

E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss and James Bruss
DATE: December 23, 2008
SUBJECT: A Reason To Smile?

It's easy to grin when your ship's come in and you've got the stock market beat, but the man worthwhile is the man who can smile when his pants too tight in the seat. – Judge Elihu Smails

If the economic news of late is a bad comedian telling tired old jokes, then we investors are the dead horse and we continue to take a beating. The bad news now seems to cover the spectrum, from the financial to the political to the personal. Unemployment is growing and home prices are declining; the specter of massive federal spending has morphed into reality, with much, much more to come; and we just learned two weeks ago of a \$50 billion Wall Street snow job that destroyed the wealth of numerous individuals and charities. Add to this litany, doomsday pronouncements about the systemic bankruptcy of the U.S. banking system, and you get a downright somber national mood.

It may be difficult in times like these to heed the wise words of that distinguished jurist. But perhaps there is *real* cause for a smile. After all, the market is littered with cheaply priced stocks.

Take bank stocks. It is quite startling to consider this fact: in the last ten years, the share prices for the **SNL Bank Index** (all U.S. banks traded on the major exchanges) have declined 39%. (Indexes of smaller banks actually show increases.)



SOURCE: SNL Financial, LC

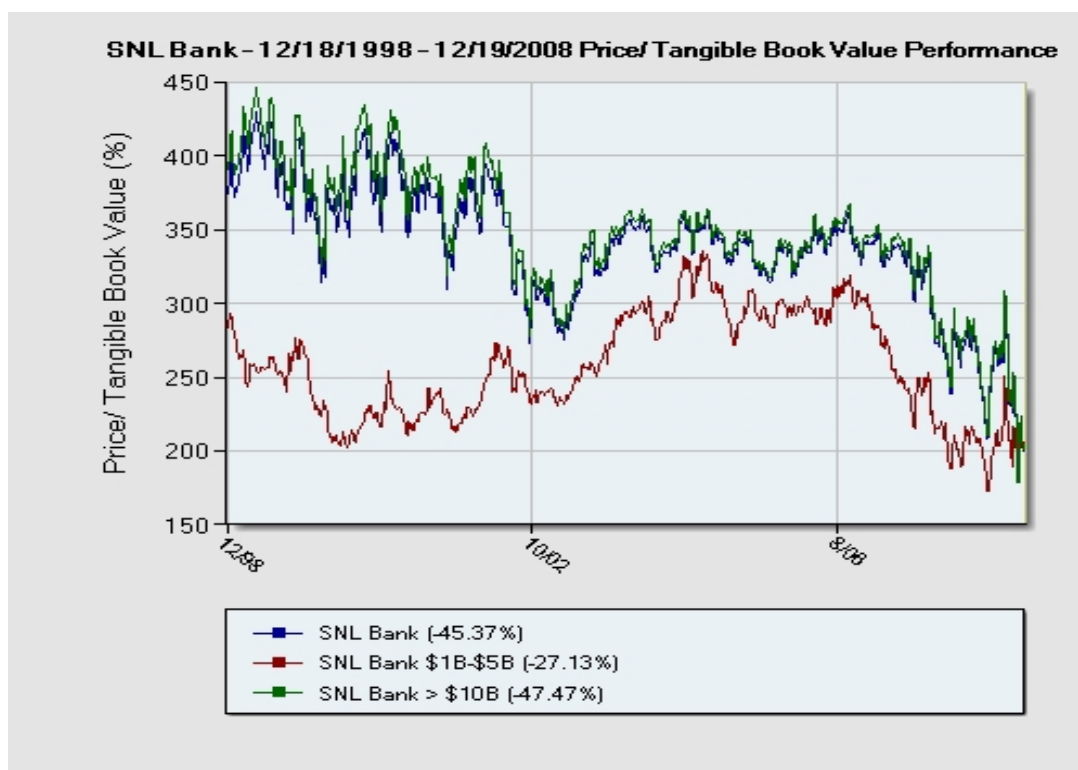
This battering of bank stock prices followed a massive run up in prices of nearly 50% by December 2006. Since then, prices have cratered: the **SNL Bank Index** is down 60%; the **SNL Bank > \$10B Index** is down 61%; and the **SNL Bank \$1B-\$5B Index** is down 44%. It stands to reason that bargains in bank stocks abound. That is certainly true. Looking at the graph above, it also stands to reason that the best bargains are with bigger banks, since they have already suffered so much pain. Smaller banks, here represented by the **SNL Bank \$1B-\$5B Index**, are still priced well-above their 1998 level, while the 51 largest banks (those with more than \$10 billion in assets) are down more than 43% from 1998.

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Given these bargains in larger bank stock prices, the smart money should be buying those stocks, right? Well, maybe not. We don't claim there aren't deals among larger banks. But, as Warren Buffett has said: "Price is what you pay; value is what you get." There is more to a bargain than a cheap price. One of the primary ways we investors can gauge whether a stock is expensive or not, is by looking at the ratio of price-to-tangible book value (P/TBV). (When earnings are crippled by economic circumstances like those we are experiencing today, P/TBV is a far more reliable indicator of long-term value than the price-to-earnings ratio.)

Like bank stock prices, P/TBV ratios for banks have also taken a major hit over the last ten years. The P/TBV for larger banks has seen roughly the same decline as bank stock prices. But for smaller banks, whose stock prices have risen since 1998, P/TBV has had an opposite and almost equal result. For example, the P/TBV of **SNL Bank \$1B-\$5B Index**—whose stock prices have increased 30% the last ten years—has declined 27%.



SOURCE: SNL Financial, LC

What does this mean? While the holders of small bank stocks have generally been (modestly) rewarded over the last ten years, the stock prices as a function of the underlying value of those banks have experienced a decline similar to that of big banks. In other words, smaller banks have been more adept at building shareholder value than big banks have been, and the appreciation in stock price is, at least, a partial reflection of that. We have been saying this for years now. Big banks, which have come to rely on off-balance sheet activities and exotic (now toxic) securities to generate profits, have failed to build shareholder value. Small banks, which have generally steered clear of the big bank model, continue to build shareholder value and appreciation in stock price.

This, however, is all historical. One can't deliver returns solely on the basis of what has already happened, no matter how creditable a guide history can be. But value can deliver returns. Here, again, small banks provide the best opportunity. Whereas the larger banks represented in the SNL Bank > \$10B Index have a current P/TBV of over 200% (as of December 19, 2008), the ratio is significantly lower with

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smaller banks—approximately 130% for the **SNL Bank \$500M-\$1B Index** and just under 100% for banks in the **SNL Bank \$250M-\$500M Index**.

The P/TBV for **SNL Bank \$1B-\$5B Index**, which we focused on in the charts above, is nearly the same as bigger banks—just over 200%. This suggests that as banks grow out of the **SNL Bank \$500M-\$1B Index** and into the **SNL Bank \$1B-\$5B Index**, their prices appreciate significantly. This is a recognition by the market that a bank of about \$1 billion in asset size has—through its operating history, solid management, underlying value, and size, among other things—become more valuable. It is generally more valuable precisely because its market capitalization is larger, more shares are outstanding, and, as a result, the stock is likely more liquid. Those who invest at **SNL Bank \$500M-\$1B Index**-type prices will likely find their investments appreciate as they begin to attract investors seeking the liquidity of **SNL Bank \$1B-\$5B Index**-type bank.

As many of you already know, our sweet spot in terms of asset size is between \$250 million and \$1.5 billion. We believe well-run banks in good markets can achieve strong shareholder value and price appreciation. So, putting our own portfolio to the test, what is the P/TBV for our banks? It's a mere 127%, well-below the P/TBV for banks in the \$1 billion to \$5 billion slot (200%) and about the same as banks in the \$500 million to \$1 billion slot (130%). Over half of our banks are trading at prices *below* the tangible book value. They are primed for appreciation.

In the late 90s, the P/TBV for big banks topped out at about 450%. Even after the burst of the tech bubble in 2000, big banks continued to see steroidal P/TBVs. As recently as late 2006, the P/TBV for big banks was above 350%. Given the psychology of the current trauma, it is unlikely the market will allow for such inflated P/TBVs for big banks any time soon. Rather, we expect value seekers to pursue *real* value: talented management, good markets, strong book value. That is something to smile about.

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