The FORTRESS PARTNERS
E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: February 15, 2007
Subject: A Disconnect—Bank Performance and Bank *Stock* Performance

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When we wipe the condensation off the mirror to allow us to see our image these frigid northern mornings we wonder whether we're looking at a Pollyanna or a cold-hearted, steely-eyed investment manager you expect us to be. We hope we are neither one but rather rational investment managers focused on an industry in which we earned our spurs—banking. We work hard not to be cheerleaders but rather voices of reason in a media driven environment which we would characterize as filled with misinformation and disinformation; misinformation about banking and its role in the economy and disinformation about the economy and economics.

The media and the investment manager/research analyst talking heads have been overtly talking down the prices of banks as they talk about the impact of the flattening and inverted yield curve on bank net interest margins and bank profitability. More recently these same nattering nabobs of negativism (we will forever be indebted to Spiro T. Agnew's speech writer for that alliterative turn of phrase) have tried—but unsuccessfully—to predict the demise of U. S. economic growth due to (take your choice), according to Brian Wesbury, Chief Strategist and Economist of First Trust Advisors in the Chicago area, writing in the February 14, 2006 *Wall Street Journal*:

> "Many believe that the debate is over on global warming, nationalized health care, tax hikes, the rich versus the poor, the trade deficit and 'obscene' oil company profits. Forgotten in this rush to pass judgment on capitalism is the fact that the last two times government seriously tried to control the U.S. economy—in the 1930s and in the 1970s—they made a terrible mess of it."

All of this is said to have an adverse impact on the performance of banks. In fact, the result from our vantage point—in front of the cold mirror—has been to act as a depressant on bank *stocks*, not an impediment to bank *performance*.

The NASDAQ Bank Index declined 1.37% for the month January—talked down by the media and the uniformed, while on a fundamental basis our portfolio banks continue to perform consistent with our selection expectations in terms of our key indicators:

- Balance sheet and earnings as to:
    - growth,
    - margins,
    - credit quality.
- Management is the key element in creating sustainable growth in earnings and earning assets while maintaining net interest margins and strong credit quality in this environment. Such a combination drives shareholder value. The following tables display the key results to date of the portfolio banks which have reported 4th Quarter 2006 earnings:

Percent Change
Fortress Partners' Portfolio Banks
Fourth Quarter 2005 vs. Fourth Quarter 2006
Reported Results as of 2/14/07

GROWTH

Q406 vs. Q405	Earnings Per Share	Loans	Deposits	Assets	Book Value
Average	43.5	34.5	35.5	34.7	22.4
Median	6.2	20.7	17.5	21.2	14.9

The **GROWTH** statistics for loans, deposits, assets and book value continue to show double digit increases quarter over quarter. It is this kind of growth that will drive earnings. Earnings this period were restrained a modest up-tick in expenses (observed by an increase in efficiency ratio—the lower the better) which offset the continued improvement in Net Interest Margin.

One more point on earnings: SNL Financial, LP, the principal data base provider for banks and thrifts tracks earnings of all publicly traded banks and thrifts. As of the close of business, February 14, 2007, with most of the 1,250+ banks reporting, median earnings growth for Q4-06 was 3.9% versus earnings for Q4-05. **That means that the application of our selection criteria resulted in a 59% improvement in earnings performance!**

Fortress Partners' Portfolio Banks
Fourth Quarter 2005 vs. Fourth Quarter 2006
Reported results as of 2/14/07

KEY PERFORMANCE STATISTICS

	Return On Average Assets	Return On Average Assets	Return On Average Equity	Return On Average Equity	Net Interest Margin	Net Interest Margin	Loss Re-serves/Non-Performing Assets	Loss Re-serves/Non-Performing Assets
	Q406	Q405	**Q406**	Q405	**Q406**	Q405	**Q406**	Q405
Average	1.09	1.08	10.8	13.4	4.42	4.03	1540.3	472.6
Median	1.11	1.05	11.3	13.3	4.09	3.79	349.1	328.2

The **KEY PERFORMANCE STATISTICS** show a decline in the aggregate of our banks' return on average equity for the quarter (an annualized number)—not unreasonable considering the 14.5% median gain in book value both from the **GROWTH** table above. The improvement in the Net Interest Margin compared to 4Q05 is particularly pleasing to us because it reflects how well our bankers understand their business and the importance of pricing on both sides of the balance sheet. We know anecdotally that our bankers turned away loan opportunities in the latter half of 2006 because pricing was not acceptable, thereby sacrificing some loan growth. The battle of the yield curve will continue and we are confident that our bank selection process positions us for success in the yield curve battle. The improvement in the ratio of Loan Loss Reserves to Non-Performing Assets was rewarding as well and speaks volumes of our strong focus on banks and bankers that understand credit quality—how to find it and how to keep it. Arguably the economy can't continue its Goldilocks performance forever, right? And even if it did, there will be industry sectors like housing that will stumble from time to time. Diligence by our banks regarding credit trends is imperative. As we begin to acquire a position in a bank and as we add to that position, it is part and parcel of our interviewing process.

We view all of these bank performance statistics as being very good news. But the market seems to view our high performing banks quite differently and has been viewing the somewhat erratic earnings performance of the banking behemoths—JP Morgan Chase, Citigroup, Bank of America, Wachovia and others as being far better quality earnings than those of the small banks we've cited in the past and in this memo today. We wait for the next big blow-up. What will it be? Derivatives? Corporate governance? Compliance? Big isn't always better. We've shown you in the past how over long periods of time the NASDAQ Bank Index of 528 banks has solidly beaten the index of large banks, the Philadelphia KBW Bank Index (BKX).

Last August we showed you a table similar to the one below comparing the performance of bank stocks in the various geographical sectors of the US. As you may recall, *Investors Business Daily* (IBD) tracks 197 industry groups every day to report on the performance of the stock prices in the groups. Those with the greatest upward momentum are at the top of the list and those with the least upward momentum are at the bottom—the best being 1 and the lowest, 197. We've added to the August table, the ranking of those same groups of banks as of February 14, 2007. The span of time represented is approximately nine months:

Bank Location/Sector/ Number in Group	February 9, 2007 Rank	August 11, 2006 Rank	May 12, 2006 Rank
West/Southwest (87)	**169**	14	146
Southeast (153)	**183**	40	155
Northeast (131)	**181**	47	162
Savings & Loans (154)	**177**	69	157
Midwest (76)	**190**	97	179

We think this table demonstrates the disconnect between bank *stock* performance and bank *earnings* performance of our select faster growing banks. While growth in earnings, loans and deposits among our banks continues at a double-digit pace, stock prices have not reflected that growth. It also demonstrates sector rotation—rotation out of banks and into the hot sector *du jour*.

In the case of banks, we think it is fulfillment of the prophesy of the media sages—the talking heads who have convinced the investing public, including many investment managers that that investing in small banks these days is not a cool thing to do. They say small banks are, after all, subject to the whims of the yield curve (meaning net interest margin shrinkage). The big guys are not. Small banks will have a hard time dealing with the "crisis" in the housing market meaning credit losses and the big guys won't because they sell their mortgages to Fannie Mae or Freddie Mac. Small banks will have a hard time with a general slowdown in the economy, meaning credit problems with commercial and industrial loans and on and on and on. What these commentators suffer from is short memories. They've forgotten (or never knew) that small banks have substantially diversified their sources of income with some of our banks garnering 20% to 30% of revenues from non-interest sources. They've forgotten (or never knew) that small banks have the same access to Freddie and Fannie that the big banks do. They've forgotten that small banks never got burned on loans to air carriers or the telecom industry or any of the fads pursued by the money center banks over the years which, as a group, so often behave like a bunch of lemmings plunging over a cliff.

The public markets haven't always been friendly to well-managed publicly traded businesses. Is it any wonder that private equity investment and investors are having a field day? We are in such a period and probably have been for the better part of two years as the mantra of the media mavens has been consistently focused on the Fed and interest rates, the inversion of the yield curve and the impact on bank net interest margins—not to mention the worry of a recession signaled by an inverted yield curve (which was debunked yesterday by Chairman Bernanke in his testimony before the US Senate Banking Committee [2-14-07]). In banking, these periods come and go.

Attractive *investment* returns are available because stock prices increase. Stock prices increase over time—assuming a constant price to earnings ratio because of earnings increase. Earnings in banks—as we've pointed out frequently on these pages have, over the past 40 years grown at a faster rate than aggregate earnings of all companies. Our banks are doing very well. Their business values as measured by book value are growing at double digit rates and we believe their current valuations to be reasonable. So whether or not their *prices* go up in 2007, their *value* increase will be eventually realized. And so we conclude—logically, we believe, that investment in small faster growing banks will continue to provide attractive and steady long term investment returns.

Equity investing has been as much influenced by emotions as by reason and some would argue that emotions dominate investment strategies and tactics. A whole field of academic study has grown around behavioral finance and behavioral economics. We'll begin delving into that subject next month in the **Fortress Partners *E*-Memo** and what we can learn from this new field of science as it applies to investing in banks.

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