

## E-Memo

**TO:** INVESTORS/MEMBERS/PARTNERS AND FRIENDS  
**FROM:** Jon Bruss  
**Date:** September 11, 2008  
**Subject:** Are We There Yet? Or Is It Too Late?

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To answer the first question, we may already have been “there”. To answer the second: I don’t think so. Regular readers know we can’t just leave it at that, right?

### Are We There Yet? (Revisited)

We have been in a bear market for bank stocks since the end of last year (a bear market being defined as a decline of 20% or more).

### A BEAR MARKET FOR BANKS

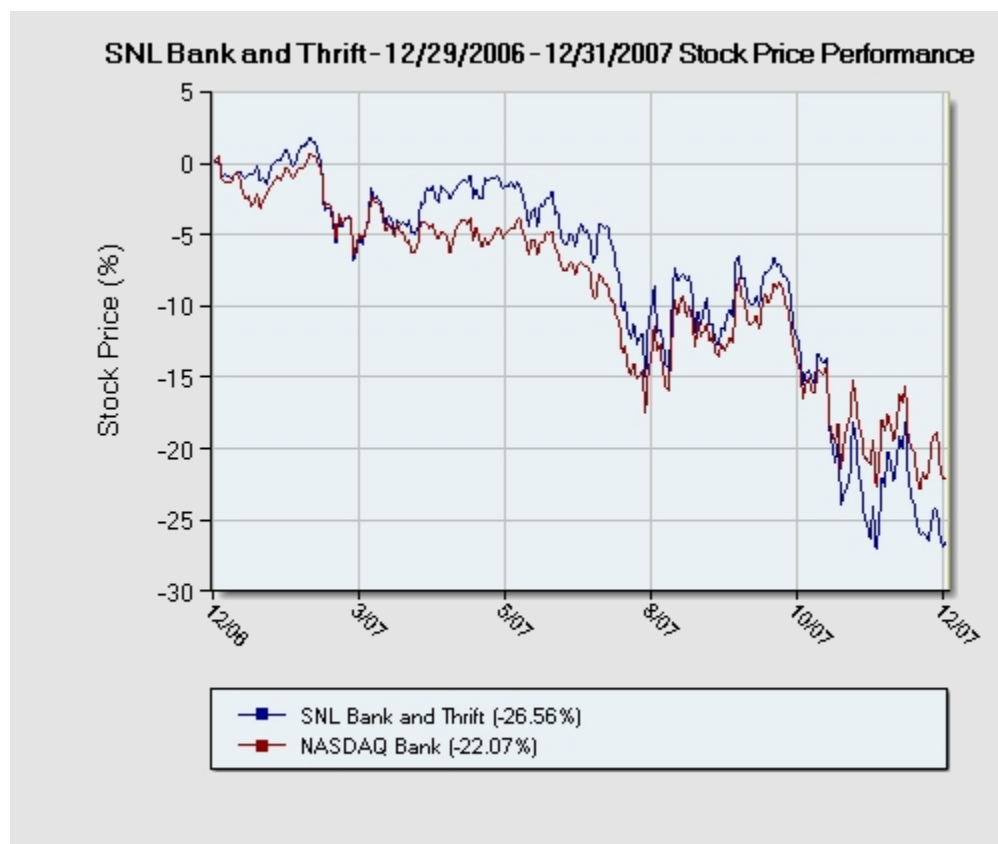


Figure 1

The SNL Bank and Thrift Index of 574 banks and thrifts includes both the largest—like Bank of America , CitiGroup—and some of the smallest—those that are not household names. Banks and thrifts in this index are traded on the NASDAQ, the American Stock Exchange, and the New York Stock Exchange. This index arrived in bear market territory at the end of November, 2007.

The NASDAQ Bank Index of 497 names includes some larger banks like Fifth Third and Northern Trust, but only contains banks and thrifts traded on the NASDAQ. This index entered bear market territory in late December, 2007, on the heels of the SNL Bank and Thrift Index.

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Figure 1 depicts the one year malaise that turned into a bear market. Since the end of 2007, the picture became even gloomier as illustrated in Figure 2 below.

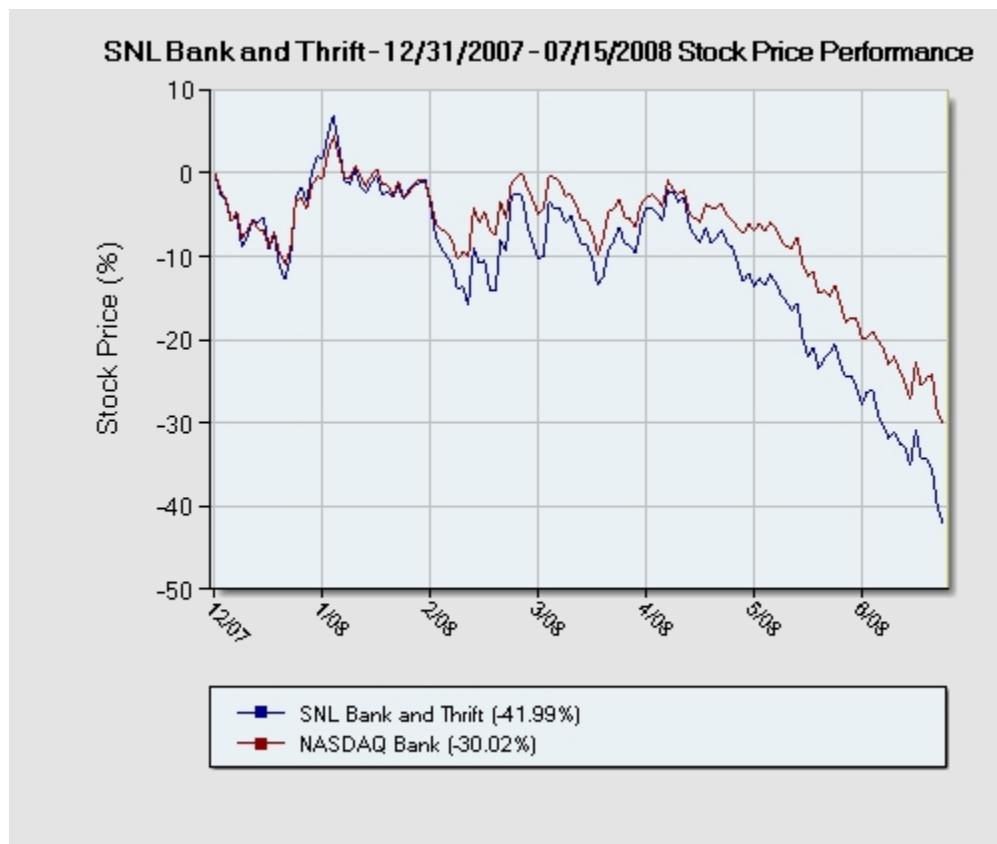


Figure 2

The decline in the first 6½ months of 2008 nearly doubled the decline that took place in 2007. It made owning bank stocks and having faith in the industry very painful.

The September 8, 2008 *Milwaukee Journal Sentinel* quoted me saying I am on the cusp of declaring capitulation in bank stocks took place on July 15<sup>th</sup>. Based upon the evidence of these two indices, we conclude the bear market lasted at least 6½ months. We've seen nothing in the last three weeks to dissuade us from that position. For example, see Figure 3 below.

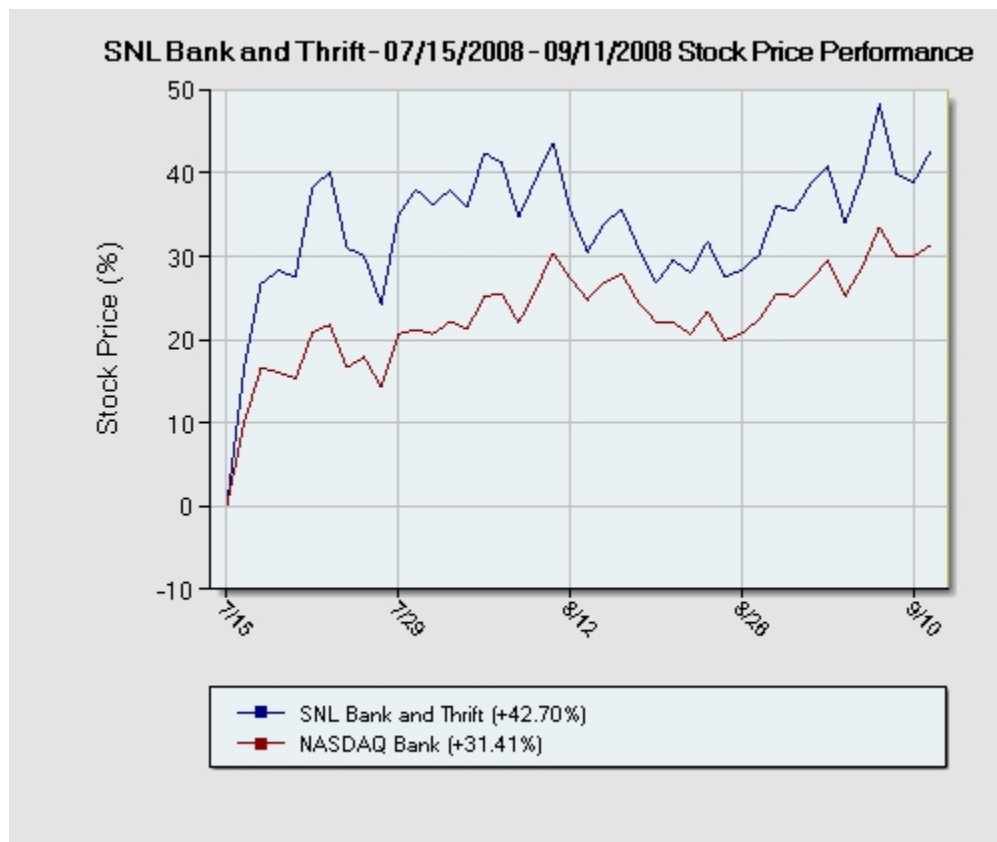


Figure 3

We are not chartists and we are not traders, but part of our job is to understand macro trends in our markets in addition to understanding bank fundamentals. Our evidence is more than gut feeling. We have had eight trading weeks since July 15<sup>th</sup>. In that time, the indices we are considering in this E-Memo are up 31% to 43%. This doesn't have the feel of a "sucker rally" or a "dead cat bounce".

This recovery hasn't taken us out of the woods by any means. The SNL Bank and Thrift Index will need a 90% increase and the NASDAQ Bank Index will need a 43% increase to return to the level at year-end 2007. The banks in these indices have a long way to go, but both indices have performed extremely well since July 15<sup>th</sup>. Both indices peaked on August 11 and have since meandered sideways. We expect periodic breakouts with interludes of drifting sideways. But we believe the general direction of the indices and the underlying stocks is up.

Do we think there will be no more bad news? Certainly not. In fact there will definitely be more bad news. More write-downs and write-offs will be pre-announced as the September 30<sup>th</sup> quarter end approaches. The regulators will close more banks on Friday afternoons over the next year.

On Sunday, September 7<sup>th</sup> the US Treasury announced that both Fannie Mae and Freddie Mac have been placed under federal conservatorship and will be managed by the recently formed Federal Housing Finance Agency. The common shares and preferred shares of each will be essentially wiped out. Many smaller banks held Fannie and Freddie preferred shares in their portfolios. These shares were rated AA- as recently as July 31, 2008, but traded at nearly half of par value. It appears that banks ranging from JPMorgan Chase on down will have to turn "Other Than Temporarily Impaired" classifications of these shares to a loss and run the loss through their income statements this quarter. According to the

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Associated Press, the Federal Reserve and other federal banking regulators said they were “prepared to work with these institutions to develop capital restoration plans”. We believe this is good for the equity markets in the long run because it removes yet another unknown hanging over the markets like a sword of Damocles.

### Or Is It Too Late?

The media continues to press the bad news about banks on the public, but on July 15<sup>th</sup> the markets said enough. They said we believe that we know enough about the bad news in the past and we knew that something like a Fannie and Freddie plan was in the offing. We know that the Bank of East Podunk will fail and we can probably name a dozen or two others. We hear there may be as many as 100 or 200 bank failures but that isn't the 3,000 we suffered through in the late 1980s and the early nineties. We think we understand the kind of banks that will survive in the long term. Their prices today, September 11<sup>th</sup>, 2008, are really very attractive but they have only returned to the low level of June 4, 2008.

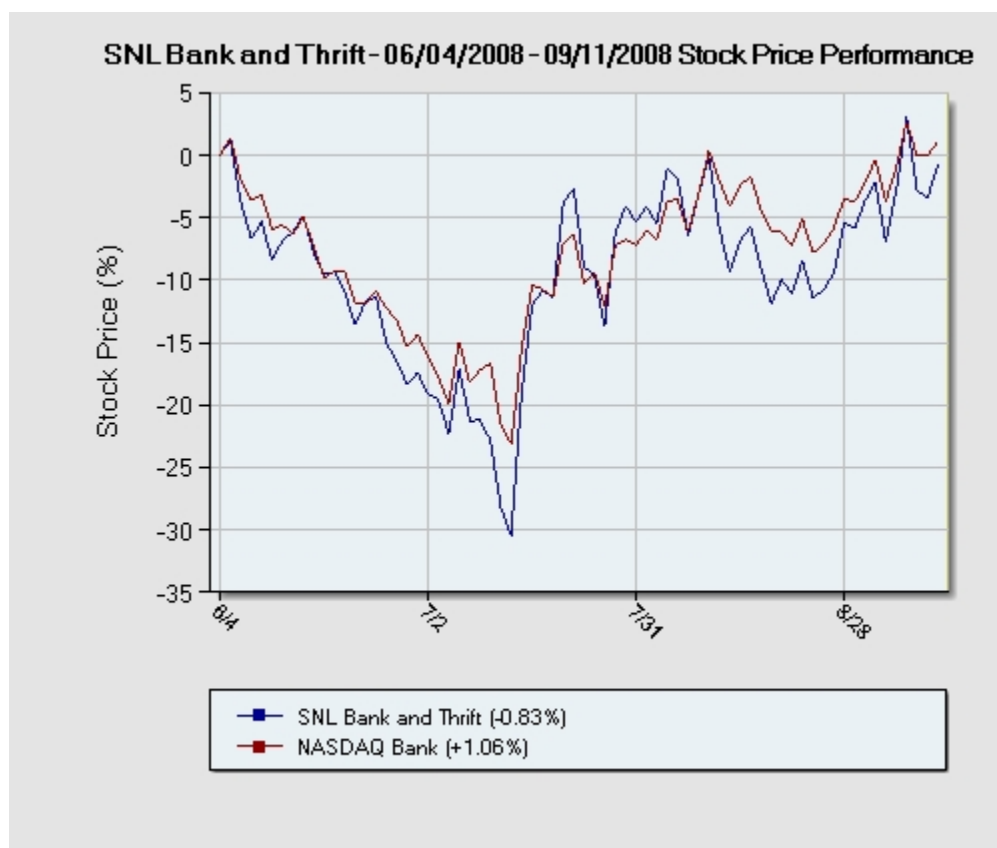


Figure 4

It is useful to step back into history to see what how these indices performed in 1991. By then we had seen over 2,000 bank and thrift failures and before it was all over there were 450 more in 1991 and 1992.

Here's how these indices performed then:

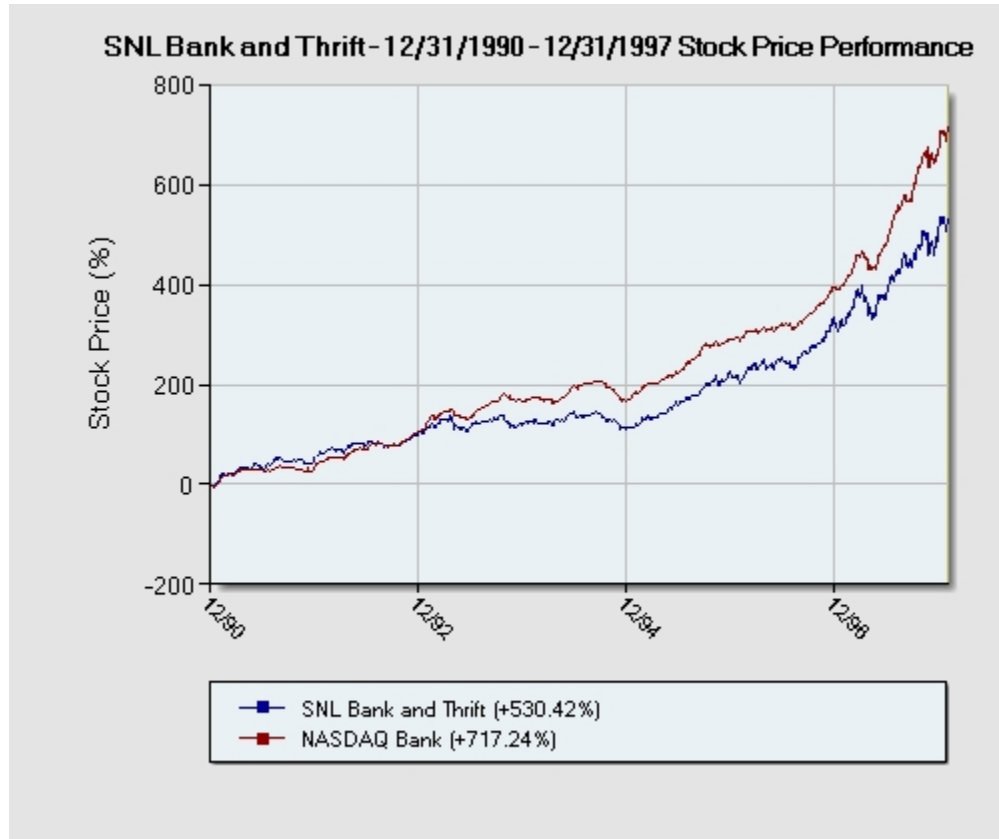


Figure 5

There is no need to rub your eyes; your imagination is not playing tricks on you. Bank stocks about doubled in the two years from December 31, 1990 to December 31, 1992. Stocks more than doubled in the period December 31, 1994 through December 31, 1996. Then, fueled by the M & A craze, jumped another 300% by the end of 1997!

Does history repeat itself? Often it does. Is it too late? We don't think so. Some are forecasting the next run in bank stocks will make the numbers from the 90s pale in comparison. That is a bold prediction and we can hope it's true. But even a fraction of that boom will be extremely rewarding.

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