

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS

FROM: Jon Bruss and Bob Ollech

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SUBJECT: ARE WE THERE YET?—AND OTHER QUESTIONS AND OBSERVATIONS FROM THE BACK SEAT

Those of us who are parents can cite the innumerable times we've heard "Are we there yet?" from our kids in the back seat while on a car trip (although with on-board DVD players, video games and the like, we hear it less often now). A similar question arises from bank stock investors today when asking when we will get to the bottom of the current cycle of small bank stock malaise, "**Are we there yet?**"

The answer: We're not sure—and we don't know of anyone who is. Each of the past downturns in bank stocks has exhibited somewhat different characteristics and each, it seems, has had a different cause: Real estate in the late eighties, busted M&A ventures in the nineties and in this decade, take your pick from the inverted yield curve to the sub-prime mortgage mess, the fall in housing starts, the drop in real estate equity, or worries of a slowing economy and a rise in potential credit problems. For those climbing the wall of worry there are other reasons, we're certain. As portfolio managers we've tried to put ourselves in the shoes of bank investors and bank executives who are also bank investors. For purposes of this letter, have tried to think of questions you might be asking. Here are some questions—hopefully just like yours—with our answers:

QUESTION: Small bank stocks have generally performed well since 2000 but have tailed off in recent years. What happened?

ANSWER: March 2000 marked the peak of the broad stock market indices and the final month of a two-year decline in bank stock prices that erased 37% of the value of the NASDAQ Bank Index. In the five years that followed, the NASDAQ Bank Index more than doubled in value, far outpacing the S&P 500. The rise in value was not straight up, but was marked by periodic declines of as much as 13% along the way.

For the 28 months from the beginning of 2005 through April 30, 2007, the total return for the NASDAQ Bank Index was 5.4%. Without dividends, the return was actually slightly negative. What happened? The Fed began raising the Fed funds rates in late 2002 and kept raising them through June 2006. The yield curve, or the difference between short-term rates and longer-term rates, flattened and then inverted. This made it much harder for banks to maintain, much less expand, net interest margins. During the same period, the booming housing market began to rollover and competition for loans and deposits intensified. In short, the operating environment for banks became more difficult and, for many banks, the pace of earnings growth has stalled, or at least slowed.

QUESTION: As this was happening, why wouldn't bank investors like you move to a cash position?

ANSWER: Deciding which asset classes to allocate investment dollars to is something most sophisticated investors consider individually; it is not a decision controlled by the investment manager. Accordingly, most investment managers aim to keep the dollars entrusted to them fully invested stocks. Why? Because—**its difficult, if not impossible, to consistently time the market.** Not every downturn is the same, but all have eventually been followed by an upturn. For example, this year we at Fortress Partners have faced four consecutive months of negative returns. We're not thrilled with that circumstance, but it is something we've experienced, and recovered from, before. In 2000, our total drawdown (private fund jargon for negative return) for September, October and November was 9.6%, followed by gains of 5.2% in December 2000, 5.7% in January 2001 and 4.0% in February 2001--a total gain of 14.9%. In August, September and October of 2001 our portfolio dropped 11.7%--the 9-11 attack as you'll recall. In the next three months the portfolio rebounded 11.6%, almost totally reversing the previous three months decline. Had we moved to cash the end of either of those two periods to avoid further decline, we'd also have had to be sufficiently prescient to know

that the next three months would have reversed decline and been able to buy back all the shares we'd sold on the first business day of the month. We know that other managers have had similar experiences.

QUESTION: When will this decline be over?

ANSWER: The Readers' Digest version is "We don't know." We do know that the decline will end because they always do, we just don't know precisely when. In the meantime, we think bank stock portfolio managers like us should be continuing to do what we are paid to do: Invest client funds in the best banks we can find.

Recently, one of the brokerage firms with which we do business, FIG Partners in Atlanta, provided its clients with some research which focuses on this timing uncertainty. Their work shows that the decline in forward price to earnings ratios (P/Es) of a sample of more than 500 publicly traded banks—with \$200 million to \$10 billion in assets—has, to date, not brought the P/Es of banks to the nadir of Spring of 2000 when we started our fund. And, because the forward P/Es (based on analysts' earnings estimates) are as much as two multiples lower than P/Es based upon actual trailing earnings, they conclude that bank stock prices need to decline even more. According to our Bloomberg data source, the average P/E ratio for the banks in the NASDAQ Bank Index over the last 10 years was about 16X compared to about 18X today. We don't know when the P/E compression will end and neither do the folks at FIG.

We are of the opinion that the operating environment for many banks is approaching a trough. Net interest margins appear to be in the process of bottoming and bankers report that deposit and loan price competition, while still intense, is starting to moderate. The inverted yield curve has persisted for more than 12 months, which is, by historic standards, getting long in the tooth. In all cases, when the yield curve has re-sloped, it has been because short-term interest rates were lowered. As the economy appears to have slowed of late, the odds of a Fed rate cut later this year appears to have increased, something which would help to ease pressure on margins and also improve investor sentiment toward the banking sector. Another interesting sign is that bank merger and acquisition activity has begun to pick up. Often times, when the going gets tougher, the easiest alternative for smaller banks is to hang a "for sale" sign on the door. And other bankers, looking to keep their organization on a growth trajectory, are eager buyers. There have been plenty of buyers lately who are willing to pay premium prices and, anecdotally, many of the bankers we talk to regularly have told us that significantly more "deal books" are landing on their desks than only six months ago. Through early May, according to SNL Financial, 100 bank and thrift acquisitions have been announced, compared to 299 for all of 2006. The average deal price has equated to a generous 24X earnings and 245% of book value. We expect M&A activity to remain strong for some time.

QUESTION: So what do we do in the meantime?

ANSWER: We think investors have three choices: (1) Do nothing; (2) Sell all their small bank holdings, or (3) Do what savvy bank investors were doing during the last two significant declines in bank stocks and are doing today--adding selectively to their holdings of banks. With almost all small banks being shunned by investors, there are plenty of great opportunities for discerning investors who can look out 12 to 18 months to an environment that is friendlier to banks.

QUESTION: But the experts (read journalists and bank stock analysts) say otherwise.

ANSWER: We know. Stock analysts are human beings. When earnings estimates are missed and the market is going against them, the natural tendency is to get more conservative and to cut earnings estimates and ratings. To many investors, ourselves included, analysts' earnings estimates and stock ratings are interesting, but we don't place much stock in them as an indicator of value or of a bank's ability to create value for its shareholders. (An aside to all of you analysts who are stressing out about a bank earning a penny

or two less than your model predicted last quarter: Relax and focus your efforts on the big picture value creators like organic growth in loans and deposits, prudently priced acquisitions, increased market share and the like. None of us trusts the weatherman's prediction more than a day or two out—why do you think your projections of bank earnings 12-18 months from now should carry much weight? And why no angst when a bank beats your estimates by a few pennies – estimate errors are errors, regardless of the direction! In fact, underestimating the earnings capacity of a bank might be the bigger sin as it could cause you and your clients to overlook a great long-term investment.) The financial press is no better. With too few exceptions, journalists focus on the headline de jour, not thoughtful analysis of what is likely to happen months from now. The media writes or broadcasts to attract an audience so that it can sell advertising. In this era of “drive-by” reporting and short attention spans, it strikes us as foolish to expect much in the way of thoughtful analysis from the mainstream business media.

CONCLUSION: Profitable investing often requires a contrarian approach—buying when the herd is nervously selling (and lightening up on positions when everyone else is rushing to buy). Given human nature, that is often easier said than done. Doing so requires having sufficient information to make a decision about the issues at hand, the expertise to differentiate between relevant information and noise, and the temperament to endure the temporary decline in the value that may persist until other investors return to behaving rationally. We practice what we preach. We have confidence in the durability of the banking sector and in the long term investment merits of small banks in particular and think you should, too.

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