

# Brick Financial Management LLC

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Re: March 2006 Client Letter (<http://www.brickfinancial.com/letters/200603clientletter.html>)

Dear Partners, Clients and Friends,

**For the first quarter of 2006, our Core Portfolio Average trailed the Wilshire 5000.** Our portfolios returned 4.1% to the Wilshire's 5.4%. and the S&P's 4.2%. The returns for both model portfolios versus relevant stock market indices (including reinvested dividends) as of March 31, 2006 follow<sup>1</sup>:

	March	YTD 2006	2005	2004	2003	2002	Since Inception
Relative Value <sup>2</sup>	1.22%	5.76%	-1.49%	33.54%	44.09%	-2.09%	96.27%
Choice <sup>3</sup>	2.72%	0.22%	-1.90%	15.31%	22.31%		38.67%
<b>Portfolio Average<sup>4</sup></b>	<b>1.65%</b>	<b>4.10%</b>	<b>-1.61%</b>	<b>28.07%</b>	<b>37.31%</b>	<b>-2.09%</b>	<b>76.34%</b>
Wilshire 5000	1.84%	5.44%	6.38%	12.48%	31.64%	-5.54%	56.89%
S&P 500	1.25%	4.21%	4.91%	10.88%	28.68%	-5.88%	46.82%
Wilshire 4500	3.81%	9.53%	10.03%	18.10%	43.84%	-4.21%	96.09%
All Domestic Equity Mutual Funds	2.24%	6.57%	6.65%	11.96%	32.44%	-5.46%	59.33%

We are going to give readers of our client letters a little reprieve this month by keeping this letter extremely short. Whatever we can't fit here in less than three pages, we will address another time.

## 2006 Q1 in review

The first quarter of 2006 has been phenomenal for the stock market. Every major index is up for the year. Most have approached or exceeded the returns it took the previous twelve month to achieve. The S&P 500 posted its best quarter since 1999 with a gain of 4.2%. Small-cap companies, represented by the Wilshire 4500, fared even better posting gains of about 9.5%. One theory why small-caps may have outperformed is that hedge funds, which have proliferated in recent years, poured money into this area of the market, creating a sort of self-fulfilling trend. The more hedge funds invested in small companies, the more the stocks of those companies tended to rise, which in turned triggered more hedge fund managers to do the same. All this action simply caused the prices to rise even more.

## Small-caps seem pricey

The small-cap outperformance of large caps over the last few years suggests that small-caps may be becoming richly valued. The P/E ratio of the Wilshire 4500 is a lofty 35.8 while the



P/E of the S&P 500 (a proxy for large-cap stocks) is about 18.1. Of course small-caps may deserve this premium. Conventional wisdom, oops, wisdom says that the growth potential of small-caps so far exceeds that of large-caps that they *should* fetch a higher relative price. Of course opinions on why certain groups of stocks outperform change over time. The fact of the matter is that no one really knows what large or small-caps will do relative to one another in the future.

### Valuation matters

Our belief is that valuation always matters. Our knee jerk reaction is to say that small-caps are due for a pull back and that large-caps *should* outperform. But who knows. We don't have the benefit of a crystal ball. We will just keep plugging along and will do our best to go to where the returns are. And over long periods, the returns are with good companies bought at bargain prices. This is why we continue to try and position our portfolios where our downside is limited but our upside is promising. As the following table shows, we invest in good companies (high ROE) at bargain prices (low P/E), relative to the market.

	Price-to-Earnings	Price-to-Book	Return-on-Equity
Relative Value	14.5	2.76	19.74%
Choice	19.1	3.75	21.65%
<b>Core Portfolio Average</b>	<b>15.9</b>	<b>3.06</b>	<b>20.31%</b>
Wilshire 5000	20.4	2.95	14.46%
S&P 500	18.1	2.97	16.41%
Wilshire 4500	35.8	2.66	7.43%

Source: Wilshire Associates, Standard and Poor's, MSN Money (as of April 20, 2006)

### Two on the bench

The interesting development in our portfolios this month is that we sold some long time holdings and bought some new ones. Our sells include Anheuser-Busch and Amazon.com. You should not however take our selling these positions as an indicator that we do not like the companies. This is simply a case where we saw opportunity elsewhere and wanted to exploit it. To use a metaphor, we run these portfolios as if we are the general manager of a baseball team. Although we have a 25-man roster, only 9 will play at a time. The 9 that play will hopefully give the team the best chance to win *at the moment*. This doesn't necessarily mean that the 16 men on the bench are poor players or even inferior to any of the starting 9. It is highly possible (given how things are known to change) that one of the 16 will break into the starting lineup.

### Three to the starting lineup

Thus we would liken the selling of Anheuser and Amazon.com as simply a change in our lineup. These "players" are going to ride the pine for a while, perhaps temporarily. In the meantime we're giving some other players a chance to play because we think that, *at the moment*, they give us a better chance of winning. The new players to our lineup include K-Swiss, CDW and American Eagle Outfitters. Two of these positions are new while one (American Eagle) is seeing a return to our portfolio.

We will be getting into the details of each of these companies, and why we like them later. We will post the commentary on *The Brick Blog*. For now, here is a brief description of each company:

### **K-Swiss**

Known as the “50-year shoe”, the classic tennis shoe is a mainstay in the casual shoe market. Unlike other shoe companies, that constantly need to come out with new styles and must pour insane amounts of money into research and development, K-Swiss’ appeal is its “plainness”. This \$1 billion company hasn’t suffered from in lack of variety in its product line either as it has been able to grow its equity at a rate of 19.3% per year over the last 9 years.

### **CDW**

CDW went public in the spring of 1993 and since then has returned 38% per year. CDW is a direct marketing distributor of name-brand products from companies like Microsoft, Apple, Hewlett-Packard, Sony, IBM, and Cisco. The company generates more than \$6 billion in revenues and has more than 300,000 different customers. CDW was (unjustifiably) lumped with many of the internet bubble stocks of the late 90s and stock took a nose-dive after 2000. But the company remained strong and should now return to its ascent upwards.

### **American Eagle Outfitters**

Had you invested \$10,000 in this company 10 years ago, today you’d have \$415,000. Not a bad run for a company that, for most of its existence has been in the shadow of the Gap and Ambecrombie & Fitch. American Eagle is a retailer that designs, markets and sells its own brand of clothing targeting 15 to 25-year-olds. Although other youth clothing retailers have struggled over the years dealing with fickle fashion tastes, American Eagle has kept its ROE consistently above 20% and has increased its EPS in all but two of the last 10 years.

### **Subscribe to *The Brick Blog***

In closing, we would like to remind you to subscribe 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>

### **Become a client**

As always, thanks for your confidence in us. If you are not already, find out how to become a client ([http://www.brickfinancial.com/become\\_a\\_client.html](http://www.brickfinancial.com/become_a_client.html)). Please don’t hesitate to call us at (973) 313-1220 or 1-888-BRICK-10 or email us at [info@brickfinancial.com](mailto:info@brickfinancial.com).

Sincerely,



Benjamin B. Taylor



## Endnotes

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<sup>1</sup> 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).

<sup>2</sup> The inception date for the Relative Value model portfolio is 12/6/2002.

<sup>3</sup> The inception date for the Choice model portfolio is 4/4/2003.

<sup>4</sup> 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.