

E-MEMO

TO: INVESTOR/MEMBERS AND FRIENDS
FROM: Jon Bruss
DATE: June 10, 2004
SUBJECT: Is this really the end of bank stock performance as we knew it?

We don't think so. I think it's safe to say that even without conferring with Bob, who is canoeing in the Canadian wilderness, or John, who is painting his pier in Bella Vista, Arkansas. I have to be careful not to sound shrill when I talk about all the negative financial media, the nattering nabobs of negativism, to paraphrase a late politician. Here is a partial listing of what THEY say will happen as the Fed increases interest rates:

- All stocks will decline.
- Retailing stocks will decline because credit card rates will increase.
- Utility stocks will decline.
- Bank stocks will decline because increasing interest rates "are not good for banks."
- All interest-sensitive stocks will decline (you can take your pick here because they sure don't know).
- Housing starts will decline because mortgage rates will increase.
- Auto sales will decline because auto finance rates will increase.

In reality, most if not all of the foregoing is the "no risk" approach to financial journalism. Just repeat what has happened before and pass it off as newsworthy even though it may no longer be true. Perhaps circumstances have changed significantly enough to call for a different view, a new look or, heaven forbid, require some original research – phone calls to new sources not tapped by the mainstream even though they may be quite reputable. If they did that, they would find that interest rates are at a 40-year low. Is it likely that they will reverse and reach the highs of 20 years ago? Housing starts were high (as I recall even some record highs) as rates were higher in the past 5 years or so. Is it likely that housing starts will face a sharp decline as a result of Fed action on rates? Has anything changed over the past several interest rate cycles that might cause bank profits to go up rather than down? I think we all know the answers to those questions, especially the last one, if you have been reading our E-Memos for the past year or so.

So as I fuss and fume over what the talking heads on CNBC are saying or what the pundits on Fox News are discussing or even what the writers of the Wall Street Journal or Investor's Business Daily are scrawling, I have to take a deep breath. As I was doing just that earlier this week, I received an electronic dose of sanity from one of the brokerage firms we deal with, which was taking a look at their 10-year track record. What I saw were facts, not suppositions. Reviewing that firm's commentary (call or write if you'd like to know the name of the firm) I confirmed that we were on the right track, that the kinds of banks we have in our portfolio meet the criteria another well-respected firm follows for its recommendations. We use more data points than they because we like to drill down into some of these factors for more detail, but our interests are, for the most part, parallel: stock price growth, earnings growth, asset growth, dividend rates and growth, net interest income growth and net interest margin, non-interest income growth, non-interest expense rates, asset quality, return on average equity and return on average assets. Their universe of stocks followed totals slightly over sixty. Here's what they found:

TABLE 1

FACTOR	10 YEAR GROWTH RATE (Median)
Stock Price Annual Growth Rate (AGR)	12.75%
EPS AGR	10.28%
Dividend AGR	13.43%
Revenue AGR	8.72%
Non-Interest Income Per Share AGR	12.32%
Total Expense Per Share AGR	8.55%

Interesting numbers but what do they mean? Simply this: ***THIS IS NOT THE END OF BANK PERFORMANCE AS WE KNEW IT!*** We would argue that it is only a precursor to better days. According to our brokerage friends: Over the past decade banks have been challenged by foreign loans, risky leveraged-buyout loans, commercial real estate problems, exceptionally volatile interest rates including flat and/or inverted yield curves, recessions, terrorists acts, and beliefs that the consumer is overextended. The banking industry has responded to these challenges, which have provided great headlines by consistently reporting sound results. (See TABLE 2 below showing earnings growth rates of banks vs. US corporate profits.) We agree with this brokerage firm that regional (micro and small cap) banks results were even better. Furthermore, we conclude that, in the past decade, banks have shown the ability to weather far worse rate storms than those we seem to be facing today.

TABLE 2

	10 Years 1992-2002	20 Years 1982-2002	40 Years 1962-2002
U.S. Commercial Bank Earnings	9.15%	9.43%	9.54%
U.S. Corporate Profits	5.65%	7.05%	6.58%

Sources: FDIC, U.S. Department of Commerce and BEA

How does Foundation Financial Partners, LLC stack up against the results cited on the previous page (TABLE 1)? Well, we haven't been in business for 10 years, so there is no direct comparison to the 10-year table. However, the brokerage firm did publish *three-year* results showing a compound annual growth rate of **23.32%** in stock prices for the 60+ selected names for the *three-year* period ending December 31, 2003. By comparison, **Foundation's compound annual growth rate was 30.58%**, net of fees and expenses for the same *three-year* period.

We cannot and should not extrapolate future performance based upon performance for the past three years. Interestingly, the brokerage firm's annual growth rate of stock prices was a median 8.34% for the past *five years* ended December 31, 2003, while Foundation's results for the *four years* ended March 31, 2004 was **22.8%** (and don't forget, the first quarter of this year was virtually flat, performance-wise). Four years vs. five years is not a fair comparison but is, nonetheless, interesting to contemplate.

At Fortress, we get paid to do better than the averages, and toward that end, we strive mightily. It's our job to find those banks and thrifts with earnings that are growing faster than the averages, with dividends increasing every year, with clean asset portfolios, with a sound asset/liability strategy and with good management track records. We do that each and every day, and we do it for the long term.

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 June 4, the betting focused this month as the soonest that the Fed would change rates and that the increase would be 25 basis points. From our point of view, the sooner the better. In any case, as we have said in the last two months, we are prepared for improved margins in our selection of banks and thrifts most likely to benefit from a rate increase.

May 2004
PERFORMANCE HISTORY (1)(2)

	Inception to Date (49 Months) 3/29/00-5/31/04	Three Year Return Annualized 5/31/01-5/31/04	Twelve Months Ending 5/31/04	Year to Date As of 5/31/04	Last Month
FOUNDATION	+130.79%	+21.52%	+20.87%	-0.42%	-1.00%
Dow Jones Industrial Average	+ 1.27%	- 0.19%	+17.60%	- 1.71%	-0.36%
NASDAQ	- 55.86%	- 1.56%	+25.08%	- 0.66%	+3.47%
S & P 500	- 20.35%	- 2.13%	+18.32%	- 1.47%	+1.21%
S & P 600 (Small Cap Index)	+ 39.09%	+ 8.69%	+31.49%	+ 4.28%	+1.45%
NASDAQ Bank Index	+ 106.38%	+ 15.12%	+18.92%	- 0.33%	+2.46%

(1) After management and other expenses but before charges for Performance Allocation, indices reflect reinvestment of dividends.

(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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