

E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss
DATE: April 29, 2009
SUBJECT: Are We Out Of The Woods?

Over the last seven weeks, stocks have rebounded (mercifully), lending an air of clarity to the markets. Clarity is one thing that has been missing since at least the fall of Bear Stearns early in 2008, so it is more than welcome. The question many are now tempted to ask is: Are we out of the woods?

The simple answer is no. This is not to say we have no reason for optimism, but progress will be impeded by considerable headwinds. The air of clarity, it happens, was really a sense of resignation that the markets and their components would have to (and could) right the ship not just without the assistance of the federal policy—such as it is—but despite federal policy. We have said it before and cannot emphasize it enough: the lack of consistency and transparency in governmental action has not only obstructed the financial recovery; it is a major cause of the financial crisis.

There remains cause for concern, but there are also silver linings. First, the Fed's money pump has certainly helped re-introduce some stability into the economy. And notwithstanding the alarmist reporting to the contrary, banks actually are lending. (The proof is in the numbers and the numbers are publicly available at <http://www.federalreserve.gov/releases/h8/Current/>.) If anything is to blame for a lack of credit in the economy it is the lack of loan demand (businesses are deleveraging) and the disappearance of the shadow banking system (non-bank lending, securitized debt market, etc.). Banks, like other companies, are not immune to the laws of supply and demand. When there is demand for credit, banks lend. Both commercial and consumer borrowers have clamped down on spending and debt over the last few months, and this is reflected in the (slightly) lower levels of credit since the beginning of the year. Nevertheless, the commercial banking industry has been central in lubricating an economy that is no longer totally desiccated.

The headwinds are strong though. Some of the government's programs, such as TALF (Term Asset-Backed Securities Loan Facility), designed to reinvigorate the shadow banking system, have fallen flat. Others, such as PPIP (Public-Private Investment Program), remain untested. Given the lack of clarity and consistency in federal policy over the last 12 months, there is plenty reason to be cautious about PPIP. PPIP is designed to construct a market for so-called toxic assets by inducing private capital into partnership with the government in a sweetheart deal for private investors. Private investors will put up X dollars, matched by X dollars from the government's Troubled Asset Relief Program (TARP) to buy distressed assets from financial institutions. But the FDIC and Fed will provide up to 12X in financing for the purchases, creating six times leverage. The risk, in other words, is entirely with the government. The beneficiaries? Favored non-governmental entities like Goldman Sachs and PIMCO.

For the rest of the investment world, neither program is appealing since it involves partnership with the government. It is perhaps the most telling measure of the distrust of government that the terms of PPIP have been made so extraordinarily friendly to private capital. Nevertheless, most investors have avoided these programs that entail the risk that the government will change the rules mid-game and end up calling all the shots. The course of the last 12 months is littered with examples of the Treasury Department and others doing that very thing.

Speaking of favored non-governmental entities, the market remains justifiably cautious about the government's relationships with Wall Street. Take the AIG debacle. The government pumped billions of dollars into AIG so it could cover approximately \$90 billion in CDS obligations. Obligations to whom? Goldman Sachs, for one, to the tune of about \$13 billion. Goldman Sachs, which sent its former chairman, Hank Paulson, to Washington to run the Treasury Department and Mr. Paulson's young associate, Neel Kashkari, to run TARP. The same Goldman Sachs that narrowly avoided the fate of Lehman Bros. by the Fed's quick approval of its application to become a commercial bank holding

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company. With friends like that, who needs sound financial judgment? More to the point for investors, what good is sound financial judgment when you don't have the friends Goldman and others do?

Another headwind comes as a hangover from the Lehman Bros. failure. When Lehman went under, the economy screeched to a halt. Businesses and consumers didn't merely refashion their approach to risk; they avoided it entirely and irrationally. Just as we had spent the previous several years blowing up debt balloons, after Lehman we hoarded cash and spent only on necessities. Since December, however, this risk aversion hysteria has begun to dissipate. Consumers have begun spending (consumer spending rose 2.2% in the first quarter, the most in two years) and money has begun to flow through the economy. But it may well be too late for leveraged businesses tied to consumer discretionary spending—for example, electronics such as computers, TVs, and cell phones—that have already suffered through a dismal fourth quarter and still face cautious consumers. The stress will likely be felt in commercial lending portfolios.

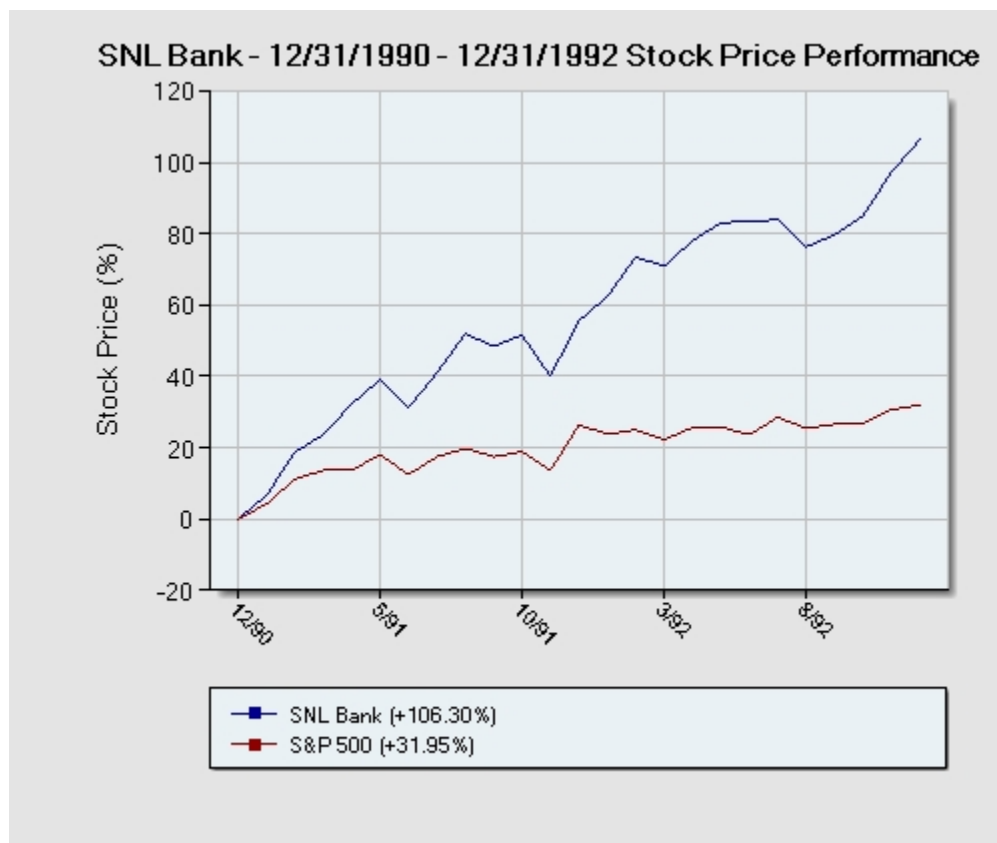
Then, of course, there is commercial real estate (CRE). For over a year now, bankers and analysts have predicted that CRE would be the "next shoe to drop." That is now beginning to happen. The bankruptcy of mall titan General Growth Properties is the clearest indication of the pain now hitting big shopping malls. The same pain is rippling through strip malls and beginning to cause big headaches for the smaller banks that financed those developments. As unemployment increases (or even maintains its current levels), retailers will continue to be stressed and CRE will continue to suffer. Banks with heavy CRE investment—especially those with high concentrations in non-owner occupied CRE—will pay the steepest price.

Topping it off is the din of media commentary. Every talking head has an opinion and it seems the most strident come from those least informed. One has only to tune into the Sunday morning news shows to hear the likes of Cokie Roberts and Sam Donaldson and other prominent banking experts pretend they have a clue what the term "zombie bank" means or what are the prospects for recovery in the financial sector. While the spectacle may be alternately farcical and nauseating, it is THE spectacle the media feeds its viewers. It is past time to begin viewing the story we hear from the media as, at best, a lagging indicator; at worst, an infantilized Hollywood version of economic distress.

These problems are nothing to sneer at. We can continue to expect all the clarity and insight of a mud puddle from the media. We can expect the uncertainty created by the heavy hand of government interference and stress in commercial and CRE portfolios to be a drag on banks for at least a few years to come. And naturally, some banks will suffer more than others.

But meanwhile, in the real world, banks continue to operate and some, believe it or not, are actually making money. Anecdotally, three of the five California institutions in our portfolio of publicly traded banks have reported results for the first quarter and each was profitable. California! The banking industry—contra Roubini, Geithner, the Wall Street Journal, and CNBC—is not staring into the abyss. We don't contend it is the picture of good health, but it is far healthier than many self-proclaimed experts would have us believe. The opportunities for solid, sustainable growth are myriad. As we've said in the past, when the shadow banking system dried up, it took with it over 60% of the credit capacity in this country. Somebody will need to extend this credit in the future and well-capitalized, well-managed commercial banks will be ideally situated to do just that. It will not happen overnight (banks simply can't double or triple in size that quickly), but it is just one more indication that the future of commercial banking is bright.

Finally, we leave you with the chart affixed below and this thought: the market leads the economy.



The market presaged the recession and it will be out front of the recovery (if it that is not already happening). In this case, bank stocks will rebound before the banking industry regains its excellent health. This is what happened during the last major banking crisis in the early 90s. As the U.S. continued to experience a rash of bank failures (450 in 1991 and 1992), bank stocks took off. While the S&P put together an impressive stretch in those two years, bank stocks more than doubled.

Expect it again.

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PARTNERS

CAPITAL MANAGEMENT, LTD.

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

262-369-1095 (Jon Bruss and James Bruss)

www.fortresspartners.com

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