E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: August 10, 2005
Subject: Are You Overweight?

It's no secret that Americans are growing—out that is. Government statistics say that two-thirds of us are overweight. Think that figure is inflated? Consider the following anecdotal evidence:

- The FAA recently instructed airlines to add 10 pounds per person to estimated passenger weights for determining compliance with airplane take-off weight limits.
- One of the reasons that the Boston Red Sox decided to rebuild Fenway Park was that the old seats were too narrow for today's fans; the new seats are four inches wider.
- Today's size 10 was sold as a women's size 14 in the 1940s.

Many of us (including your humble scribes) would, no doubt, do well to skip dessert and spend more time in the gym, but there is one area where we think being overweight can be good – being overweight bank stocks in your investment portfolio.

Although we have been signing the virtues of small-cap banks and thrifts for a long time, we are always happy when others, especially successful money managers, come out in support of our views. Last week the Wall Street Journal published a story called "Finding Value by Standing Pat" which featured Davis Advisors and its chief portfolio manager, Christopher Davis (*WSJ*, page D-1, 8-1-05). Davis manages over $35 billion in two mutual funds and employs a "value" strategy that emphasizes buying quality companies in reliable industries and holding on to them for a long time. Davis' portfolio turnover routinely runs in the single digits, while the average US equity mutual fund has a turnover rate of 89%, according to Morningstar, Inc. To laymen, that means that the average mutual fund manager changes the majority of their holdings every year, incurring trading costs and, quite frequently, triggering potential tax costs. (In late 2003 we cited Michael Mauboussin, investment strategist at Credit Suisse First Boston who pointed out that of the funds he studied, the 31 top performers for the decade ending 12/31/02 had four common characteristics, one of which was low portfolio turnover.) Davis' family and his firm's employees are its fund's largest shareholders, with investments of more than $2 billion, so expenses and taxes are something they pay attention to. Davis' approach has served its investors well as the funds they manage have nicely outperformed the broader market over time.

What really caught our eye, however, was that Davis's fund's portfolios are **significantly over-weighted in banks** and other financial stocks. At over 40% of their assets, the funds that Davis manages have about twice the market weight invested in banks and other financial services stocks. The fund's holdings of "growthy" sectors like technology and healthcare are, and have been, virtually nonexistent.

Why? Davis makes the following points about banks and financial services stock:

Banks are a nonobsoletable business. No matter what happens to the economy or interest rates, virtually all of us will be a customer of banks and other financial businesses. Delivery channels have changed over time with the advent of on-line banking and ATMs replacing bank tellers, and the mix of banking products is expanding (think debit cards, home equity loans, and the profusion of different mortgage loan options) but the banking system is essential to the functioning of the economy. Try to imagine conducting any kind of commerce without banks and the payments system!

Microsoft founder Bill Gates, once called the banking industry a "dinosaur" that was headed for a decline (which is funny because banks are big users of Microsoft software). While Bill may be a software expert, it's apparent that Bill "don't know banks." As baby boomers age, the demand for financial products and services will rise and banks will continue to offer the products and services that customers need, delivered in the way they want.

There is plenty of diversity within the financial sector. Investors seem to want to lump all financial stocks together, but there is actually a great deal of diversity within the industry. Banks, insurance and brokers comprise the primary industries within the financial sector, but there in plenty of diversity within those industries. Within the bank sector there are the behemoths like Citigroup and Bank of America, there are regional banks and a plethora of community banks. Some banks focus on niches like credit cards, small business lending, mortgage banking or customer ethnicity. Others concentrate on trust and asset management and private banking. Some banks deliver services through traditional brick and mortor branches, others are virtual banks, conducting most of their business on-line. Additionally, there are banks in every region of the country and many are engaged in international markets as well.

Banks operate in a vast industry, where even the biggest global players have relatively small market share and plenty of room for growth. Although the US banking market is dominated by the top 50 banks, no single banking entity has more than 10% of total domestic deposits. Contrast that with the automobile industry where the "Big Three" control 71% of the market or the US soft drink market where Coke and Pepsi hold a combined 75% market share.

Davis points out that he likes financial stocks because, **"They also tend to be relatively cheap."** Financials represent about 22% of the market cap of the S&P 500 Index, but about 30% of the index's earnings. In the past, we have shown, using figures from the FDIC and the Commerce Department, bank earnings have grown at least one-third faster than U.S. corporate earnings over nearly any time horizon in the last 40 years. In essence, bank stock investors are able to buy a high quality and faster growing earnings stream at a discount to the market.

Finally, **banks and other financial stocks tend to be generous dividend payers**. Like us, Davis thinks that dividends encourage managements to be more disciplined in allocating shareholder capital, leading to stronger price appreciation over time. Add in the fact that dividends are tax-favored, with a maximum federal tax rate of 15% and that banks have, as a group, have grown dividends by over 10% annually over the past 10 years and we think you have a recipe for tasty returns in bank stocks.

Yes, we are unabashedly bullish on banks. We hardly ever fail to be otherwise. We are long term investors not sector rotation specialists. Each of us are personally overweight banks—even more so than Chris Davis. Our skin is in the game. We've put our money where our mouths are.

So, go ahead, BULK UP!!—on bank stocks that is.

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