E-MEMO

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
DATE: August 9, 2004
SUBJECT: Observations on the June 30, 2004 Quarter and its Meaning for the Balance of the Year

The sun shone brighter on banks this past quarter than in preceding quarters. Over the preceding quarters we'd witnessed shrinking net interest margins because our banks were asset sensitive. This meant that their balance sheets were positioned for rates to increase, but as a consequence, they were likely suffering flat or shrinking margins. This quarter also saw some modest margin shrinkage, but several of our banks reported margin improvements and, when listening to their remarks on earnings conference calls, we saw sun shining through the clouds as we heard management teams suggesting that margins should stabilize, if not improve, for the balance of the year as market interest rates edge higher. The Fed raised short-term interest rates 0.25% at the end of June, but it was too late to impact the second quarter results. The impact of that rate increase, as well as those anticipated to occur yet this year, should benefit future earnings.

Our observations relative to bank net interest margins:

- Margins should improve because of asset sensitivity, meaning that asset yields will rise faster than funding costs, as general market interest rates trend higher;
- Asset sensitivity has been ratcheted up by a number of banks which means that margin improvement should be even more noticeable in ensuing quarters;
- Bank loan demand will increase as the economy improves, the increase thereby weighting the mix between loans and investment securities more heavily to higher-yielding loans, which will also have a positive impact on margins; and
- Problem loans should continue to shrink as we observed with a number of our banks so far this year. This, too, will work to improve margins (since banks don't accrue interest on most problem loans).

As we looked at loan growth, we saw almost across the board double digit increases in loan growth year over year. This was more apparent at smaller banks than at the large regional banks, but even there we heard the nearly unanimous opinion that we had reached what one analyst termed an "inflection point for commercial loan demand." We also are hearing from our banks and others we know that their commercial borrowers are calling to reset their loan relationships and credit lines in anticipation of expansion and increased levels of capital spending.

What does this mean for the future? How will it impact bank stocks? In which banks should we be investing? What does the flattening yield curve mean for bank stocks versus the S & P 500? We have our own answers to some of the questions and some we have, quite frankly, borrowed from Bob Albertson, the Chief Strategist for the financial services brokerage firm Sandler O'Neill and Partners in New York.

Earnings for nearly two-thirds of our banks improved an average of 8.7% for the quarter, while for the first six months, the increase was 11.5% for more than 70% of those same banks. Slightly more than one-third of our banks, showed an average decline in earnings of 13.5% for the quarter while for the first half, less than 30% showed an average decrease of 9.8%. Of those declines, most if not all came as no surprise to us and were generally reflective of non-recurring items, meaning that in the next quarters, earnings should be back on track. We believe that as the economy improves and short-term interest rates climb, earnings will continue to improve but at a more rapid rate than in the recent past.

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According to Bob Albertson, bank investors should be focused on banks with a substantial commercial banking component. We certainly agree and have been in that camp for some time. Because our banks are generally so-called "community banks," most have a consumer component, but that component is generally outweighed by the influence and impact of these banks' commercial business.

As short term rates increase more rapidly than long term rates, the yield curve will become more flat. As that happens, according to Albertson, the bank index should beat the S & P 500 (as it has for all 11 instances over the past 25 years when the yield curve began to flatten). Finally, according to Albertson, the banking sector is a long way from a peak.

During the week just finished, the equity markets took a real dive. Banks were not entirely unscathed by the decline, but they held up relatively well this week, and for that matter, for the first seven months of the year. Why? Well, just in case we haven't made this argument before, our records show that the bank index, meaning generally, banks, have a low correlation to the broader equity markets, as both the year-to-date and first week of August numbers below show. Our research shows that our (Foundation's) correlation to the broad equity market, as represented by the S&P 500, is only .39, for the life of the fund through July 31, 2004, even lower than that of the NASDAQ Bank Index (0.59). For those non-statisticians among us, 1.0 is perfect positive correlation. The following chart shows actual performance of the indices versus Foundation Financial Partners for the year and week (one of the worst this year):

RECENT MARKET INDEX PERFORMANCE

	Year to date as of 7/31/04	First Week of August, 2004
FOUNDATION	**-0.87%**	**-1.17%**
Dow Jones Industrial Average	-1.91%	-3.17%
NASDAQ	-5.57%	-5.84%
S & P 500	+0.14%	-3.40%
S & P 600 (Small Cap Index)	+4.02%	-5.49%
NASDAQ Bank Index	+0.40%	-1.99%

Not surprisingly, we at Fortress Partners continue to be bullish on banks. As you know, not all banks perform equally. To paraphrase the late, great political cartoonist/satirist, Walt Kelly, all banks are created equal but some are created more equal than others. As we see it, all banks have similar opportunities, but some succeed in exploiting their opportunities more successfully than others. Our job at Fortress Partners is to find those banks and invest in them on your behalf. That is a never ending task here in Hartland, Wisconsin.

Last year, as some of you may recall, we recited some interesting fund performance numbers:

In the July 15, 2003 edition of the *Consilient Observer*, Michael Mauboussin, Credit Suisse First Boston's market strategist, discussed his research on the underperformance of investment managers and points out why he thinks they have under-performed.

Mauboussin found that 70% of all active managers have underperformed the market (defined as the S & P 500) over the previous 5 years and 75% underperformed for the last 10 years. I think that no matter how you cut it, those percentages are astounding. Furthermore, Mauboussin found 31 general equity funds which managed to outperform the market for the past 10 years, from 1992 through December 31, 2002. These funds, he found, share four common characteristics (italicized) which set them apart from most other funds:

1. *The 31 funds all have lower than average portfolio turnover.* Those of you who have been a part of Foundation Financial Partners for a while will note that you have had some of the same names in the portfolio for a long time, some even going back over three and one-half years (**now over four years**) to our very beginning. Low turnover means higher profits for investors as a general rule but in some periods means less than attractive performance.
2. *They have above average portfolio concentration.* That is a hallmark of Foundation with a total of 24 names, 7 of which are trust preferred issues, the rest common share issues (**both still the same**).
3. *They have a value bias rather than a growth bias*. Though bank earnings have grown faster than those of industrial companies, most bank and thrift stocks are, and remain, a value play.
4. *They tend to have their offices outside of New York or Boston.* Enough said.

We think those observations still hold true. How about you?

Finally, our results, such as they are for the month:

July 2004
PERFORMANCE HISTORY (1) (2)

	Inception to Date (52 Months) 3/29/00-7/31/04	Three Year Return Annualized 7/31/01-7/31/04	Twelve Months Ending 7/31/04	Year to Date As of 7/31/04
FOUNDATION	**+ 129.74%**	**+17.62%**	**+13.12%**	**-0.87%**
Dow Jones Industrial Average	+ 1.06%	**+ 0.90%**	+12.16%	- 1.91%
NASDAQ	- 58.05%	**- 1.92%**	+ 9.29%	- 5.57%
S & P 500	- 21.49%	**- 1.48%**	+13.16%	+ 0.14%
S & P 600 (Small Cap Index)	+ 38.75%	**+ 7.92%**	+21.52%	+ 4.02%
NASDAQ Bank Index	+ 106.23%	**+ 12.04%**	+14.25%	- 0.40%

(1) **After** management and other expenses but **before** charges for Performance Allocation; indices and Fund performance include the reinvestment of dividends.
(2) The performance information has been prepared and presented in compliance with the Performance Presentation Standards of the Association for Investment Management and Research (AIMR-PPS®), the U.S. and Canadian version of the Global Investment Performance Standards (GIPS®). AIMR has not been involved in the preparation or review of this information.

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