

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: March 14, 2006
Subject: Signs of Spring

One of the surest signs that Spring is just around the corner is the annual deluge of seed catalogs that arrive in the mailbox this time of year. How we've managed to get on all these companies' mailing lists we'll never know; our efforts at gardening are usually limited to some tomato plants, a patch of rhubarb, a few flowers and some wishful thinking about having enough time to actually plant a real garden.

Gardening catalogs are full of promise with pictures of perfect specimens of all manner of fruits, vegetables and flowering plants. The accompanying descriptions are marketing masterpieces, touting prize-winning tomatoes the size of softballs, 400 pound pumpkins, huge strawberries, giant asparagus and more. The latest "new and improved" hybrids promise bigger yields and resistance to all manner of pests and diseases. All one has to do, they seem to suggest, is to drop a seed in the ground, wait a few weeks, and reap a bumper crop.

While leafing through some of these catalogs we were struck by how similar they were to the marketing materials for many mutual funds and other investment products being offered today. Don't get us wrong, some of this material is good quality informative work that discusses important things like risk and consistency of results; but mostly, it is slick stuff, full of pictures of people enjoying the good life—presumably because they invested in the advertisers' financial products. Like the seed catalogs that don't talk about the manual labor required to ensure good results, such as preparing the soil, fertilizing, watering, weeding, spraying and the like, the investment ads seem to suggest that investors need only send in their money and then sit back, take it easy, and harvest a fortune.

For example, a recent brokerage firm's ad promoted its "separate account" program, promising the "personalized attention" that was otherwise only available to "wealthy" clients. The small print below the text disclosed that the program included a two percent "wrap fee" on top of a management fee and that the "separate account" was really managed as part of a larger model portfolio; all of the clients held the same stocks in the same proportion and, after fees, returns were less than an index fund.

In another ad, a mutual fund family trumpeted the recent results of its international fund, which was up nearly 60% over the last three years. Admirable returns to be sure, but they failed to comment that those results were lower than what investors could have achieved in a benchmark international index fund. Moreover, there was no mention that those returns had been achieved with more risk and much higher portfolio turnover.

In the mutual fund world, last year's "hot" funds are often flooded with money from new investors and results frequently disappoint the following year because the torrent of new money makes it more difficult for the fund managers to manage the portfolio in the same way that produced the good results in the first place. Only a handful of funds have managed to outperform appropriate benchmarks over time. Underperforming funds are often merged into larger funds from the same management company, hiding their dismal record from view. No wonder the SEC sets such rigid guidelines for investment company advertising.

Successful investing and successful gardening are alike in many ways. In both, the end results benefit from careful preparation, in-depth research, selection of appropriate varieties, and some regular fertilizing, weeding and pruning along the way. Some years produce bumper crops, most years are about average and a few years are complete busts. Results are never guaranteed. The "growing conditions" may not be ideal (bad soil, too much rain, too little sun – rising interest rates, an anemic economy), the chosen variety may not perform as expected (the investment thesis might be out of favor), or marauding pests might consume the crop (changes in tax laws and new regulations or insider fraud). Yet, these risks can be managed to minimize their impact and improve the odds of bringing in a good crop in most years.

In many ways, we view our portfolio like a garden. We believe that we have chosen fertile ground in which to plant (the small-cap bank universe), which in itself raises our odds for success. Why, you ask?

- As we've argued previously, small cap companies, especially in banking, can respond more quickly to changes in the market whether that means offering new products and services or figuring out how to outflank a larger competitor by providing faster responses and more personalized service. Likewise, they can adjust the composition of their assets and liabilities more quickly to respond to changing interest rates.
- Small cap banks are highly regulated, as are large cap banks, but they are less complex and easier to understand. We think their straight-forward business models and consequent high level of transparency are attractive to investors. In simple terms, there is a high probability that what you see is what you get. That is not the case for many other sectors of the market.
- The small-cap bank universe is still largely inefficient; that is, analyst coverage is sparse and information does not get disseminated nearly as quickly or as widely as it does for large companies. However, we can almost always get the senior management of small-cap banks on the phone or visit with them face-to-face on short notice. (Try that with the CEO of Microsoft or IBM!) We hear and see the managers of the small banks we invest in directly - not filtered through an investor relations staffer or consultant.

We spend a lot of time studying the data and when our research tells us their prospects are likely to be good, we add some new varieties to the garden (banks with interesting business niches and faster growth potential). We keep a core of proven producers that generate reliable results period after period, and we prune or harvest some of our crop when it is apparent that their productivity is waning or if there is a better alternative. In some years the growing conditions are unfavorable (rising interest rates in 2004-2006) and despite our best efforts using the best selection skills available to identify the best possible hybrids, the crop is disappointing. In other years, we get a bumper crop that surprises even us.

Most years, the garden produces an abundant harvest that keeps our investors (and thereby, us) happy. This month marks our sixth year in the bank stock "garden." Over the past two years we've focused our attention on faster growing varieties of banks. We believe that just like in gardening, where it is important to select faster growing varieties for shorter growing seasons, it is also important to select faster growing varieties if there is a long growing season in order for us as managers/gardeners to be able to raise several crops in a year. And not to flog this horse too much more, but we find our attention turning increasingly south where the growing conditions are often more favorable. By South we mean the Southeast, including Florida, Georgia, and up the East Coast as far north as Virginia, and the Southwest, including Nevada and California. For at least a generation, folks have been moving to these areas to work and raise their families, to retire, or just to enjoy the more moderate climate. Population growth created demand for financial services and a crop of new banks sprouted up in response to this demand. These banks, with their well-trained and entrepreneurial executives, have experienced strong and steady growth and, we believe, improve our odds for investment success in small cap banks.

There are always new and exciting things happening in the small-cap bank universe and we continue to learn and to refine our techniques with the aim of producing a "good crop" for our investors, year in and year out.

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