E-Memo

TO: INVESTOR/MEMBERS, CLIENTS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: April 11, 2005
Subject: The Last Five Years-Exhilarating and Humbling

On April 13 last year we marked in passing the 4th Anniversary of our activities as an investment manager. This year the mark is 5 years. And what an important anniversary it is. Five years is of critical important to investors. Five years is a period of time during which an investment management firm can set a record which will make or break it. We came within 22 basis points—less than a quarter of one percent of meeting our 20% annual return target and that is humbling as well as exhilarating.

We are humbled by all of you who have invested with us during the past five years. We are humbled by **you**r courage in the face of the declining markets of 2000-2002 and by **your** increased understanding of the markets in which we invest and how and why we invest. We are grateful for **your** continued support in the face of a financial press that continues to look more like a group of lemmings running pell mell to its destruction as it encourages investors to move out of the banking sector because rates are on the rise. Last April 13th we said:

> "And, of course, like a choir of Pygmalions, they "talk" the price of bank and thrift stocks down. Now if this weren't enough, expect to hear the same chorus from the same choir when rates decline. Can you really have it both ways in the face of countervailing facts? We just have been through one of the better—if not the best—periods for bank performance in the past four decades. Bank prices have reflected that, haven't they? So where were the pundits when rates began to decline? They were wailing that bank earnings were going to be hurt by declining rates. In fact, the exact opposite happened, and when the market caught up with the facts, the pundits disappeared only to return when it became obvious that if the Fed dropped rates any further, it would have the same effect as pushing on a string. It was then apparent that rates would have to increase—eventually. They have been back in full force since last summer talking bank stocks down. I believe they have been especially vocal over the past 60 to 75 days."

Isn't that just amazing how one could write something like that last year and find that it is spot-on 12 months later? The same chorus, the same programs, the same print media—amazing. Is there a 12-month press cycle when it comes to banks? The more things change (some things really have changed in the past year) the more, it seems, they stay the same.

Much of what we know about banks is public information. It's there for everyone to read and learn. Banks have changed and not just over the past 10-to-15 years, but in the past year or two, as well. What we've learned in the past five years is that these changes have been significant—almost seminal in nature. They have brought to the forefront a new breed of banker, a professional who has likely been trained by and at a larger bank than those in which we normally invest. He or she is a senior person who has been "displaced" by mergers and acquisitions. They have examined the new regime and the new culture and found it lacking, both in terms of opportunity and satisfaction. They are builders who have, so to speak, picked up their tools and moved on to a new project. They have started new banks and built them rapidly to the point where today they hold $500 million in assets or more—some upwards of $1.5 billion. They have built their institutions around individuals like themselves, rather than by buying other banks. They understand the value of organic growth and would rather (as one of our banks told us) acquire a senior lender from a larger bank with a $100 million portfolio of loans and deposits than pay a big premium to buy a $100 million bank. We have long favored organic growth over acquisitions because we've seen too many bankers that simply aren't good at evaluating and integrating them. In reality, the majority of acquisitions end up destroying shareholder value, a fact some noted banking industry analysts have recently brought to light.

Some of these "new breed" bankers have been hired by bank directors to replace previous CEOs who were more focused on personal income than shareholder outcome. They have turned these companies around and, in the case of thrifts, helped transform them into more bank-like institutions with stronger profitability and far less exposure to changes in interest rates. It has been at the same time humbling and exhilarating to see the old paradigms being moved aside and the new coming to the fore.

It has been humbling and at the same time exhilarating though to see that the same measures we applied when we developed our first portfolio apply to our new paradigm banks. We chose the right filters through which to push the mix of nearly 1,250 publicly traded banks and thrifts in our investment universe. Measures like:

Asset quality is even more important to the new bank than the old bank. It is true that almost all banks have become more sensitive to asset quality and to avoiding mistakes of the past—though there are always new mistakes to be made. The best large banks have slavishly dedicated staff to monitoring credit quality to the point where it becomes a part of the culture. The best small banks likewise are dedicated to maintaining high credit quality. We like to find bankers who have been "born and raised" in a high asset quality culture because they will, out of habit, impose that cultural trait on their new organization.

Valuation. Price to book value and price to earnings ratios are as important to us today as they were five years ago. While five years ago, finding banks with single digit P/E ratios or P/BV ratios of less than 125% was like shooting fish in a barrel. Those ratios still play an important role today, but the fish in the barrel are of an entirely different species. Banks were and are a value play. Our definition of value, however, has evolved. Banks that look cheap are often cheap for a reason and some of the best "values" may look expensive, at least on the surface. It takes more than a computer screen of ratios to find true value today. It takes in-depth analysis of a bank's strategic plan, the capability of its management to execute that plan and the prospects of its market area. It requires an understanding and evaluation of how management allocates capital and how the balance sheet and income statement components interrelate. In short, it requires more hard-nosed research and more effort and insight than ever to uncover real value today. We read reams of reports, talk to scores of bankers and analysts and rack up thousands of miles to find under followed and undervalued banks to invest in. We would have it no other way.

Growth was and remains an important factor to us. Earnings growth, asset growth and market growth. This is where we find value today. Value in growth? Absolutely!

- *Asset growth—growth in loans and deposits drive earnings growth and earnings growth drives stock prices.*

  That earnings growth drives stock prices is a truism as old as the market and, because it's old, is easily forgotten. Remember 2000 and the months which followed? Value was found in those banks that were consistently growing high quality earnings. The markets seemed to ignore those banks and their rock-solid earnings in favor of high-flying tech stocks where earnings where as illusory as their stock prices. From the end of March 2000 through the end of March 2005, the Nasdaq Composite is down over 55%, while the Nasdaq Bank Index is up 118%. Over time, the markets reward consistent earnings growth and few sectors have provided stronger or more stable earnings growth than small and mid-cap banks.

- *Markets which are rapidly growing present two opportunities:*

  Some high growth markets are marked with consolidation. Consolidation provides opportunistic banks like one which we visited just last week in Florida—a long time holding of ours which is today reaping the rewards of patience and careful building out of its infrastructure so that it can readily absorb the high quality lenders and branch leaders displaced by consolidation in its markets. It is gratifying to see that our decision to invest in and stick with this bank is now paying off and exhilarating to hear bank management talk about their ability to capitalize on the mistakes of being made by Wachovia in its acquisition of Southtrust and by Fifth Third as it tries to integrate its purchase of First National Bank of Florida. You can't know about such opportunities unless you are watchful and know the players--both acquirers and targets.

> *Other high growth markets provide banks with opportunities for rapid double digit organic growth* like one of our California banks which marked its 14th consecutive quarter of year-over-year earnings growth in excess of 25% coupled with double-digit asset growth over 16 consecutive quarters (with the exception of a planned reduction in growth to a single-digit for the fourth quarter of 2004).

These last two visits, one face to face and the other via conference call were humbling and exhilarating because the banks cited represent one selected during our first year of operation and one selected just this past year. They are just two examples of what we believe are the future of banking in the United States.

These banks represent what we have called "*[t]he FOUNDATION of a strong, free economy. . .*" and represent two of over 1,250 publicly traded banks and thrifts which are a part of *". . . its diverse and competitive banking system.*" We believe that over the past five years we have played a small role as *"interested and proactive shareholders promot[ing] efficiency and good performance and foster[ing] a healthy banking and economic system—the FOUNDATION of a free economy."* It is exhilarating and humbling to be a part of banking as a professional investor. We wouldn't have it any other way.

FORTRESS
PARTNERS
CAPITAL MANAGEMENT, LTD.
700 Walnut Ridge Drive, Suite 200, Hartland, WI 53029
262-369-5369 (Jon Bruss) • 262-369-5742 (Bob Ollech)