

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: July 11, 2005
Subject: Too Good to be True?

Some of you may remember L. William Seidman. He headed the FDIC during the thrift crisis in the '80's and did a very credible job of managing that agency for the benefit of the FDIC Insurance Fund and the bank and thrift industries. We keep an ear and an eye on CNBC during the day so we get to see him from time to time. He is chief commentator for the network, generally commenting on economic and monetary affairs. As you may recall, he headed an accounting firm in Michigan which became BDO Seidman, one of the top 10 accounting firms in the US. Before joining the Reagan administration as chairman of the FDIC, he served as vice chairman and chief financial officer of Phelps Dodge and dean of the college of business at Arizona State University in Tempe, Arizona. He is also publisher of the magazine, *Bank Director*.

He was recently asked to comment on the American banking system by a reporter from *The Asian Banker*. We thought what he had to say about our banking system was important enough to be included in this month's E-Memo.

According to Seidman, "we are currently experiencing some of the most favorable conditions we've seen in years... The impact on the nation's banks has been remarkable, as we now have record capital; record profits; a record number of total assets (\$10 trillion); the lowest number of problem banks; and the lowest percentage of nonperforming loans (NPLs). Given this scenario, one might be tempted to say the U.S. banking system looks so strong, *it's almost too good to be true.*" (italics from the writers of this E-Memo)

Apparently many brokerage analysts don't have access to the same data sources that we or Seidman look at because to read or listen to them you'd think the only way that banks can make money is when the yield curve is steep and they can ply the so-called carry trade—borrowing short and lending long. Or you might think the residential housing business was about to blow up (the housing bubble is about to burst) and that you ought to run away from banks. As you might expect Seidman had some thoughts on that subject, having lived through such a period when he ran the FDIC and later the Resolution Trust Corporation. He thinks that it is unlikely that the problems of the 1980's will resurface in the next economic cycle and here's why:

- **Construction loan activity at banks is much lower** than it was 20 years ago. That's important because that was the "genesis" of much of the asset quality problems commercial banks faced in the '80's.

While some of our banks are more heavily involved in construction lending than others, we find that their loan to value ratios are far lower than they were in the early to mid-eighties.

- **Adjustable rate mortgages** are today the preferred way to participate in the financing of housing by commercial banks. Seidman points out that adjustable rate mortgages were illegal as late as the '70's making it impossible to avoid inflation driven interest rate crunches.

As the cost of funding changes for a bank, rates adjust accordingly on these mortgages allowing a bank to protect its net interest margin.

- **The impact of inflation** on bank and thrift fees and profits is **hardly noticeable**. Again, unlike the era we lived through in the '80's.
- Most importantly, according the Seidman is the **quality of bank and thrift leadership**. These are bankers who learned their lessons well in the '80's and '90's. These are today's bank presidents.

Across the board, we see in the banks in our portfolio very high quality managers who have an understanding of risk born from experience—the experience of the '80's and '90's. In fact, quality management is of significant importance to us. It is one of our major qualifications to get into our portfolio.

Seidman concludes that the **conditions which caused the problems in banks 15 to 20 years ago are not present today and are not likely to be present in the future.** This does sound like it is too good to be true. Investing in banks must have some pitfalls, right? As the wag once said, "If it's too good to be true, it probably isn't." And when asked whether there were any issues that worried him and worried US bank regulators he responded with the following:

- **Monster banks.** Like JPMorgan Chase, Citigroup and others. Why is he worried about them? Simply because they are difficult for regulators to supervise and if they do fail, they will be too difficult to take over because of their business complexity and scale.

You'll recall that we like to invest in micro and small cap banks because we can understand them. They are easier, much easier for regulators to supervise. That reduces a lot of investor risk. Their business models are easy to understand, their business plans are straightforward—what you see is what you get! While Seidman's interview took place before the "monster bank", B of A, announced the acquisition of MBNA, we wonder what he had to say about that. We can think of more reasons to avoid that acquisition than to make it. It alone could fill up pages of commentary.

- **Home equity lending.** According to Seidman this is the fastest growing item on banks' balance sheets. These loans, he says, put the borrower at risk of losing his home if he can't repay the loan. He also sees a trend to refinance credit-card debt with home equity loans, which drastically increases the risk of bankruptcy for consumers.

*The banks in which we are interested are **commercial banks** and as such generally provide home equity loans only as an accommodation to their commercial customers. We agree with Seidman regarding the dangers of excesses in home equity loans. However we don't see such excesses in our banks.*

- **Derivatives.** These are alternative investments found in the portfolios of the largest banks though. Many of these investments have been untested in an economic downturn. They have become the favorite play toys of large hedge funds and the likes of Fanny Mae and Freddy Mac are issuers of these toys and banks are buying them.

We'd be remiss if we didn't point out that some smaller banks have been seduced into investing in derivatives as well. We'd like to point out that not all derivatives are created equal and some of them, if properly structured and well understood by the CFO or CEO of the investing bank, can play an important role in the bank's investment portfolio. Regulators are effective in influencing bank executives and directors of smaller banks to understand what they are investing in. We engage in similar conversations ourselves with bank execs to assure that they adequately understand the derivatives in which they are investing.

- **Consumer savings.** Seidman is worried about the low level of consumer savings which he and many others believe could act as a cushion for consumers in a down turn.

We don't think this is as much a banking problem as it is a national economic issue. Moreover, we believe that savings have taken different forms in recent years than those measured on bank balance sheets. These include investments held in IRAs, Keogh Plans, 401-b and 403-b plans, life insurance, annuities and home equity and investment brokerage accounts, just to name a few.

- **Current good conditions.** Yes, current good conditions can breed complacency and complacency can result in bad loans. After all, bad loans, according to Seidman are made in good times.

We certainly agree but, having said that, we need to point out that it wasn't only real estate construction loans which went bad in the '80's and early '90's. There were plenty of foolish commercial loans made as well. The same managers that received their baptisms of fire in real estate construction during the last 15 or 20 years were also there for those bad commercial loans and they are the one's who have established the hard nosed credit culture we seek when we invest in banks.

Seidman provides an upbeat conclusion however: "We are enjoying an unprecedented run of high performance for the U.S. banking industry. We've learned a lot from past mistakes, both community and large banks are standing up to national and global market competition, and directors understand their responsibilities and duties better than ever before. As long as we keep our eyes open and our ethics high, banking's past will not become [its] prologue."

We couldn't agree more with Seidman's assessment of the banking industry today. Certainly not all banks will remain unscathed. We aren't perfect and sometimes a bank in which we are invested suffers from a lapse in internal controls which causes a sharp drop in earnings. However, if we have made an accurate judgment regarding management, we can rely upon them to turn things around quickly. Such a capability is more likely to be found in smaller banks which tend to be far more flexible than their larger brethren. They are far better able to respond quickly to any issues which arise on the competitive front or on the asset quality front. That's another reason why we like to invest in small banks.

Finally we would be remiss if we didn't again point out to you that selling in May and going away would have been a bad move for the months of May and June and, so far in July. The chart below illustrates our advice:

	NASDAQ Bank Index	America's Community Bank Index
May	+3.51%	+4.23%
June	+2.91%	+3.49%
July (through the 8 th)	+3.55%	+3.52%

Small banks have rallied, according to the indexes by 9% to 10% since bottoming in April. We believe this show of strength is reflective of the commentary set forth above by Bill Seidman and our continuing confidence in the vibrancy and vitality of the US banking industry. We believe that this month small banks will again show their strength by reporting solid increases in earnings, loans and deposits for the quarter ended June 30.

Too good to be true?

FORTRESS

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