

E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss
Date: February 26, 2008
Subject: Circling Overhead/Biding Our Time

Recently I've had cause to recall an old cartoon in either the *New York Times* or *The New Yorker* magazine, which depicts two vultures sitting on a limb of a dead tree. One vulture says to the other "Patience my [posterior], I'm going to kill something."

I suspect many bank and thrift investors are beginning to feel the same way. Unlike these cartoon vultures, real vultures usually don't kill to eat but rather act as nature's garbagemen, picking at the dead pieces until nothing remains. Whether or not the cartoonist intended that irony, the sentiment expressed by the cartoon vulture seems to be on many minds as we endure the decline in bank stocks.

Last week another cartoon circulated (you may have seen it) entitled "The Subprime Primer." Despite its raunchy language, it was spot on. In the cartoon, a mortgage broker interviews a prospective customer hoping to buy a home he can't afford. But the broker abdicates his responsibility to verify employment and income, and relies instead on the (now dubious) axiom that homes *always* go up in price. The bank is quickly anxious to get rid of the mortgages it bought from the mortgage broker and finds an eager investment bank willing to apply lipstick to the pig by creating CDOs. The accounting "czar" (read SEC or FASB) is, of course, equally willing to help in that process by allowing (large) banks to invest in these deals with insufficient disclosure to investors while the rating agency stamps a AAA rating on the CDOs. When mortgagees fail to make their payments, the CDOs fail. Everyone else, from the mortgage broker to the rating agency, has earned non-refundable fees for his or her part in the scheme. In the end, left holding the empty bag is the treasurer of a Norwegian village that bought a tranche of the CDO, powerless to do anything but hurl obscenities at the geniuses who created the CDOs. He must have felt like the cartoon vulture.

Here, we are not vultures—real or cartoon—but we'll take lessons where we find them. Unlike the cartoon vultures, we are patiently circling overhead—though sometimes we may feel otherwise. But as bank stocks decline, we see bounty in the wreckage.

So bank investors like us are biding our time, waiting for the subprime mess to blow over. It's unlikely this pall will disappear overnight. This is, after all, an election year. Congress will get around to seriously focusing on subprime as soon as it concludes its far more urgent business—investigating steroid use by the heroes of our national pastime. At the top of Congress's agenda will be how to legislate good judgment (speaking of irony). The answer is easy: form a new executive agency called the Department for Curbing the Abuses by Mortgage Bankers and their Co-Conspirators.

While legislative and regulatory retribution to avoid a recurrence may seem appealing, we need to be careful what we wish for; experience teaches us there is no problem Congress can't exacerbate. In laying our problems at the feet of Congress, we are likely to be repaid with obstacles to financing for legitimate first-time buyers of the American Dream—which, along with a nice starter home, already comes packaged with a generous helping of bureaucratic red tape (including a doorstep-size pile of legal paper containing very small type no one can read and a multiplicity of signatures attesting that the borrower has read through the very small type). This is an outcome none of us should desire.

So what do we, as bank investors, do in the meantime? Nothing? Hold on to what we have? Sell into rallies? Build cash? Well, yes.

Take a look at CHART I on the next page. The NASDAQ Bank Index is the broadest of the four, containing approximately 525 banks—broadly representative of banks in which we invest. Half the banks we invest in have asset sizes ranging from \$1 billion to \$5 billion—the SNL Bank \$1B-\$5B in Assets Index. For the most

February 26, 2008

Page 2

part, our banks are on the bottom end of the \$1 to \$5 billion size range. We also invest in a handful of so-called micro cap banks, which are represented in the SNL Micro Cap Bank Index.

Since the beginning of the year, volatility has reigned supreme. Volatility creates opportunities to cautiously buy and sell. There were plenty of opportunities to do just that with individual bank stocks moving up or down, 10% or more. During the sharp up-turns we are selectively paring back some positions to create cash to invest in attractive nuggets have been exposed by the liquidity crunch. This crunch has been caused by the subprime debacle and the precipitous drop in housing starts that has wreaked havoc on many community banks. On the sharp downdrafts we are looking to establish positions in the aforementioned nuggets.

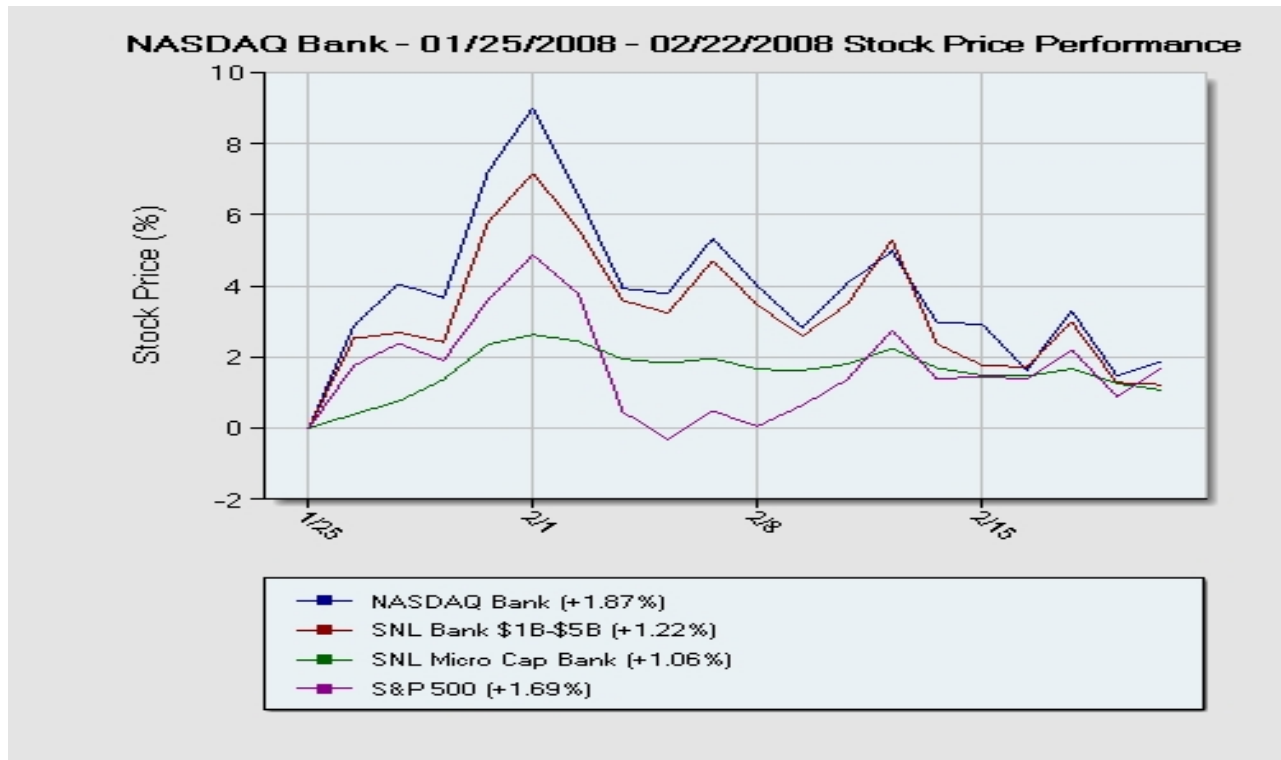
CHART I



SOURCE: SNL Financial, LC

Chart II starts on the date of the last **E-Memo** and runs four weeks through February 22. In this period of time we've endured a second round of Fed rate cuts—this time by 50 bps (for a total of 125 bps this year alone and probably more to come); a monoline insurance company panic involving AMBAC, MBIA and FGIC—up until now not exactly household names; and auction failures in auction rate bonds causing highly regarded institutions to pay penalty rates of 15% to 20% per annum when previously they were borrowing at rates in the very low single digits.

CHART II



SOURCE: SNL Financial, LC

The last three weeks haven't been any picnic for the stocks of banks, especially larger ones. The NASDAQ Bank Index is market cap weighted and is heavily influenced by banks such as Fifth Third (FITB) and Northern Trust (NTRS). Even Northern Trust fell victim to the spill-over of subprime. A couple of institutional money market funds in which it had invested client funds needed to be rescued to avoid "breaking the buck", dropping below \$1 in net asset value. This set the larger banks on their ears causing a one-day drop last week of 1.41% during an otherwise benign period.

Finally, it is worth noting that after all the turmoil in the markets for financial institutions, the index which declined the most (see **CHART I** above) was the S & P 500, the index generally considered the most representative of the US stock market. It has declined 7.85% since the first of the year; by comparison, the NASDAQ Bank Index has declined only 2.44%.

I'd be remiss—indeed disingenuous—if I failed to follow up on our observations on the half of our bank earnings reports we hadn't received before our last **E-Memo**. All our banks have now reported Q407 results. We had hoped for flat to slightly declining Q4 median earnings. Instead, on the median, our banks' earnings were hammered in the Q4. However, **our banks' earnings for the entire year gained 8.7% compared to 2006**. Having observed these statistics for several years, I would also be neglectful if I didn't point out that we are dealing with a sample size of fewer than 20 banks which can lead to some substantial distortions. A larger sample size, all publicly traded banks reporting to SNL Financial, LC showed an earnings decline of 9.2% vs. our decline of 15% while for **all of 2007, SNL banks had an earnings decline of 4% vs. our earnings gain of 8.7%**. Along with the significant declines in earnings—even losses for the quarter—several things stood out:

- The **median book value per share** for the period actually **increased** nearly 5%! Yes, banks did retain earnings. (Table 1)

February 26, 2008

Page 4

- While the profitability measures of Return on Average Assets and Return on Average Equity suffered, the **banks remained profitable for the year**. (Table 1)
- **Asset Growth was in the low double digit range**. (Table 1)
- **Net Interest Margin hardly blinked**—I think that will change for the better over the next quarters as asset-sensitive banks catch up with downward deposit pricing adjustments. (Table 1)
- **Non-Interest Income saved the bacon** of a few banks as it **increased** as a percent of total revenue. (Table 1-A)
- **Expense control drove down the median Efficiency Ratio** (lower is better). (Table 1-A)
- Credit issues proved to be a challenge for many banks as **non-performing loans doubled** while **reserve coverage declined by 44%** (but still comfortably in excess of NPAs) and **charge-offs were stable**. (Table 1-A)

TABLE 1

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	-15.0%	8.0%	10.9%	11.0%	4.8%	0.67%	7.61%	4.01%
Q307 vs. Q306	-8.4%	9.8%	14.7%	15.7%	8.6%	0.84%	10.36%	4.05%

TABLE 1-A

Median Change	Non-Interest Inc./Operating Revenue (%)	Efficiency Ratio (%)	NPA's/Loans & OREO (%)	Reserves/NPAs (%)	Net Charge-Offs/Recoveries (%)
Q407 vs. Q406	13.38	57.75	0.75	174.7	0.10
Q307 vs. Q306	12.19	60.88	0.46	311.6	0.11

Seven of our banks reported charge-offs 0.08 % or less (one of those reported a recovery). These seven banks had a median reserve coverage against non-performing loans of 686% of non-performing loans. A bank's greatest risk exposure is in its loan portfolio. With wide-spread regulatory concerns regarding reserve adequacy, we believe many of our banks took advantage of a "kitchen sink" opportunity and substantially built reserves. At median 175% NPA coverage and continued low levels of charge-offs (0.10%), our banks appear well positioned for whatever their region's economy may throw at them.

Continued softness in bank stock has made for greater upside opportunity and, with patience, we'll see that happen. We believe that judicious commitment to this sector is increasingly appropriate with the passage of time but patience in waiting for the bottom (which we will know only well after it happens) is essential.

If there is any way we can help you in that process, please don't hesitate to call.

FORTRESS

PARTNERS

CAPITAL MANAGEMENT, LTD.

700 Walnut Ridge Drive, Ste 200, Hartland, WI 53029

262-369-1095 • info@fortresspartners.com

THIS COMMUNICATION IS NOT AN OFFER OF INTERESTS IN FORTRESS PARTNERS BANC VENTURES I, LP, FORTRESS PARTNERS BANC VENTURES II, LP OR FOUNDATION FINANCIAL PARTNERS, LLC. PERFORMANCE INFORMATION IS HISTORICAL AND IS NOT INDICATIVE OF, NOR DOES IT GUARANTEE FUTURE RESULTS.