

Brick Financial Management LLC

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February 17, 2007

Re: December 2006 Client Letter (<http://www.brickfinancial.com/letters/200612clientletter.html>)

Dear Partners, Clients and Friends,

Our Core Model Portfolio finished 2006 up 12.9% versus 15.8% for the S&P 500. The portfolio returned 91.3% since inception. That compares to 63.2% for the S&P 500. The returns for both model portfolios versus relevant stock market indices (including reinvested dividends) as of December 31, 2006 following¹:

	2006	2005	2004	2003	2002	Since Inception
Core Portfolio	12.89%	-1.61%	28.07%	37.31%	-2.09%	91.25%
Wilshire 5000	15.77%	6.38%	12.48%	31.64%	-5.54%	72.28%
S&P 500	15.79%	4.91%	10.88%	28.68%	-5.88%	63.14%
Wilshire 4500	15.28%	10.03%	18.10%	43.84%	-4.21%	106.38%
U.S. Equity Mutual Funds	12.56%	6.65%	11.96%	32.44%	-5.46%	68.28%

The Market

The S&P 500 advanced strongly in the fourth quarter, up 6.7%. The Core Portfolio also posted satisfactory gains for the quarter with gains of 8.5% led by Berkshire Hathaway (+15.5%), Coca-Cola FEMSA (+21.5%), and PACCAR (+17.6%). Although we did well for the quarter, we trailed the market for the year. That said we remain pleased with our relative performance. The best performing sectors of the S&P 500 were energy (+22.2%) and telecom (+32.1%), two industries in which we had no positions.

The Core Portfolio benefited from a shift in market preference from small/mid-cap stocks to mid/large-cap stocks. The large-cap sector in particular has been out of favor for many years thus the return of excess gains in the sector is not surprising. However, there may be some among you concerned the returns in the mid/large-cap area, where the Core Portfolio is concentrated, may dry up as quickly as they came. But we feel the positions we hold continue to be undervalued and we see further promise, with slight trepidation, in these positions going forward.

Coming trends

Our trepidation is borne of a few trends we saw this year and others we think will continue into 2007. Most markets around the world had gains during 2006. This would suggest most markets are fairly valued. Additionally, the CBOE VIX Index which measures the implied volatility of the S&P 500,



showed very little volatility in the market this year. Investors seemed to be complacent. With the above average returns for the year and volatility at all time lows, investors may be thrown off by any major hiccups in the market going forward.

One potential hiccup is the housing market will likely continue to see increasingly downward pressure. The freewheeling days in real estate of the mid-2000s are coming to a perilous end. Home prices are falling below the mortgages placed on them. Home builders have bloated and unsold inventories. All this while jobless claims are ever rising. The surplus of supply with an inevitable increase in defaults on current mortgages by financially challenged families will certainly affect the lending institutions that invest in mortgages. This will likely (or should) make lenders less willing to lend at reasonable, let alone favorable terms, putting further pressure on current real estate values. Housing and lending institutions are joined at the hip. Thus we may see the financial sector suffer as real estate continues to decline.

Another trend we may see continue into the year is the bull market in energy. Eventually, this bubble must burst as well. We just have no idea when it will occur. In the meantime, skyrocketing energy costs will likely suppress returns in the stock market, especially in consumer sector.

Currently, we are not in the real estate or financial sector, thus we should avoid the current and future losses the market is giving and will give in these areas. The silver lining is should this happen, we may begin to see values in these sectors as stock prices decline. On the other hand, there may continue to be outsized gains in the energy sector. Unfortunately, we see no values in this area so we'll stay clear.

However we remain optimistic

Part of the reason we remain perpetually optimistic about how we will perform for you, despite the headwinds we anticipate in the coming or in any year, is in large part due to our inherent advantages over alternative forms of investment. All things being equal, we will perform better for you than the typical mutual fund. A major, though not the only, reason we enjoy this advantage is our costs versus the costs incurred by the typical mutual fund are much lower.

Why costs matter: an illustration

To best illustrate this we refer to John Bogle, former chairman of Vanguard. In an article titled "What Can Active Managers Learn from Index Funds?"², Bogle states:

“today we understand that the costs incurred by market participants matter . . . and matter a great deal. . . Based on my best estimates of the costs currently incurred by investors in U.S. equity funds, here is the picture:



Average Equity Mutual Fund	% of Average Assets
Advisory Fees	1.1%
Other Operating Expenses	0.5
Total Expense Ratio³	1.6%
Transaction Costs ⁴	0.7
Opportunity Cost ⁵	0.4
Sales Charges ⁶	0.6
Total	3.3%
Taxes ⁷	1.6
TOTAL	4.9%

Bogle's example applied to our portfolio

In the article Bogle goes on to demonstrate the aforementioned fees greatly diminish the resulting portfolio of the typical fund over long periods of time. Taking Bogle's lead we can compare the effect costs have had on our portfolio versus alternative investments in a typical mutual fund or index fund over the last 4 years. Using Bogle's as well as industry figures from other sources⁸, we compare the typical mutual fund's expenses, an index fund's expenses and our typical clients' expenses in the following table:

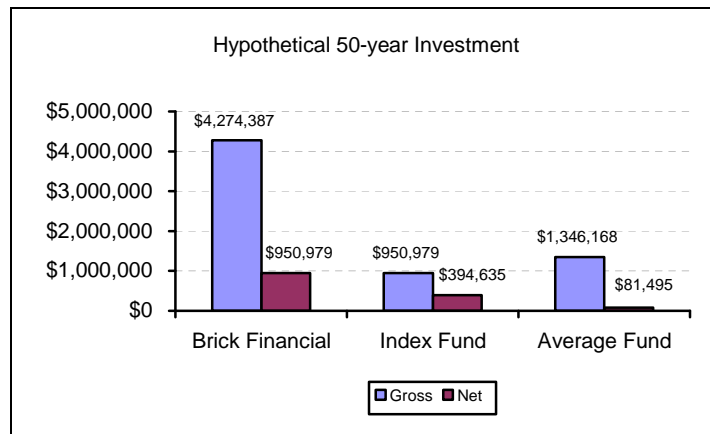
Category	Typical Mutual Fund	Average S&P 500 Fund	Typical Brick Fin'l Client
Gross Returns (2003 – 2006) (A)	15.5%	14.7%	18.2%
Advisory Fees	1.1%	0.2%	1.5%
Other Operating Expenses	0.5	0.1	0.0
Total Expense Ratio	1.6%	0.3%	1.5%
Transaction Costs	0.7	0.2	0.4
Opportunity Cost	0.4	0.0	0.0
Sales Charges	0.6	0.3	0.0
Total	3.3%	0.8%	1.9%
Taxes	3.0	1.2	1.6
TOTAL (B)	6.3%	2.0%	3.5%
Net Returns (A - B)	9.2%	12.7%	14.7%

As the table above demonstrates, the gross annualized return of the Core Portfolio was 18.2% over the last four years, which handily beat the S&P 500 gross returns of 14.7% over the same period and the gross return of the typical equity mutual fund's return of 15.5%. Of course, as they say in the biz, "You can't eat gross returns". Once we account for the after-tax expenses in the chart above, the net annualized returns of the Core Portfolio, the S&P 500 as represented by an index fund and the typical

equity mutual fund are 14.7%, 12.7% and 9.2% respectively. The following charts show the results on these annualized returns on an invested \$1,000 over four and fifty years (as in the Bogle example).

Notice that while the typical mutual fund had higher returns than the index fund on a *gross* level, it failed to beat the index on a *net* level. While the index *fund* was able to capture 97% of the pre-tax returns of the index that it tracks, the typical mutual fund was only able to capture about 62%. Meanwhile, our Core Portfolio Average beat the index fund on a gross *and* net level. Recapping, the index fund captured 97% of the index’s return and mutual funds captured about 91%. In contrast, our Core Portfolio Average captured a full 106% of the pre-tax return of the index.

The differential between our net returns and the returns of the index fund are also worthy of attention. Our net returns of 14.7% beat the Average Fund’s return of 9.2% by 5.5%. Although this seems like a small amount, over a 20 year period, a 5.5% premium will result in 2.67x more money! Over 50 years (the typical investment lifecycle of the typical investor) a 5.5% premium will result in almost 12x more money.



It goes without saying that \$1 million dollars is a lot of money. But \$12 million is better! All in all, most investors earn below-average or average returns due to high expenses, poor investment selection, and little protection should the stock market not rise substantially over the course of one’s investment horizon. By keeping costs down, finding undervalued stocks, and having the flexibility to avoid investments that are overpriced and exposure to markets that have meaningful downside risk, we been able to deliver market-beating returns for its clients and plans to continue doing so for many years to come.

Become a client

As always, thanks for your confidence in us. If you are not already, find out how to [become a client](#). Please don't hesitate to call us at (973) 486-9860 or email us at info@brickfinancial.com.

Sincerely,



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1 The gross returns of 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. 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 http://www.vanguard.com/bogle_site/december042000.html

3 Unweighted mutual fund ratio. The weighted ratio is about 1.1%.

4 Most studies show far higher transaction costs. But since market impact itself must be a net zero, (i.e., your aggressive sale creates my bargain purchase), my low estimate reflects how much “The Street” charges for its trading services.

5 Assuming 12% stock return; 6% cash return; 7% of assets in reserves.

6 Five percent (5%) sales charge, amortized over ten-year holding period.

7 Assuming 10% fund after-cost return, 1% income, 9% capital; 50% of gains realized annually, two-thirds long-term, one-third short-term; maximum tax bracket.

8 *The Great Mutual Fund* by Gregory Baer and Gary Gensler

