

E-MEMO

TO: INVESTOR/MEMBERS AND FRIENDS
FROM: Jon Bruss
DATE: May 10, 2004
SUBJECT: **What did the Chairman say about interest rates?**
Surprising news about dividends (higher dividends = higher earnings growth)

The chairman of the Federal Reserve Board of Governors has been on the front page of most daily newspapers for the past several weeks. His remarks before the Joint Economic Committee of the US Congress, and the next day, his somewhat different remarks before the US Senate's Banking Committee were followed by one of the most widely watched FOMC meeting announcements in months on Tuesday last week. So what did the Fed chairman say? Clearly, it was important for stocks because the major indices, including the NASDAQ Bank Index, went into a tailspin. First, and very importantly for bank stocks, the chairman signaled that the Fed was done with easing, that deflation was no longer the issue *de jour* for the Fed, but it was being replaced by indicators of inflation (which according to some economists are the wrong indicators to be watching - the monetary aggregates and commodity prices tell it all).

One comment by the Fed chairman in his testimony before the Joint Committee on Tuesday, April 20, 2004, was totally missed by most of the financial press except (you guessed it!) *Investors Business Daily*, where reporter Chris Gessel, the next day (April 21) quoted Greenspan as saying, "Many banks indicate that they now either are interest-rate neutral or are positioned to benefit from rising rates." Gessel went on to say that the markets took that to mean it was time to sell and sell "hard." Gessel said that Greenspan made that comment in a "matter of fact" manner. And why not? We at Fortress have been looking at the same data as the Fed. We can come to no other conclusion. We have been saying the same thing for more than a year. Banks are ready for the coming increase in rates even though the so-called experts don't buy it. We do, and we are continuing to take advantage of lower prices to add to existing positions and to start new ones as well. We continue to believe that this is a golden opportunity to buy and hold selected bank stocks. And we are putting our money where our mouth is.

2004 has yet to show the promise expected by investors. As you will note in the table at the end of this E-Memo, with April results included, the major equity indices tipped into negative territory for the year. It was a case of too much good economic news for the markets. The long anticipated turnaround in jobs came in March, and upon its announcement, the market decided that the news was apparently too good and began its slide. Hoping against hope that the April numbers would not turn out to be quite as good, upon learning that they were (and a lot better than expected) and that the March jobs numbers were revised upward, the market continued its skid so that as of the end of the day on Friday, May 7, all indices were under water year to date with the NASDAQ Bank Index down 5.16%, the Dow down 3.22%, the NASDAQ off 4.26% and the S & P down 1.19%. Not much promise there. Foundation Financial Partners, LLC — a snapshot as of May 7 from the beginning of the year — down 0.81% but nonetheless outperforming the indices to which we compare ourselves.

We have especially focused over the past four years on absolute performance, but when blood is flowing from the market body in general as it is today, blood is likely to flow from us as well, but at a lower rate. Here's why: dividends. Banks pay high dividends. Banks regularly increase their dividends. Shirley Lazo in her "Speaking of Dividends" column in the May 10, 2004 issue of *Barron's* asserts that "Dividend-paying stocks are where the action is these days." Moreover, she points out that among S & P 500 issues, dividend payers outpaced non-payers in February, March and April. In fact, those stocks that paid a dividend rose an average of 1.99% this year through April while those that didn't fell 1.48%. That's pretty dramatic. What does it say about the 2003 tax cut on dividends? I think it speaks volumes. While in the short run, such performance wasn't visited on our banks, I believe that in the long run it will. Here's why. Our colleague, Bob Ollech, handed me a recently-published study which suggests that "expected future earnings growth is fastest when current payout ratios are high and slowest when payout ratios are low . . . [which] contradicts the view of many who believe that substantial

reinvestment of retained earnings will fuel fast future earnings growth.” The study, by Robert R. Arnott, chairman of First Quadrant, LP and Research Affiliates, LLC in Pasadena, California, and Clifford Asness of AQR Capital Management, LLC in New York, was published in the *Financial Analyst's Journal*, January/February 2003 edition. This is pretty dry stuff, 18 pages of it, in fact, including three pages of footnotes and bibliography. Having read it, we've concluded that the arguments are quite compelling and are well supported by hard statistics. Arnott and Asness challenge conventional thinking which “sees the low dividend payouts of recent times as a sign of strong future earnings to come.” Moreover, the research they've done appears to support the research our colleague, John Cornwell, did last year regarding the earnings growth rate of industrials vs. banks for the past 40, 20 and 10 year periods. Bob Ollech cited that research when he sent a Special Edition E-Memo to you on April 20. The recent evidence according to Shirley Lazo is that dividend-paying stocks outperformed non-payers in the S & P during the first four months of 2004. Arnott and Asness, upon reading her piece, would probably not be surprised because, after all, they would say that paying out a significant portion of earnings as dividends instills management discipline and better allocation of capital, and that is why dividend-paying companies actually signal their earnings expectations through dividends and increases in dividends payouts while companies who don't pay dividends or have low payouts may be inefficient in their allocation of capital. That is why we have focused on higher dividend payers in our ongoing search for our portfolio holdings.

As we commented last month, 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 May 7, the betting focused on August to late 2004 as the soonest that the Fed would change rates. As of the most recent view, it seems nearly certain that a change will take place in August, and bets were even being placed on June. From my point of view, the sooner the better. In any case, as we said last month, we are prepared for improved margins in our selection of banks and thrifts most likely to benefit from a rate increase.

**APRIL 2004
PERFORMANCE HISTORY (1)(2)**

	Inception to Date (49 Months) 3/29/00-4/30/04	Three Year Return Annualized 4/30/01-4/30/04	Twelve Months Ending 4/30/04	Year to Date As of 4/30/04	Last Month
FOUNDATION	+133.12	+26.11%	+26.43%	+0.59%	-1.69%
Dow Jones Industrial Average	-6.38%	-1.61%	+20.58%	-2.18%	-1.28%
NASDAQ	-58.01%	-3.19%	+31.13%	-4.15%	-3.71%
S & P 500	-26.11%	-3.95%	+20.76%	-0.42%	-1.68%
S & P 600 (Small Cap Index)	+32.56%	+7.93%	+38.73%	+2.43%	-3.38%
NASDAQ Bank Index	+82.66%	+13.15%	+21.25%	-3.57%	-5.18%

(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.

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