

E-Memo

TO: INVESTOR/MEMBERS, CLIENTS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: December 17, 2004
Subject: Christmas Reprise — Is Now the Right Time for Banks?

Our last E-Memo generated quite a few responses encouraging us to write again, especially after a good business acquaintance sent his most recent "Regional Banking Review." We're talking about Joe Stieven, a senior bank analyst who hangs his hat at the firm of Stifel, Nicolaus & Co. in St. Louis. He has credibility with us for two reasons: He's from the Midwest and he's a former Fed bank examiner (like Bob). Joe knows banks. Much of the narrative in Joe's report rang true with us. We thought you'd like to see what Joe had to say. If some of it sounds familiar it may be because you've read it in past issues of this E-Memo. In any event, we think its good re-enforcement for our view that the operating environment for banks remains good and that there are still plenty of opportunities to make money investing in the sector.

Joe: Asset Quality Improved During the Third Quarter

FORTRESS: In our August 9 E-Memo to you we said, "Problem loans should continue to shrink as we observed with a number of our banks so far this year. As the economy improves so does loan quality. We think this is one of the many good news stories ignored by the financial press. As problem loans decline, it means that the loan is repaid and its funds are available to be lent again, or that it has become a productive loan once more. In either case, the funds are again earning interest and adding to the margin. We continue to see asset quality improvements at most of the banks in our portfolio.

Joe: The Four Recent Prime Rate Increases Should Help Net Interest Margins

FORTRESS: We've harped on this point repeatedly over the past year or so. Our August E-Memo quoted Bob Albertson, well known portfolio strategist from Sandler, O'Neil Partners. His words last summer ring even truer today as the yield curve continues to flatten: "As short term rates increase more rapidly than long term rates, the yield curve will become more flat. As that happens, according to Albertson, **the bank index should beat the S & P 500 (as it has for all 11 instances over the past 25 years when the yield curve began to flatten)**. Finally, according to Albertson, **the banking sector is a long way from a peak.**" The yield curve has undergone a significant flattening since the Fed began raising interest rates in June.

Joe: Consolidation Activity Remains Healthy

FORTRESS: We said in July that "bank mergers and acquisitions will continue to be 'sizzling.' Reason? Banks are seeking 'to increase earnings via vigorous expansion'." As we've said before, we don't buy banks in hopes they'll be acquired. We buy banks in good markets, with good management and strong financials – which just happen to be traits acquirers appreciate as well. In December, we pointed out that our banking myth of the month was "**the bank and thrift merger and acquisition game is all but over**", was far from the fact and while 8,100 banks had been acquired, more than 3,000 banks had been formed in the last twenty years, most by bankers displaced in mergers with large banks." Acquisition activity continues apace and as larger banks merge there will be fallout resulting in more new banks being formed (some of which may find their way into our portfolio) only to be acquired a few years later by a larger bank. And on and on it goes.

Joe: The Long-Term Outlook Remains Sound

FORTRESS: Having just read and listened to several reports from the financial media that said bank stocks were going to go into the tank because interest rates were going up, Jon titled our June E-Memo "Is this really the end of bank stock performance as we knew it?" and devoted it to debunking this conventional view. The E-Memo included the following chart based upon statistics from Stifel Nicolaus' universe of bank stocks.

FACTOR	10 YEAR GROWTH RATE (Median)
Stock Price Annual Growth Rate (AGR)	12.75%
EPS AGR	10.28%
Dividend AGR	13.43%
Revenue AGR	8.72%
Non-Interest Income Per Share AGR	12.32%
Total Expense Per Share AGR	8.55%

"Interesting numbers but what do they mean? Simply this: **THIS IS NOT THE END OF BANK PERFORMANCE AS WE KNEW IT!** We would argue that it is only a precursor to better days. Over the past decade banks have been challenged by foreign loans, risky leveraged-buyout loans, commercial real estate problems, exceptionally volatile interest rates, including flat and/or inverted

yield curves, recessions, terrorist acts, and beliefs that the consumer is overextended. The banking industry has responded to these challenges... by consistently reporting sound results."

Joe: We believe that stock selection is even more critical at this point. The strong performance of bank stock prices over the past four years easily raises the possibility that the group's performance could slow relative to other industries, especially in the near term.

FORTRESS: Our December E-Memo said, "*[t]o many, bank investing remains a traditional low P/E, low book value enterprise to which our strategy sounds like a rather dicey, high-risk affair. Here is where our definition of 'value' diverges from others. In our view, a stock is a 'value' if we can buy it today for a price that is substantially less than we expect it to be in the future. And it is here that our collective years of banking experience really pay off; we believe that we can separate the banks with above average future prospects from the also-rans.*" **We invest in individual banks—not the market.**

Joe: Many regional banks are gaining market share internally versus the larger banks due to customer dislocation; . . . have long focused on internal growth versus the "slash and burn" mentality of larger banks; . . . regionals attack specific niche areas [while] . . . large banks are operating from a defensive position with little room to grow internally.

FORTRESS: In our December E-Memo listed a number of characteristics common to the banks in which we have recently invested. Three of those are spot on with Joe's observations:

- *"They are focused on a specific business niche . . .*
- *"They are focused almost entirely on organic growth and generally share an aversion to acquisitions.*
- *"In one way or another, each of these new holdings has benefited from consolidation in their markets; whether it is the customer dislocation that often results when a local bank is acquired, or the availability of seasoned local bank executives who chafed under the bureaucracy of a larger bank."*

We are not promoting Joe Stieven as the "Oracle of St. Louis" but we respect his ability to analyze and understand banks and thrifts and we take comfort in his confirmation of our long-held beliefs. We may differ from time to time as to how we view the industry, but our beliefs are grounded in the data and vetted by our experience – not influenced by the latest babble from the talking heads on CNBC.

IN SUMMARY

1. Asset quality continues to improve.
2. The five recent prime rate increases will help improve margins — at least the banks that we invest in.
3. Bank merger activity remains robust with no end in sight. There are still just too many banks in the US!
4. The long-term outlook remains sound for banks.
5. Stock selection (that's what we do) will become exceedingly important since the price performance for the overall bank group is projected to approximate that of the broad market over the coming 12 months.

For readers who have managed to wade through all of the foregoing, it was not our aim to say "You saw it here first!" Rather, we wanted to provide some reinforcement to our view that it is still a good time to invest in a carefully selected portfolio of small banks and to encourage those of you who might still be sitting on the fence to make an initial investment in Foundation Financial Partners, LLC or to add to your existing investment.

Now is the right time for banks and thrifts!

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FORTRESS

PARTNERS

CAPITAL MANAGEMENT, LTD.

**700 Walnut Ridge Drive, Suite 200, Hartland, WI 53029
262-369-5369 (Jon Bruss) • 262-369-5742 (Bob Ollech)**