

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: November 9, 2005
Subject: The Best Time to Invest Is . . .

The Fed continues to push short-term rates higher, oil prices are up 45% year-to-date and most other commodities are sharply higher as well. The war in Iraq is grinding on, adding \$7 billion a month to the budget deficit, which is at an all-time high. Much of the Gulf Coast has been decimated and needs billions of dollars to be rebuilt. Foreign competition, especially from China, is accelerating and the US auto industry is on the ropes. Air is starting to leak from the real estate bubbles in some regions of the country and Congress seems to be more interested in partisan bickering than working to solve the Nation's problems. Negative news about the direction of the economy and the stock market seems to be everywhere.

So, what does a stock investor with dollars to invest do? When is the "right" time to invest? Should an investor just close their eyes and put their money to work regardless of where the market is at the time? Should they use dollar cost averaging to spread their investment purchases over time? Or, should they try to time the market to get the "best" price? And what about investing in a unique sector of the market, like small-cap banks?

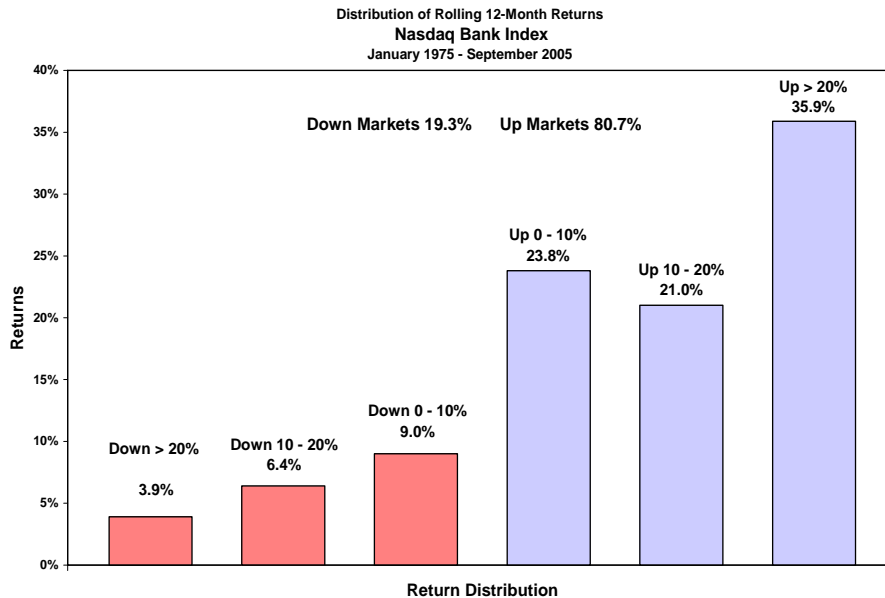
Certainly, there are better and worse times to invest; the problem is that it is very difficult to know precisely when those times are. Many investment strategists use common economic indicators to help them determine the optimal investment time points. Investing in a sector, like banks, ought to be even more predictable, since everyone knows that banks are susceptible to rising interest rates and economic weakness, right? Not so, it turns out.

We decided to test the relationship between some commonly cited economic indicators and market signals and the contemporaneous performance of the *Nasdaq Bank Index*, a benchmark for our specialty, small-cap banks, to see if there really was any significant predictive value in using those indicators to determine an optimal time to invest.

We set our intern, Steve Holtkamp, a student from Marquette University's Applied Investment Management program, to the task of gathering the data. We measured the rolling 12-month return of the Nasdaq Bank Index for 357 12-month periods beginning in 1975 and ending September 2005. The results are summarized in the chart to the right.

Eighty-one percent of the time (289 out of the 357 periods) the index had a positive return and in nearly 36% of those periods, the subsequent return was greater than 20%. Twenty-one percent of the time the return was between 10% and 20% and in 24% of the periods the return was between 0% and 10%. The average return for all "up" 12-month periods was nearly 22%, while the average loss in all down periods was about 13%. The average return for all 357 rolling 12-month periods was 15.2%. The best 12-month return was a whopping 65% (which started at the end of 1996, a period in which bank merger activity was accelerating) and the greatest 12-month loss was 48% (which started in late 1989, a few months prior to the start of the 1990-91 recession.)

Return Distribution Nasdaq Bank Index			
357 12 Month Rolling Periods			
January 1975-September 2005*			
*Ending 9/2005			
Up > 20%	Up 10 - 20%	Up 0 - 10%	Market Up
36%	21%	24%	81%
Down 0 - 10%	Down 10 - 20%	Down > 20%	Market Down
9%	6%	4%	19%
Best 12 Month Return	65%		
Worst 12 Month Return	-48%		

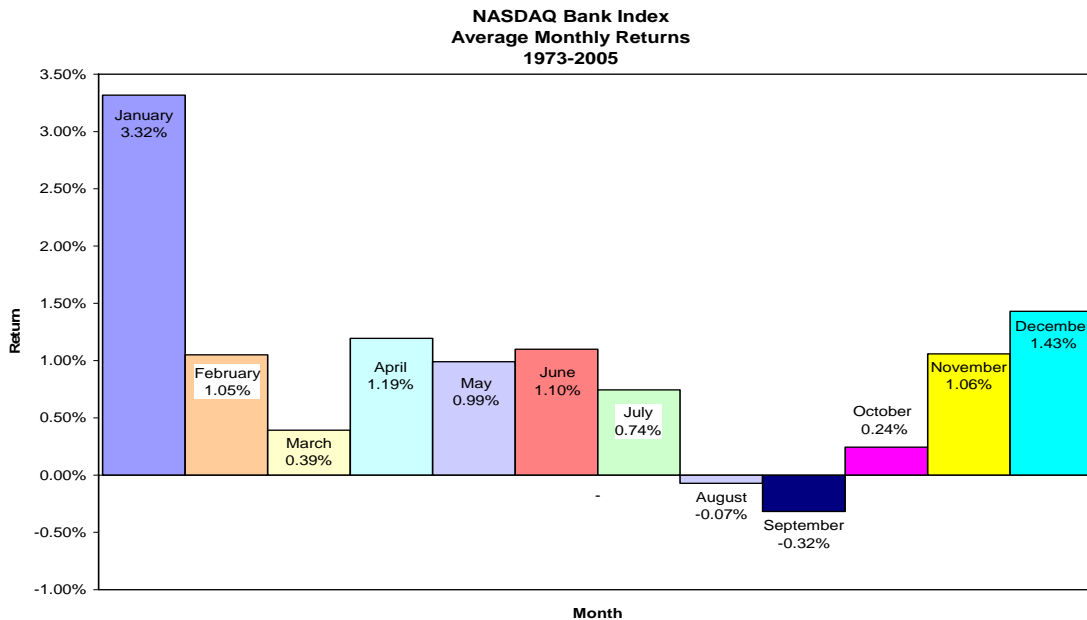


Those results weren't all that surprising since a similar study of the S&P 500 Index, a benchmark for the broader market, by *Bernstein Investment Research and Management* showed that index was up in 77% of the rolling 12-month periods since 1946. What did surprise us though was how **poorly** some of the generally accepted negative economic indicators actually predicted future returns for the bank index. There were 55 months in which the economy was in recession and the bank index produced positive returns in the subsequent 12 months 87% of the time. In periods when interest rates were rising, the bank stock index was up 81% of the time 12 months later. In periods marked by rising oil and gold prices (potential indicators of inflation) the bank index rose approximately 80% of the time. Investors who relied on those negative indicators would have forgone significant gains.

Nasdaq Bank Index Returns v. Economic Indicators 1975-2005*			
Economic Indicator	# of Rolling 12-Month Periods	Percent of Subsequent 12-Month Periods	
		Market Up	Market Down
Recession (a)	55	87%	13%
Rising Interest Rates (b)	59	81%	19%
Gold Prices up 10%+	33	79%	21%
Oil Prices up 10%+	53	82%	18%

*Ending 9/2005
(a) Months in which GDP growth was negative for the preceeding 12 months
(b) Federal Funds Rate
Data Source: Bloomberg and Concise Encyclopedia of Economics

With all of the monthly return data gathered, we thought we would also look at the average monthly returns for the Nasdaq Bank Index to see if there was any pattern that might improve the odds of success. We sorted 30 years of monthly return data for the bank index, which is displayed in the graph below.



The data squares with results of other studies we've reviewed which show that a significant portion of the stock market's return over time is generated in the period from November through May. Our data suggests that investors seeking to put money to work in small-cap bank stocks would do well to do so in late October and early November to take advantage of historically strong returns for the months of November, December and January.

There are indeed better and worse times to invest in the stock market especially if you are a short-term trader. Still, very few (if any) investors are able to consistently identify those optimal buy and sell times. Moreover, as our research shows, several of the mostly widely used market "signals" are **worse than worthless** for predicting future stock market returns, especially for small-cap banks. Investors who relied on those negative indicators to decide when to get out of the stock market would have foregone significant gains.

Over the longer-term, however, the old saying holds true; it is "time in the market" and not "timing the market" that leads to the accumulation of wealth. It is important to remember that the direction of the stock market is closely tied to the direction of the economy, which despite recessions, wars, fluctuating interest rates and natural disasters, has trended up over time. As a final thought on the subject, we'd leave you with the mental picture a man playing with a yo-yo walking up a hill. Many investors are drawn to the up and down motion of the yo-yo (the periodic fluctuations in stock prices), clearly their real focus should be on the upward slope of the hill (the stock market's long-term trend). The best time for a long-term investor to invest really is now!



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