

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Bob Ollech and Jon Bruss
Date: September 19, 2006
Subject: The Consensus is (Mostly) Wrong

Many investors, both professional and individual, place great credence in the predictions of market "experts" when shaping their investment strategies. Hundreds of billions of dollars are positioned and invested based on the thinking and outlook of Wall Street's top investment strategists. The views of these "experts" are always interesting and informative, but it seems to us that few investors ever look back to see if the strategists got it right.

In December of each year, *Barron's* produces an issue focusing on the investment outlook for the following year. At the end of 2005, *Barron's* surveyed 12 strategists from leading Wall Street firms to get their outlook for 2006. Collectively, these strategists have more than a dozen advanced degrees, are supported by staff with diplomas from some of the country's top B-schools and budgets of millions of dollars to spend on research. While their salaries may not reach the level of Wall Street's top investment bankers and traders, most earn more than enough to afford a nice apartment in New York and a week-end home in the country. Collectively, their opinions must reflect the keenest investment thinking available, right? We'll let you decide based on the results below:

Stocks The 12 experts were asked to make predictions about the stock market, including forecasting the return of the S&P 500 Index for 2006 and identifying the segments and sectors of the market they expected to perform best. What did they say? And how have they fared so far this year? Projections for the S&P 500 at year-end 2006 ranged from 1125 to 1530 (a mere 36% spread) with the median forecast of 1362, an increase of roughly 9%. *The long-term average annual return from stocks has been about 10%, so that was hardly a daring forecast. Where are we now? At the end of August, the S&P 500 was at 1320, equating to a total return of 5.8% year-to-date. Perhaps the "experts" will get close on this one.*

All 12 of the "experts" were confident that large-cap stocks would outpace small-cap stocks this year because large-caps were "cheaper" relative to small-cap stocks and small-cap stocks had "had their run." (A similar group of strategists held that same view at the beginning of 2005 and small-cap stocks trounced big-cap stocks by 2.8% last year.) Through the end of August, the S&P 500 had a total return of 5.80% while the S&P 600 (small-cap stocks) was up 5.79%. Statistically, a dead heat. *Longer-term, small-cap stocks have been the place to invest. Since 1973, small-cap stocks have outperformed large-cap stocks by over 3% annually. Micro-cap stocks, the smallest of the small-caps (where we prospect for our bank stock investments), have done even better, beating large-caps by over 6% per year over the same time frame.*

What sectors did the experts think would garner the best returns for the next 12 months? The top three sectors picked by the experts were: Healthcare, Technology and Financials. What's the score so far this year? According to Standard & Poor's, through the end of August, Financials are up over 10%, the Materials sector is up 7.49% and the Consumer Staples sector is up 5.39%. The Technology sector is down 2.71% and Healthcare is off 2.07%. At least the "group-think" got one sector (financials-our favorite) right. Not a single strategist even mentioned the second best performing sector, Materials.

Interest Rates Each of the strategists was asked to make predictions as to the Federal funds rate at the end of June 2006 and to project the rate on the 10-year Treasury bond at year-end. Forecasts for the Fed funds rate (which was 4.25% at the time of the survey) were tightly grouped in a range from 4.00% to 5.00%, compared to the actual rate 5.25% at the end of June. Apparently, the experts "read the tea leaves" differently than the Federal Reserve. Forecasts for the 10-year Treasury ranged from a low of 4.00% to a high of 5.30%. Today, the 10-year Treasury rate is about 4.82%, having been as high as 5.25% and as low as 4.35% so far this year. We suppose most of the strategists will claim they still have time to be proven right, but we doubt that is any comfort to the investor who bought a slug of 10-year bonds at a 4.5% yield at the beginning of the year based on several strategist's views that rates were heading down from there.

Need more evidence about the futility of predicting interest rates—by “experts” or otherwise? Consider this: Twice each year, the *Wall Street Journal* solicits a host of economists for their predictions of interest rate trends and targets. *Wealth Manager* magazine recently evaluated more than 20 years of that data and found that the collective consensus estimate of the economists was correct only 30% of the time regarding the **direction** of interest rates, much less the actual absolute interest rate level, 12 months out. Overall, the experts’ accuracy has been dismal, at best.

So what does all this tell us? Burton G. Malkiel, a professor of Economics at Princeton, concluded in his seminal text on investing, *A Random Walk Down Wall Street*, that changes in securities prices have the same distribution and are independent of each other, so anyone who bases their predictions of future stock and bond prices on past trends does so at their own peril. His view reflects the efficient market hypothesis, which says that all relevant information about a security is already known and is reflected in its current market price. Only by accepting more risk can an investor expect to gain higher returns. More simply, highly-paid “experts” have no better ability to predict the future of the broad stock market returns or interest rates than a dart-throwing monkey (and the monkey will work, literally, for peanuts).

So what is an investor to do? In short, the answer seems to be to “stick to your knitting,” or more simply, invest in what you know. Even stalwart supporters of the efficient market hypothesis begrudgingly acknowledge that there are areas where the efficient market theory simply can’t explain investment results. We believe that investing in small and micro-cap banks is one of those areas where investors can actually achieve above market, risk-adjusted returns. Over the last 10 years, the NASDAQ Bank Index has provided a total annualized return (including dividends) of 14.07%, compared to 8.31% for the S&P 500 Index. The annualized standard deviation of those returns has been about 15% for each index. What does that mean? At the most basic level, simply more return for an equal amount of risk. (See “*Special Edition - Hedge for Your Portfolio*” in the *E-Memo* section of our web-site www.fortresspartners.com for more on this subject.)

How is that possible? The small and micro-cap bank universe is not widely followed by securities analysts and many of the bankers are reluctant to talk to outside investors. Accordingly, relevant information can be hard to come by and may be even harder to interpret. Average daily trading volume is often only a few thousand shares. Bank financial statements do not lend themselves to “traditional” analytical techniques and keeping track of changes in banking regulation and assessing their impact is not something most investors are equipped to do. Successful investing in small and micro-cap banks takes special expertise—expertise rarely found anywhere except among those who have formed and managed banks and regulated those same institutions. That expertise is found at Fortress Partners, where we are dedicated to utilizing what we know about banks to create attractive *risk-adjusted* investor returns. And we don’t know it all and never will—we hope, so we continue our studies, working as hard as we did as undergrads and in graduate school to hone and expand our skills and knowledge as *America’s Bank Investor*.

Financial stocks currently comprise about 23% of the total equity market capitalization and our educated guess is that most investors have a lesser portion of their portfolios allocated to financials. If your portfolio is “bank-light” and in need of attractive *risk-adjusted* returns, we can help. Please call us for more information.

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