

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: April 10, 2006
Subject: Six Years and Other Thoughts

One of your writers remembers it well. Six years ago. March 29, 2000. That's the date when we reached critical mass with over \$1,000,000 dollars to manage and four of us (including one of your writers) with the investment savvy and courage to invest in a fund which was managed by an ex-banker, not an investment management professional. This fund planned on investing only in small banks and thrifts. Remember, banks and thrifts were in the "tank" at that point in time, coming off the meteoric highs of 1998 to swoon and wallow to the lows of early 2000 just as NASDAQ was at P/E ratios approaching 200 (and no, that's not a typo), the S & P 500 and the Dow at equally heady levels and the talking heads believing (and bubbling aloud) that the sky was the limit. Well the NASDAQ, S & P 500 and Dow Jones Industrials we hear these days (every day, it seems) are hitting new **FIVE** year highs, *not SIX year but FIVE* year highs. Those courageous and savvy few have reaped a reward few others have enjoyed. We thought that you'd like to see just how well small banks have done as compared to the stocks of other better known and better followed indices over the past six years. You'll be able to get some sense as to how those hardy risk takers and prescients fared:

March 2006 PERFORMANCE HISTORY (1) (2)

	Inception to Date (72 Months) 3/31/00-3/31/06	Five Year Return Annualized 3/31/06	Three Year Return Annualized 3/31/06	12 Months Ending 3/31/06	3 Months Ending 3/31/06
Dow Jones Industrials	+15.03%	+ 4.59%	+14.11%	+ 8.26%	+ 4.24%
NASDAQ Composite	- 47.32%	+ 5.48%	+21.11%	+18.02%	+ 6.37%
S & P 500 Index	- 4.86%	+ 3.96%	+17.19%	+11.72%	+ 4.21%
S & P 600 Index (Small Cap)	+ 98.82%	+15.01%	+29.95%	+24.08%	+12.84%
NASDAQ Bank Index	+144.39%	+14.12%	+16.90%	+11.96%	+ 5.90%

(1) **Indices** performance includes the reinvestment of dividends.

As the leftmost column of the foregoing table illustrates, the NASDAQ and the S & P 500 are not yet out of the woods. And the Dow Jones Industrials have just begun to dig out. The S & P 600 (Small Cap) Index has turned in the best performance of any of indices in the table for the last five years, annualized, but for the last six years its performance plays second fiddle to the NASDAQ Bank Index. The NASDAQ and the S & P 500 still haven't recovered from their meteoric highs of March 2000 and their subsequent plunge, the heat from which burned a lot of investors very badly—so badly in fact that they remain on the sidelines today. We fear for their long-term welfare for we know that the equity market is the only place where they can be cured—where they can "take the air" so to speak and recover. The equity market will win over long periods all the time, every time, over cash.

You've been very kind to allow us to manage some of your investable funds and you've been very kind, complementary and encouraging regarding our E-Memos. We find that many of you enjoy reading them as much as we do writing them. Thanks. We enjoy your encouragement and compliments but if you disagree, please let us know. We learned long ago that we can never stop learning—and we've learned a lot from many of you.

We've learned recently (and contrary to what we've been taught) that up really means down and that good really means bad. This isn't *Catch-22* speak, but it may, in its own weird way, be a form of post-modernism where there are no absolutes and what you see is *not* what you see (or get) but only what you think you see. It wasn't long ago that the first Friday after the first Monday of each month, when the employment numbers were reported by the Bureau of Labor Statistics (BLS), were anxiously awaited (at 7:30 a.m. Central Time) to confirm the success of the current Administration's efforts to juice-up the economy by cutting taxes. You remember that, don't you? Talking head economists would talk about the President's tax cuts as if they were rat poison or Eggs Benedict—depending upon which political party they represented. In any case, the BLS business survey numbers many times did not accurately reflect what was really happening in the economy. The household survey (the "other" employment numbers) seemed to reflect an epidemic of small business start-ups which were not caught up in the business survey net. As a result, these good numbers were "under-reported." According to some, the household numbers reflected the reality of a booming, investment driven economy. So when the numbers hit expectations, it caused a modest rally in the stock market and when expectations were substantially exceeded, the rally went for several days and, well, you know the rest of the story.

So now we fast-forward to last Friday, April 7, 2006. The employment numbers were slightly better than expected (by about 5%). That's good, right? Wage increases were only about two-thirds of what was expected. That's really good, but that news was apparently not good enough (or really bad) because the stock market took it on the chin on Friday. Why? Well, adding 200,000 plus jobs and missing the target on the upside is really a downer for the market because traders think that this one single data point will influence the Fed to increase rates not only in May, but at the end of June as well. At least this is what was reported ad infinitum, ad nauseum, all day. Now admittedly, the gnomes at the Fed have fallen in love with the Phillips Curve which, for those who may not have suffered through Economics 102, contends that when the unemployment rate falls below a certain point, wages will be driven up and that will become inflationary. Apparently, these same Phillips Curve watchers are too busy staring at the "Curve" to read other statistics which show us to be in world-wide competition; if labor costs get out of line here in the US, someone else, someplace else will start making it cheaper. Oh, and by the way, while all of this was happening on Friday, our elected representatives decided to take a two-week break for Easter (heavens, Easter? We thought that governmental bodies were taking Easter off—the calendar, that is.) and decided that they'd address the immigration issue (which, by the way might help to solve our labor problem, if, in fact we have one, couldn't it?) when they returned.

So why did the market really take a dive on Friday? We have a sneaking suspicion that it really didn't have a lot to do with new job creation, the drop in unemployment and the benign report on wages. We think it had a lot to do with another item that was, at best, under-reported and that was our now vacationing elected representatives decision to take a pass on the renewal of the President's tax legislation which is currently set to expire in 2008. Sure, maybe it will be taken up again when our poor hard-working legislators return, well-tanned, to Foggy Bottom after the Easter Recess (does the sun shine throughout the lower 48 like it does in Florida, Arizona and Hawaii?) but, in the meantime, uncertainty was created and if there is anything that market participants don't like it's uncertainty.

And that brings us to Steve Leuthold. Steve is one of our favorite market sages. He is certain that he is contrarian and concerned. One of the reasons we like him is that he breathes the clean, clear, cold air of Minnesota rather than the befouled air east of the Hudson or the smog of LA or the fog of San Francisco. We've repeated it here often, and will do so again for our newer readers, a study put forth several years ago by then Senior Market Strategist for Credit Suisse First Boston, Michael Mauboussin, in which he found that, among other factors causing out-performance of fund managers was the location of their offices. And guess what, the lion's share (whoops, we promised not to use that phrase in this context

because “lion’s share” really means “all”—it comes from the Latin version of the Aesop’s fable or so one of you has informed us) did NOT reside along the left coast or the right coast, but in fact, in the heartland of this great nation. So, in any case, Steve, in addition to being a favorite of ours and living in the far north of the heartland has a great track record of being right and putting his money (and that of his clients) where his mouth is. He’s been at the investment business for more than 40 years. *Barron’s* interviewed him recently for its April 3, 2006 issue. Sandra Ward, the author/interviewer, says that it is “surely a sign of the times when Leuthold, as keeper and dissector of just about every market statistic and indicator known to man, detects no discernible trend in the market . . . while this contrarian’s contrarian is worried about rising interest rates . . .”

Perhaps you read the interview, but in case you didn’t, here’s one of many questions and answers we thought were pretty darned good:

Barron’s: This brings us to the yield curve.

Leuthold: Talking about the yield curve inverting is like arguing about how many angels can sit on the head of a pin. A yield-curve inversion generally has had negative implications for the economy. More fascinating, *our Doug Ramsey discovered a yield-curve inversion is a buy signal for financial stocks. In the last seven inversions, from the time of each inversion, the financial sector went up about 8% relative to the S&P 500 in the following six to seven months. In absolute terms, the financials rose about as much.**

*We added the emphasis to the last three sentences in Leuthold’s answer.

Ms. Ward asked Steve whether he’d increased his weight in financials. His response was “No.” He went on to explain that his portfolios had about 9% in financials but “we’ll review it at the end of the month.” So, Steve, we hope you’re not too late.

This interview took place toward the end of March, we suspect. It precedes an earnings season during which we expect nothing but good things from our portfolio of banks. And look at the chart on page 1—the NASDAQ Bank Index was up 5.90% in the first quarter. Maybe Leuthold’s Doug Ramsey is on to something.

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