.45%	-2.44%	-1.90%	15.31%	22.31%		34.99%
Portfolio Average⁴	-0.60%	2.41%	-1.61%	28.07%	37.31%	-2.09%	73.48%
Wilshire 5000	-0.03%	3.53%	6.38%	12.48%	31.64%	-5.54%	54.05%
S&P 500	0.27%	2.93%	4.91%	10.88%	28.68%	-5.88%	45.01%
Wilshire 4500	-0.99%	5.51%	10.03%	18.10%	43.84%	-4.21%	88.90%
All U.S. Equity Mutual Funds	-0.45%	4.19%	6.65%	11.96%	32.44%	-5.46%	55.77%

We have created two new portfolios

At the end of 2004 we mentioned that we would be adding portfolios that are broadly diversified for clients with specific investment goals to our investment choices. This month marks the launch of two diversified portfolios designed for investors with those objectives. The first portfolio (Equity ETF) is a portfolio meant to provide returns comparable to the returns of the total stock market as measured by the Wilshire 5000 Index with slightly less risk. The other portfolio (Fixed Income ETF) is meant to provide returns comparable to the bond market as measured by the Lehman Brothers Aggregate Bond Market Index. Each portfolio is made up exclusively (for the moment) of exchange traded funds (ETFs). [If you would like to learn more about ETFs, please read our [Client Education Brochure](#) (pp. 23-24).]

We are still Heretics

Regular readers of our letters may be a little thrown off by this recent development. We have repeatedly told you that broad diversification will hamper returns, which is one of the reasons we prefer to run concentrated portfolios. We have also told you that investors should abandon a short-term mentality. We have also pointed out that stocks (as opposed to other asset types) present the greatest likelihood of increasing our invested capital.



That investors should build portfolios that have broad diversification and should be concerned about short-term volatility are much more likely to be words uttered by a “Zealot”. A Zealot, as described by author and portfolio manager [Robert Haugen](#)⁵, is a true believer in the Efficient Market Hypothesis (EMH) and Modern Portfolio Theory (MPT)⁶. Let us assure you that we have not changed our stripes. We remain “Heretics”⁷ (disbelievers in EMH and MPT). We still believe in concentration, in a long-term mindset, that price matters and stocks should beat bonds. [For a discussion on EMH and MPT, see our Client Education brochure.]

We strive to *optimize* returns

That said we realize that there are some investors in special situations where our preferred style of investing may not be necessary. For the uninformed, our preferred style of investing – value investing – is designed for optimum long-term returns. But optimizing returns may simply not be of interest to some investors. They’d just rather keep the capital they have because they may have short-term time horizons or no desire to increase their wealth. Thus, diminishing short-term volatility takes on increased importance relative to optimizing returns.

The Zealots and the pros & cons of index funds

One way to achieve this end is by investing in a mix of assets (stocks, bonds and cash) which mimic a passive index and do so at the lowest possible cost. One good idea that the Zealot’s have developed is the index *fund* designed to do just that. An index fund captures about 99% of the market’s yearly return even after considering management costs. However, the structure of the index fund is both pro and con. The pro besides its low cost is it will give the exact return of the index (before management fees), since it owns all the stocks *in* the index in the same exact proportion. The con is it will *only* give the exact return of the index. Since it owns every stock in the index, it will own both good and bad stocks at the same time.

But the success of index funds versus active management can not be denied. The Zealots feel justified in their if-you-can-beat-em-join-em mantra as, since their creation, index funds have been able to beat actively managed mutual funds in any given year 80% of the time once costs are included. And when looked at over long periods (over 20 years) they beat more like 95% of actively managed funds. Why do index funds beat active management? Because most investors can not overcome their own behavior. Frequent buying and selling results in insurmountable costs and fails to beat a passive, low cost approach. These statistics are seen by the Zealots as proof positive that EMH and MPT are in fact legit.

Heretics are value investors

So what’s with us Heretics? In the face of the evidence, both academic and practical, how can we still believe that markets are inefficient? How can we continue to believe that we can find bargains in the market through careful study? How do we think that we can overcome our costs and avoid typical investor mistakes, when others cannot? Because to do otherwise would require us to *ignore* the evidence, both academic and practical, that says the market *can* be beaten by following certain principle based guidelines. The guidelines that have been laid out for us by Benjamin Graham and David Dodd, authors of the investing classic, [Security Analysis](#). In essence those guidelines are:

1. An investor should always remember that all things have an intrinsic value and although intrinsic value cannot be determined precisely, it is imperative that it is estimated
2. An investor should be aware that market price and intrinsic value are not the same and often diverge
3. An investor should follow a system of buying when prices are below intrinsic value and selling when prices are above

Value investing is no secret but hard to adopt

The most famous and wealthiest practitioner of this system is no other than Warren Buffett. But the list of successful Heretics does not end with Mr. Buffett. Numerous studies show that the implementation of this system consistently outperforms the market. The system is only limited by how well the practitioner can adhere to it. Heretics have exploited inefficiencies in the market for economic gain for years. One would think that these anomalies would be discovered by the general investing public. And then exploited by them all, thus eliminating the any extra advantage available. But as Buffett has said, the secrets of the system have been known for 70 years (since the publication of *Security Analysis*), and there seems to be no great migration towards its adoption.

This brings us back to beginning which is assisting those clients interested more in capital *preservation* than capital *appreciation*. However, since we are Heretics, and can't shake the habit of buying dollar bills for 50¢, we have to be true to ourselves. We have to find a way to continue to find undervalued assets (appreciation) while reducing the short-term volatility of our portfolios (preservation).

Traditional asset allocation (Investment Policy)

The Zealot answer to the problem would be to create a portfolio set with some fixed percentage in stocks, some in bonds and some in cash *without* regard for valuation. This would be executed through some investment combination in index and actively managed mutual funds. The practice commonly referred to as asset allocation (or the Investment Policy decision), thought by the Zealots to be the most important decision an investor can make. The Zealot believes that the asset allocation decision, and *not* security selection, is the *most important determinant of long term performance*.

As proof they reference one (that's right, one) study. We'll call the study BHB⁸. The Zealots tell us that BHB says that of the determinants of performance - asset class selection, security selection and market timing – asset selection determines 93.6% of long term portfolio performance. [We find it odd that BHB did not consider management fees, transaction costs and taxes among the determinants.] They also went on to say that security selection determined less than 5% of portfolio performance. The Zealots love BHB as it seems to support EMH which states that security selection is pointless.

Variation in returns is not total returns

But we (the Heretics), being skeptical by nature and being unable to ignore the success we've had with security selection, didn't buy the interpretation of the BHB study. So we actually read the thing. What did we discover? At no point does the BHB study measure *total long-term returns*. What it measures is the total variation in quarterly (short-term) returns⁹. In

other words, BHB measured how much a portfolio went up and down over short periods and *not* how much money it made in the long term. BHB determined the successful portfolio as one that didn't fluctuate a lot. Whether or not the portfolio actually made any money was *not* a determinant of investing success. Hmm...interesting.

Variation in returns means little

We must keep in mind that the variation of quarterly returns alone tells us practically nothing about the prospects of investors achieving their financial objectives. Funding financial objectives comes from portfolio contributions and the compounding of returns over time. In other words, returns should not be ignored, even in the short-term. [Further, even if short term volatility is of utmost concern, we must realize that extreme diversification does not necessarily eliminate it. A more effective technique would be to choose investments that have similar returns but do not move in tandem. In other words, they should have a high negative correlation¹⁰.]

Traditional asset allocation fails

When using the material in the BHB study, and interpreting the results correctly, we find that the *asset allocation decision determines only 15 percent of returns over a 10-year period*¹¹. This little tidbit damages the credibility of the asset allocation process as practiced today, which is to say that long term investors should *automatically* be invested mostly in stocks and short term investors should automatically be invested in bonds and cash. This portfolio management by autopilot is nonsense. In our Client Education Brochure, we point out that over 10-year periods, stocks perform better than bonds and cash over 80% of the time. But turned on its head, we see that bonds and cash perform better than stocks 20% of the time. If your time horizon is only 10-years long, wouldn't you want to know *which* assets would perform best over the coming period? What you wouldn't want to do is make an assumption that history will repeat itself. We think it important that we account for those times when stocks underperform.

Using, better yet, misusing the BHB study the Zealots set portfolios with rigidity (i.e., 20% large cap stocks, 10% foreign stocks, 15% small cap stocks, 10% short term bonds, etc). They wind up owning stocks from every corner of the market. Should any one piece of the portfolio advance or decline too significantly away from the original asset allocation, Zealots either buy or sell accordingly. This would seem to make sense if it were not for differing time horizons, valuation and costs.

As we just mentioned, there are occasions when both bonds and cash perform better than stocks, usually during extended bear markets. Thus the problem arises when arbitrarily selling (or buying) a portion of a portfolio that has advanced (or declined) significantly. The problem is exaggerated when valuations of the securities and the time horizon suggest just the opposite action should be taken. Extreme diversification, as traditional asset allocation requires, would always have the client in some asset that was underperforming. At best the portfolio would do about average with the market. As Heretics we can't shake the belief that we should try and can do better than the market.

Value allocation succeeds

Brick Financial believes that most investors should have some exposure to stocks, bought at low valuations, at all times. But when we create portfolios we will let the *valuations* of groups of stocks, bonds and cash, determine the asset allocation. This process is sometimes called “Tactical Asset Allocation” (TAA). A more fitting title would be “Value Allocation” (VA) which accounts for valuation of securities, investment time horizon, costs and fees.

Thus our goal with these portfolios is to take advantage of the pros of the index *fund* (low management costs, low underlying transaction costs, tax efficient) and avoid its cons (requirement to own economically weak companies). We want to continue to take advantage of the value investing system which is to buy undervalued assets or securities and sell overvalued ones. We also want to exhibit flexibility when setting Investment Policy.

Enhanced/Strategic index funds

We are fortunate to live in an era where index funds have advanced to the point where they are able to do more than just simply track and broad index. Available to us are products that are designed to take advantage of market anomalies. Commonly called Enhanced Index Funds or Strategic Index Funds, these funds set rules that are designed to include or exclude any security the manager sees fit. They are not hogtied to owning obviously inferior investments as tracking a broadly based index fund would require of them. The better enhanced/strategic indexing strategies have a favorable record against traditional indexing, usually with a margin of victory approaching 3% with less volatility. We plan on using these funds through ETFs as well as more traditional index ETFs in combination to generate adequate returns with less volatility.

Our approach

We believe that over periods of time, we will outperform the markets through our stock selections of individual securities (Our Core Portfolios). Our Equity ETF portfolios and our Fixed Income ETF portfolios will round out the Value Allocation of our client portfolios. Thus, although we use the tool of traditional asset allocation, we do will let this tool dictate our investment strategy. The Investment Policy statements we create for our clients will in turn give a range for an asset type (i.e., 50% to 70% equity) rather than a fixed percentage that would leave very little opportunity for taking advantage of an undervalued market.

If you find that you are interested in this type of portfolio structure, please do not hesitate to call us or email us.

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And lastly, we would like to ask for your referral. 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 New Finance*, Robert A. Haugen, (Prentice Hall, 3rd edition, 2003)

http://www.amazon.com/exec/obidos/redirect?link_code=ur2&tag=brickfinancial-20&camp=1789&creative=9325&path=http%3A%2F%2Fwww.amazon.com%2Fgp%2Fproduct%2F0130497614%2Fsr%3D8-1%2Fqid%3D1145467264%2Fref%3Dpd_bbs_1%3F%255Fencoding%3DUTF8

⁶ A Zealot is a true believer in the Efficient Market Hypothesis and Modern Portfolio Theory. Modern Portfolio Theory - Overall investment strategy that seeks to construct an optimal portfolio by considering the relationship between risk and return, especially as measured by alpha, beta, and R-squared. This theory recommends that the risk of a particular stock should not be looked at on a standalone basis, but rather in relation to how that particular stocks price varies in relation to the variation in price of the market portfolio. The theory goes on to state that given an investors preferred level of risk, a particular portfolio can be constructed that maximizes expected return for that level of risk (also called modern investment theory). Efficient Market Theory - The now largely discredited theory that all market participants receive and act on all of the relevant information as soon as it becomes available. If this were strictly true, no investment strategy would be better than a coin toss and every single investment would give the exact same return.

Proponents of the efficient market theory believe that there is perfect information in the stock market. This means that whatever information is available about a stock to one investor is available to all investors except, of course, insider information, but insider trading is illegal. Since everyone has the same information about a stock, the price of a stock should reflect the knowledge and expectations of all investors. The bottom line is that an investor should not be able to beat the market since there is no way for him/her to know something about a stock that isn't already reflected in the stock's price. Proponents of this theory do not try to pick stocks that are going to be winners; instead, they simply try to match the market's performance. However, there is ample evidence to dispute the basic claims of this theory, and most investors don't believe it.

⁷ A Heretic is a true *disbeliever* in EMH and MPT. Many times Heretics are also self described value investors.

⁸ "Determinants of Portfolio Performance," by Brinson, Hood, and Beebower, *Financial Analysts Journal*, (1986)

⁹ "The Asset Allocation Hoax," by Jahnke, *Journal of Financial Planning*, (1997)

http://www.fpanet.org/journal/articles/2004_Issues/jfp0804-art8.cfm

¹⁰ In probability theory and statistics, correlation, also called correlation coefficient, indicates the strength and direction of a linear relationship between two random variables. In general statistical usage, correlation or co-relation refers to the departure of two variables from independence. The correlation is 1 in the case of an increasing linear relationship (positive correlation, variables move in tandem), -1 in the case of a decreasing linear relationship (negative correlation, variables move in opposition), and some value in between in all other cases, indicating the degree of linear dependence between the variables. The closer the coefficient is to either -1 or 1, the stronger the correlation between the variables. When designing portfolios we want assets (variables) that have similar potential for high returns but are negatively correlated.

¹¹ "The Asset Allocation Hoax," by Jahnke, *Journal of Financial Planning*, (1997)

http://www.fpanet.org/journal/articles/2004_Issues/jfp0804-art8.cfm