

# THE CASE FOR BANKS

Presented to

*American Association of  
Independent Investors*

Mid Winter Retreat

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**FORTRESS PARTNERS  
CAPITAL MANAGEMENT**

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## *The Case for Banks—Portfolio Weighting Disparity*

**Banks, thrifts and other financials are lacking in investors' portfolios.**

➤ **Bank and thrift investments are generally under-represented in portfolios of retail and institutional investors.**

- Banks and thrifts (depository/financial services companies) constitute the **largest publicly-traded industry group in terms of number** of trading symbols/publicly quoted and traded common equity names.

- Financial services companies (which include banks and thrifts) constitute approximately:

- **23% of the S&P 500 market cap** but are under-represented in the S&P 500 because they represent
- **30% of the earnings** of the S&P but generally carry
- **lower price to earnings multiples** than non-financial companies
- **Banks and thrifts represent 1,325+ trading symbols** or roughly 20% of all publicly-traded companies (excluding closed-end funds and REITs)
- **Banks and thrifts constitute >\$1.4 trillion of market capitalization**

## *The Case for Banks—Rapid Earnings Growth*

### Bank earnings grow faster than perceived

- Banks are generally viewed with disdain when compared with trendy investments in biotech, technology, retailing and Internet stocks because they are thought to be:
  - Stodgy, unexciting investments, and therefore
  - Have slow earnings growth
- The exact opposite is true:

*As an industry class, bank earnings have outgrown corporate profits over the past 40 years, 20 years and 10 years by 35% to 54%*

	10 Years 1994 – 2004	20 Years 1984 – 2004	40 Years 1964 – 2004
<b>U.S. Commercial Bank Earnings</b>	8.9%	10.0%	9.7%
<b>U.S. Corporate Profits (incl. Banks)</b>	6.6%	6.5%	6.8%

Source: FDIC and US Department of Commerce

## *The Case for Banks—Rapid Earnings Growth*

- Our detailed analysis of these results shows an even more dramatic difference between banks and US corporate profits when banks are separated out.
- Banks with market capitalizations of less than \$3 billion are slated to enjoy earnings growth of 10.3% for the period 2004-2008 according to a recent Lehman Brothers report.

## The Case for Banks— Increasing Dividends

Banks pay higher dividends and have increased payouts at a faster pace than S&P 500 Index. See below the comparison of the S&P, 219 dividend-paying financial services sector companies and banks and thrifts each with >\$1 billion in market cap:

Industry Sub-sector/ Index	Number in Sample	5-Year Average CAGR % in Dividends	Number in Sample	10-Year Average CAGR % in Dividends
Banks	84	13.60	84	14.75
Thrifts	16	22.55	16	21.53
Total Financial Sample	219	10.65	219	12.44
S & P 500 Index	500	1.43	500	3.29

- **Dividend yield** on the above 100 banks based on 6/30/99 cost was **4.56%** compared to the *current* yield of the NASDAQ Bank Index of **2.35%** and the 1999 yield of that Index of **1.99%**.
- **Dividends** tend to **remove the temptation** of management **to spend shareholder capital foolishly**, especially on acquisitions.
- **Bank dividends generally exceed those of non-bank companies.** As of 1/19/07:
  - NASDAQ Bank Index yield is **2.35%** *versus*
  - the S&P at **1.77%**,
  - the Dow at **2.15%** *and*
  - the NASDAQ Composite at **0.73%**

## *The Case for Banks— The Total Return Rocks!*

- With or without dividends, the total return of the NASDAQ Bank Index beats the S&P and the Dow:

Annual Returns (1)	NASDAQ Bank Index	S&P 500	Dow Jones Industrials
Without Dividends	10.37%	6.71%	6.81%
With Dividends	12.92%	8.42%	8.93%

Source: Bloomberg

(1) For the 10-year period 12/31/96 – 12/29/06.

- Finally, *dividends are real; earnings are an opinion*. Dividends provide a level of assurance that the earnings of the payer are for real.

## *The Case for Banks—Lower Volatility*

**Investment in banks and thrifts has low correlation to the market** as represented by the S&P 500

- NASDAQ Bank Index BETA .66

## *The Case for Banks— Industry Consolidation/“Creative Destruction”*

### **Rationalization – there are too many banks in the U.S.**

- Rationalization will continue apace for the foreseeable future while new banks will be formed to replace some of those which have disappeared.

	<b>FDIC INSURED BANKS &amp; THIFTS</b> (Top – Tier) (Source: FDIC)
<b>Beginning Total 12/31/1984</b>	<b>15,084</b>
<b>Acquired/Merged</b>	<b>(8,444)</b>
<b>Closed due to Failure (Primarily S&amp;L Crisis 1987- 1991)</b>	<b>(2,266)</b>
<b>Other Changes</b>	<b>45</b>
<b>New</b>	<b>3,225</b>
<b>Ending Total 12/31/2004</b>	<b>7,597</b>

Source: FDIC

## *The Case for Banks—Industry Consolidation/Creative Destruction*

- **Rationalization will act as a floor on bank prices at the minimum and drive bank prices upward as publicly-traded institutions in a region or state become scarce.**
- **Banks and thrifts will consolidate because of:**
  - **Aging management** and no replacement
  - Inability or lack of interest in dealing with **regulatory burden**
  - Inability to continue to **grow assets and earnings** without substantially increasing product offering
  - Inability to adapt to **technological advances** of competitors and client/customers.
- **Low trading multiples and high take-out multiples** make investment in banks for the rationalization play alone a great opportunity.

## *The Case for Banks—Great Demographics*

**Favorable demographics** will continue to push growth in demand for banking and related financial services as 45 – 64 age group continues to rapidly expand.

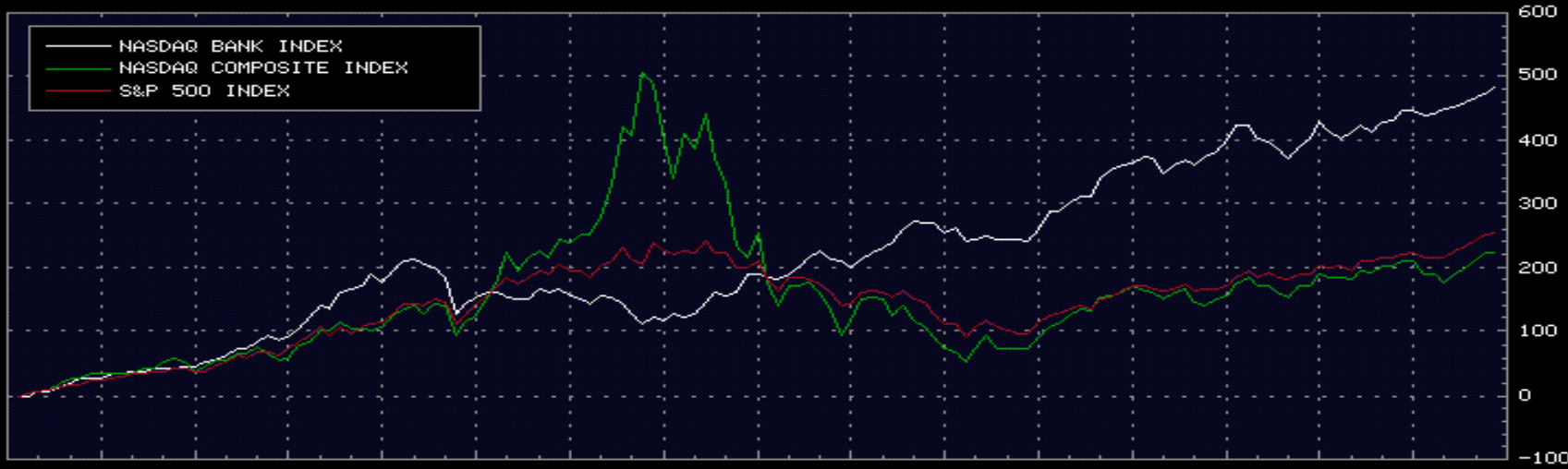
## The Case for Banks—11.9-Year Comparative Returns

<HELP> for explanation. P143 Index COMP  
 Hit 1<GO> for Options, Hit <Page> for table.

**COMPARATIVE RETURNS** Page 1/11

Securities	Range	Crcncy	Prc Appr	Period	Monthly Total Ret	142 Mo. Difference	Period Annual Eq
1 CBNK Index	2/28/95 - 12/29/06	USD	346.07 %	Monthly	484.88 %	263.61 %	16.09 %
2 CCMP Index		USD	204.29 %		221.28 %		10.36 %
3 SPX Index		USD	191.00 %		256.00 %	34.73 %	11.32 %

(\* = No dividends or coupons)



OCT95 JUL96 APR97 JAN98 OCT98 JUL99 APR00 JAN01 OCT01 JUL02 APR03 JAN04 OCT04 JUL05 APR06 JAN07  
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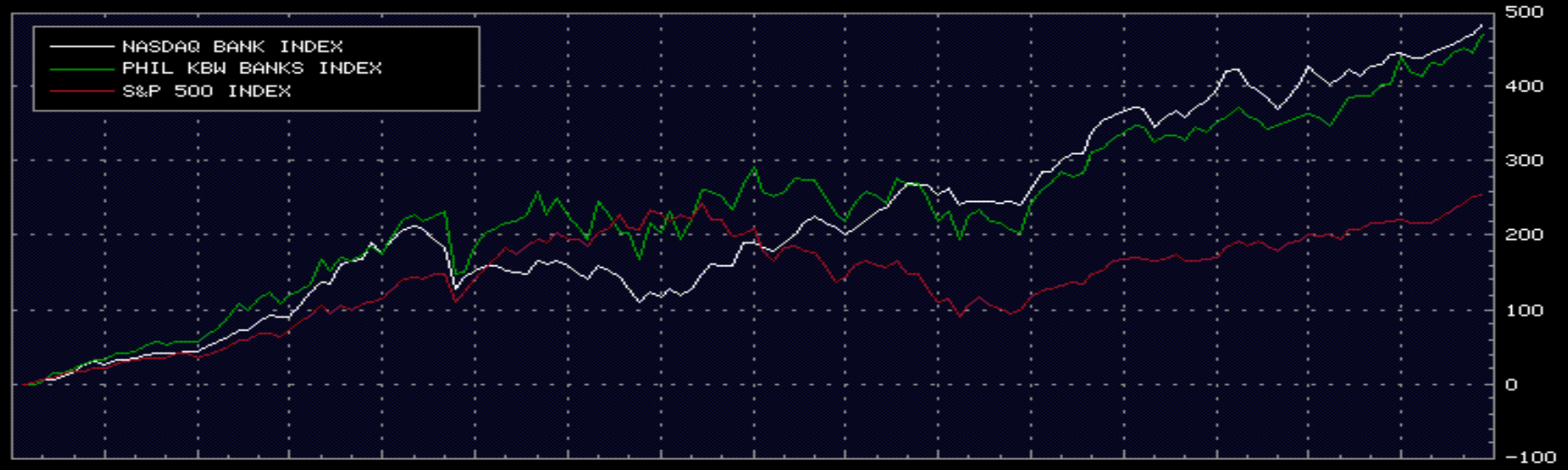
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2 BKX Index		USD	309.23 %		471.93 %		15.87 %
3 SPX Index		USD	191.00 %		256.00 %	-215.92 %	11.32 %

(\* = No dividends or coupons)



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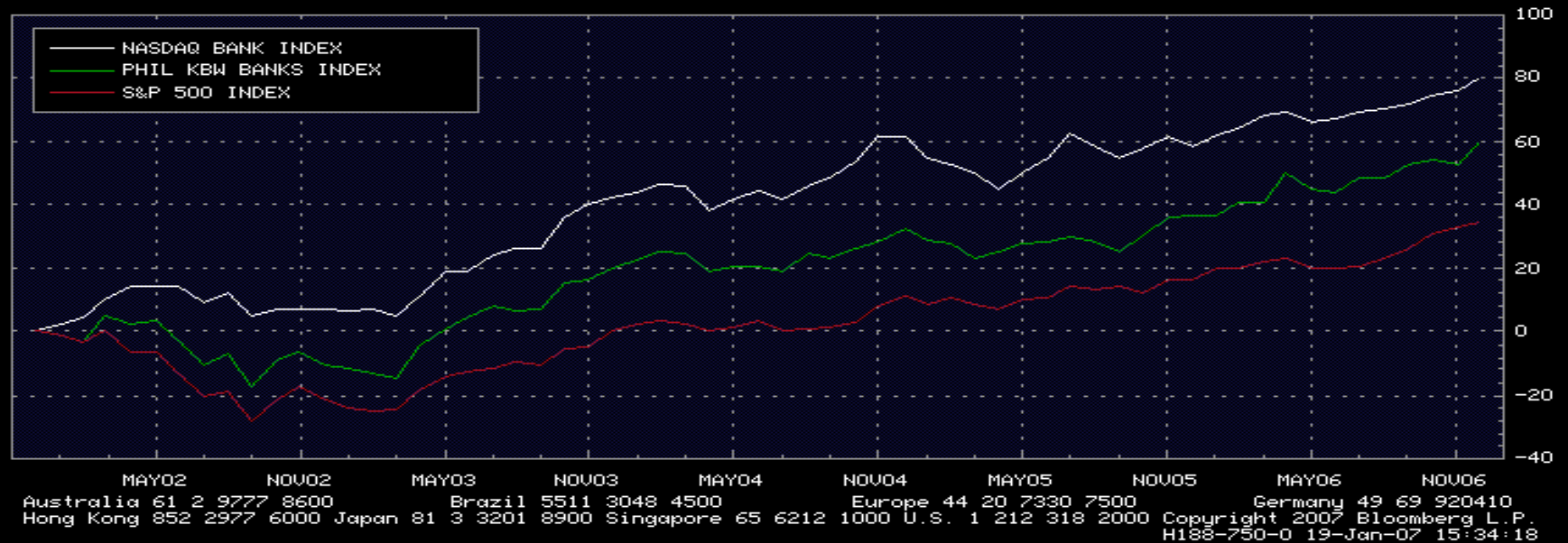
## The Case for Banks—5-Year Comparative Returns

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**COMPARATIVE RETURNS** Page 1 / 6

Range **12/31/01** - **12/29/06** Period  Monthly  60 Mo. Period

Securities	Crcny	Prc Appr	Total Ret	Difference	Annual Eq
1 CBNK Index	USD	60.07 %	80.42 %	20.67 %	12.53 %
2 BKX Index	USD	36.63 %	59.75 %		9.83 %
3 SPX Index	USD	23.54 %	34.99 %	-24.77 %	6.19 %

(\* = No dividends or coupons)



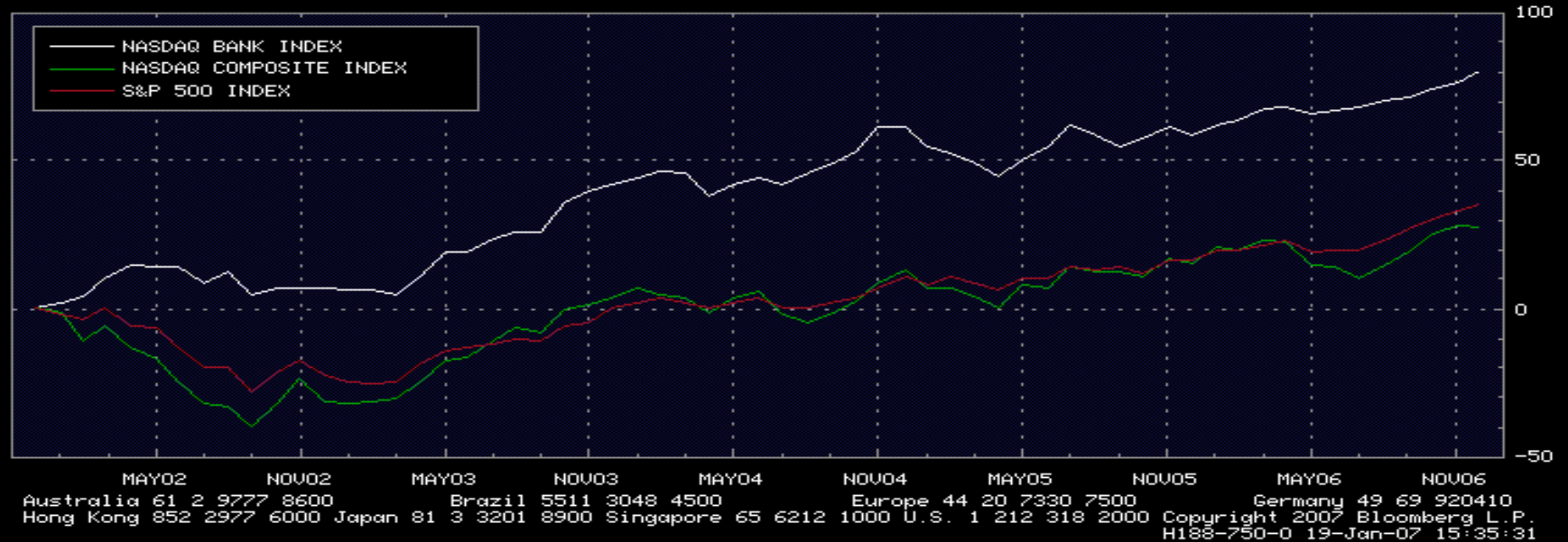
## The Case for Banks—5-Year Comparative Returns

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**COMPARATIVE RETURNS** Page 1 / 6

Securities	Range	Crcny	Prc Appr	Period	Monthly Total Ret	60 Mo. Difference	Period Annual Eq
1 CBNK Index	12/31/01 - 12/29/06	USD	60.07 %	Monthly	80.42 %	52.86 %	12.53 %
2 CCMP Index		USD	23.84 %		27.56 %		4.99 %
3 SPX Index		USD	23.54 %		34.99 %	7.42 %	6.19 %

(\* = No dividends or coupons)



*The Case for Banks— The Analysis*

## Bank Balance Sheet

<b>ASSETS</b>				<b>LIABILITIES</b>	
Cash		\$	3	Deposits	\$ 75
Securities		\$	20	Borrowings	\$ 10
Loans	\$ 70			Other	\$ 7
Less: Loan Loss Reserves	\$ (1)				\$ 92
Net Loans		\$	69		
Other		\$	8	<b>EQUITY</b>	\$ 8
		\$	100		\$ 100

## *The Case for Banks— The Analysis*

### Bank Income Statement

Interest Income	\$ 7.0	
Interest Expense	<u>\$ (2.0)</u>	
Net Interest Income		\$ 5.0
Provision for Loan Losses		\$ (0.5)
Noninterest Income		\$ 2.5
Noninterest Expenses		<u>\$ (5.0)</u>
Income Before Taxes		\$ 2.0
Income Taxes		\$ (0.8)
Net Income		<u><u>\$ 1.2</u></u>

## *The Case for Banks— The Analysis*

<b>Bank Evaluation Ratios</b>	<b><u>Typical Range</u></b>	<b><u>High Performance</u></b>
<b>Earnings and Profitability</b>		
Net Interest Margin	3% - 5%	4.5% +
Noninterest Income / Revenue	10% - 40%	25% +
Efficiency Ratio	40% - 75%	< 50%
Return on Assets	0.75% - 1.75%	1.25%+
Return on Equity	8% - 25%	16% +
<b>Asset Quality</b>		
Nonperforming Assets / Total Assets	0.2% - 2%	< .50%
Loan Losses / Total Loans	0.0% - 2%	< .25%
Reserves / Total Loans	0.8% - 2%	1.5% +

## *The Case for Banks— The Analysis*

<b>Bank Evaluation Ratios</b>	<b>Typical Range</b>	<b>High Performance</b>		
<b>Financial Soundness</b>				
Equity Capital / Total Assets	6% - 10%		7%	
Tier 1 Capital Ratio	6% - 12%		10%	
Dividend Payout Ratio	0% - 60%		25%	
<b>Growth</b>				
EPS Growth	5% - 10%		> 15%	
Loan Growth	5% - 10%		> 15%	
Deposit Growth	5% - 10%		> 15%	

## Other Investment Criteria

- Interest Rate Sensitivity
- Market Area
  - Growing or Stagnant?
- Ownership
  - Insiders (> 10% < 35%)
  - Institutions (< 20%)
- Management
  - Enlightened?
  - Entrenched?
  - Corporate Governance?

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**THIS PRESENTATION MAY  
BE FOUND AT:**

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