E-MEMO

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
DATE: July 9, 2004
SUBJECT: Barron's (and others) finally find banks

We've commented before on these very pages about financial journalists—sometimes positively but mostly critically. Why? Because they have, in most cases, totally ignored their responsibility to inform the public about what is really going on in banks. Too many of them have simply regurgitated "conventional wisdom," for example, that higher interest rates are bad for banks, and therefore, bank stocks should be sold. Few in the financial press have expended the effort to actually investigate the facts. Our view, one, incidentally, endorsed by many bank executives, is that a trend toward higher interest rates will actually benefit earnings at most banks. The fact that higher interest rates are usually keyed, in part, by an accelerating economy and more demand for credit, also means better loan growth opportunities and even better margins.

If the reporters really dug into the banking industry they would likely be surprised at the changes that have occurred in just the past decade. Banks today have much better tools to manage interest rate risk, their revenue sources are much better diversified, and they have effectively utilized technology to significantly improve their operating efficiency. In sum, bank earnings are much less sensitive to changes in interest rates than they were in the past. Just today a reporter called acknowledging my critical response to a recently-published article. We had a good discussion, and the reporter plans to cover the subject in a feature article to be published soon.

Overall, I've found that Barron's does a good job of informing (and entertaining) its readers. My hat's off to this publication for exceptional reporting during the past three weeks in particular. Barron's and others have provided us with grist for the mill this month.

Mergers & Acquisitions not likely to diminish

"Bank on it." That headline appeared in the June 14 edition of Barron's. Written by Rhonda Brammer, this piece is one of the best banking articles I have seen written by a non-financial company reporter. She files stories on small cap companies, and the upshot of her thesis is that bank mergers and acquisitions will continue to be "sizzling." Reason? Banks are seeking "to increase earnings via vigorous expansion." Our data source, SNL Financial, indicates a total of 106 merger announcements have taken place this year (through June 18) 80 of which were banks and 26 of which were thrifts. That compares with 242 last year and 231 in 2002. With over 8,000 banks in the country, nearly 1,000 of which are publicly traded, we don't see the pace of consolidation slowing any time soon.

Rising Rates Damage Banks? Not likely.

In the same Barron's article, Brammer quotes Tony Davis, a bank stock analyst from Ryan, Beck & Co., who has followed banks for nearly 20 years. Davis says that "a two-percentage-point rise in rates would actually boost earnings of big banks slightly and lift overall net of smaller banks, since they have a more stable deposit base, a healthy 5%-6%." Davis does not include any discussion of the impact of improving economic activity on increased demand for loans. That impact has occurred in the past, and there is no reason to think otherwise regarding the current expansion. And why do big banks want to buy smaller banks? In our opinion, it is simply because as Davis put it so well, "they have a more stable deposit base."

Craig Woker, a financial institution research analyst working for Morningstar.com, the independent research firm that rates mutual fund performance and also provides independent research, had this to say:

> Long-term issues are big drivers in the value of banks, just like any other stock. Getting a handle on these isn't always easy, and at Morningstar, it sometimes causes our valuation of a company or opinion on a firm to differ markedly from other investors'. . . . [B]anking firms are all too often lumped into one indiscernible blob.

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Woker went on to say that "[a]s with any complicated issue, it's easier for investors to rely on their 'conventional wisdom' rather than earn the real kind by studying the nuances of different firms." (***And different industries—my comment.***) Woker points out that bank stocks have underperformed this year, and you will note that at the end of this memo when you look at our performance vs. the indices. Further, he points out what regular readers of the Fortress E-Memo know: ". . . that banks posted strong (if not record) earnings in the first quarter." Since most banks also saw improving credit quality, Woker maintains that the primary reason for the underperformance of bank stocks this year can be attributed only to interest rate fears. In his words, "This reaction is just plain silly." He points out, "based on the latest quarterly filings **of the 10 largest US based banks and thrifts**, based on asset size, **seven** of the 10 **would experience a material increase in net interest income if rates moved higher**."

Barron's chimed in on June 21 in an article in the *Current Yield* section entitled "Financial Institutions Brace for Rate Hikes– Could fears that rising interest rates will derail banks and financial companies be vastly overblown?" The author quotes Andrew Harding, director of taxable fixed income securities at National City Investment Management, which runs $6.7 billion of taxable fixed income assets, as saying, "These guys now have so much more financial might than ever. Banks and financials have much better balance sheets than they did 10-15 years ago," to withstand rate increases.

Exactly my experience. I remember 1994 as if it was yesterday, listening to our bank presidents at Fortress Bancshares respond to pointed questions by directors who wondered why we couldn't do better (notwithstanding six rate increases in the year - some of them 50 basis point increases). Many of the tools available today weren't available 10 years ago – the software tools now available to manage bank balance sheets are not mainframe monsters but rather, nimble PC routines, readily available at modest prices. No bank or thrift need be left behind.

Should banks be a large part of your portfolio?
We have long held that bank stocks should represent ***at least*** a market weight of most investors' investment portfolios. Again, Barron's has some thoughts you should consider. In an article on June 28 entitled "Rate Expectations," Andrew Bary points out that "[f]inancial stocks account for 20% of the S & P 500 but the earnings contribution of the sector is 30% because financials tend to have lower price-earnings ratios than the overall market. The average financial P/E is around 12 times forecast 2004 profits, against 17.5 times for the S & P 500 itself." He continues, stating that the actual contribution is probably around 35% because General Electric gets nearly half its profit from its financial arm, GE Capital, and Ford and GM have produced most of their recent profits from their financial divisions. And what about our portfolio? Our weighted average P/E based upon last 12 months' earnings is 13.1 times. (Because most of our stocks are not followed by the investment analyst community, estimates for 2004 are not available for most of our names. However, for those where there are estimates, the multiples range from 10 to 11.5 times.)

Bank Dividends and Total Return
Those of you who have followed this E-Memo over the past 18 months know that we were very enthusiastic about the Bush Administration's proposal to cut taxes on dividends. That legislation became a reality in May 2003. We contend that dividends *do* play an important role in investor returns – more important than we realize. How important? The last nine years provide us with a good look (10-year data for total returns are not available): The S & P 500 Index provided a nine-year total return of 10.04% per annum and the NASDAQ Bank Index, 17.23%. Now the interesting part: The S & P 500, *without* dividends reinvested into the index, provided a return of 8.26%, while the NASDAQ Bank Index provided a return of 14.64%. The reinvestment of dividends improved the S & P return by 21.5% and the Bank Index return by 17.7%. Two conclusions can be drawn from the foregoing: One, dividends *are* important and have a substantial impact on returns. Two, the Bank Index outperformed the S & P, even without dividends.

A recent study that appeared in this week's Barron's (July 5) confirms our view on the importance of bank stock dividends. Shirley Lazo, author of the *Speaking of Dividends* column looked at a study by the highly-respected Richard Bernstein, Merrill Lynch's chief US investment strategist, and his colleague, Savita Subramianian, a quantitative strategist. In the study, Bernstein and Subramianian looked at their firm's US Equity Universe to finds stocks with: (1) a dividend yield at least equal to the five-year treasury note (currently about 3.8%), and (2) a projected five–year dividend growth rate equal to that of their firm's highest inflation-rate forecast over the next five years (currently 2.5%). They then calculated expected returns, adding dividend yield and five-year projected dividend growth and also narrowed the universe to the S & P 500. Interestingly, they found that *the banks in this very small but elite group would generate an expected return of 10.7% per annum while the others, mostly public utilities, an*

8.6% return. For the banks, the dividend growth rate averaged 6.5% per year, while the others grew at 3.8%, ***a 71% better growth rate for the banks***. Again, we conclude that dividends *do* matter and that banks generally grow their dividends faster than utilities (and, we might point out, industrials in general). The fact that dividends are currently taxed at a maximum 15% rate makes the value of dividends all the greater.

No matter how you cut it, stock price appreciation is handsomely aided by dividends, provided the stock pays dividends. Bank stocks in the Bank Index beat the S & P 500 (which includes a healthy dose of banks) by a substantial margin. That is the kind of margin (with or without a dividend) I want to have working for me. It can work for you when you invest in banks.

June 2004
PERFORMANCE HISTORY (1) (2)

	Inception to Date (51 Months) 3/29/00-6/30/04	**Three Year Return Annualized 6/30/01-6/30/04**	**Twelve Months Ending 6/30/04**	**Year to Date As of 6/30/04**
FOUNDATION	**+ 131.69%**	**+18.82%**	**+20.56%**	**-0.03%**
Dow Jones Industrial Average	+ 0.89%	**+ 1.92%**	+17.86%	+0.80%
NASDAQ	- 54.49%	**- 1.35%**	+25.44%	+2.43%
S & P 500	- 18.80%	**- 0.69%**	+18.14%	+3.44%
S & P 600 (Small Cap Index)	+ 46.80%	**+ 9.34%**	+34.92%	+10.06%
NASDAQ Bank Index	+ 110.27%	**+ 13.98%**	+20.36%	+1.56%

(1) **After** management and other expenses but **before** charges for Performance Allocation; indices and Fund performance include the 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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