

E-Memo

TO: CLIENTS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss
Date: January 28, 2008
Subject: It *IS* a Great Time to Buy Banks!

Every time this E-Memo draft was started, some event caused us to withdraw what had been written and, for the most part, start over again. When the current issue of *Barron's* arrived this past weekend, we noticed that this highly respected journal found itself in the same situation—the impact of events moving faster than the ability to analyze and document the changes. *Barron's* went so far as to call back its panel of seers for a review of their recommendations of the three previous weeks. We don't ever remember that happening, but what caused it was the largest percentage (*not* percentage point) cut in the Fed funds rate in one-third of a century.

The events of this past week, the stimulus package and the 75 bps Fed funds rate cut, have overshadowed (and maybe contradicted) the clear facts which indicate that the economy remains strong. With the stimulus of the 75 bps cut in the Fed funds rate, our guess is that the economy will be absolutely screaming by the end of the third quarter of 2008 and into the last quarter of this year. We don't think that we are alone in making that observation. Other than the fact that bank stocks were oversold in 2007 and early weeks of this month, the rebound in those stocks last week was nothing short of stunning. Why the sharp rebound? What had changed other than the growing perception that these stocks had been oversold and the markets were conducting a "fire sale". We believe part of the decline in bank stock prices has been related to concerns regarding the media created panic about the economy. There isn't enough space in this note to detail all the reasons we believe the media have it wrong. As recently as this morning on CNBC's Squawk Box, one of its newer "editors", Dennis Kneale, took his fellow journalists (including *Newsweek* and the political pundit, Pat Buchanan) (see <http://www.cnbc.com/id/15840232?video=629448277&play=1>) to task for ignoring economic facts and participating in an effort to create a recession. See also Brian Wesbury's Op-Ed piece in this morning's (January 28, 2008) *Wall Street Journal* entitled "The Economy is Fine (Really)". Here's an excerpt:

It is hard to imagine any time in history when such rampant pessimism about the economy has existed with so little evidence of serious trouble.

True, retail sales fell 0.4% in December and fourth-quarter real GDP probably grew at only a 1.5% annual rate. It is also true that in the past six months manufacturing production has been flat, new orders for durable goods have fallen at a 0.8% annual rate, and unemployment blipped up to 5%. Soft data for sure, but nowhere near the end of the world.

It is most likely that this recent weakness is a payback for previous strength. Real GDP surged at a 4.9% annual rate in the third quarter, while retail sales jumped 1.1% in November. A one-month drop in retail sales is not unusual. In each of the past five years, retail sales have reported at least three negative months. These declines are part of the normal volatility of the data, caused by wild swings in oil prices, seasonal adjustments, or weather. Over-reacting is a mistake...

We believe it really is!

The 75 bps cut in the Fed funds rate last Tuesday was followed by an immediate like cut in the US Prime Rate. This had an immediate impact on the yield curve, making it steeper, so that it currently resides around 140 basis points—about the same level it was in 2004. This is good news for banks, all of which make a living borrowing short and lending long. We also know banks are impacted by the broader economy. Obviously, when economic activity in a sector declines, banks with loans and deposits in that sector are impacted. So, if a cut in the Fed funds rate of 75 bps with the odds at 96% (as this being written) for another 50 bps cut on January 30, is a significant stimulus to the general economy, banks will benefit mightily. We believe those two

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reasons alone account for the majority of the bounce banks have seen since January 22. But banks were so oversold, it is clear to us that there is far more upside left.

As you know we like the daily newspaper *Investor's Business Daily* (IBD), not only for its editorial content but for its investment business content as well. In the last year or so we've referred several times to the IBD's 197 Industry Group Rankings. According to IBD, "[these] Industry Groups are ranked 1 through 197 on price performance of all stocks in the industry in the latest 6 months (1 = best performance) . . . Studies show . . . that group action determines at least half of a stock's performance." What a difference seven months makes. Table 1 shows the difference between June 8, 2007 and January 25, 2008:

TABLE 1

Industry Group	6/8/2007 Rank	YTD 2007 % Price Change	1/25/08 Rank	YTD 2008 % Price Change
Banks—Midwest	196	(10.7%)	81	(0.6%)
Banks –Northeast	194	(9.6%)	55	(0.5%)
Banks—Southeast	192	(7.7%)	92	(0.1%)
Banks—West/Southwest	184	(7.3%)	124	(1.9%)

It seems to us the improvement in rankings this past week, ranging from 5 points to 23 points, indicates prices have ceased their wholesale decline, bottomed (at least for the time being) and have begun the climb out of the hole.

Additional specific evidence was found in the Q407 earnings reports of the banks we own in our micro and small cap portfolio. When viewing the following statistics please keep in mind that Q407 results are from 47% of the banks in our micro and small cap portfolio whereas 100% of the banks in that portfolio have reported their Q3 results.

TABLE 2

Median Change	Per Share Earnings Growth	Loan Growth	Deposit Growth	Asset Growth	Book Value Growth	Return on Ave. Assets	Return on Ave. Equity	Net Interest Margin
Q407 vs. Q406	6.3%	8.0%	8.7%	8.6%	7.0%	1.02%	11.42%	4.33%
Q307 vs. Q306	-8.4%	9.8%	14.7%	15.7%	8.6%	0.84%	10.36%	4.05%

TABLE 2-A

Median Change	Non-Interest Inc./Operating Revenue (%)	Efficiency Ratio (%)	NPA's/Loans & OREO (%)	Reserves/NPAs (%)	Net Charge-Offs/Recoveries (%)
Q407 vs. Q406	10.53	57.82	0.65	135.70	0.10
Q307 vs. Q306	12.19	60.88	0.46	311.6	0.11

The take-away items are as follows:

- Earnings growth may not be positive after the balance of the banks report. 37% of those reporting had earnings declines related to margin compression and/or "kitchen sink" bad debt provisions.
- **Loan, deposit and asset growth** declined, but **still reflect high single digit growth** which bodes well for future earnings growth.
- **Book value grew** in all banks despite the 37% that reported earnings declines.
- Profitability metrics may change when the other 53% report.

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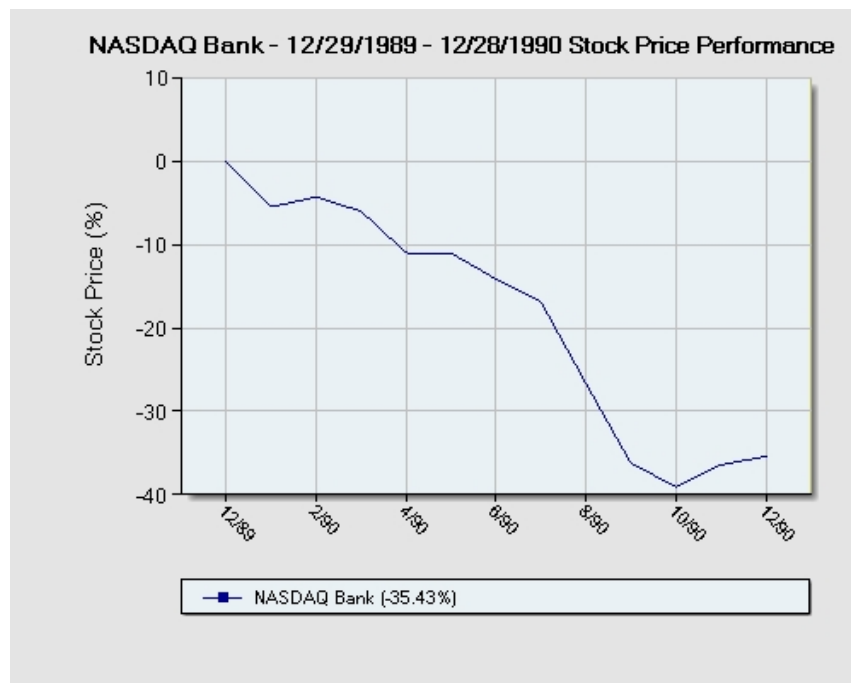
- **Operating costs (Efficiency Ratio) appear to be under control** despite costs involved in collecting charged off loans.
- **Non-performing assets ratio increased but is still in control** and **reserve coverage of non-performing assets also remains within our range of tolerance**, especially considering two of our reporting institutions have significant real estate collateral which allows them to maintain a lower reserve level.
- **Net charge offs appear to be in excellent shape** but, of course, are subject to the caveat that half the banks haven't reported.

We are quite encouraged by these results. The sky is not falling. Huge write-offs don't appear to be right around the corner. Our bank management teams are taking advantage of the decline in the price of their banks' shares to cleanse the balance sheet of items which could impair results in the future while still paying attention to balance sheet growth which will build a solid base for future results.

If we are not at the point where a re-commitment to banks, especially micro and small cap banks is appropriate, we are very close. None of us are sufficiently wise to allow us to accurately call the bottom or the top in stocks—certainly not micro and small cap banks. None includes us as well. That said, the wise are beginning to commit cash to this sector and raising cash elsewhere to add to the sector.

We included the following chart in the letter to our investors and thought it worthy of inclusion here. 2007 was one of the worst years on record for bank stock prices and the fourth quarter provided no relief. The NASDAQ Bank Index recorded positive results in only three of the last 12 months. Banks with assets between \$1 billion and \$5 billion, which correspond to the banks in our portfolio, were off a collective 28.9% in 2007, according to SNL Financial. The return of the NASDAQ Bank Index was a 22.1% decline in 2007, its worst showing since a 35.4% decline in 1990 when the country was sliding into a sharp, but relatively short, recession (Chart 1).

CHART 1



Source: SNL Financial, LC

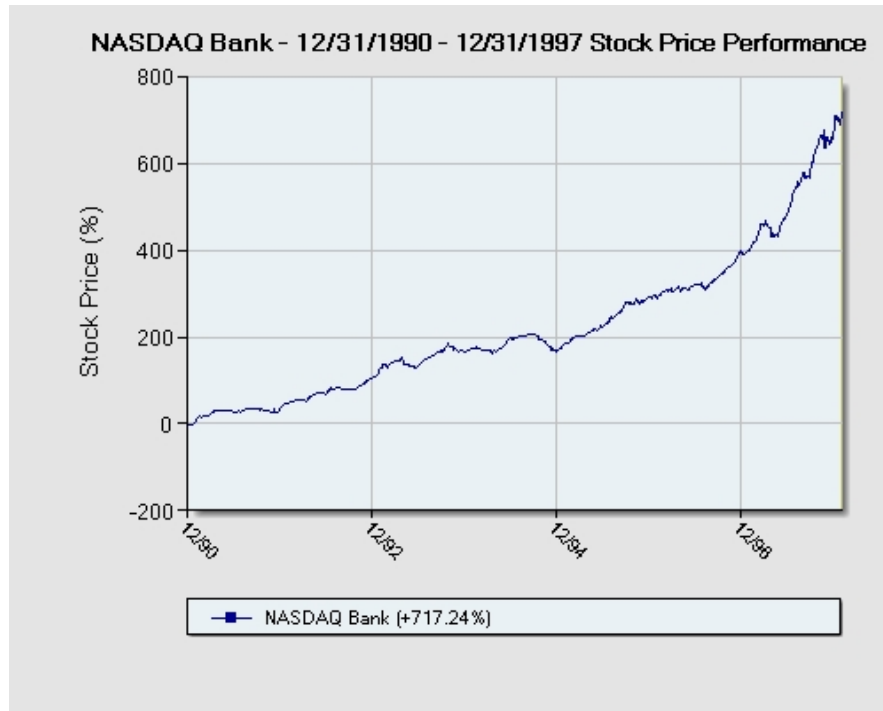
The preceding year, 1989, marked the peak in bank failures with 534 banks "resolved" by regulators. An additional 382 banks were closed in 1990. The banking system is in far better condition today than it was

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then. The issue of bank and thrift failures isn't even on the table today. It is worth noting, however, that from its nadir in 1990, the NASDAQ Bank Index advanced for seven consecutive years, notching a return in excess of 717% for the period, equal to 35% annualized (Chart 2).

CHART 2



Source: SNL Financial, LC

The year 1990 was the second worst year in the history of the Bank Index since 1974 when it declined 38.7%. July 1990 was the start of the 1990-1991 recession which ended in March 1991. The year 1998 was characterized by the Asian debt crisis, the Russian ruble denominated debt moratorium and the storied implosion, failure and subsequent bailout of Long Term Capital Management. None of the events of 1998 received the publicity that this sub-prime mess has gotten.

We believe that judicious commitment to this sector is appropriate. If there is any way we can help you in that process, please don't hesitate to call.

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