

## E-Memo

**TO:** INVESTORS/MEMBERS AND FRIENDS  
**FROM:** Jon Bruss and Bob Ollech  
**Date:** November 14, 2006  
**Subject:** As the (Banking) World Turns

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We've never been wrapped up in daytime soaps except as played out on Bloomberg TV and CNBC on weekdays. We couldn't help think about the title of this soap as we are reminded of how fickle the markets can be regarding industry sectors. Naturally we're talking about banks—our sized banks in particular. As you know, we are investors in micro- and small-cap banks and thrifts. Those institutions are generally found traded on the NASDAQ and a smattering on the American Stock Exchange.

As part of our August E-Memo we focused on some fascinating statistics from *Investor's Business Daily (IBD)* which we'd like to update to make our point regarding the importance of banks in your investment portfolio. *IBD* separates the broader market into 197 industry groups. *IBD* regularly ranks 197 industry groups by recent relative price performance with "1" being the best and "197" the worst. The banks and thrifts in which we invest fall into the groups in the following table. Three other banking groups listed by *IBD* are not in our bailiwick: Super-Regional Banks, Money Center Banks and Foreign Banks.

Bank Location/Sector (#)	5/12/06 Rank	6/16/06 Rank	8/11/06 Rank	9/15/06 Rank	11/13/06 Rank
West/Southwest (95)	146	45	14	14	81
Southeast (153)	155	83	40	51	116
Northeast (135)	162	79	47	66	132
Savings & Loans (155)	157	108	69	73	115
Midwest (78)	179	140	97	111	155

The changes between August and September are modest though the changes from mid-May to mid-June are quite significant. We are somewhat at a loss to explain just what went on between mid-May and mid-June just as we find it difficult to explain what took place between September and November. We have noticed however that as the percent of banks and thrifts hitting new 52 week highs exceeds 16% of all NASDAQ stocks hitting new 52 week highs, NASDAQ bank stocks in general are on the move, first hitting 15%-16% of NASDAQ Composite new highs which is roughly their representation in the Composite then growing to 20%, 25%, 30% and some days even higher. In early September banks were in the 20%-25% range as other groups such as REITs hit new highs. On Friday, September 15, banks represented 30% of the new highs. On Monday, November 13, banks represented 13.5% of the new highs. So what to make of all this?

If you're a trader, this makes a great deal of sense. We are investors, not traders. In the last 60 days bank analysts began repeating the mantra we've heard for the better part of the summer—the twin headwinds of a flat yield curve and increased rate competition for loans and deposits were making it difficult for smaller banks to continue to produce results such as those of the past several quarters. And they were right—for the most part.

However, we've always sought out banks which, in our opinion, "get it". Over the years, we believe we've succeeded. While results we've seen for *all banks* for the Third Quarter of 2006 are in the range of a 7% increase in earnings quarter over quarter, banks like the one featured last month in our October E-Memo did better—a whole lot better. Enterprise Financial Services Corporation (EFSC) reported that earnings grew by 29% compared to the Third Quarter 2005. Sure we had some banks which reported significantly lower results for the quarter but on average here's how *our banks* performed:

<u>Average</u>	<u>3<sup>rd</sup> Quarter 2006 vs. 3<sup>rd</sup> Quarter 2005</u>
Earnings Growth	+13.8%
Loan Growth	+25.6%
Deposit Growth	+18.2%

<u>Average</u>	<u>For the 3<sup>rd</sup> Quarter 2006</u>
Net Interest Margin	4.36%
Asset Quality	
• NPAs/Loans	0.59%
• Reserves/NPAs	495.0%
Net Charge-offs/ Loans (annualized)	0.27%

Here's what we've garnered from the foregoing portfolio statistics:

- Our selection of fast growing banks continues to prove itself and while we may, from time to time, find that we underperform our benchmark NASDAQ Bank Index, we understand that it is weighted toward (and therefore substantially influenced by) larger banks than those in our portfolio. Stocks of large banks have, for most of the past year, outperformed smaller banks.
- Even though our banks slowed a bit in earnings growth this quarter to the mid- teens from the low-twenties of the immediate past quarters,
- We did see loan and deposit growth continue in a steady path—comparable to the immediate past quarters.
- The average net interest margin has grown a bit since the end of the year from a level of 4.07% or by nearly 30 basis points—a notable shift upwards in the rate market environment in which we found ourselves in the past quarter.
- Finally, credit statistics reflect our ongoing focus on credit quality and various credit risk measures:
  - *NPAs/Loans:* Measures the percentage of non-performing assets (NPAs), mostly bad loans, which are not performing according to standards established at the time the loan was made divided by total loans outstanding. The banks in our portfolio had, on average, much less than 1% of their loans in the nonperforming status. That number is better than average.
  - *Reserves/NPAs:* In our years of experience examining and managing banks, the most consistent way in which a bank can get into serious trouble is with bad loans. To the extent that the percentage coverage of NPAs by loan loss reserves exceeds 100%, the more comfort we take that the bank is properly reserved. This quarter, our portfolio banks' reserves averaged nearly 500% of nonperforming assets, which confirms our confidence that they are managing their credit quality appropriately and well better than average.
  - *Net Charge-offs/Total Loans* While we've seen lower ratios over the past several quarters, this quarter's number was distorted by one bank's sizable write-off, equaling nearly 1% of total loans. The median ratio for this period was an annualized 0.05%, a very good number.

So the market has recently turned down for NASDAQ Banks or so it appears. The statistics in *IBD* are interesting of course because they reflect sector and specific stock momentum. While the momentum has temporarily turned away from banks and to something more glamorous like—h-m-m-m-m, Enterprise Computer Software, Internet Network Stations, Educational and Entertainment Computer Software, Computer Software—Security, Internet Content Providers—need we say more? Of course. We can't resist and our friends at the *Wall Street Journal* provided us with the fodder on page C10 of the November 13, 2006 issue.

The focus of the chart was energy and the title of the chart and accompanying narrative was "The Energy Sector: A Changing Landscape". According to the *WSJ*/December 9, 1998, oil was trading at \$11.16 per barrel. On November 10, 2006 the price was \$59.59. The value of the total market back in 1998 was \$11.3 trillion and last Friday the market capitalization was \$15.7 trillion—a 38.9% increase. What the *Wall Street Journal* concluded in its charts and what we conclude are quite different. Following is our chart showing market sectors selected from the *WSJ* chart using *WSJ*'s market value statistics:

Date	Oil/Barrel	US Equity Market Value	Oil & Gas Sector	Technology	Telecom	Banks
December 9, 1998	\$11.16	\$11.26 trillion	\$0.64 trillion	\$1.82 trillion	\$0.76 trillion	\$0.81 trillion
November 10, 2006	\$59.59	\$15.74 trillion	\$1.40 trillion	\$2.17 trillion	\$0.47 trillion	\$1.45 trillion
Percent Change	+434.0%	+39.8%	+118.8%	+19.2%	-38.2%	+79.0%

The chart shows what we all know about energy—the oil and gas sector, right? But how about those stogy old banks? Well *WSJ* says that their market values "have grown, in part from profitable in-house trading of energy commodities." Really? We wonder if the guys at Enterprise Financial Services in St. Louis (or for that matter any of the banks in our portfolio) think that their market value has grown from energy trading. (With all due respect to the fine folks at the *Wall Street Journal*, the closest the folks at Enterprise come to energy trading is the local service station where they exchange a credit card charge for a tank of fuel.)

The market capitalization for all publicly traded banks grew by 79% over the past 7 years and 11 months. We thought you'd be interested (we were) that the **NASDAQ Bank Index during the same period appreciated in value by 85%**. The NASDAQ Bank Index consists of 525 banks, mostly all small in size. We'd like to bet a lot on the fact that most if not all of them, even the very largest, likely never traded energy commodities. So if these NASDAQ Banks grew by 85% and all banks grew by 79% in the same period, seems to us that the NASDAQ Banks grew a lot more than the total of all banks and, arguably, the larger banks that were doing the energy trading, right? So the real growth in banking market value came not from trading energy commodities but from straight banking "blocking and tackling" as executed by the banks in which we invest.

And so, *As the (Banking) World Turns*—on to large cap stocks including all the tech stock sub-sectors in *IBD* and large cap banks (which has happening over the past couple of weeks) even though their earnings prospects can't hold a candle to what our smaller banks produce, we'd like to remind you that:

- From December 9, 1998 to November 10, 2006 the growth in the market value of banks outstripped the growth in market value of technology stocks by a multiple of four (4) times,
- The banking sector's performance against the once and might telecom sector is literally infinitely better and
- Banks' value growth doubled the growth of the market value of all publicly traded stocks from December 9, 1998 to November 10, 2006.

***And finally as we are less than 10 days from our national Thanksgiving Day holiday, we are thankful for you are readers, investors and clients, and the industry that has made unprecedented prosperity possible in this country, our diverse and competitive banking system which is***

The **FOUNDATION** of a strong, free economy.

**FORTRESS**

**PARTNERS**

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