

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: October 13, 2005
Subject: Is there Value in Growth?

While there seem to be as many approaches to stock investing as there are investors, two stand out in our minds: "Growth" and "Value." Growth investors buy stocks of companies experiencing rapid sales and earnings growth. A high price is OK with them as long as prospects for rapid growth persist. Growth investors will hold those stocks until growth slows. Value investors, on the other hand, live to buy stocks on the cheap, sifting through battered stocks to find those where they think the problems are temporary, betting that the price will recover as those issues are resolved. Value investors typically sell those stocks when they become "fairly" priced.

In a sense, each investor group makes a bet on the natural tendency of earnings growth to converge toward a historical rate. The growth investor is concerned that a company's earnings growth will slow to that historical average and the value investor is counting on a recovery to that historic range. In statistical terms, this is known as "reversion to the mean." Reversion to the mean is the enemy of growth investors and the friend of those in the value camp. Growth investors can get hurt if a high-priced stock ceases to grow as fast as the market expects; growth stocks often fall fast and hard when their growth rates slow. Remember the tech stock boom? And bust? On the other hand, value investors can be snared by "value traps," companies that look cheap, but never recover from their problems. So which approach is "correct?" Both are, it turns out. According to data compiled by Mercer Investment Consulting, active managers using either a growth or a value style outperformed the S&P 500 Index from 1981 through 2003. Investors' portfolios should have representation from each style.

So where do bank stocks fit in the growth/value continuum? Historically, banks have been accorded lower price to earnings (P/E) multiples than the broader market and most investors slot bank stocks in the "value" category, looking to buy them at low P/E ratios and low price/book value ratios. Indeed, banks have historically traded in a relative P/E range of 50% to 105% of the P/E of the S&P 500, with an average of about 75%. But is that discount warranted? As the table to the right illustrates, bank earnings have actually grown faster than corporate profits as a whole, for the last 40, 20 and 10 year periods. If faster growing companies fall into the "growth" camp, should investors' view of banks be updated? We certainly think so.

Profit Growth Comparisons	Compound Annual Growth Rates		
	10 Years	20 Years	40 Years
	1994-2004	1984-2004	1964-2004
U.S. Commercial Banks	8.90%	10.02%	9.68%
U.S. Corporate Profits	6.58%	6.48%	6.77%
<small>Data Source: FDIC and U.S. Dept. of Commerce, BEA</small>			

Can a stock be both a growth stock and a value stock? Or are growth and value mutually exclusive? The highly respected investment firm, Bernstein Investment Research and Management, studied the broad stock market from the growth/value perspective and found that about one-sixth of all stocks actually fit in both categories; that is, they had above average earnings growth *and* below average valuations. We suspect that small and mid-cap banks are well-represented in this group.

For a mathematical exercise in why growth matters, consider the examples in the first table on the following page. This table illustrates theoretical earnings and stock prices for banks with different earnings growth rates. For valuation purposes, we assumed that each bank would trade at a P/E ratio that approximates its growth rate. This P/E to growth, or PEG ratio, is one "rule of thumb" that many growth investors use to gauge stock valuations. (In our example, the PEG ratios equal 1.0, well *below* the current 1.5 PEG ratio of the S&P 500 Index.)

	Bank 1		Bank 2		Bank 3		Bank 4	
Growth Rate	8%		10%		12%		15%	
P/E Ratio	8 x		10 x		12 x		15 x	
Buy Price	\$ 8.00		\$ 10.00		\$ 12.00		\$ 15.00	
	EPS	Price	EPS	Price	EPS	Price	EPS	Price
Year-end 1	\$ 1.08	\$ 8.64	\$ 1.10	\$ 11.00	\$ 1.12	\$ 13.44	\$ 1.15	\$ 17.25
Year-end 2	\$ 1.17	\$ 9.33	\$ 1.21	\$ 12.10	\$ 1.25	\$ 15.05	\$ 1.32	\$ 19.84
Year-end 3	\$ 1.26	\$ 10.08	\$ 1.33	\$ 13.31	\$ 1.40	\$ 16.86	\$ 1.52	\$ 22.81
Year-end 4	\$ 1.36	\$ 10.88	\$ 1.46	\$ 14.64	\$ 1.57	\$ 18.88	\$ 1.75	\$ 26.24
Year-end 5	\$ 1.47	\$ 11.75	\$ 1.61	\$ 16.11	\$ 1.76	\$ 21.15	\$ 2.01	\$ 30.17
Gain	\$ 3.75		\$ 6.11		\$ 9.15		\$ 15.17	
% Gain	47%		61%		76%		101%	

A stock that grows earnings at 8% and maintains a PEG ratio of 1.0 would produce a theoretical return of 47% over 5 years. Not bad, but compare that to the 76% theoretical return produced by the company that grew at 10% for five years, or the 101% theoretical five-year return generated by the 15% grower. Note that the return was higher, despite the fact that the lower growth example was a “cheaper” stock based on its initial P/E ratio. Critics of this analysis would rightly point out that it is simplistic and that few companies have been able to sustain consistent double-digit annual earnings growth for more than a few years. Those are valid points, but the example helps to illustrate why growth matters.

In the small-cap bank universe, there are a surprising number of banks that have successfully grown their earnings at a double-digit pace for the last five years. Using our SNL Securities database, we found 291 publicly-traded banks with five-year compound annual growth rates (5-year CAGRs) in earnings per share of 10% or more. 185 of those managed a 5-year CAGR of 15% or more! For anyone that is still skeptical that there is a strong relationship between earnings growth and total return, take a look at the chart on the right and see if it doesn't convince you that growth must be an important consideration when selecting bank stocks.

At Fortress, we like cheap stocks as well as any “value” investor, but we recognize that, in the long run, companies can only increase their value to investors by growing their sales and earnings. Accordingly, our definition of “value,” is a bit different than most traditional value investors. To us, “value” means being able to buy a stock for less than its worth, *which does not necessarily equate to a “cheap” price today*. We concentrate on finding those banks that have the ability to grow quickly and profitably and we don't mind paying a fair price for them, confident that their faster franchise growth will lead to faster earnings growth, which will result in greater returns for our investors over time.

Yes, there is “value” in “growth.”

Sample Size	5-Year CAGR	5 Year Total Return	
		Average	Median
111	< 0%	82%	77%
129	0% - 5%	98%	91%
174	5% -10%	133%	113%
126	10% - 15%	172%	166%
83	15% - 20%	211%	205%
58	20% - 30%	295%	246%
44	30% +	348%	246%

Data Source: SNL Securities

FORTRESS

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