

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: September 18, 2007
Subject: Trust and Transparency

So now what? A question I'm sure many of you, investors, clients and readers would like to ask and have answered. We've elected to write this before the Fed's much anticipated announcement at its FOMC meeting in September in the unlikely case that you would be surprised by the action taken—or not taken. We've read the Fed Chairman's August 31st speech at the Federal Reserve Bank of Kansas City. In that speech, we believe he clearly set the table for a rate decrease this month. In that speech he took pains to focus on the mortgage market and housing with negative references and effects at least 22 times. Chairman Bernanke then mentioned the potential adverse impact of all these on the broader economy 19 times. He impressed us with the fact that the Fed is "paying attention", contrary to what the press seemed to think. And when all is said and done, whether it's a one-quarter percent cut or a one-half percent cut, the impact on the economy will likely not be felt for 12 to 18 months—and after all the hullabaloo, the real culprit needing our focus, according to many economists and retired Fed chairman Alan Greenspan in recent interview (CNBC/NBC 9/17/07), *inflation*, may end up getting a *boost* from the rate cut. We need to be careful what we wish for!

And how does this impact banks? Well, from our perspective, we are living in a period of credit and debt market turmoil rarely seen—perhaps the last time was 9 years ago in 1998 when, on the heels of the Asian Debt Crisis, Long Term Capital Management (LTCM) collapsed. While the overwhelming majority of banks in the US had no investment in LTCM or held no debt of any Asian sovereignty or corporation, *all* banks saw the impact of those events and suffered through them. Bank stock prices, as measured by the NASDAQ Bank Index, plummeted 26.8% from June 30, 1998 to October 7, 1998. From October 7, 1998 to December 31, 1998 prices rebounded 19.3%, recovering a portion of their loss for the year. Treasury yields dropped dramatically as well, falling from around 5.4% in late June to a low of 4.16% on October 5, 1998, a drop of 23.3%—only days ahead of the low reached by the NASDAQ Bank Index on October 7. The yield bounced back to 4.65% by December 31. The flight to quality in 1998 is similar to what we are observing in the debt and credit markets today. Most small banks have little, if any, exposure to sub-prime and Alt-A loans. However, the flight to quality appears to have been triggered because the yield on the 10 year note has fallen by 13% since its peak of 5.16% on July 9 to its nadir of 4.34% on September 10, 2007.

NASDAQ Banks caught the sub-prime flu earlier in the year (late February), and have, as a group, declined, 12.75% year to date through September 10, 2007.

In both 1998 and 2007, the fundamentals of banks, especially the measures of credit quality, were, and remain, sound. However, in 2007 we are coming off a period of extremely low loan delinquencies—a period of time which could not continue forever. Hence, we expect, as does the market, some increase in stress on banks as some of them work through cyclical credit issues. These credit issues are, however, not sub-prime related.

Sub-prime delinquencies and foreclosures seem rather benign in and of themselves because none of us is a sub-prime borrower. However, foreclosures are approaching record levels in many regions of California, Florida, Nevada and Arizona. Isolated though they may be, the whole matter has been exacerbated by the securitization of these mortgage loans and the slicing of such pools of loans into tranches ranging from AAA-rated to BBB-rated to residual/equity-like tranches. The rating agencies made assumptions about these loans that failed to fully take into consideration teaser rates and house purchases by non-owner occupied house speculators, among other things. Hence, sub-prime mortgage securitizations became toxic waste followed shortly thereafter by Alt-A and then prime jumbo mortgages such as those originated and purchased by Thornburg Mortgage and other highly respected firms. As the markets for these securitizations seized up (think of trust and transparency as the components of the lubricant for the credit market engine), the market assumed that anything that made loans was or would be injected with the sub-prime toxin (after all that's what Jim Cramer, the stock maven from CNBC repeatedly said) and soon all

kinds of corporate debt and credit issuance, including bank issued trust preferred shares, came to a screeching halt. The market was, and to some degree is, characterized by panicked sellers and reluctant buyers—but buyers to be sure at a price.

And that is where we are as this is being written. However, First Tennessee (FTN) and KBW elected to create another pool of bank and insurance company issued trust preferred shares last week in order to test the market—break the ice, so to speak. As of the close of noon today all but 3% of this pool had been sold. The fact that over 97% of this pool has been sold is a positive event in our view. It required some discounting by FTN and KBW to get it to this point ; but it is thank goodness, a step along the path to a return to normalcy--a return to the sanity that has characterized this market in the past.

Word on the Street is that others are about to follow suit with new pools of bank issued trust preferreds (and around noon today we recieved news that Cohen Brothers was in the process of marketing another pool). This market, following the age old admonition of “physician, heal thyself” is beginning to heal itself. We believe it speaks volumes regarding the strength of the markets, their resiliency and yes, the resiliency of the US economy.

But, first and foremost, it speaks loudly of the importance of transparency and trust. Could anything like this have been pulled off in the sub-prime securitization markets? Probably not. Why? We’d look to transparency and trust which, we believe, characterize the small banks in which we invest.

Transparency? Sure. As we’ve talked about that on these pages in the past, all U.S. banks and thrifts are regulated. State chartered banks are examined for safety and soundness by the state banking authority granting the charter and either the FDIC, the Federal Reserve or the OTS. National banks are covered by the Office of the Comptroller of the Currency. Examinations are scheduled on a 12-18 month cycle. In addition, banks file complete quarterly financial statements with their respective federal regulators each and every quarter. Speaking from an ex-bankers experience and the experience of an ex-federal regulator, those statements are reviewed regularly and, if appropriate, will trigger a phone inquiry from the review examiner to the CEO or CFO of the filing bank. Transparency? You bet! A key reason why pooled bank issued trust preferred shares can again be issued.

So where does trust come into this picture? What role does it play as a component of the lubricant of credit markets? The Merriam-Webster Dictionary defines trust as:

1 a : assured reliance on the character, ability, strength, or truth of someone or something **b** : one in which confidence is placed

2 a : dependence on something future or contingent : **HOPE** **b** : reliance on future payment for property (as merchandise) delivered : **CREDIT** <bought furniture on *trust*>

3 a : a property interest held by one person for the benefit of another **b** : a combination of firms or corporations formed by a legal agreement; *especially* : one that reduces or threatens to reduce competition

4 *archaic* : **TRUSTWORTHINESS**

5 a (1) : a charge or duty imposed in faith or confidence or as a condition of some relationship (2) : something committed or entrusted to one to be used or cared for in the interest of another **b** : responsible charge or office **c** : **CARE, CUSTODY** <the child committed to her *trust*>

We’ve highlighted the meaning we see as applicable to banks. First of all, there’s systemic trust—*the assured reliance on the character, ability, strength, or truth of someone or something*. The regulatory system is *something* in which we have learned to place trust; we’ve learned to rely upon the system to protect us as depositors AND as investors. To be certain, regulators are human. They can err. But the regulatory system has enough checks and balances in it to assure that such errors are *de minimus*. We trust the system to cause reliable and accurate financial statements to be produced on a quarterly basis—statements upon which we can rely to determine the condition of banks (they’re called “statements of condition”) and we rely on the authority of the regulatory body to stop unsafe or unsound banking practices before they become fatal.

Second, we rely on the *character, ability, strength* (and *truth* or honesty) of the management of the bank. We've often said that though it is invisible, the word "trust" is engraved in stone over the entrance to a bank. Sure, there are unscrupulous individuals in every business, including, unfortunately, banks, and despite federal background checks and fingerprinting, some have crept into the system. But we believe that history and experience have are reliable resources upon which to make a judgment on the character, ability and strength of a bank.

We believe that the transparency of the system and the trust in the system and in its participants provide for a unique investment opportunity today as the credit and debt markets are roiled and the prices of bank stocks are spoiled.

As bank stocks begin their climb back, the opportunity for investors to add to their holdings in bank equities or to begin anew in building a portfolio of banks has arrived.

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