

# The FORTRESS PARTNERS

## E-Memo

**TO:** INVESTORS/MEMBERS AND FRIENDS  
**FROM:** Bob Ollech and Jon Bruss  
**DATE:** July 17, 2007  
**SUBJECT:** REPORTS OF THE DEATH OF SMALL-CAP BANKS HAVE BEEN GREATLY EXAGGERATED

Shares of small-cap banks remained under pressure in June with the NASDAQ Bank Index down 3.02% for the month. The NASDAQ Bank Index is down nearly 8% year-to-date through yesterday and results have been negative for five of the first six months of this year. A host of banks, especially those in the upper Midwest, and more specifically in Michigan, are down 30% or more year-to-date and several are trading at less than half their all time highs. Those results, while painful, point to increasingly attractive valuations in the bank stock universe and, we believe, better returns ahead.

One of the basic tenets of successful long term investing is to invest regularly, regardless of what the market is doing at the moment. Attempting to time the market often results in being on the sidelines when stocks turn up. Not buying when the market is down or the sector is out of favor means forgoing the opportunity to buy good quality stocks at attractive valuations. As we've noted before, profitable investing often requires a contrarian approach—buying when the herd is nervously selling. 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 material information and noise, and the temperament to endure the temporary decline in the value that may persist until other investors return to behaving rationally (which is often longer than many investors can psychologically endure).

Despite regular corrections, the long term trend of the equity markets, including small-cap bank stocks, is up. Why? Because the value of a business is based on the underlying earnings stream that it generates and, domestically, **corporate profits** have **increased** at an average annual rate of **about 7%** for the last 40 years. But **banks**, according to data from the FDIC, have **increased their earnings** at an average yearly rate of **almost 10%** over that same time span. That 40 year time horizon includes periods when the economy was booming and times when it was in recession, as well as periods of high inflation and low. In the banking world, it encompasses the bank and savings and loan debacle of the late 1980s, multiple credit “crises” in the international, agricultural, energy and commercial real estate sectors. Interest rates cycled up and down multiple times, credit spreads expanded and contracted and the yield curve cycled from normal to steep to inverted and back again many times.

The table below summarizes nearly 33 years of market history for the NASDAQ Bank Index. In a nutshell, the information in the table shows that bank stocks have performed well over a long period of time, despite corrections that have lasted, on average, about 7 months. The most severe corrections, in terms of decline in value, relate to significant economic “shocks” which tend to occur infrequently. The worst correction occurred between September 1989 and October 1990, a period that corresponded with the peak of bank failures in the U.S. as the excesses of the 1980s were finally wrung out of the banking system.

Bull Market				Corrections				Recovery	
Start	End	# Months	Return	High	Low	# Months	Decline	Full Recovery	# Months
Sep-74	Jun-75	10	34.08%	Jul-75	Sep-75	3	-12.44%	Mar-76	6
Oct-75	Aug-79	47	61.18%	Sep-79	Mar-80	7	-19.45%	Nov-80	8
Apr-80	Jan-84	46	125.73%						
Jun-84	Feb-87	33	165.96%	Mar-87	Nov-87	9	-26.67%	Dec-92	61
Dec-87	Aug-89	21	30.61%	Sep-89	Oct-90	14	-51.73%	Nov-92	25
Nov-90	Aug-94	46	230.91%	Sep-94	Dec-94	4	-11.01%	Apr-95	4
Jan-95	Apr-98	40	222.30%	May-98	Aug-98	4	-27.85%	Mar-02	43
Sep-98	Apr-99	8	15.60%	May-99	Feb-00	10	-22.66%	Dec-00	10
Mar-00	Apr-02	26	67.61%	May-02	Mar-03	11	-10.30%	Feb-04	11
Apr-03	Feb-04	11	36.50%	Jan-05	Apr-05	4	-10.95%	Mar-06	11
May-05	Dec-06	20	18.99%	Jan-07	Jun-07	6	-7.80%		

Regulators implemented tougher banking rules and bank investor sentiment bottomed out. 1990 marked a multi-year low-point in bank valuations and set the stage for a powerful rally that lasted nearly four years. The correction in mid-1998 corresponded to the collapse of hedge fund Long Term Capital Management and Russia's default on its national debt. The correction that started in May 2002 corresponded to the U.S. invasion of Iraq. Since then, corrections have been relatively mild and quickly recovered; in less than 12 months for the three most recent corrections.

Like many long term investors, we seek solace—and validation, in looking back. We found that the NASDAQ Bank Index generated a 12.78% annualized return for the 32 years and nine months covered in the table above, while the S&P 500 Index generated a 10.14% annual return. That difference may not be significant when compared over a few years but when the view is extended to nearly 33 years, the difference is astronomical—a 5,048% return (a \$10,000 investment on September 30, 1974 grew to \$504,833 by June 30, 2007) for the Bank Index vs. a 2,266% return for the S&P 500 Index (\$10,000 invested in S&P 500 Index grew to only \$226,599 over the same period). For the last 20 years, the Bank Index has outperformed the S&P 500 Index 9.91% vs. 8.32% annually and, for the last 10 years, 6.91% vs. 5.43%, annually. **We find the results for last 34 years--or 20 years--or 10 years to be a very compelling argument for a long term investment strategy involving banks.**

As we discussed in last month's *E*-Memo, we think that the operating environment for many banks is entering a trough. Net interest margins appear to be in the process of bottoming and more than a few bankers report that deposit and loan price competition, while still intense, seems to be moderating. The inverted yield curve has persisted for more than a year, which is, by historic standards, getting long in the tooth. One of the most interesting signs that valuations are attractive is that bank merger and acquisition activity appears to be accelerating. Anecdotally, more than a few bank CEOs have told us that they are currently seeing more "pitch books" from banks interested in selling than in recent memory. And, there have been plenty of buyers lately who are willing to pay premium prices (often larger banks which want to continue to grow). Through early July, according to SNL Financial, 158 bank and thrift acquisitions have been announced, compared to 299 for all of 2006. The average deal price has equated to a generous 26.4X earnings and 254% of book value. It is clear that acquisitive bankers are using the recent lull in small-cap bank stock prices as an opportunity to expand their franchises. We expect this trend to continue for some time.

Is there a looming sea-change in the works for the banking industry that is permanently changing how investors value bank stocks? Do banks no longer play a key role in the economy or are banks in danger of becoming obsolete? Is there an impending crisis just around the corner that will drastically alter the industry for the worse? We think not. Certainly, the banking industry continues to evolve, but that evolution has resulted in leaner banks that are more responsive to the needs of customers, be they businesses or consumers. Arguably, as a group, banks are better managed and financially stronger today than ever before. The current correction phase in bank stocks can be attributed, we believe, to the normal ebb and flow of investor sentiment at a time when many smaller banks are going through a period of slower growth and modest earnings pressure. When will the current contraction phase end? No one knows for sure, but if history is a guide, we are closer to the end of the cycle than the start.

With apologies to Mark Twain, "The reports of the death of small-cap banks have been greatly exaggerated."

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