

# BEST OF BREED



FINANCIAL FUNDS

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## FBR SMALL CAP FINANCIAL FUND CASHES IN ON BANKS

Financial stocks have taken their share of hits during the past year and a half. Sluggish results on Wall Street have hurt brokers and pulled down big banks that rely on trading and initial public offerings to boost earnings. But the news from the financial sector hasn't been all glum. With consumers clamoring to obtain mortgages, some lenders are thriving. In fact, demand for loans helped financial funds outpace the Standard & Poor's 500 stock index by about 12 percentage points for the 12 months ending in November. And if demand remains strong, financial stocks could climb even further.

In addition to posting competitive returns, financial funds have helped provide important diversification for investors. The average fund in Morningstar's financial category has an R-squared rating of only 42, suggesting that the funds are generally out of step with the S&P 500. Financial funds can be a particularly valuable complement to technology holdings, because the two sectors tend to move in different directions. In 1999 the average technology fund gained 134.6 percent, whereas the average financial fund lost

about 1.2 percent. The next year technology dropped 31.6 percent, and financial funds rose 27.4 percent.

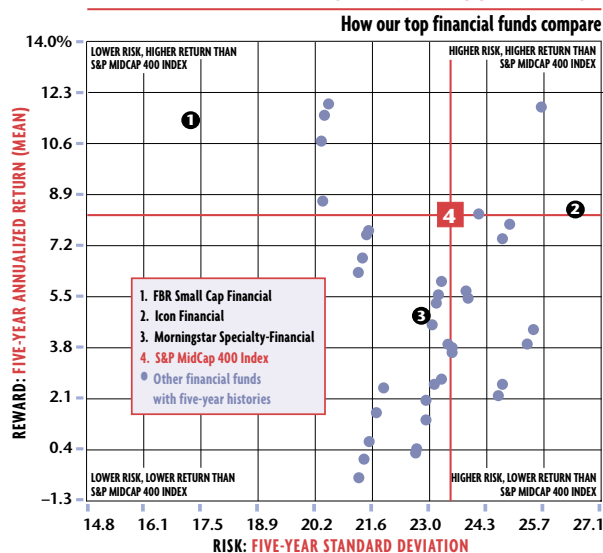
Which is the best financial fund? To decide, we turned again to the eight-part screen developed by Donald Trone, chief executive of investmgt, a consulting firm in Pittsburgh. Trone's due-diligence process seeks funds that are at least three years old and have at least \$75 million in assets. In addition, most holdings must be consistent with the category, and the expense ratio must fall below the category's top quartile. The alpha and Sharpe ratios must exceed category medians. The one- and three-year returns must also best the medians, as must five-year results if the fund is that old.

Of 111 financial funds tracked by Morningstar, only two—FBR Small Cap Financial Fund and

Icon Financial Fund—passed all Trone's screens. We awarded the title to FBR, which had higher one-, three-, and five-year returns and more attractive risk scores.

FBR also stands out because unlike many of its competitors, which hold broad cross sections of financial stocks, FBR is a niche fund, focusing almost exclusively on small banks. Portfolio manager David Ellison

### FIVE-YEAR RISK-REWARD SCATTERPLOT



Best of Breed	Ticker	5-Year annualized return	5-Year std dev	5-Year-rtn category % rank	5-Year tax-cost ratio	3-Year annualized return	3-Year-rtn category % rank	12-Month total return	12-Month-rtn category % rank	Morningstar 5-year rating	P/E ratio	Expense ratio	Turnover ratio
FBR Small Cap Financial	FBRSX	11.38	17.34	5	1.18	22.94	3	23.47	1	5	15.5	1.53	68
<b>Runner-up</b>													
Icon Financial	ICFSX	8.19	26.46	19	3.01	11.08	15	-7.71	62	4	16.0	1.41	174
<b>Benchmarks</b>													
S&P MidCap 400 Index	—	8.12	23.49	—	—	3.31	—	-6.27	—	—	26.1	—	—
Morningstar Specialty-Financial	—	4.97	22.95	—	1.42	4.46	—	-4.22	—	3	18.2	1.55	138

SOURCE: Morningstar Principia. Data as of 11/30/02.

explains that he buys only solid thrifts and banks that quietly serve their local markets, making home mortgages and loans to small businesses and individuals. He steers away from institutions involved in such glamorous fields as bond trading and investment banking. "I don't want to wake up tomorrow and discover that one of our stocks has

## FBR Small Cap Financial TOP 25 HOLDINGS

As of September 30, 2002 (not audited; for informational purposes only)

Rank	Security name	Percent net assets
1	Quaker City Bank	4.14
2	Washington Federal Savings	3.88
3	FirstFed Financial	3.84
4	Hawthorne Financial	3.68
5	Brookline Bancorp	3.33
6	FirstFed American Bancorp	3.13
7	Sterling Financial	3.09
8	ITLA Capital	3.03
9	Waypoint Financial	2.92
10	PFF Bancorp	2.63
11	Bancorp Rhode Island	2.45
12	Hudson City Bancorp	2.40
13	Banc Corp.	2.10
14	PennFed Financial Services	2.09
15	Pacific Union Bank	1.98
16	New York Community Bancorp	1.91
17	Banner	1.91
18	Willow Grove Bancorp	1.82
19	Medford Bancorp	1.78
20	Parkvale Financial	1.74
21	Downey Financial	1.68
22	Capitol Federal Financial	1.68
23	Seacoast Financial Services	1.67
24	First Bell Bancorp	1.61
25	Pacific Crest Capital	1.59

SOURCE: Morningstar Principia

Best of Breed	Best-fit index	Best-fit R squared	Best-fit alpha	Best-fit beta	Sharpe ratio	Median mkt cap \$MM	Total assets \$MM	% Financial services	% Assets in top 10 issues	Total return 2001	Total return 2000	Total return 1999	Total return 1998
FBR Small Cap Financial	S&P MidCap 400	18	18.74	0.26	1.31	221	379.2	99.9	33.66	23.86	32.42	-5.43	-13.61
<b>Runner-up</b>													
Icon Financial	S&P MidCap 400	50	8.17	0.76	0.30	3,112	127.2	98.8	36.96	2.61	50.02	-1.71	7.04
<b>Benchmarks</b>													
S&P MidCap 400 Index	—	—	—	—	-0.03	2,322	—	18.8	8.81	-0.60	17.49	14.72	19.11
Morningstar Specialty-Financial	—	—	—	—	0.04	19,402	103.9	95.6	42.74	-3.02	27.43	-1.18	6.29

SOURCE: Morningstar Principia. Data as of 11/30/02.

reported a big loss in Bolivia," he says.

Ellison also avoids banks that are expanding rapidly; such growth can generally be achieved only by issuing questionable loans, he reasons. Instead he prefers steady performers that tend to grow slowly year after year. These stable businesses can typically expand their profits and increase book value by 5 to 15 percent a year, Ellison says, and their stock values tend to track the growth. "Profits at these companies are not huge, but they have been extremely reliable for years," he says. "These banks serve middle-class Americans who need loans to pay for their cars and houses. Their business grows steadily, and management just needs to operate sensibly in order to stay out of trouble."

In particular Ellison seeks banks that keep a tight rein on expenses. Because the market for loans is so competitive, banks can't necessarily boost profits by raising the rates they charge borrowers. But managements can maximize earnings by cutting costs. Ellison says that costs of companies in the industry range from 0.8 percent of assets to 4 percent of assets annually, a significant spread. He searches for banks that fall near the low end of the spectrum.

Ellison monitors more than 300 small banks, which typically have price-to-earnings ratios ranging from 8 to 16. To limit risk, he shops for the cheaper names and usually holds about 60. Holdings in the fund generally post price-to-book ratios of less than 1.5, about a third of the figure for the S&P 500. "If you buy a technology company that trades at 20 times book, you

run the risk that the price may drop to 18 times," he says. "But if you buy a profitable bank selling at 1.25 times book, there's very little chance that the value will decline much."

One low-priced stock Ellison owns is Washington Federal Savings in Seattle. In mid-December the shares were selling at a price-to-earnings ratio of about 11, yet the company's return on equity for the 12 months ending in September was a healthy 15.7 percent, and the stock offered an attractive dividend yield of 3.6 percent. Another bargain holding is Banc Corp. in Birmingham, Ala. Serving 37 locations in Alabama and Florida, this bank was selling for 1.3 times book value in mid-December.

Although Ellison buys stocks in cities of all sizes, some of his best holdings come from small and midsize markets. "A bank doesn't need to be in a big city to excel," says Ellison. "The fund has done very well with small banks in Idaho and Oregon. What matters is whether management understands how to operate efficiently."

After buying a stock, Ellison typically holds on to it for years, figuring that the biggest rewards come from waiting patiently as the book value grows, pushing up the share price along with it. This cautious style is one reason why FBR ranks among the least volatile funds in its category.

To be sure, part of Ellison's recent success must be attributed to the good fortune enjoyed of late by small banks. Fleeing stocks with erratic earnings and questionable accounting, investors have poured into small banks and pushed up

## BLOOMBERG WEALTH MANAGER'S PAST PICKS FOR BEST OF BREED: HOW THEY MEASURE UP

Fund	Month/year featured in magazine	Latest 5-yr-rtn category % rank	5-Yr-rtn category % rank when featured	Latest 3-yr-rtn category % rank	3-Yr-rtn category % rank when featured	Latest 12-mth-rtn category % rank	12-Mth-rtn category % rank when featured	Best-fit alpha	Best-fit index	Latest total assets \$MM	Total assets when featured \$MM
<b>LATIN AMERICA</b>											
T. Rowe Price Latin America <b>PRLAX</b>	12/02–1/03	1	1	1	1	1	11	5.94	Wilshire 4500	152.4	152.4
<b>PRIME-RATE FUNDS</b>											
Eaton Vance Prime Rate Reserves <b>EVPRX</b>	11/02	—	—	—	—	—	—	-1.38	CSFB High Yield	2,434.0	2,453.0
<b>SMALL BLEND</b>											
Dreyfus Small Cap Stock Index <b>DISSX</b>	10/02	44	40	55	51	41	51	—	S&P SmallCap 600	174.8	149.8
<b>SOCIALLY CONSCIOUS FUNDS</b>											
Ariel Appreciation <b>CAAPX</b>	9/02	—	—	—	—	—	—	18.51	S&P 500	1,365.4	1,480.7
<b>DIVERSIFIED EMERGING MARKETS</b>											
Dreyfus Emerging Markets <b>DRFMX</b>	7/02–8/02	2	3	7	7	30	5	6.07	MSCI PAC XJP	479.5	485.8
<b>SHORT-TERM BOND</b>											
PIMCO Low Duration Institutional <b>PTLDX</b>	6/02	9	6	14	13	7	6	0.20	LB Mortgage-Backed	5,581.9	4,182.0
<b>FOREIGN STOCK</b>											
Julius Baer International Equity <b>BJBIX</b>	5/02	2	2	9	5	5	14	—	MSCI EASEA	498.5	305.3
<b>MID-CAP VALUE</b>											
Muhlenkamp <b>MUHLX</b>	4/02	26	22	36	32	69	43	4.68	S&P MidCap 400	642.3	561.6
<b>MULTISECTOR BOND</b>											
Janus Flexible Income <b>JAFIX</b>	3/02	4	4	9	24	15	6	-2.53	LB Aggregate	1,580.5	1,272.6
<b>LARGE BLEND</b>											
First Funds Growth & Income II <b>FFGIX</b>	2/02	14	4	28	7	90	25	-0.04	S&P 500	80.9	139.0
<b>DOMESTIC HYBRID</b>											
American Balanced <b>ABALX</b>	12/01–1/02	4	6	4	6	17	4	10.63	S&P 500	11,607.8	7,755.7
<b>SPECIALTY-TECHNOLOGY</b>											
North Track PSE Technology 100 <b>PPTIX</b>	11/01	9	2	5	12	10	6	3.75	Wilshire 4500	172.3	283.3
<b>LARGE GROWTH</b>											
Smith Barney Aggressive Growth A <b>SHRAX</b>	10/01	1	1	1	1	74	1	8.16	Wilshire 4500	1,702.4	2,075.4
<b>MUNI NATIONAL INTERM</b>											
Dreyfus Basic Interm Muni Bond <b>DBIMX</b>	9/01	6	5	5	5	25	2	0.24	LB Municipal Bond	131.6	108.5
<b>SMALL BLEND</b>											
Ariel <b>ARGFX</b>	6/01	3	5	10	14	23	2	—	Russell 2000	1,190.8	321.9
<b>SPECIALTY-HEALTH</b>											
Vanguard Health Care <b>VGHCX</b>	5/01	1	1	14	16	3	6	6.88	S&P MidCap 400	13,782.0	17,242.4
<b>MID-CAP GROWTH</b>											
INVESCO Dynamics <b>FIDYX</b>	4/01	57	16	79	26	79	47	-5.17	Wilshire 4500	3,869.6	8,884.9
<b>SPECIALTY-REAL ESTATE</b>											
Columbia Real Estate Equity <b>CREEX</b>	3/01	38	12	67	18	46	41	-1.55	Wilshire REIT	781.8	437.5
<b>LARGE VALUE</b>											
Ameristock <b>AMSTX</b>	2/01	1	1	9	2	32	11	9.33	S&P 500	1,399.9	125.0

SOURCE: Bloomberg L.P. and Morningstar Principia. Data as of 11/30/02.

share prices. This represents a big shift from the late 1990s when bank stocks turned sour at the height of the bull market. At the time, the yield curve was inverted—that is, short-term rates were higher than long-term rates—and lenders' profit margins were being squeezed. Investors shunned the slow-growth shares in favor of technology. Since then, lower interest rates have helped banks report healthy profits. Conservative accounting—implemented by the industry after problems in the 1980s—has enabled small banks to avoid blowups, increasing their appeal for investors seeking stability.

Although bank shares may not be as cheap as they were two years ago, the prices cannot be considered excessive, says Ellison. "After the strong showing in 2002, there's no way this fund is going to give you a 50 percent return in 2003," he says. "But the industry remains healthy, and there's good reason to expect decent returns in the future."

Interestingly, despite its stellar record, the fund still has only \$379 million in assets. Although new investors are regularly discovering the fund, Ellison says it can probably never grow to be a giant with several billion dollars in assets. The market capitalization of

small banks is simply too limited, so FBR will likely remain a niche product.

Ellison says people sometimes ask him for innovative investing ideas, but he offers little help. "For this fund, we don't look for bold experiments," he says. "If a bank in Florida has a new approach to making boat loans, then I won't invest. I only want banks that are doing the same mainstream things we've seen for years and years." That philosophy may seem dull, but it has helped the fund produce winning long-term results.

*Stan Luxenberg is the former executive editor of Individual Investor.*