

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: May 12, 2006
Subject: Free Market Capitalism, Banks & the late Louis Rukeyser

Last week Louis Rukeyser died. He was a Friday evening fixture on TV for our parents (and for some of us) for lo these many years. For thirty-two years he helped Americans, from all walks of life, to have a greater understanding and appreciation for Wall Street. What made Rukeyser captivating to all who watched him was that he was, according to the *Wall Street Journal's* "Review & Outlook" column, "an eternal optimist." The *Journal* says "he spread confidence to many millions . . . starting in 1970." Rukeyser had his critics, however, and sometimes the label of "optimist" was hurled back at him as an epithet. The past 36 years have proved him right. He was right about the stock market being a producer of wealth, but more importantly, according to the *Journal*, he was responsible for the rise of the investor class. Many of us have a stake in the markets today through our SEP, 401(k), IRA and Keogh plans. While he didn't create any of those plans, he helped to make sure "many millions" were comfortable playing the investing game along side the professional investors who appeared regularly with him on his program. The *Journal* points out that one of his regular and consistent pieces of advice was to "not get greedy on a story about some sizzling stock." We believe, as does the *Journal*, that history has confirmed—"validated" is the word used by the *Journal*—Rukeyser's optimistic view of the American capital system. The ultimate course of the market since 1970—right in the center of the controversy created by the war in Vietnam to the center of the controversy over the war against terrorism—also validated Rukeyser's unbridled optimism and his eternal bullishness about investing in America. We, like the writers of the "Review & Outlook" on May 5th, "will miss this particular cheerleader for the next 30 years as well."

Closely on the heels of the aforementioned "Review & Outlook" column on May 5th came an interview by Stephen Moore of the *Wall Street Journal* in its new Saturday/Sunday edition of May 6-7, 2006 with Charles Koch, CEO of Koch Industries, the largest and most profitable privately held company in the U.S. We won't bore you with all the details of the interview—you may have seen it—but we were pleased to see, yet again, another successful capitalist claim to be influenced by some of our favorite political economists including the likes of Frederick A. Hayek, Ludwig von Mises of the Austrian school of economics and Joseph Schumpeter who was influenced by the Austrian school. Recently we read the text of a speech by Steve Forbes, another capitalist of note reprinted in *Imprimis*, a publication of Hillsdale College in Hillsdale, Michigan. Forbes, delivering that speech at an event sponsored by Hillsdale, cited the influence of Hayek and von Mises on him and the American economy.

Von Mises and Hayek were never discussed by professors in our economics classes and Schumpeter was treated with disdain, as was his theory of "creative destruction." Schumpeter argued that those daring spirits, entrepreneurs, created technical and financial innovations in the face of competition and falling profits—and that it was these spurts of activity which generated (albeit sometimes irregular) economic growth.

Frederick Hayek catches the attention of economists and political theorists today for his argument that "spontaneous order"—the idea that a harmonious, evolving order arises from the interaction of a decentralized, heterogeneous group of self-seeking agents with limited knowledge. That was powerful stuff in academia in the two decades following the 1950's. In fact, it still is. John Maynard Keynes was all the rage then, as he is now, in academia. Hayek totally debunks socialism and socialistic planning. And he was right.

What about von Mises? Von Mises argued that a socialist government could not make the economic calculations required to organize a complex economy efficiently. According to David Henderson (a research fellow with Stanford University's Hoover Institution and an associate professor of economics at

the Naval Postgraduate School), a biographer of von Mises, “although socialist economists disagreed with von Mises, modern economists agree that von Mises' argument, combined with Hayek's elaboration of it, is correct.” Von Mises was a strong proponent of *laissez-faire*; he advocated that the government not intervene anywhere in the economy (as we recall, this included government regulation of the banking system).

By now you are asking yourself, “what does this have to do with banking?” First, while we can't hold a candle to Rukeyser's erudition—and his ability to articulate the arcane aspects of investing and the creatures of Wall Street—we are unabashedly optimistic about the long term outlook for America, for the equity markets and for banking. Why? We've talked about this before but we think it bears repeating. We believe that:

- The FOUNDATION of a strong, free economy is a diverse and competitive banking system,
- Interested and proactive shareholders promote efficiency and good performance and
- Those factors foster a healthy banking and economic system—the FOUNDATION of a free economy.

We've held these tenets for years, based loosely on our private reading of Hayek and von Mises, and we set them down in black on white when Fortress Partners went into the investment management business in 2000. We are optimistic about banking because we operate in the largest, most free (read “unplanned”) economy in the world. America continues to be a magnet, perhaps the strongest of magnets, for capital from all around the world. The Chinese invest their dollars here not because our rates are attractive, but because our economy is the most secure in the world. As Americans we love to hate the Chinese because of their approach to exchange rates, but for all the vitriol our politicians and some businessmen subject them to, they love us. Without our diverse and competitive banking system, we'd not be that magnet for capital. America's attractiveness as a place to invest has kept our rates down over the past several years.

We've discussed before on these pages the diversity of the US banking system. It is amazing. There are nearly 8,000 banks in the US. These banks are, under current legislation which promotes branching across state lines and consolidation of charters, mostly independently owned. Is there any industry you know of with 8,000 mostly independent participants where upon the acquisition of one, another springs up shortly? Eight thousand banks across the US represent diversity not found in any other industry.

Arguably, we may have too many banks (or too many banking locations/branches). But it is clear that when a bank is sold, another often springs up to compete with the larger acquirer. We have this diversity because bankers and citizens can, provided they are able to raise around \$5 million in capital and create a sound business plan, open a bank. This is clearly a form of Joseph Schumpeter's “creative destruction”. A group of bank organizers (many of whom have come from that just acquired bank) decide that they can do it better and more efficiently and does so within a very short period of time. And who do they seek as customers and clients? Small businesses, including many which have been formed over the past decade or so and are seeking businessmen, like themselves, as lenders/advisors/“partners” in the opportunity provided only in America. These businesses, by the way, are the very same businesses which continue to create new jobs at a very brisk pace (faster, we think, than GM and Ford can eliminate them) and are leading the way in the deployment of capital to improve productivity—the conundrum which has resulted in the continuing low level of inflation.

There are those who would like to see banking concentrated in the hands of a dozen or so large banks. We wouldn't. We know that competition is good; consumers and businesses are better served by

competition. It is only because of small banks—the kind we in which we invest—that the big banks can't get away with price gouging. It is only because of small banks that small business is properly and adequately served. It is only because banks, especially small banks, that our economy grows and remains diverse. And that growth and diversity helps us to maintain our freedom. It is only because of the freedom to form new banks, and the diversity and multiplicity of those new banks flowing from that freedom, that small businesses are able to grow rapidly to create new jobs and to improve productivity.

Yes, we are optimistic about our economy, about America and about our freedoms. We share that optimism with the late Lou Rukeyser. Our optimism is based upon the foundation that markets work best when they can operate in freedom. Our optimism is further validated by highly respected capitalists like Koch and Forbes in the US who understand the underpinnings of our economy as elucidated by the likes of Schumpeter, von Mises and Hayek. Our optimism for banks is based upon the essential nature of their role in this free, capitalistic and entrepreneurial economy.

Last month we added a chart to these pages (we thought just to celebrate our 6th anniversary) but we thought it added a lot to the discussion and so we decided to keep it and up date it. If Schumpeter were alive, in accented English he would have explained his theory of creative destruction, we think, as he looked at the table below. He would note that the NASDAQ Composite hasn't quite recovered from the "destruction" (Was it creative?—Some think so.) of 2000, while small businesses and banks certainly seem to have done quite nicely, thank you. Von Mises and Hayek, and we suspect Schumpeter as well, would all observe that many of the members of the broader, small cap indices like the Russell 2000 and the S & P 600 are small companies, which by their very nature, are feisty.

Here's how those publicly trade businesses and publicly traded banks (537 of the latter) have fared:

**April 2006
 PERFORMANCE HISTORY (1) (2)**

	Inception to Date (73 Months) 3/31/00-4/30/06	Five Year Return Annualized 4/30/06	Three Year Return Annualized 4/30/06	12 Months Ending 4/30/06	4 Months Ending 4/30/06
Dow Jones Industrials	+17.89%	+ 3.36%	+12.77%	+14.16%	+ 5.55%
NASDAQ Composite	- 47.70%	+ 2.43%	+17.36%	+21.89%	+ 3.81%
S & P 500 Index	- 3.58%	+ 2.70%	+14.68%	+15.41%	+ 3.90%
S & P 600 Index (Small Cap)	+ 98.80%	+13.36%	+26.66%	+31.40%	+12.83%
NASDAQ Bank Index	+145.54%	+13.68%	+14.87%	+16.11%	+ 6.40%

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

The Fed increased rates again this week marking the 16th consecutive meeting in the last 23 months at which the Federal Open Market Committee elected to increase the Fed funds rate by 25 basis points. The message in the accompanying press release seemed to indicate that the Fed would be watching key economic indicators closely. Unfortunately for the markets in general, and banks specifically, the Fed did not imply nor state explicitly that it was "one and done," which many investors were hoping for. You know that the market was looking for just those kinds of words after parsing the minutes from last month's FOMC meeting released on April 18th and Chairman Bernanke's testimony before the Joint Committee on Economics on April 26th. The market leapt for joy after those two days, coming back down to earth a bit after Marie Bartiroma of CNBC reported that, in a casual meeting with Bernanke, he

stated that his remarks before Congress were misunderstood. It is all about interest rates, oil and commodities it seems.

Strong earnings from banks that had reported first Quarter 2006 results, have nothing to do with how investors are looking at banks or so it seems. The aggregate increase in first quarter earnings for all of the public traded banks that have reported was 12.2%. Our portfolio of banks had an average earnings improvement over last year's first quarter of 21.4%. In addition, for the banks we follow the future looks bright with excellent credit quality (though we don't think it will get much better), strong growth in loans of 17.7% and core deposit growth of 14.2%. All of that bodes well for the balance of 2006. From what we hear from our bankers there appear to be no unmanaged clouds on the horizon. Currently, our banks carry an average forward P/E of 15.3X, while the NASDAQ Bank Index carries forward P/E 18.0X. By way of comparison, the S & P 500 generated a 14.2% increase in earnings in the first quarter with a forward P/E 15.4X.

We like the idea of selling at a price to earnings growth ratio (PEG) of .71 rather than a PEG of 1.08. How about you?

FORTRESS

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