

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Bob Ollech and Jon Bruss
Date: November 19, 2007
Subject: Sour Grapes, Aphorisms and Bromides

We completely misjudged the ability of the uninformed—the financial media, electronic and print to create a maelstrom. A maelstrom into which banks and financial stocks in general have been caught up and sucked down—a few deservedly so for complicity in creating the credit catastrophe by aiding, abetting and elevating “sub-prime lending” to an epithet. It is frustrating, to say the least, to sit by without comment while those drawing six figure salaries publicly display their ignorance by confusing Federal Reserve regulation of banks for SEC regulation of brokerage firms or while the headline writers call First National Bank of Smalltown, USA and Merrill Lynch and Goldman Sachs “banks” thereby compounding the problem. Unfortunately, banks and their lobbies, the American Bankers Association and the Independent Community Bankers Association, sit idly by allowing their members to be painted with the same tar brush used to vilify the investment brokerage firms—interestingly, all located east of the Hudson River.

We have been and remain unabashed supporters and defenders of the small cap banking sector. We don't, however, wear rose colored glasses. Small cap banks and bankers sometimes make dumb mistakes and they suffer for it. However, we don't hear them clamoring for a bail out when they get stuck with a toes-up golf course loan or defaulted restaurant loan—the kinds of loans their heads told them not to make but . . . And you can bet your bottom dollar that such loans do exist and some of the nearly 8,800 banks in the US made and own those kinds of loans. But these same banks and bankers recognize that this is a free market economy. They recognize that the risks they take in such a free market economy like ours may sometimes result in an interruption or detour on the path to prosperity—perhaps, even failure.

Small bank stock prices have dropped dramatically this year. For example, the NASDAQ Bank Index which represents over 500 banks of sizes ranging from the largest, like Northern Trust or Fifth Third, to very small start-up banks has dropped 18.9%. Banks with assets ranging from \$1 billion to \$5 billion in assets—the banks in the SNL Index of Banks (164 in total) have collectively dropped 25.60% since the beginning of the year. The SNL Thrift Index for that asset size range (41 in total) has dropped 21.13%. Over 50% of our assets invested in publicly traded banks and thrifts are invested in that asset size range.

Why such a drop? Were they invested in or were they originators of sub-prime loans? Actually all of the banks in which we invest reported in their earnings releases for the quarter ending September 30, 2007 they did not do either. We can't but come to the conclusion that the baby is being thrown out with the bath water. And when the source of information for most investors owning bank stocks is CNBC, the *Wall Street Journal* or *Barron's* its no wonder that a few—actually just a handful of banks—can take down a whole sector of nearly 1,300 participants—publicly traded banks and thrifts. And, very, very few investors (including us) saw it coming—at least to the extent it has wreaked havoc on these stocks. Well certainly one would think that the fundamentals are eroding, right. Well, not exactly. While our portfolio is select and limited to 19 names, we think that it can provide some validation of the aphorism of the baby being thrown out with the bath water. Here's what we saw in the September 30th financial results for our banks:

Credit & Loan Metrics	Q307	Q306
Median Non-performing assets to total loans & other foreclosed real estate	0.46%	0.54%
Median loan loss reserve coverage to non-performing loans	311.6%	248.78%
Median Net Charge-offs/Average Loans (annualized)	0.11%	0.07%
Median Loan Growth	9.8% (vs. Q306)	26.8% (vs. Q305)

We noted that two of the three key credit metrics we follow for the banks in which we are invested actually improved modestly during this period. Non-performing assets can lead to charge-offs. Any increase is a red-flag. The growth of the coverage of non-performing loans by loan loss reserves reflects the slight decline in non-performing loans and the strengthening of loan loss reserves. It is likely that non-performing loans may increase further but loan loss reserves among our banks continue to be adequate as measured by coverage of non-performing loans.

Growth Metrics	Q307 vs. Q306	Q306 vs. Q305
Median Loan Growth	9.8%	26.8%
Median Deposit Growth	14.7%	20.2%
Median Asset Growth	15.7%	20.5%
Median Book Value Growth	8.6%	14.4%
Median Earnings Growth	-8.4%	0.2%

While growth metrics among the banks in our portfolio have declined from the comparison of 2006 vs. 2005, our banks are continuing to make loans and gather deposits, achieving double digit growth in deposits and assets while slipping a bit in loan and book value growth—the latter, a symptom of a decline in earnings growth as noted above.

Profitability Metrics	Q307	Q306
Median Return on Average Assets	0.84%	0.95%
Median Return on Average Equity	10.36%	12.38%
Median Net Interest Margin	4.05% (vs. 3.81% [Q207])	4.22% (vs. 4.38% [Q206])
Median Non-interest income to operating revenue	12.19%	14.72%
Median Efficiency Ratio	60.88%	61.12%

For our banks, return on average assets and return on average equity have slipped—the latter a bit more than the former due to continued growth in book value. The net interest margin numbers are interesting in that it appears as though the pinch of the second quarter of 2007 has given way to some expansion in Q307 while in 2006 the exact opposite was took place.

If our banks are viewed as a microcosm of well-run small banks—and they may be, then we would conclude that the health of the industry is not reflected in its stock prices and the indices of those prices. Certainly some price and index erosion could be expected but 25%+? Instead, we'd have to conclude that perception has trumped fundamentals and has become reality. Small banks aren't headline-fodder like Citigroup, JPMorgan Chase, B of A, Wachovia or Washington Mutual. Among other things to be thankful for this time of year—that is another, or is it? We usually don't mind flying under the radar of the media. Now, however, is an exception—a very frustrating exception. We'd like the world to know that our banks weren't involved in the sub-prime slime and that they are focused on conventional banking practices—in football terminology, straight blocking and tackling—lending and deposit gathering.

Earlier this month former FDIC directors Bill Isaac (1978-1985) and Bill Siedman (1985-1991) both FDIC chairmen during a period in which 2,700 banks and thrifts failed, and current FDIC Chairman Sheila Bair appeared on Kudlow & Company on CNBC (now the only show worth watching on that channel). Under some rather incisive questioning by host Lawrence Kudlow, all agreed that the condition of the banking industry and its ability to absorb shocks was far better today than during the years of the savings and loan crisis of the eighties and early nineties. We haven't had any bank failures in the last couple of years and, we have had only a handful this year—four to be precise! Underlying this recent performance according to the FDIC trio is that today's banks are *better* capitalized, *better* reserved and *more* profitable than they were in the eighties and nineties—and at least our bank selections appear to be meeting the current stress with strong key fundamentals.

So this week while the financial media celebrate their self-induced panic let us be thankful for the vibrant free market economy in which we live and has afforded us with unparalleled prosperity and provides us with much to celebrate.

Happy Thanksgiving!

FORTRESS

PARTNERS

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