

Brick Financial Management LLC

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Re: December 2007 Client Letter (<http://www.brickfinancial.com/letters/200712clientletter.html>)

Dear Partners, Clients and Friends,

Our Core Model Portfolio returned to the winner's column this year besting each of the benchmark indices for 2007. The returns for both model portfolios versus relevant stock market indices (including reinvested dividends) as of December 31, 2007 following¹:

	2007	2006	2005	2004	2003	2002	Since Inception
Core Portfolio	20.30%	12.89%	-1.61%	28.07%	37.31%	-2.09%	130.07%
Wilshire 5000	5.62%	15.77%	6.38%	12.48%	31.64%	-5.54%	81.93%
S&P 500	5.49%	15.79%	4.91%	10.88%	28.68%	-5.88%	72.09%
Wilshire 4500	5.39%	15.28%	10.03%	18.10%	43.84%	-4.21%	117.53%
U.S. Equity Mutual Funds	6.55%	12.56%	6.65%	11.96%	32.44%	-5.46%	79.31%

Our long-term performance

In our [2005 client letter](#), we said that an investor would need at least five year or more to make a decent assessment of a stock picker's skill. Truth be told, to be *statistically* certain of a manager's skill level in picking stocks one would actually need many more years. We will touch on this more later but the basic idea is, the more information one has (years of return), the less one can assign random chance to investment prowess or ineptitude. Our Core Portfolio is now five years old making it an opportune time to asses our performance as stock pickers and benchmark 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

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. 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 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. 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 our [June 2005 letter](#), we think the market will return 7½-9% annually over the foreseeable future. Since we wrote that letter the S&P 500 has returned about 10.8%, above our expectation. In any event our value-oriented approach, concentrated strategy, and long-term focus should provide a margin of at least 4-7% over the market. A 4-7% margin over the market may not be much in your mind. But over 20 years a 4% margin will yield twice as much money while a 7% margin will get four times as much money. Those little differences mean a lot over time.

Our performance “report card” and 2007 in review

From the table below it’s easy to see that over the last one, three, five years and since inception we have increased our capital. In addition, our Core Portfolio has beaten the market and the average domestic equity mutual fund over that time. We would generally say that meeting either of our performance *expectations* would garner us a grade of at least a B. With annualized returns of 17.9%, we’ve exceeded our performance expectations of 12-15% and outperformed the market since inception by about 6.6%. In other words, we think we have performed respectively over the last 5-plus years (ending 12/31/2007) and we have earned a grade of B+.

	1 Year	3 Years	5 Years	Since Inception
Core Portfolio	20.3%	10.1%	18.6%	17.9%
S&P 500	5.5%	8.6%	12.8%	11.3%
<i>Margin of victory/(defeat)</i>	14.8%	1.5%	5.8%	6.6%
<i>Annualized return of 12-15%?</i>	Yes	No	Yes	Yes
<i>Outperformance of market by 4-7%?</i>	Yes	No	Yes	Yes

This past year marked the year that put the Core Portfolio back on track in terms of performance expectations. This allowed us to improve the Core Portfolio’s winning record of beating the market to 3 of the last 5 calendar years. We pointed out to you in a [previous letter](#) that even the most highly regarded and successful stock pickers typically do not beat the market year in and year out. In other words, our year-to-year performance puts us among good company.

Reasonable risk

Of course we would like to outpace the market every single year but that simply isn’t going to happen. That said we are less concerned about our year-to-year performance than we are our performance over several years. A slightly better, albeit still inadequate, indicator of our skill as stock pickers and our management of risk is our performance over several rolling multi-year periods. Since inception we have had 26 three year periods of returns (December 2002 to December 2005, January 2003 to January 2006, etc) in the five plus years we have been running our model portfolios.



3-year rolling returns			
Ending Date	Core	S&P 500	Difference
11/30/05	19.06%	12.10%	6.97%
12/31/05	20.05%	14.39%	5.66%
01/31/06	22.59%	16.42%	6.17%
02/28/06	23.83%	17.11%	6.72%
03/31/06	23.24%	17.22%	6.02%
04/30/06	19.83%	14.67%	5.16%
05/31/06	15.18%	11.63%	3.54%
06/30/06	14.90%	11.22%	3.68%
07/31/06	12.67%	10.80%	1.88%
08/31/06	12.23%	10.95%	1.28%
09/30/06	13.34%	12.30%	1.04%
10/31/06	12.02%	11.44%	0.58%
11/30/06	12.91%	11.82%	1.10%
12/31/06	12.46%	10.44%	2.03%
01/31/07	13.61%	10.32%	3.29%
02/28/07	10.68%	9.09%	1.59%
03/31/07	10.53%	10.05%	0.48%
04/30/07	14.20%	12.24%	1.96%
05/31/07	15.20%	13.02%	2.18%
06/30/07	13.33%	11.67%	1.66%
07/31/07	14.16%	11.75%	2.41%
08/31/07	15.73%	12.16%	3.57%
09/30/07	16.02%	13.14%	2.89%
10/31/07	16.86%	13.16%	3.71%
11/30/07	12.92%	10.09%	2.83%
12/31/07	10.14%	8.62%	1.52%

There are several goals we have in running our portfolio and if met will demonstrate its risk relative to the market. They are:

1. limit the frequency of negative return 3 to 5 year periods
2. limit the magnitude of the losses in those losing multi-year periods relative to the market
3. limit the magnitude of “peak-to-trough” drops in value to 25% or less and fewer than once in any 3 to 5 year period

As can be seen from the chart above, we have had no negative return 3-year periods easily passing the first litmus test of reasonable risk. The chart also reveals the Core Portfolio has never lost to the market in any three year period since inception. Finally, in the five-plus years of the Core Portfolio's existence, we have had one "peak-to-trough" period of greater than 25% lasting a period of four months. Just as the best investment managers have all had periods of year-to-year underperformance, they have had peak-to-trough losses of 25% or greater at least once or twice every decade or so. Once again, we are in good company.

However, as we alluded earlier, five years of performance data may not be enough to be absolutely certain of our superior (or inferior) skill as stock pickers. To be *statistically* certain (95% confidence level) a manager will outperform or underperform the market by at least 4% one would need at least 20 years of return data². I doubt anyone wishes to wait this period of time in order to be certain of if they are invested with a skillful or inept manager. Since the time we have been running our portfolios has fallen well short of that 20 year period, you must rely on other measures to assess our skills.

The short-term process produces long-term results

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... 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... 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'."

Since it is adherence to a sound investment 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 and whether or not we have closely adhered to that process. Proven time and again, the process we follow commonly referred to as "value investing" has produced exceptional results and should in the future.

In support of the above, Legg Mason Capital Management performed a study in an attempt to find the common characteristics of mutual funds that beat the S&P 500 index during the period of 1992 to 2002³. What was found were four common attributes of the outperformers:

- Low portfolio turnover – As a whole, this group of investors had a 30% turnover ratio compared to 110% turnover of the average mutual fund and a 7% turnover of the index. In other words, the typical mutual fund holds their stocks for less than a year triggering the highest transaction costs and capital gains taxes. Those funds also probably do not let their winners run, selling too soon and buying too late. The typical outperforming fund however holds onto their stocks over three years, mitigating transaction costs, delaying and reducing

taxes and taking full advantage of the ascent of their holdings. The turnover of the outperformers is similar to that of the index.

- Concentrated portfolio – The long term outperformers tend to have a higher portfolio concentration than the index. These portfolios on average have 37% of assets in their top-10 holdings versus 24% for the index. [Other studies](#) have also shown the performance advantage of concentrated portfolios.
- Intrinsic value investment approach – The outperformers seek stocks with prices that are less than their value, an approach in which [Warren Buffett says](#) binds many successful investors.
- Geographic location – Almost none of the ourperformers hail from the East-coast financial centers of New York or Boston. Warren Buffett has often said that remaining in Omaha, Nebraska has allowed him to shut out the noise of Wall Street and operate in his circle of competence.

Although not an official finding of the study another characteristic of the outperforming funds is they are candid with their shareholders. They often admit their mistakes and explain their thinking on the choices they have made whether the outcome was positive or negative. We believe doing so has the benefit of self-focusing the managers of these funds on the proper approach to outperforming the market. We would add this as a fifth common attribute of outperforming funds.

Our process supports our principles

We developed a series of [investment principles](#) very similar to the common characteristics of the market beating mutual funds. If strictly followed, our principles will likely lead to long-term superior performance as it has for other successful stock pickers whom have followed a similar approach. These principles are intended to guide us in our daily pursuit of serving you better. Thus, in the absence of 20 years of performance data, we encourage you to measure our behavior against these principles.

This is admittedly a qualitative pursuit but not a trivial one. Asking and answering the following 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 (or pleasing). Those questions are:

- Has Brick Financial demonstrated behavior that is in line with its commitment to a long-term investment philosophy?

Typically, our turnover ratio has been at or below 15%. Meaning we hold onto our positions for 6-7 years. This holding period is not quite as long as the index or an index fund but is longer than the outperforming funds (3 years) and much longer than the typical mutual fund (less than 1 year).

That said, we must not make it a strict rule to hold our investments for some preset amount of time. As we will discuss later when we cover our mistakes, holding for short periods sometimes makes



sense. How long we hold will ultimately be determined by the movement in the stock's price versus the underlying intrinsic value of the business. Since we cannot determine with any great degree of accuracy the timing in which these two, price versus value, will diverge or converge we cannot predict how long we will hold on to any individual position. Although our turnover ratio will fluctuate over the years our investment approach will result in holding our investments for long periods of time.

- 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?

We aim to own somewhere in the range of 10 to 35 positions in our Core Portfolio. Over the years we have continually decreased the number of individual positions in our portfolio. At the end of 2007 we held a total of 17 stocks (excluding ETF positions) in the Core Portfolio with 71% of our funds in the top-10 holdings. In other words we are much more concentrated than the outperforming funds profiled in the study above. We believe this level of concentration is an advantage to us.

Unfortunately it has the nasty byproduct of increasing the short-term volatility in our portfolios. To combat this volatility in the overall portfolio, we hold positions not highly correlated with others positions in the portfolio. However, as we will explain later, volatility will usually work to our favor.

Further, [studies show](#) holding a relatively concentrated portfolio in the range of where we intend to (10 to 35 stocks) eliminates over 90% of the company specific volatility. Adding positions beyond this number does little to reduce volatility any further and only serves to [reduce return](#).

We also try to invest in quality businesses. A good indication of whether or not a business is top notch is whether it generates high returns on its capital. Return on invested capital (ROIC) of the average American business has historically been somewhere around 10%-11%. The top-10 companies in our portfolio have on average a ROIC of 58% and all are over 13%.

Position	Return on Invested Capital
Berkshire Hathaway	15%
American Eagle Outfitters	41%
Ebay	127%
Aeropastle	36%
K-Swiss	27%
Biovail	51%
InterActive	13%
Accenture	78%
PACCAR	251%
Coca-Cola FEMSA	13%
Average	58%

- Is Brick Financial adhering to a value-oriented approach to investing?

Our goal remains to invest in good if not great companies at bargain prices. If we cannot find good/great companies that are trading at bargain prices then we will settle for fair prices. If we cannot find even those companies we will invest in not so good companies at rock bottom prices. This approach has resulted in a portfolio that has consistently held stocks at better values (high earnings yield) with greater returns (high ROIC) than the overall market. The earnings yield (the inverse of the P/E ratio) of the Wilshire 5000 index at year end was about 4.5%. All our positions had earnings yields in excess of this amount.

Position	Earnings Yield
Berkshire Hathaway	7%
American Eagle Outfitters	11%
Ebay	6%
Aeropastle	7%
K-Swiss	15%
Biovail	28%
InterActive	9%
Accenture	12%
PACCAR	12%
Coca-Cola FEMSA	9%
Average	11%

- 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?

In previous years we did not make extensive use of margin or shorts. With the advent of specialty ETFs that allow the foregoing, we delved into this area with varying degrees of success. Ultimately, we did not do as well in these products as we hoped. Remembering margin is not necessary for successful investing, we shied away from these particular products. The ETFs which simulate shorting have help us a little more. Not being ones to bet completely against the market, we have kept these products as a small portion of the Core portfolio. But we believe their use and presence in the portfolio will help stabilize short term variation in our returns going forward.

We have not strayed from our focus of bottoms-up individual stock investing. This instance marks where we tried something a little different and when we made a mistake, we recognized it early and corrected it. We are always making efforts to expand our circle of competence in terms of individual companies we can invest in. This effort also includes expanding our knowledge of financial products we think can help us reach our goals.

- Is Brick Financial being forthright in their communications? Are both successes and failures emphasized with the same degree of candor?

As always we are looking for new ways to communicate with you and will always be open and honest with you. We always challenge our thinking against evidence which may suggest we are off base. This is an ongoing pursuit. We also challenge our actions against our principles recognizing sometimes the two may diverge. This letter as are our past letters regularly point out our mistakes and missteps as well as our successes. The process of challenging oneself as an investor and being open and honest about ones decision-making is essential to success.

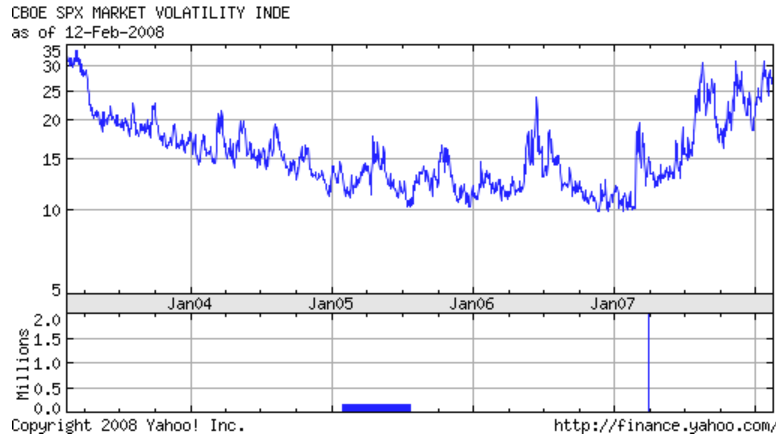
Volatility

Earlier in this letter we mentioned the recent rise in volatility will likely help our future returns. The CBOE VIX Index measures the implied volatility of the S&P 500. In the short run, there is a strong negative correlation between the VIX and the level of the market. When the market is falling, the VIX rises because investors are selling excessively. In essence volatility rises because investors begin to panic, looking to put their money elsewhere, seeking more protection from a downturn in a down market. This is exactly backwards. An investor should seek protection when markets are high.

But this behavior bodes well for investors who can stomach short term gyrations in the market. It is likely that with such feverish selling, the market will depress the stock price of companies that don't deserve the treatment. When the index reaches levels of 20 or above, this usually indicates investors are skittish and a simultaneous rise in selling and fall in stock prices ensues. If you happen to be a buyer of stocks at those times, you will likely do well in the periods that follow. Some notable moments when the VIX rose above 20 and a subsequent rise in stock prices followed are:

- October 1987 stock market crash
- Collapse of the UAL buyout
- Iraqi invasion of Kuwait
- Beginning of the Gulf War
- LTCM hedge fund collapse and bailout
- Terrorist attacks of 9/11
- Recession of 2002

The last time the CBOE index was at the level it is today was the end of 2002. Since that time our Core Portfolio did well in the months that followed because we were buyers at the end of 2002. The period to follow this latest rise in the VIX should also prove to be profitable for us because we are once again being offered stocks at discount by panicked investors.



Where the bargains are

Where are we likely to find companies being offered at discounts to their intrinsic value? The chart below gives us some clue. Small-cap and mid-cap stocks have enjoyed a multi-year run of return supremacy. The small and mid-cap sectors have enjoyed returns of greater than 16% over the five-year period ending January 31, 2008, well above their historical averages. This has caused the sectors to become extremely overbought. Meanwhile the large-cap sector, the growth sector in particular, has been unloved over the same period.

Morningstar Style Indexes (as of 1/31/2008)	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Mid Growth Index	-9.40	-12.46	-9.40	4.55	12.55	17.68	6.11
Small Value Index	-1.50	-7.86	-1.50	-11.00	5.97	16.72	9.72
Mid Value Index	-1.83	-8.20	-1.83	-9.83	8.03	16.17	9.35
Small Core Index	-5.24	-13.87	-5.24	-12.10	6.09	16.03	10.28
Mid Core Index	-6.02	-12.60	-6.02	-7.49	7.72	15.45	8.38
Small Growth Index	-10.52	-15.71	-10.52	-2.60	6.64	15.30	3.05
Large Value Index	-3.01	-8.49	-3.01	-3.99	9.74	14.07	6.95
Large Core Index	-5.92	-8.88	-5.92	0.49	7.86	12.37	5.53
Large Growth Index	-9.43	-14.29	-9.43	-0.66	4.76	8.25	-0.54

Source: Morningstar.com

The large-cap growth sector includes names like Microsoft, Wal-mart, McDonald's, Nike and other names that are very familiar to us. These companies and those like them are now trading at price earning multiples either equal to or less than their historical multiples and the multiples of the market. For these companies, this makes little sense. They remain the dominate players in the space and should be commanding higher prices than they do today. With the always present law of "reversion-to-the-mean", we believe small and mid-cap stocks will underperform relative to the past while large-cap, particularly in the growth sector, will outperform. As you may have noticed, we have been adjusting the Core Portfolio over the last few months to reflect this belief.

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 *Stocks for the Long Run*, by Jeremy Siegel

3 “Investing: Profession or Business?” by Legg Mason Capital Management

