

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Bob Ollech and Jon Bruss
Date: December 18, 2007
Subject: A Great Time to Buy Banks? Really?

For those of us invested in bank stocks, our portfolios certainly haven't seen any semblance of the proverbial Santa Claus rally or Christmas Cheer this month. As we look over our shoulders at the past 11 months quite frankly there is little to cheer about. Symptomatic of the lack of cheer (read doom and gloom) FIG Partners of Atlanta in a December 10 publication points out that 201 of the publicly traded banks were trading at book value or less compared to September of 2006 when 59 were under book, while twice as many banks were trading at 200% of book value or more as are trading there now.

What is even more incredible according to FIG is that many of the banks trading at under book value have excess capital! Community banks generally operate with 7% equity capital to total assets. All other things being equal, the bank regulators are quite comfortable with that level of capitalization as are we as investors. For a bank that means that for each \$1 of excess capital it can add \$14.30 of brand new squeaky-clean earning assets or it can pay a dividend equal to the excess capital if it so chose. What this all means is that the investing public is so turned off by lenders that they won't pay \$1.00 for \$1.00 of easily identified, easily-made-liquid excess capital. That's what the lack of transparency in the credit markets has done to the banking industry—an industry in which most of the participants—certainly those in which we (you and us) invest—thrive on transparency and know precisely what is in their portfolio, as do their investors.

FIG Partners goes on to make this point, we've added the bold-face for emphasis:

"We realize that banks' fundamentals are perceived to be weak and that a new credit cycle has obviously dawned ... and that 4Q07 earnings are not expected to be much. However far away the bottom may seem, we remind investors that numerous bank stocks are already trading at low levels. As much as we expect slow to no growth of EPS in the next several quarters coupled with higher credit problems, greater loan losses and more reserves, many stocks are already cheap. **The smart money may be preparing for the next move upward, even while many of us industry experts fear the worst. Today's valuations should be a wake-up call, even if many investors are not yet ready to listen.**"

Following this theme are some excerpts from FIG Partners' Weekly Musings of December 17, 2007. We have sought and received their permission to quote that issue. We couldn't have said it any better ourselves and so we repeat it here with our additional comments in italics:

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BANK STOCKS IN 2008 - *It Is A Great Time To Buy Banks*

WARNING: This is NOT another negative commentary with 38 bank stock rating downgrades, a plethora of EPS estimate cuts, and an overall admission that the end of the world for Banking is already here so we better write something with a "CYA" tone that salvages our 2007 bonus payment from our employer.

... [It] has become obvious that investors need to be grabbed by their shirt collars. While there are plenty of near-term challenges within the Banking sector ... there are a few fundamental truths about bank stocks of which we MUST remind investors with either short-lived careers or just short memories. Consider this analogous to hitting you over the head with Grandma's old frying pan—we feel there are five key points to consider as investors either keep short-selling stocks, or better yet, search for a bottom in bank valuations and commit new capital to this sector at some point in the next 6-9 months (*we're not so certain of the timing but would rather be early to the party than late—see point #5 below*).

1. Banks' Tangible Book Values Will Grow In 2008

When we tell this to investors, the facial smirks and rolling eyes tell us that many investors simply forget how banks and thrifts operate. Yes, credit issues are a problem today (i.e., loan losses and quarterly provision expenses are likely to jump the next few quarters), and weak Net Interest Margins and lower loan volume will reduce top-line revenues. But, these are unlikely to wipe out bank earnings. EPS should decline year-over-year in 2008 for many banks (both large and small—

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we guess at least 5%), but Banks' EPS are not going to zero. This means that most companies, even after dividend payments (which we feel are safe and secure at over 90% of the companies), have retained earnings which causes tangible book values to increase. Due to lower interest rates and the likely scenario of further Fed rate cuts, we think unrealized securities values are a net positive in 2008 (i.e., remember that most banks have plain vanilla securities portfolios. . .).

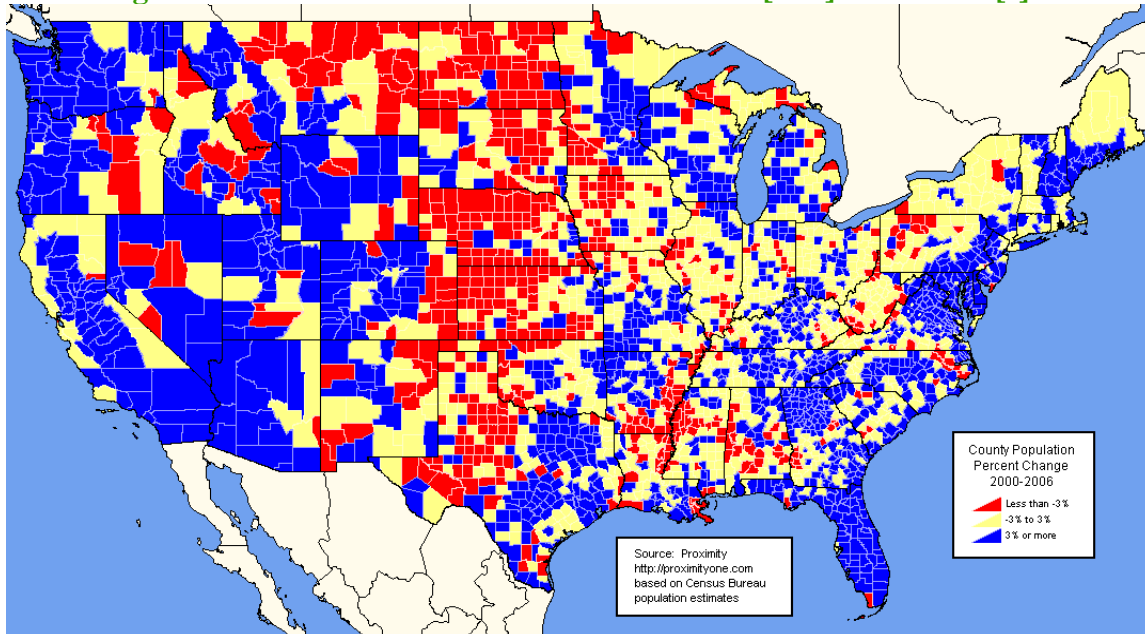
2. A "Free Pass" For 4Q07 Charge-Offs & Provisions Expense Will Set The Stage For New Money Into Sector

It is widely believed (and we agree) that many banks will record a heavy degree of loan losses and credit-related expenses in their 4Q-2007 EPS reports coming in mid-to-late-January. As we heard recently from one mid-cap bank CFO, "we have a free pass, so we might as well use it." (*In fact we have been so crass as to describe this to prospective investors and client/investors as a "great flushing sound" though, we have been quick to add that not all may take the free pass, especially if there is no need to.*) In our view, investors do not care about current quarterly EPS, but rather are focused on overall credit quality and having some credibility behind loss expectations in 2008. We think this is a large positive that sets the stage for new dollars to begin heading into bank stocks. Yes, we are probably early to think that investors will pour money back into the Bank sector after the BKX (*Keefe Bruyette Woods-Philadelphia Stock Exchange Bank Index*) Index fell 24% in 2007 and the SNL Bank & Thrift Index dropped 25%, but any signs that banks are taking aggressive actions to resolve their issues (even though this probably takes 2-3 more quarters—*again, we are not certain that it will take this long*), we feel could spark the arrival of contrarian investors to begin buying.

3. Demographics & Local Markets Still Matter — Most Problem Areas "Grow" Themselves Out Of Their Oversupply

It has been our experience for nearly two decades that markets with population growth and net in-migration of new households and residents tend to be the ones best able to come back from bouts with excess real estate supply (i.e., inventories of new houses and lots, and/or office space, retail square footage, hotel rooms, etc.). Hence, while many bank investors scream "bah, humbug" from their perches this season, we remind you that demographics and banking still overlap rather well. Banks tend to be a mirror of the communities . . . they serve (*and we are community bank investors*), therefore bargain hunting in bank and thrift stocks must include some appreciation for local growth of people and jobs. (*Our focus is **in the blue** and in those areas where there is significant population growth—growth that will absorb real estate excesses faster and grow businesses **and banks** faster than in slow growth or no growth areas*) See the graph below from data provider Proximity (www.proximityone.com).

Net In-Migration Patterns The Past Six Years ... Where [Are] Your Bank[s] Located?



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4. M&A Will Not Stay Dormant All Year — Sellers Will Think Like Investors Again & Accept Buyers' Low Stock Prices

The common complaint from many analysts and investors alike is that banks are afraid of each others' asset quality, therefore they are reluctant to engage in merger transactions. Of course, the buyer's currency (aka, stock price) is way down in most cases, which hardly facilitates M&A. But, we see a more important trend unfolding. For the last several years, selling banks accepted shares which fell in price significantly. Now that stock prices are way down, the ability to experience future upside is greater than ever and we think that selling bank boards are likely to learn from the mistakes of others and think like investors. (*We hope so too.*) We think if sellers step back and consider their alternatives, it is a BETTER time to sell today when buyers' stocks are down, not the opposite. Hence, the doomsday scenario that zero M&A will occur may be true for the next few months while buyers and sellers see each other's 4Q EPS reports and 10-K filings, but we doubt there is an M&A drought for all of 2008. Our expectation is for overall price-to-tangible book and P/E multiples to be lower than the past few years, but still at handsome premiums to current stock prices.

5. Markets Are Irrational, But This Cuts Both Ways — The Comeback In Bank Stocks Will Surprise Many

As portfolio manager Hans Schroeder at Green Street Capital Management points out (*see his chart on the next page*), there have been several well-defined peaks and troughs in the NASDAQ Bank Index since 1998. In fact, there are eight periods where this bank sector index hit a low and then rallied in subsequent months . . . While every cycle is . . . unique, we believe that history repeats itself—eventually. This does not mean we see an immediate rally in the next 30 to 60 days, even though this current drop in Bank stocks is the longest of the past decade (i.e., per analysis done by Green Street Capital Mgmt. of a 22.6% drop in the NASDAQ Bank index since late February 2007). We anticipate a major rally in bank stocks at some point during 2008...perhaps after the release of 1Q-2008 EPS in April. While waiting four months may seem like an eternity to some managers who are paid for monthly performance, there are plenty of value-based investors willing and able to buy-and-hold. Yes, that old concept of buying and then *holding* bank stocks will actually return to popularity again in 2008.

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Yes, we at Fortress Partners believe that 2007 will go down as one of the worst years of stock price performance for banks, but 2008 holds promise for better results, in our view. Why? There is no question in our minds that at least through the first half of 2008 difficult fundamental operating conditions will persist. However, bank stock prices have typically lead the economy into economic slowdowns/recessions by at least six months and have lead on the way back up as investors anticipated improving conditions and the resumption of earnings growth.

We remain confident that the fundamentals on which we focus will ultimately support our long-term bullish view of small cap banks and thrifts.

**MERRY CHRISTMAS
AND A
HAPPY AND PROSPEROUS NEW YEAR!**

FORTRESS

P A R T N E R S

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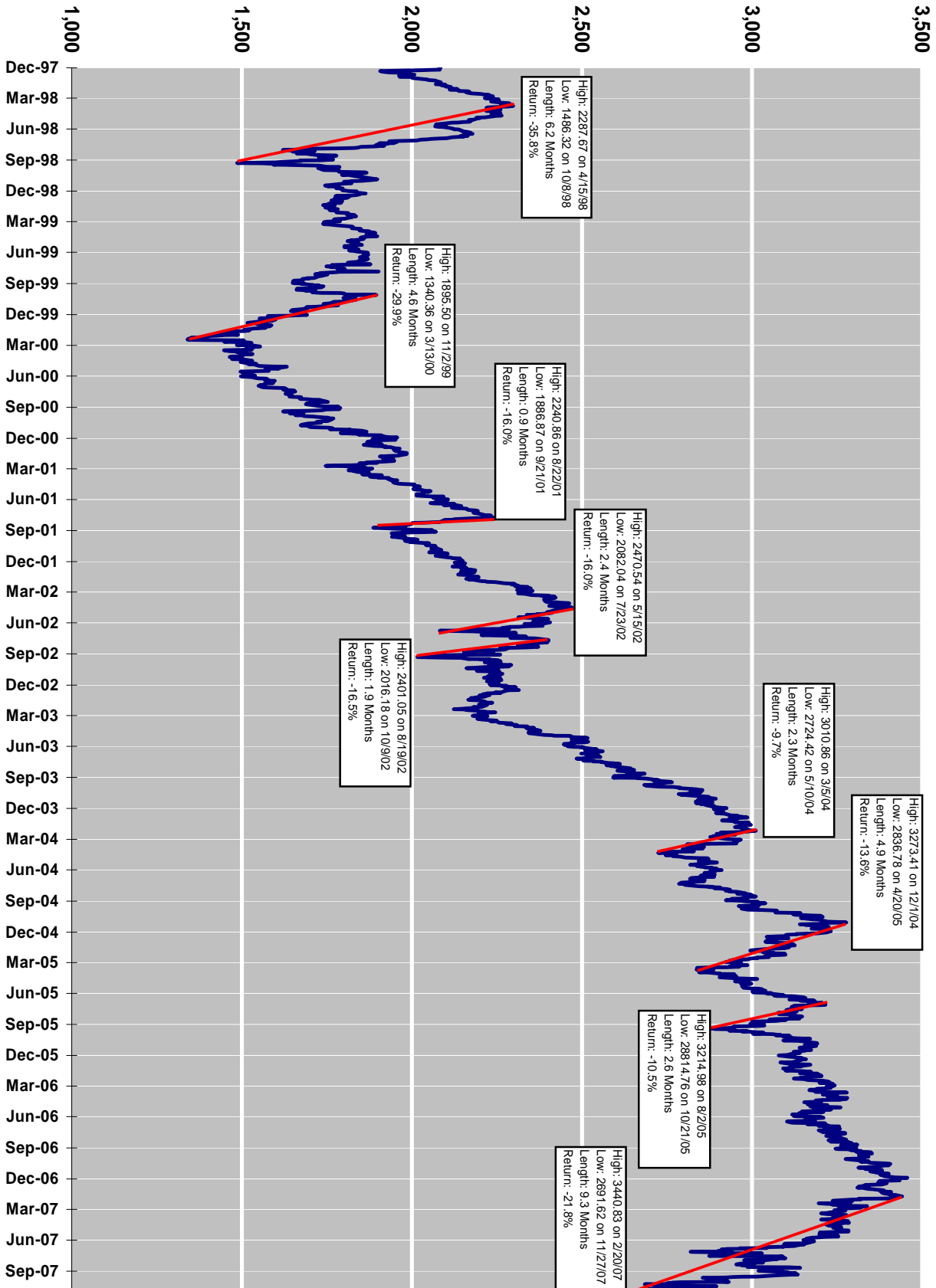
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Meaningful Declines in Nasdaq Bank Index Since 1998



Source: SVL Financial