

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: January 16, 2006
Subject: On the Other Hand . . .

We have all sorts of excuses for our tardiness. Normally we'd like to have our thoughts in your hands by the 10th of the month but we didn't make it this month, in part because of the New Year holiday schedule and our strong desire to complete our audit as early as possible so that we can provide our investors accurate information regarding performance for the year and K-1s as soon as possible.

We all tend to focus on short term results, whether we are long term or short term investors. It's just natural. We invest in real time and we hear or see business news as it is happening. The Fed's decisions on interest rates provide for an almost circus-like event in the month in which the Federal Open Market Committee meets. We watch CNBC or Bloomberg TV for the announcements dealing with rates, inflation, GDP growth, employment and on and on. The investment markets have gotten to the point that, for the first time in 2006, "investors" will be able to invest in futures contracts—place our bets, if you will—for Fed funds rate changes, inflation rates, employment/unemployment numbers and GDP growth. The investing public has become a creature of the print and TV media more than ever before.

We put our pants on one leg at a time as you do. It would be easy for us to become transfixed by the numbers and the vast array of information available on Bloomberg (now over 64,000 data sets). We could easily become like our kids or grandchildren or even some adults—saucer-eyed staring at the screens—all six screens in our research and trading room. And so the media had us all on the edge of our chairs waiting to learn whether Bill Miller, the much lionized manager of the Legg Mason Value Trust, had beaten the S & P 500 for 16 years in a row. He did. On the face of it, pretty darned impressive, right? Well maybe. *Barron's*, in its January 9, 2006 issue, takes a closer look at that record. It found that over the last 15 years 19 funds (that's right, 19) have outperformed Miller and the Legg Mason Value Trust. How can that be? Well *Barron's* looked at *annualized* returns rather than *calendar* year returns and focused on diversified equity portfolios rather than sector portfolios or international portfolios. The S & P 500 provided a 15-year annualized return of 11.4%. The 15 year annualized returns of the 19 funds averaged 16.4%. Why did *Barron's* take this approach? "Simply because, for long-term investors, what counts is the final numbers—not the gyrations in between," *Barron's* said.

"'You don't have to beat the market every year to post a great long-term record,' says Don Phillips [in *Barron's*], a managing director of Morningstar, in an e-mail message after looking at the [*Barron's*] screen's results. 'Allowing a manager to be out-of-step with the market occasionally may well increase your odds of beating the market over time, as you can't beat the market unless you're willing to do something different.'"

John Mauldin, in his most recent investment letter (January 13, 2006) entitled "The Sacrifice Ratio" cites one of his favorite writers, James Montier. Montier, a contrarian, had some very interesting things to say in a research paper. See how what he has to say fits with the *Barron's* article just a few days before:

"Whilst the consensus may sometimes be right, it is unlikely you will make money from investing in it. As [*the noted economist, John Maynard*] Keynes put it, investors should "go contrary to the general opinion, on the grounds that if everyone agreed about its merits, the investment is inevitably too dear". So going against the crowd is still likely to be the best recipe for consistently adding value. . .

- In a world in which everyone is trying to outperform each other, doing what everyone else is doing is unlikely to work as a viable source of long term alpha [*see*

our January 2005 E-Memo entitled "Alfie & Alpha" at <http://www.fortresspartners.com/pdfs/0105Ememo.pdf> for a discussion of alpha.]

As the quotation from [John] Maynard Keynes makes clear, equity prices should reflect the consensus view. So betting with the consensus is unlikely to generate significant outperformance [*i.e.*, *alpha*].

- Going against the crowd is not painless. [Neurophysiologists] have found that social pain (the pain of going against the crowd, or being excluded) is felt in the same parts of the brain as real physical pain. So contrarian investing is a little bit like have your arm broken on a regular basis.
- The returns [for] bearing this discomfort can be sizeable. For instance, a model relating the P/E people are willing to pay to measures of underlying volatility shows that as volatility declines . . . people will pay more, but of course, they end up earning less . . . [B]uying the market when it is in the comfort zone (*i.e.* volatility is low) results in very low real returns over the long run (an average of 1.3% per annum). In contrast, buying equities when it feels absolutely awful to do so can generate high returns. When the market is in the "you must be mad to buy equities" [*or "you must be mad to buy banks"*] mode, the real return over ten years is 15% per annum!
- So, where are big consensus trades at the moment? Many investors seem to have itchy trigger fingers when it comes to getting into growth styles. The logic seems to be that after five years of value outperformance, surely growth is due to bounce back . . . Of course, buying any of these is likely to result in accusations of insanity and calls for your internment in an institution. Such are the joys of being a contrarian."

We have looked at ourselves off and on over the past year and said maybe we do need some time off. Perhaps an institution would provide us with a head clearing which could bring us to our senses. Upon further reflection, we thought better of it. Investors hire us to provide exceptional results over the long haul. On the other hand, underperformance for any period (especially when it is absolutely negative) is hard to stomach—perhaps more for us than you know. Yes, it is like having your arm broken repeatedly. We are not looking for sympathy but we want you to know that we are not indifferent to posting red numbers at *any* time.

However, we are investing in banks for the long term. Banks may be out of favor from time to time and may underperform the market just like the industry has outperformed the market in recent years. But, just as a reminder, for the five years that ended December 31, 2005, the cumulative return (including dividends) for S & P 500 was barely in positive territory (2.74%) and the NASDAQ Composite was still negative (-8.74%) while the NASDAQ Bank Index was up 78.65%! Earlier we referred to the 19 funds that beat Bill Miller over the long term. We don't have a record that goes that far back. But each of these funds has a five year track record. While we can't disclose that record to the broad distribution of this E-Memo, we can take a few minutes to qualify you telephonically or electronically and then provide you with comparable data on our performance. We are happy to do that for reasons which should be obvious. Here is what we found with the 19 funds for the 5 years ended December 31, 2005:

The 19 Bill Beaters*

Annualized 5-Year Return

• Average return for all 20 funds:	13.6%
• Highest return:	25.6%
• Lowest return:	4.6%
• Bill Miller's return:	4.6%
• S & P 500	0.5%
• NASDAQ Bank Index	12.3%

5-Year Annualized Standard Deviation*

• Average standard deviation for all 20 funds:	16.8%
• Highest standard deviation:	21.2%
• Lowest standard deviation:	11.5%
• Bill Miller's standard deviation:	19.6%
• S & P 500 (5-year)	14.8%
• NASDAQ Bank Index (5-year)	11.8%

*Source: Morningstar, Inc. *Standard Deviation measures the degree of variation of returns around the mean (average) return. The higher the volatility of the investment returns, the higher the standard deviation will be. For this reason, standard deviation is often used as a measure of investment risk. All other factors held equal, a lower standard deviation is better.*

Yes, investing in banks is somewhat of a contrarian approach to investing. We won't deny that. On the other hand, we think that the examples of the 19 funds, each of which beat Bill Miller (they also did the same for the 15 years ending 12/31/05) is quite telling especially when stacked up against the NASDAQ Bank Index—our benchmark. The average annual return of all the funds managed by this august group of managers *barely* beat the Bank Index, but soundly beat Miller.

How did they (and Bill Miller) accomplish all this with the dollars entrusted to them by their investors? They took more risk. A lot more risk. Their average standard deviation was 16.8%, **50.8% higher** than the NASDAQ Bank Index! Remember, all other factors held equal, a lower standard deviation is better.

On one hand, although we topped our benchmark in 2005, we didn't perform up to our own expectations and we will feel as though our collective arm is being broken—again. On the other hand, we take comfort in knowing that over the long term, banks, the sector in which we specialize, can match returns with the 19 Bill Beaters while exposing you to a lot less risk—over 50% less risk in the last 5 years.

FORTRESS

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