

E-Memo

TO: INVESTOR/MEMBERS, CLIENTS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: February 8, 2005
Subject: **And what about *Beta* ? (not the little fish swimming in your aquarium)**

Last month, we discussed the term "*Alpha*" as it relates to investment managers. Recall that *Alpha* is the incremental return above and beyond the market return that a portfolio manager adds by virtue of knowledge and skill (luck is not a source of true Alpha). This month, we'll explore the concept of "*beta*" and relate it to one of our 10 myths about investing in banks, namely the myth "that bank stocks just move with the market." Through our discussions, we've found that many investors think that bank stocks tend to march in lock step with the broader market, moving up when the market rises and down when the market retreats. We've developed some empirical evidence that support our contention that small-cap banks and thrifts comprise an exceptional investment sector – one with lower volatility **and** superior returns compared to the broader market. More about that later, but first, a brief discussion of *beta* and how it relates to investing.

"*Beta*," or more properly, "*Beta Coefficient*," is a measure of the volatility of a stock, or a stock portfolio, in comparison with the market as a whole. Said another way, *beta* is the sensitivity of a stock's return to the returns of the market. In the investment world, risk is defined in terms of volatility. The more volatile a stock's return, the greater is its risk. *Beta* is a way to quantify that risk. For those of you that are statistically inclined, *beta* is the covariance of a stock's return to the market, computed by fitting a regression line through many observations of a stock's daily returns and the corresponding returns of the market.

In practical terms, *betas* range from 0 to 3 or so. A negative *beta* is possible (a stock which consistently moves opposite of the market's trend), but is exceedingly rare, as are stocks with a *beta* over 3. A beta of 0 means a security's return has no correlation to the market; an example is cash in the bank vault. A stock with a *beta* between 0 and 1 (a "low-beta" stock) will be less volatile than the market. A stock with a *beta* of 1 moves in step with the market and a *beta* greater than 1 (a "high-beta" stock) indicates a stock whose price is more volatile than the market. Simply put, the more volatile a stock's price, the higher is its *beta*.

By way of example, a stock with a *beta* of 2 will tend to move 2% for every 1% move in the market. High-beta stocks rise rapidly when the market is running up and plunge when the market turns down. Many technology stocks have high *betas*; they offer potentially outsized returns, but also significant downside risk. A low-beta stock, on the other hand, typically experiences a more muted decline in down markets and less upside in a rising market. Conservative investors intent on preserving capital focus on low-beta stocks, such as traditional utility stocks, while more aggressive investors who are willing to take more risk, look for high-beta stocks in an attempt to maximize their returns.

Does all this theory about *beta* work in practice? As with many statistics, relying on *beta* as a precise measure of risk is unwise. In reality, a stock's *beta* can change over time (and some services that calculate betas may do so over different time interval - which is why *betas* from different sources often vary). Smart investors treat *beta* as an **approximation** of a stock's relative risk.

If you're still with us, there is one more very important point about *beta* that is often misinterpreted – **a low beta does not necessarily mean low returns!!** To back up that statement we extracted 23 years of data on the NASDAQ Bank Index (the longest history our vendor could supply), a surrogate for our investable bank universe, and compared it with the S&P 500 Index, the index which most investors use as a proxy for the entire stock market. Here is what the data showed:

- The NASDAQ Bank Index had a *beta* of .67 and an annualized average rate of return of 14.3% over the 23 year period.

- The annualized rate of return for the S&P 500 Index was 10.4% for the same period and, by definition, its *beta* was 1 which means that
- An investment in the NASDAQ Bank Index (if you could invest in it directly) earned, on average, nearly 4.0% more annually than the broader market and did so with only two-thirds of the volatility!

These are powerful numbers – more return with less risk – the investing equivalent of a free lunch (and our fund, Foundation Financial Partners, LLC has fared even better in the 58 months since its inception). See the chart below for more detailed return information.

An interesting aside is that in only seven of those 23 years did the NASDAQ Bank Index under-perform the S&P 500 and in only five of those years were returns actually negative. As interesting is that in only one year, 1990, were returns for the NASDAQ Bank Index and the S&P 500 Index both negative (which says something about the wisdom of including a portfolio of small-cap banks as a significant component of a more broadly diversified portfolio).

As a reminder, Foundation Financial Partners, LLC now accepts new investments on a monthly basis. If you've considered joining us as an investor in the fund, or adding to your existing holdings, we stand ready to help you make it happen. Feel free to call us with any questions you may have.

For your consideration, our results since March 2000:

January 2005
PERFORMANCE HISTORY (1) (2)

	Inception to Date (58 Months) 3/29/00-1/31/05	Four Year Return Annualized 1/31/01-1/31/05	Three Year Return Annualized 1/31/05	12 Months Ending 1/31/05
FOUNDATION	+ 150.86%	+ 22.89%	+ 21.39%	+ 5.46%
Dow Jones Industrial Average	+ 5.68%	+ 1.15%	+ 4.10%	+ 2.10%
NASDAQ	- 54.90%	- 6.72%	+ 2.65%	+ 0.33%
S & P 500	- 15.09%	- 1.99%	+ 3.24%	+ 6.21%
S & P 600 (Small Cap Index)	+ 59.90%	+ 9.75%	+ 12.07%	+ 16.53%
NASDAQ Bank Index	+ 125.53%	+ 14.66%	+ 14.79%	+ 7.56%

(1) **After** management and other expenses but **before** charges for Performance Allocation; indices and Fund performance include the reinvestment of dividends.
 (2) The performance information has been prepared and presented in compliance with the Performance Presentation Standards of the Association for Investment Management and Research (AIMR-PPS®), the U.S. and Canadian version of the Global Investment Performance Standards (GIPS®). AIMR has not been involved in the preparation or review of this information.

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 PERFORMANCE INFORMATION IS HISTORICAL, AND PAST PERFORMANCE IS NOT INDICATIVE OF,
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