E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: March 8, 2005
Subject: The 11th Myth of Bank Investing *or* How Could the Financial Press and a Top Flight Investment Manager be so Wrong?

We never cease to be amazed how easily the financial press and analysts from large investment management firms seem to fall into the trap of buying into conventional wisdom or urban legends. Maybe it's the water from the Hudson River or the East River which causes *eastern myopia*, that curious malady which causes one to think, among other things, that the only banks are big banks like those based in New York City. Last week's issue of *Barron's* was kind enough to provide us with the theme of this month's *E*-Memo and while kudos are being handed out, we can't ignore the significant contribution made by Sanford C. Bernstein & Co., LLC analyst, Howard Mason, who provided the grist for *Barron's* own Andrew Bary. Please note that we have a great deal of respect for Sanford C. Bernstein & Sons but all organizations are made of individuals like us and we know that we all have feet of clay. Mr. Mason is no exception.

Myth #11—All Banks are the Same Really? That's news to us, but then we live in flyover country so what do we know? Well simply this: Messrs. Bary and Mason have locked their eyes on banks with market capitalizations of $2 billion or more. We can understand Mason's focus; Bernstein manages billions of dollars in assets in mutual funds and private accounts. Mason's report discloses that Bernstein-managed accounts own 1% of the common stock of seven of the 64 banks and thrifts with market caps in excess of $2 billion. Focusing on the largest banks makes the job of selecting banks and thrifts for their portfolios easier as there is plenty of float to allow them to take larger dollar positions without moving the price of the stock when buying or selling. However, readers of these pages were likely not fooled by Bary's article entitled *"The 1,000% Solution, A Crackdown on Astronomical Fees for Overdrafts Could Squeeze Banks"*. The author maintained that many banks are charging exorbitant fees, the equivalent of 1000% interest, to pay customer checks that would otherwise bounce due to insufficient funds in their accounts. These "bounce protection" programs, the author suggested, prey on low and moderate income customers, those least able to afford those fees. Because of that "fact," the author implied, many banks are likely to face customer backlash and increased regulatory scrutiny, which could ultimately affect their earnings.

We thought that Barron's usually did a more careful job of editing than they did on Bary's piece, which allowed him to imply, if not clearly state, that the 64 banks constituting Mason's list represented all banks. We know that Mason uses the same data source we use, SNL Financial, LLC, and we know that SNL Financial provides data on every publicly traded bank and thrift in the US. How many banks are there with a trading symbol? Over 1,250. And 64, or 5.12%, of the largest banks of 1,250 represents "banks"? C'mon. Bary refers to "a proliferation of U. S. bank branches; in New York and Chicago, some city blocks now feature multiple banking rivals." Mr. Bary needs to get out of NYC. He needs to visit St. Louis and Springfield, Missouri or Rancho Cucamonga and Porterville, California or Naples, Bonita Springs, Sarasota and Bradenton, Florida or Hartland, Oconomowoc, Milwaukee or Pewaukee, Wisconsin. Yes, Mr. Bary, banks do exist outside of New York and Chicago.

We are not refuting everything that Bary covered in his article because he did get at least one thing right: "*The days of single-digit bank P/Es are over. Bank stocks are likely to be supported by plump dividends, which now run at 3% to 4% across a wide swath of the industry.*" We believe he may be right about that because, as we see it, banks have for the last four decades, the last 10 years, 20 years and 40 years produced earnings growth at a far faster clip that all US companies (which includes banks). How much faster? 32% to 45% faster depending on the period of time considered.

So what was wrong with "*The 1,000% Solution*"?

We list our hang-ups here:

- 64 of over 1,250 banks and thrifts don't constitute all "banks".
- "The biggest risk may lie with the smallest banks, which have . . . a greater vulnerability to rising rates than giants . . ."
- According to Mason, "As banks compete more intensively for the mass-affluent customer, the cost of the U. S. payments system is increasingly borne by the more economically vulnerable segments of society. . ."
- "Regulators are concerned because millions of lower- and middle-income customers regularly incur bounce protection charges . . . [which] probably involves customers with checking-account balances frequently below the $2,500 average across the banking industry."

64 of over 1,250 banks and thrifts don't constitute all "banks". We apparently haven't made the case loud or long enough for the sound to get east of the Hudson. As you know, we focus our attention on approximately 450 banks with market capitalizations between $50 million and $500 million. We are know there are banks with market caps of less than $50 million just as we know there are banks with market caps of more than $500 million. Taken as a whole, banks and thrifts chartered by the states and by the Feds constitute 8,975 discrete units, not 64. Of the 8,975, more than 1,250 have trading symbols. To be sure some of the 8,975 are units of multi-bank holding companies. The 1,250+ trading symbols include many multi-bank holding companies. But what is irrefutable is that 64 banks and thrifts do not constitute all "banks" just as 1,250 publicly traded banks do not constitute all 8,975 "banks".

In fact there are several sub-industries within all of banking which constitute the entirety of banks and thrifts. These sub-industries include traditional thrifts which tend to be residential real estate lenders dependent on funding from CDs and the Federal Home Loan Banks. Then there are community banks and super-community banks which provide loans and deposit services to individuals and businesses, sell insurance and investment securities, and so on. Then there are the specialists of almost any size specializing in mortgage origination on a large scale, or which issue only credit cards and debt consolidation loans, or which specialize in loans to small to mid-sized businesses. Big banks like Citigroup and J.P. Morgan Chase are not the same as the banks and thrifts in which we invest. In fact, one of our fellow investment managers just last week said we really invest in a totally different industry. We believe he is right—and yet, we do invest in "banks".

"The biggest risk may lie with the smallest banks . . ." What makes them so sure? What do they know about the other 1,186+ publicly traded banks? We've devoted our careers to banking as managers, analysts and regulators. We've worked for and regulated big banks. We've purchased, started, managed and regulated small banks. We don't know what Messers. Bary and Mason did before they began their careers as journalists or analysts, but we can speculate. The risk Bary refers to is one of higher valuations combined with vulnerability to rising rates as compared to the "giants" like Citigroup and J. P. Morgan Chase. Mr. Bary points out in his article that "banks could find it tough to generate the 8% to 10% annual earnings growth that Wall Street has come to expect." OK. But the banks in our portfolio averaged 13% growth in core earnings last year. Moreover, those holdings with published analysts' estimates (approximately 2/3 of our holdings) have forecasted earnings growth of 22% in 2005. These are likely the *smallest banks*. We've reviewed the estimates and, in many cases, have concluded that the analysts have missed key factors which could push earnings even higher than forecast. These banks, while carrying higher P/Es, have the same tools as big banks to monitor their interest rate risks and are positioned for higher rates. We maintain that small banks will grow considerably faster than Mr. Bary's giant banks and do not have "greater vulnerability to rising rates than the giants . . ." [*Myth #10: Bank stock prices fall when interest rates go up (or bank stock prices go down when interest rates fall)*]

According to Mason, "As banks compete more intensively for the mass-affluent customer, the cost of the U. S. payments system is increasingly borne by the more economically vulnerable segments of society. . ." We don't disagree that banks are pursuing the "mass-affluent customer . . ." We think that Mr. Bary must have been heavily influenced by consumer advocacy groups to state that the cost of the U.S. payments system is being borne by economically vulnerable segments of our society. We think this statement is irresponsible at best and, at least in his article, is totally unsupported. We'll comment further in this vein on the last and final assertion made by Bary which was:

"Regulators are concerned because millions of lower- and middle-income customers regularly incur bounce protection charges . . . [which] probably involves customers with checking-account balances frequently below the $2,500 average across the banking industry." As you know, we've managed banks and worked on creating new products such as "bounce protection" (though we don't recall that label) and we talk to regulators and talk with others who talk with regulators regarding their "concerns." Of course "bounce protection" is being offered by bankers to many customers, but do you really think many bankers will take the risk of not being repaid by customers with low incomes or checkered credit histories? When we talk with bankers presenting at investor conferences or the bankers running banks in our portfolio, we find that this service is actually offered only to those customers who typically cover their bounced checks, but don't do a very good job of managing their checking accounts. An anecdote may help here: A small bank decided to put "bounce protection" to the test. One of its customers, a small town attorney who owned a three-person firm and was notorious for writing checks in an amount greater than his account balance was called into his bank. He was, as it turned out, fearful that he was about to have his accounts closed and be told to go elsewhere. Instead he was offered "bounce protection". He was relieved and applauded the bank for providing him with coverage for his "excesses." He was happy to pay the fee to avoid the embarrassment of bouncing a check. This attorney always paid for his bounced checks. He was just sloppy with his bookkeeping. And he is not alone. We, both writers and readers, may not understand this kind of mentality, but it is apparently quite common.

As portfolio managers experienced in the banking business, we know how this service is used. So do the regulators. In fact, a research note written by Keefe, Bruyette & Woods, the respected bank and thrift investment banking and research firm, confirmed their view of the regulatory perspective on bounce protection plans based on personal interviews with the regulators. Some new disclosures will likely be required, but apparently, regulators are not overly concerned about the "millions of lower- and middle-income customers regularly incur[ring] bounce protection charges . . ."

You can't believe everything you read. Certainly don't believe everything you read about banks—unless, of course, it comes from these pages. At least make sure that the writers are quoting analysts who are employed by investment firms specializing in banks and thrifts (*Myth #7: Anyone can select bank stocks*). All banks are not the same (except, perhaps, east of the Hudson).

The "1,000% Solution" would make interesting reading on the front page of *The New York Times* or a splashy feature on *60 Minutes.* It was certainly disappointing to find it in *Barron's*. We expect more from *Barron's* and its reporters. What we expect is well researched articles using expert, independent sources—and when it comes to banks, someone who knows that a handful of big banks don't constitute the entire banking industry.

All banks are not the same. It is our job here at Fortress Partners to identify those banks which we believe are unique in their universe, unique in market growth, earnings growth, loan growth, core deposit growth. In short, we seek banks whose focus is acquiring the very best bankers in their markets to provide the very best services to their clients and, thereby, the very best value to their shareholders.

Following, our results through last month:

February 2005
PERFORMANCE HISTORY (1) (2)

	Inception to Date (59 Months) 3/29/00-2/28/05	Four Year Return Annualized 2/28/01-2/28/05	Three Year Return Annualized 2/28/02-2/28/05	Twelve Months Ending 2/28/05
FOUNDATION	**+ 149.26%**	**+ 21.51%**	**+19.64%**	**+ 5.50%**
Dow Jones Industrial Average	- 8.76%	**+ 2.76%**	**+ 4.38%**	+ 3.90%
NASDAQ	- 54.22%	**- 0.73%**	**+ 6.34%**	+ 2.31%
S & P 500	- 20.32%	**- 0.90%**	**+ 4.63%**	+ 6.96%
S & P 600 (Small Cap Index)	+ 64.48%	**+ 12.28%**	**+ 13.79%**	+17.61%
NASDAQ Bank Index	+ 122.27%	**+ 14.80%**	**+ 13.53%**	+ 4.32%

(1) **After** management and other expenses but **before** charges for Performance Allocation; indices and Fund performance include the reinvestment of dividends.
(2) **FORTRESS PARTNERS Capital Management, Ltd.** has prepared and presented performance information for **FOUNDATION FINANCIAL PARTNERS, LLC** in compliance with the Global Performance Presentation Standards (GIPS®) of the CFA Institute. The CFA Institute has not been involved in the preparation or review of this information.

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