

## E-Memo

**TO:** INVESTORS/MEMBERS/PARTNERS AND FRIENDS  
**FROM:** Jon Bruss  
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**Subject:** Management, Markets and Metrics (Part 2)—Transparency

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When we analyze banks, we spend a lot of time and energy reviewing financial statements, market demographics, and economic trends. These are important aspects—the meat, so to speak—of our job as investment managers. We measure a bank's performance and value based on our review of the balance sheet, its income statement, and other statistics that enable more in-depth analysis. Information about the economic and demographic character of the markets our banks serve provides us perspective on the future viability of a bank's performance and value. To get a well-rounded understanding of a bank, however, we must also take into account other fundamental considerations: **transparency** and **trust**. These issues are all the more important in difficult times like these. We focus on transparency this month.

### Transparency

Webster's defines "transparent" as:

- a: free from pretense or deceit : frank
- b: easily detected or seen through : obvious
- c: readily understood
- d: characterized by visibility or accessibility of information especially concerning business practices.

Transparency is a word rich with meaning for us as bank investors. It hardly rises above platitude to say bankers ought to be "free from pretense or deceit", but the synonym "frank" certainly suggests a degree of forthrightness and candor more rigorous than the mere absence of deceit. When we invest in a bank, we invest in the bank's management. But we have no reason to *trust* the bank's managers if they are not frank in their dealings with investors. The bank's transparency is a necessary precondition of investors' trust.

So what does transparency mean for bank investors? First, it means banks must provide full disclosure of losses, and not just after the losses have already occurred. Bankers know—or should know, if they are really earning their wages—how to determine potential losses. They should disclose the best case, base case, and worst case scenarios to investors. That, to put it bluntly, is Transparency 101. It is clear that many large banks have not done this over the past year, but instead have allowed losses to trickle (trickle is perhaps not the best word, given the size of those losses) through their financial statements over several quarters. Investors, however, cannot properly gauge the quality of their investment when they are being pummeled quarterly by losses that should have been disclosed much earlier. One wonders whether the lack of transparency in some larger financial institutions does not also lead to self-deception. In any event, a lack of transparency certainly does prevent the bank's management from taking a hard look at itself.

Transparency is the ultimate form of self-reflection for banks. Good banks release exhaustive GAAP financial statements, earnings reports, and related statistics on a quarterly basis. In these reports, they disclose potential credit problems, which requires that they have intimate knowledge of their borrowers' businesses and any economic issues that may affect those credits. A transparent bank also discloses the composition of its funding base—where the bank gets the money it lends. This is extremely important because some funding sources are more expensive than others and some are more mobile—seeking the highest rate with no loyalty to the bank. For example, brokered and jumbo CDs can be a good funding source for banks seeking to raise capital and grow assets. But brokered and jumbo CDs may be more expensive than a checking or savings account, and will stay with the bank only until better rates become available elsewhere. Checking accounts, savings accounts, and even money market accounts provide more inexpensive sources of funding. They are also more likely to remain with the bank for a longer

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period of time, providing the bank a degree of predictability that brokered and jumbo CDs do not. Investors in banks are keenly aware that deposits vary in form, which can substantially affect the value of the bank's franchise. Good banks provide the transparency investors require to evaluate those deposits.

Transparency also means that banks must disclose their philosophy for asset/liability management and tell investors what is in their securities portfolio. Asset/liability management—how the bank manages interest rate risk and views future interest rate trends—is the key to creating strong earnings. Investors need to be told how the bank intends to deal with interest rate risk by allocating its liabilities (deposits) and its assets (primarily loans). A bank's securities portfolio—through which a bank will receive interest—can, if well-managed, help a bank increase its net interest margin; if poorly managed, the net interest margin will compress and earnings will suffer.

Finally, to be truly transparent, the bank needs to disclose to investors comparisons of performance quarter-to-quarter, quarter-over-quarter, and year-over-year. This allows investors to make intelligent and educated decisions about the direction of the bank's growth, earnings, and underlying value. In short, the more metrics the bank discloses to investors—the more transparent it is—the more investors can make informed and intelligent investment decisions.

The events of the recent weeks may undermine confidence in banks for some people. The failure of IndyMac last Friday was as much about a run on deposits (ignited by the impolitic remarks of a U.S. senator) as it was about the underlying health of the bank. The proposed government deal to prop up Freddie Mac and Fannie Mae is a problem long in gestation and the result of the government systemically propping them up for most of their history. With large banks such as Citigroup and IndyMac and large mortgage institutions like Freddie Mac and Fannie Mae, transparency will necessarily suffer.

The managers of small community banks rarely have the luxury of ambiguity. Small community banks, the banks we invest in, do not have the characteristics of large banks—complex corporate structure, numerous off-balance sheet transactions, exotic and risky business lines—that confound regulators and investors alike. When the economy booms, massive portfolios of subprime loans and mortgage backed securities yield handsome profits. When there is a slight bump in the road, the owner of those risky assets will fall precipitously.

The market has been acting over the last several months as if banks have not been transparent enough. The media and some investment professionals have added fuel to the fire by lumping commercial banks in with mortgage bankers, Freddie Mac, Fannie Mae, and investment banks. To make matters worst, the media apparently cannot distinguish money center banks like Citigroup and JP Morgan Chase from Main Street Bank. Dragging bank stocks out of their present doldrums will require healthy doses of transparency. Small community banks are uniquely positioned to lead the way out of the mess because unlike much larger institutions, small community banks are, through regulation and tough investors, compelled to be transparent.

# FORTRESS

PARTNERS

CAPITAL MANAGEMENT, LTD.

700 Walnut Ridge Drive, Ste 200, Hartland, WI 53029

262-369-5369 (Jon Bruss)

[www.fortresspartners.com](http://www.fortresspartners.com)

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