

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: February 13, 2006
Subject: This can't be right!

It can't be. But it is!

How many times have we been confronted with facts that seem to fly in the face of Conventional Wisdom? Upon reflection, we're sure you'll conclude that often that is the case. We think Conventional Wisdom is the child of bias and ignorance, two forces which sometimes *feed* each other but unfortunately never feed *on* each other. Conventional Wisdom plays an important role in domestic and international politics. Think of how the world has changed and why since September 11, 2001. Conventional Wisdom was set on its ear. How about medicine? Perhaps one of the principal impediments to curing cancer and other diseases has been bias and ignorance masquerading as Conventional Wisdom. Less than two hundred years ago, doctors still used leeches to "bleed" patients who were ill with unknown diseases. Sometimes the bleeding would involve the removal of a pint or two to relieve "pressures" or "ill humours." Today, our bloated, expensive and inefficient health care system is just that because Conventional Wisdom says medical care must be delivered according to a rigid set of rules that often seems to place more attention on a patient's insurance coverage than on providing the care. And how about our education system? Conventional Wisdom says that the best and most efficient education is provided by public schools and the more it costs the better the education, right? A recent study showed that by the time a student enters the 10th grade in the Milwaukee Public School System, taxpayers have spent nearly \$100,000 on that student's education, yet less than 50% of those students actually go on to graduate. The success of charter schools and voucher systems in Milwaukee and Cleveland shows that Conventional Wisdom is wrong again. With fewer dollars and no frills, charter schools (including long-established parochial schools) have achieved higher student test scores and graduation rates, proving that simply throwing more money at our schools doesn't result in better educated students.

Well by now you've guessed where this is going, right? Conventional Wisdom—bias and ignorance—about banks. We think we've heard all the Conventional Wisdom regarding banks, bank earnings and interest rates. Conventional Wisdom has told all of us that banks (presumably *all* banks' financial performance) will suffer as a result of the 14 increases in the Fed funds target rate over the last 19 months. And indeed on January 23, 2006 *Barron's Online* carried a piece entitled "Once Stalwart Bank Stocks Break Down." The opening sentence said, "The banking sector rolled over in December and played dead in January." Really? We wonder what banking sector the author, Michael Kahn, was writing about. The studied observer of small bank stocks may have the answer: He must have been writing about the large bank index, the BKX or Philadelphia Stock Exchange/Keefe, Bruyette & Woods Bank Index. And indeed he was. The BKX's total return for the months of December 2005 and January 2006 was -0.16%, whereas the NASDAQ Bank Index, which contains the smaller banks, like those we follow, was up 2.26%! The "banking sector rolled over"? Really? Conventional Wisdom apparently thinks that the banking sector consists of the 24 largest publicly traded banks in the US, which comprise the BKX. What about the other 1,298? Well, the performance of 545 of them that make up the NASDAQ Bank Index (which accounts for about 43% of all publicly traded banks, not just the 2% represented by the BKX) do a good job of representing the balance and their performance argues otherwise.

Conventional Wisdom has argued that increases in Fed funds rates or the flattening of the yield curve or the inversion of the yield curve will cause problems for the financial performance of banks. Conventional Wisdom has identified these problems as a drop in earnings due to a decline in net interest margins—a margin squeeze if you will, because as the yield curve flattens or inverts, the so-called "carry trade" is no longer possible.

Conventional Wisdom also argues that increases in interest rates will make it more difficult for borrowers to pay back loans and therefore there will be an increase in loan charge-offs which will have an adverse impact on earnings. We've also heard Conventional Wisdom tell us that loan growth will drop because higher rates will discourage borrowers. So 19 months after the first of 14 rate increases, just how has Conventional Wisdom fared as against the smaller banks we follow and invest in? Just as a refresher, the banks in which we are currently invested have an average market cap of approximately \$130 million—not exactly Citigroup or Bank of America sized banks. Here's a summary of what our banks reported for the most recent quarter:

FORTRESS PARTNERS
Average Portfolio Bank Performance
Fourth Quarter

<u>Average Growth</u>	<u>Earnings</u>	<u>Loans</u>	<u>Deposits</u>	<u>Assets</u>	<u>Book Value</u>
2005 vs. 2004	+19.2%	+16.3%	+15.5%	+14.9%	+13.0%

Here's what this all means:

- **Increases in rates**, the flattening or inversion of the yield curve **have not materially impacted our banks' earnings**—they're up by over 19% on average.
- **Increases in rates have not discouraged borrowers** from borrowing but in fact portfolio loans increased over 16% on average over the past year.
- **Increases in rates have not adversely impacted our banks' core deposit growth.** The growth shown above comes primarily from non-interest bearing demand deposits and transaction accounts with floating rates.

Have rates adversely impacted our banks' credit quality? Not really. Credit quality is a key brick in our wall of worry and a key element in our bank investment decision. Here are our observations:

FORTRESS PARTNERS
Average Portfolio Bank Credit Quality Statistics
Fourth Quarter

Loan Loss Reserves to Non-Performing Assets	472.58%
Charge-offs to Average Loans (annualized)	0.14%

Our decades of bank regulatory, bank management and bank ownership have taught us that the most likely way for a bank's performance to falter is for loan quality to decline. There is little evidence of that in the above statistics--which we consider to represent key elements of a "fortress" balance sheet.

We think the foregoing are key markers of the niche in which we invest. We seek well-managed, high-quality, fast growing banks in growing markets whose acquisition goals are focused on lenders and deposit gatherers with proven in-market track records, rather than just adding more brick and mortar. Smaller banks can grow faster than big banks. Faster growth can overcome the flattening of the yield curve and margin pressure. The quarterly growth statistics we cited earlier support this thesis. Last week the *Milwaukee Journal Sentinel* carried an article that touched on our bank investment thesis. Here's the link: <http://www.jsonline.com/bym/news/feb06/389921.asp>. We'll include this in the e-mail note to which this E-Memo is attached.

Conventional Wisdom, we find, is often wrong. Conventional Wisdom says, "Don't confuse me with the facts." Conventional Wisdom is lazy—it relies on what supposed experts say without thinking for itself.

It never says, "This can't be right!" It never asks, "How can that be?" Investors who follow Conventional Wisdom usually find themselves with conventional and uninspiring investment performance.

We think that the facts support continued investment in a portfolio of growing, high-quality banks selected by portfolio managers with extensive industry experience—experience in bank regulation, bank management and ownership and bank investing.

Let us know what you think; we'd like very much to hear from you, whether you agree or disagree with us, or if you'd like to learn more about our style of bank stock investing. Our phone numbers and e-mail addresses are listed below.

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