

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS

FROM: Jon Bruss and Bob Ollech

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SUBJECT: Fear vs. Fundamentals

We imagine you've all seen the credit card ad with the tag line, "What's in your wallet?" For us, the more important question is, "What's in your portfolio?" and its logical follow-on question, "Why?" What drives your portfolio decisions, fear or fundamentals?

It has become apparent over the past month that many portfolio decisions are being driven by fear rather than fundamentals. These portfolio "decisions" are being made by investors fleeing stocks which they believe (or perceive) might be tainted by "sub-prime slime." Decision makers range from middle-class owners of mutual fund shares to professional portfolio managers. The impact of this lemming-like run for the doors has been driven, to a great extent, by tele-pundits who we've all seen ringing their hands or spewing words (along with saliva—really!) like "Armageddon" and "sell everything that makes loans."

The widely reported "sub-prime mess" has precipitated a back up in the broader stock and bond markets. At the moment, the credit markets are in a state of gridlock, with lenders demanding more collateral and tighter terms than they did only a few weeks ago. Although this is making it much harder for private equity firms, sub-investment grade corporations and marginal home buyers to obtain loans, it is, we believe, ultimately a good thing as credit spreads were too low and terms were too lenient for the risks being underwritten. It will take some time before this works through the system and more rational behavior prevails, but the credit markets will be healthier and risk will be more rationally priced; which will ultimately be good for banks. In the mean time, much to its credit, the Federal Reserve has been doing exactly what it should be doing—injecting liquidity into the markets as needed in an effort to keep credit flowing.

Credit crunch? Yes, for a while. Crisis? If you bought your third spec house in southern California or south Florida with no money down, no income verification, and no credit check and each of those houses have dropped in price by 20% to 30% since you bought it and your income is \$30,000 per year and the rate on your adjustable mortgage just went up; yes, you (or more accurately, your lender, has) have a crisis. For the rest of us, life continues pretty much apace.

Our Perspective—What and Who Caused the Fear?

Is the foregoing example an exaggeration? It's not as much of a stretch as it might sound. Sub-prime loan originations totaled 20% of all originations in 2006 at an estimated value of over \$600 billion. Alt-A loans (to borrowers with decent incomes but blemished credit) were another nearly 20% of 2006's originations. Many of those loans are performing as badly as sub-prime loans, according to Moody's.

These sub-prime mortgages were not just loans to borrowers with weak credit histories—they became loans to borrowers who were such poor credit risks that they should not have been buying a house in the first place. These loans have acquired some interesting monikers: "Liar" loans because information on mortgage applications was seldom verified, or our favorite, "Ninja" loans, as in "No Income, No Job or Assets." The mortgage brokers who made many of these loans knew the game—they took their fees and sold off the mortgages, pronto! To whom? Wall Street! Investment firms then packaged them into CDOs and sold them to hedge funds and insurance companies.

We believe that the root cause of this mayhem—this ongoing credit correction—was the unabashed willingness of the Federal Reserve and its chairman, Alan Greenspan, to keep money too easy for too long. Easy money is characterized by low rates and arguably, even today, some rates are too low. So we are now paying the piper so to speak—paying for years of low rates and the explicit encouragement of Alan Greenspan to provide real estate mortgage loans to as many as possible using “creative” means to do so.

“American consumers might benefit if lenders provided greater mortgage product alternatives to the traditional fixed-rate mortgage,” Greenspan told a conference of credit union officials in February 2004. And, it appears the free market economy responded with a veritable waterfall of “mortgage product alternatives.” For example, Angelo Mozzilo, Chairman & CEO of Countrywide Financial Corporation, certainly liked his “face time” over the past several years on CNBC to regale us all with the variety of products his firm created. Where is he now? It is interesting to note that he exercised options and sold hundreds of thousands of shares of Countrywide over the past six months while the stock was trading in the \$40’s. This afternoon, Countrywide shares closed at \$18.95.

Who caused the fear? An excessively generous Federal Reserve and willing entrepreneurs like Mr. Mozzilo who created products designed to enrich his company while complying with the wishes of the Fed to provide greater mortgage product alternatives. Whenever the pendulum swings too far to one side there is always eventually an equal pull in the other direction—a correction.

More Perspective

For all the sub-prime frenzy in the media, there has been very little information reported about the size of the potential losses that are likely to result before the current cycle plays out. To put things into perspective:

- There is an estimated \$20 trillion of home value and \$10 trillion dollars of home equity in the United States (lots of people own their homes debt free and many more have mortgages that are a fraction of their home’s value).
- According to Moody’s, there is \$10 trillion of mortgage debt in the U.S., of which \$1 trillion is classified as “sub-prime” and another \$1 trillion is “Alt-A,” or loans that were made to people with incomes that are hard to verify or where there is a minor blemish in their credit history (many small business owners fall into this category).
- In total, Moody’s anticipates about \$460 billion of mortgage loans will default over the next year and losses to mortgage investors will top \$100 billion by the time the markets finally settle out.

\$100 billion is a lot of money, but it represents only about 1% of the total mortgage debt outstanding. Certainly, there will be carryover from this mess into other parts of the economy. Housing prices are likely to trend flat to down in many areas of the country and people who could not afford to own a home in the first place lose them to foreclosure. This will restrain growth for several quarters as consumers reign in spending and businesses approach capital spending and expansion more cautiously.

Main Street Marches On

Despite the mortgage mess and a host of other negative news over the last year Main Street USA and the US economy have managed to keep moving forward.

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- The unemployment rate remains near historic lows at 4.6%. *(We've always thought that it was unemployment that caused most mortgage delinquencies and foreclosures. Without surging unemployment, we are hard pressed to see mortgage problems rising to the level of financial panic. Most families borrowed appropriately, live within their means and pay their mortgages on time.)*
- American workers are earning more than ever. According to David Malpass, a noted Wall Street economist, nominal wages for non-supervisory workers alone have shot up by \$296 billion while average hourly compensation has grown by 5.2% year-over-year. And, according to economist Joe LaVorgna, employee tax withholdings collected by the US Treasury through early August of this year indicate a 6% to 7% increase in wages.

In a nutshell, most areas of the economy and the country are, in fact, doing just fine.

And Some Perspective on Bank Fundamentals

Earlier this week we returned from two days of meetings with the management teams of small cap banks—many of which are in our portfolio and many others of interest. The fundamentals of these banks, steady growth in loans and deposits and good credit quality, remain intact. In general, the bankers were optimistic about their banks' prospects.

In our own portfolio, second quarter earnings growth was disappointing to us—they were just a bit better than even with the earnings reported in the second quarter of 2006. Still the median year-over-year growth in loans and deposits for banks in our portfolio was 11.3% and 13.7%, respectively, while the median increase in book value was 11.3%. Credit quality slipped at a few of our portfolio banks, but remains quite good with non-performing loans well covered by loan loss reserves. **Clearly, value continues to be created, whether the market currently recognizes it or not.**

The baby is being thrown out with the bath water, the good are being dumped with the bad and all similar aphorisms apply. All of our bankers continue to work on executing the banking basics well, knowing, as we do, that this will pass; the question on everyone's mind is when. We do not know the answer, but we do know that there are many banks currently trading at single-digit price earnings ratios and very near their book values. These are valuation levels not seen since 2000-2001, the point at which the last rally in bank stocks got underway. We are watching our banks carefully and remain convinced by our observations that their fundamentals will ultimately overcome the current fear in the market and trend back to the prices which they deserve.

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