E-MEMO

TO: INVESTOR/MEMBERS AND FRIENDS
FROM: Jon Bruss
DATE: April 13, 2004
SUBJECT: **What happens to bank stocks when interest rates rise?**

March 29 marks the fourth anniversary of operation of Foundation Financial Partners, LLC. Each year—each month, in fact, seems to bring a milestone of one sort or another. Among those milestones, we mark our performance which, as always, follows this narrative. We wish all of you were along for the first four years, we thank those of you who shared our confidence in our direction in March of 2000, and we thank all those who joined us since then including the many who have increased their investments since their initial foray with us. We look forward to having more of you on board in July.

The subject question ought to appear in a list of Frequently Asked Questions (FAQs) about investing in bank stocks. Moreover, it should be answered by bankers and their CFOs. After all, they're the ones responsible for the balance sheets of the companies they manage. They can't control rates but they can, within a range of possibilities, control what happens to their bank's profit and loss statement and especially what happens to net interest margins and spreads. That has been a fact for as long as I have been in banking. The advent of the use of the computing power owned by banks for something other than processing transactions brought the use of simulations for all aspects of bank business planning. A key aspect of any business plan is what a business pays for inputs—raw materials—in the case of banks, deposits and other funds used to support loan and investment growth. Another key aspect of this business plan is what the product made from the raw material can be sold for. In a bank's case, that product is loans and other assets in which it can invest—fixed income securities issued by the US government and by other political subdivisions.

It really is a simple business. All a banker has to do is to make sure that his output—rates on loans—can be sold at a higher level than his inputs—deposits. The Federal Reserve System, it's Board of Governors and its Chairman cannot be controlled, but they can be anticipated. Every banker worth his salt has his ear to the rail listening for signals from the Fed and from the economy. Every banker worth his salt today, in addition to scouring the horizon for economic signs and signals, will also be watching his computer screen as he and his CFO at least monthly, if not daily, monitor the bank's loan and securities assets for rates and maturities changes and on the right hand side of the balance sheet, liabilities like deposits, repurchase agreements and Federal Home Loan Bank advances and loans, also for rates and maturities changes.

In an environment like the one we have been in for the past several years, as a banker, I'd want to have my balance sheet positioned in such a way that it would be liability sensitive. When a balance sheet is liability sensitive, the cost of inputs will decline faster than the yields or returns on assets, my loans and investments. When a bank's balance sheet is neutral it means that the bank management is anticipating a period of time when rates are not expected to change. Finally, in a period such as the one we are in right now where predictions of "just around the corner" inflation are increasingly heard, it is wise to have the bank's balance sheet structured so that assets will reprice more quickly than deposits and other liabilities.

This all seems intuitive, doesn't it? It is. With the advent of personal computing, those complex simulations for business planning were put on a floppy disk and more recently on a CD-ROM or made available on the Internet for download. The software has become extremely inexpensive. And the improvement in quality is inversely related to its decline in price so that virtually every bank, regardless of size, can have and use sophisticated modeling techniques to assure that changes in rates of 100 or 200 basis points (one or two percentage points) have no impact on the income statement. In fact, modeling has become so sophisticated that bankers can structure their balance sheets to take advantage of these changes in rates and predict the impact on earnings per share for each 25 basis point increase (or decrease) in rates.

The real experts in the field of banking know this. The talking heads, the pundits, the uninformed that you and I read or listen to every day ranging from the *Wall Street Journal* and *Investors Business Daily* to CNBC's *Morning Call* and *Squawk*

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Box haven't a clue and, what is really scary, don't really seem to care to listen to facts that fly in the face of "conventional" wisdom. And, of course, like a choir of Pygmalions, they "talk" the price of bank and thrift stocks down. Now if this weren't enough, expect to hear the same chorus from the same choir when rates decline. Can you really have it both ways in the face of countervailing facts? We just have been through one of the better—if not the best—periods for bank performance in the past four decades. Bank prices have reflected that, haven't they? So where were the pundits when rates began to decline? They were wailing that bank earnings were going to be hurt by declining rates. In fact, the exact opposite happened, and when the market caught up with the facts, the pundits disappeared only to return when it became obvious that if the Fed dropped rates any further, it would have the same effect as pushing on a string. It was then apparent that rates would have to increase—eventually. They have been back in full force since last summer talking bank stocks down. I believe they have been especially vocal over the past 60 to 75 days.

Here are the facts which you won't see in any publication you pay for or see and hear on cable or network news:

- Bankers understand the impact of rate changes on the bottom line because it is natural to want to have earnings growth.
- Regulators understand the impact of rate changes since the deregulation of interest rates nearly 30 years ago when they directed:
    - banks to focus on rate sensitivity to the point of insisting that bank directorates are trained and informed about rate sensitivity to eliminate losses of bank earnings enabling;
    - preservation of a diverse and competitive banking system—The Foundation of A Free Economy.
- In the decade of the 90's, as rates declined, banks were generally positioned so that balance sheets were liability sensitive, thereby allowing increased margins and spreads as loan yields on existing portfolios declined far more slowly than rates on deposits.
- Today, banks are generally positioned to take advantage of an increase in rates so that what bank investors will see as rates increase is substantially improved earnings in many banks as loan rates move up more quickly than the rates paid on deposits.
- Every banker I know is looking forward to the long anticipated gradual rise in rates—25 to 50 basis points at a time, which will result in substantially increased margins and most attractive bottom lines.

For over a year now, the banks in our portfolio have been positioned to be asset sensitive. Predicting *when* this positioning pays off is not a game our banks are willing to play. The date changes with new GDP numbers, jobs growth numbers, inflation rates and housing starts. Before the new jobs numbers came out on April 2, the betting focused on late 2004 or early 2005 as the soonest that the Fed would change rates. Now the betting seems to be late summer or early Fall. In any case, we are prepared for improved margins in our selection of banks and thrifts most likely to benefit from a rate increase.

MARCH 2004
PERFORMANCE HISTORY (1)(2)

	Inception to Date (48 Months) 3/29/00-3/31/04	Three Year Return Annualized 3/31/01-3/31/04	Twelve Months Ending 3/31/04	Quarter Ending 3/31/04
FOUNDATION	**+137.12**	**+26.83%**	**+28.62%**	**2.32%**
Dow Jones Industrial Average	-5.17%	**-1.59%**	+29.60%	+0.33%
NASDAQ	-56.39%	**+2.71%**	+48.69%	+3.13%
S & P 500	-24.85%	**-0.99%**	+55.14%	+1.73%
S & P 600 (Small Cap Index)	+37.19%	**+11.86%**	+32.78%	+2.82%
NASDAQ Bank Index	+92.64%	**+16.17%**	+35.33%	+1.50%

(1) **After** management and other expenses but **before** charges for Performance Allocation
(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.