Eidelman Virant
CAPITAL

Quarterly Letter December 2010

Dear Clients & Friends,

2010 was another great year for the U.S. stock market and for our investors. The US economy confounded skeptics by rebounding to new highs as measured by GDP and corporate profits. As a result, the S&P 500 appreciated a healthy 15.1%, with the small-cap index performing even better. The international index (MSCI World Ex-US) didn't fare quite as well, earning just 8.5% due to concerns over sovereign debt issues in Europe and rising inflation and interest rates in China.

When we conceived our last letter, "Top 5 Reasons to Buy Stocks Now," we clearly saw compelling reasons to be invested in stocks as a great way to protect and grow wealth for the long run. Even as optimists, we were surprised by the speed and degree of appreciation over the second half of the year. However, even with the recent run-up, many of those reasons are still intact with a few more positives added on top. A two-year extension of the Bush-era tax cuts and a 2% cut on payroll taxes should provide a boost in the near term. In fact, as long as stocks remain reasonably valued, strong market momentum often begets further gains.

However, all of the above bullish reasons have led to a dramatic rise in investor optimism. As we often talk about, the best time to buy stocks has been when people are pessimistic. Unfortunately, that is no longer the case today. The latest Investors Intelligence polls shows 59% of investors surveyed to be "bullish," with only 21% "bearish." We will be keeping a close eye on these sentiment measures. If enthusiasm reaches extreme levels, we may recommend taking some profits and increasing the average cash position.

What tricks do we have up our sleeve to continue achieving solid performance next year? As I'll outline in the next section entitled "Stan The Man," we think small regional banks present a pocket of value. Led by our dedicated bank expert Stan Finger, buying community banks has been one of the key ingredients to our stock picking secret sauce over time. With non-performing loans stabilizing, buying such shares below tangible book value offers an opportunity for consistent returns with the chance for a homerun if a buyout occurs.

As we annually do around year-end, we have also been buying shares in companies that we believe have been oversold due to tax-loss selling. Unlike our core long-term holdings, we hold these positions for a much shorter period of time since the majority of the desired gain often occurs quickly. I outlined this strategy in great detail in my 2008 commentary "Year-Ender Strategy," which you can find online at www.eidelmanvirant.com/investment-commentary.html.

We work hard to construct portfolios which we believe have the opportunity to achieve superior returns while minimizing risk. We work equally hard to communicate these strategies so you can best weather the inevitable ups and downs of the market. We believe we accomplished these goals in 2010 and will work to do even better in 2011. Thank you for your continued support and confidence.

Sincerely,

Tom Eidelman, CFA
Vice President

STAN THE MAN & COMMUNITY BANK INVESTING

BY TOM EIDELMAN

Known for his unique batting stance, longevity, and consistency, Hall-of-Famer Stan Musial, is a hero in St. Louis. His achievements with the Cardinals include 3 World Series championships, 7 NL batting titles, and 24 all-star games.

Co-founder and bank specialist with our company, Stan Finger, is also worthy of his "Stan The Man" nickname. For the past 28 years, Stan's focused approach of investing in community banks has led to long-term performance and consistency that would be the envy of many professional money managers. Even with the recent havoc caused by the credit crisis, Stan has been able to accumulate long-term investment returns well in excess of the S&P 500 and Russell 2000 indices for his clients.

The Stan Finger Philosophy

Stan believes that success can best be achieved by concentrating in one area and knowing it better than anybody else. As a professor and author in Neuroscience, a logical area of specialization was the biomedical field. However, he quickly found the hopes and false promises of such companies to be risky, volatile, and unprofitable. With limited research time due to his full-time Professorship at Washington University, Stan found comfort in the regulated aspect of banking. Stan found he could achieve success by focusing on a couple of key parameters:

- Good Location – Stan likes banks on the outskirts of cities so the city can grow into it as well as the stability of college towns.
- Clean Loan Portfolio – Conservative lending should result in low levels of loan losses.
- Sell-oriented Management - Since the big payoff in community bank investing is a buyout, Stan looks for managements or family ownership that have hinted at selling the bank in the future, or are in circumstances that would dictate such a move.
- Low price – Both personal experience and historical backtesting have showed that low valuations (low price/tangible book value) have been one of the best predictors of bank stocks future price performance.

Follow-Through

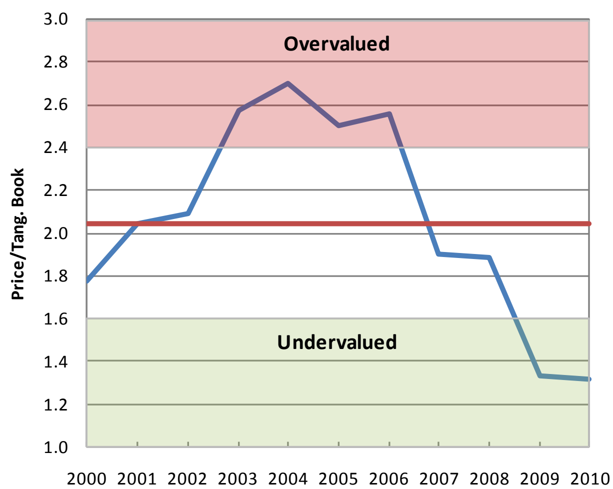
There is no substitute for doing proper due diligence and homework. To ensure that his parameters are met, Stan speaks directly with management and local analysts that follow the banks. For the most part, Stan has found bank management teams to be accessible, open, accommodating, and honest.

Stan's Approach Today

Stan believes happy times are here again for community bank stocks. His goal is to be fully invested for his clients and he noted in his latest letter that he is "pretty much 'all in' as we start 2011."

We agree that community banks meeting Stan's parameters represent one of the best investment opportunities today. Valued at just 1.3x tangible book, community banks trade at their lowest valuations in decades and are trading at a 50% discount to their 2004 valuation levels (Chart A). These low valuations imply good future returns as their profitability recovers and their low valuations attract potential buyouts.

Chart A: Community Bank Undervaluation



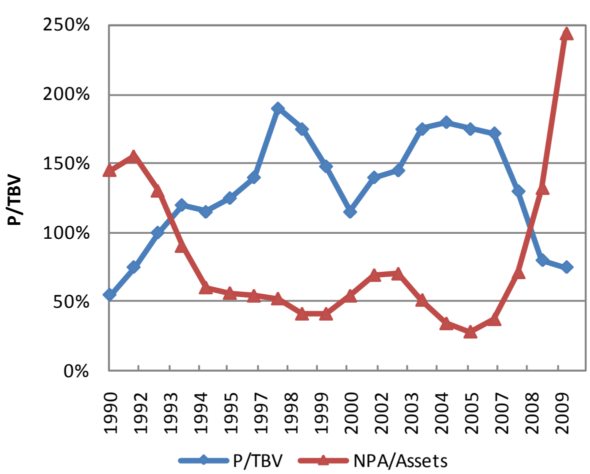
Note: Small-cap banks ($200m-$1B mkt cap) at lowest valuations since Dec '99. Data source: Factset.

Why are Banks so Cheap?

The credit crisis, housing collapse, and recession took a nasty toll on many bank's balance sheets. As businesses cut back and collateral values fell, the amount of non-performing loans on their books have reached troubling highs. Many investors are still reluctant to jump back into bank stocks until they see a recovery in credit quality.

However, history suggests that bank stock performance often front-runs actual economic recovery and now may be the optimal time to invest. After non-performing assets (NPA) peaked and began to fall after the S&L crisis in 1991, bank valuations rose throughout the rest of the decade (See Chart B). We think community bank valuations will again appreciate back above tangible book value as the cycle repeats. In fact, NPAs experienced their first improvement in 2010 from 2.44% to 2.40%. If credit quality continues to improve as we anticipate, it could result in some very healthy returns for community bank stocks.

Chart B: Valuation vs. Credit Quality



Note: When non-performing assets decreased, bank valuations increased. Source: SNL Financial & FJ Capital. Data as of Q3 '09.

Home-Run Potential

While most bank stocks earn a decent return commensurate with book value growth plus dividends, the real excitement comes from buyouts. A long-lasting trend of consolidation has seen the number of bank institutions in the U.S. fall from nearly 16,000 in 1989 to under 8,000 today. We believe incentives are in place for the consolidation trend to continue.

When thinking about bank stocks, we often picture small banks being acquired by mid-sized banks which are acquired by big banks, as illustrated in Figure 1 below. However, unlike the picture below where the little fish is lunch, acquired banks get bought out at significant premiums.

Figure 1: Bank Consolidation Food Chain

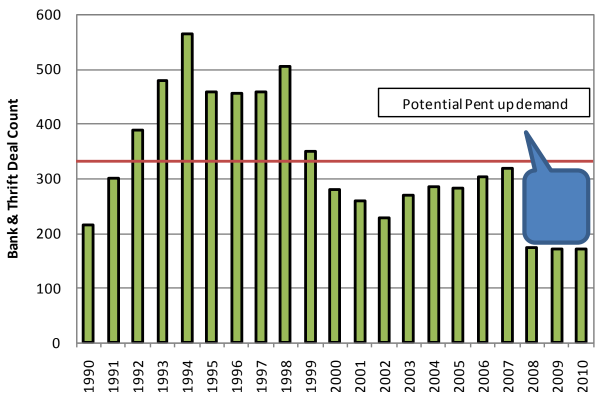
Buyout Premiums

Historically, bank buyout premiums have averaged about 35% above the previous day price and equating to 1.5-2x tangible book value. While such a buyout premium would be fantastic, we think future buyouts could be even higher. Because of low liquidity and low valuations, the 26 public bank buyouts in 2010 recorded an average premium paid over the previous day closing price of 83%! The average take-out multiple was still only 1.2x tangible book value, giving us further confidence that small-cap banks are undervalued.

Pent Up Demand

Industry dynamics, including costly regulations, slower economic growth, and low valuations indicate that there may be a wave of bank buyouts coming. Just like you may put off going to the grocery store for a few more days, eventually you have to restock your house. Chart C on the following page shows there have been 300-500 bank buyouts a year, but less than 200 for the past few years due to the credit crisis. If bank consolidation returns to past trends, we will likely see an average 330 deals a year plus a potential 500 more from pent up demand. With roughly 7800 total banks, this would equate to 1500 banks or 19% of all banks being bought out over the next 3 years.

Chart C: Bank Deal Levels Depressed



Source: SNL Financial & FJ Capital.

Taking Advantage

We think the best way to take advantage of the opportunity in the community bank space is to select stocks individually based on the Stan Finger criteria. Here is an example of a bank that would qualify:

Hopfed Bank (Ticker: HFBC) - Price: $9.04

Founded in 1879, HopFed Bank (a.k.a. Heritage) is a small "neighborhood" bank with 18 branches. They have a leading position in the markets they serve including an 11% share in the Clarksville/Hopkinsville, TN area (home to Ft. Campbell Army base) and a 20% market share in Fulton/Marshall/Calloway Counties in Kentucky (home of Murray State). With total bank assets of roughly $1.1 billion, they have a tangible equity value of $95m or $14 per share. HFBC's is extremely well capitalized with a tangible equity/assets ratio of 10.5% and has strong credit quality ratios. Only 1.3% of their assets are "non-performing" vs. double that for their regional competitors.

Given HFBC's loan portfolio shift into more commercial and industrial loans, we expect Hopfed to get a valuation boost when they establish a commercial charter, which should be this summer. With a $1.10 EPS estimate and 3.6% dividend yield, we believe shares are conservatively worth tangible book value of $14 per share, a 55% premium to the current price. While HFBC may have another quarter or two of problems to sort out, we think they will perform well in the long-term. Hopfed is just one of many strong community banks that we think represents great value in the market today.

Acquirers Benefit Too

With M&A pricing occurring at recessionary levels, buyers are able to build market share and add value to their shareholders through acquisitions. Well priced acquisitions can be immediately accretive to earnings and smart management has the potential to operate more efficiently. One example of a large banking institution that we like is Citigroup.

Citigroup (Ticker: C) - Price: $4.73

Citigroup is one of the world's largest and most diverse financial services companies. It's a market leader in credit cards, consumer finance, retail banking, corporate lending, investment banking, and brokerage. 95% of the Fortune 500 companies and 85% of the global Fortune 1000 are clients.

Early in 2009, Citicorp separated into a good bank/bad bank structure to focus on reducing their troubled loan portfolio. They have so far been successful, cutting these assets in half down to 20% of their total. Everyday, troubled loans are being sold and maturing and profitable loans are being added. As a result, non-performing loans in nearly every division have been improving sequentially for the past 4 quarters.

Despite their global scale and franchise value, Citigroup shares trade right around tangible book value and at a 30% discount to their large-cap peers. They anticipate being able to "return cash to shareholders" in 2012. With a $4.44 tangible book value and an estimated $.46 in EPS for 2011, we estimate fair value on Citigroup shares around $6.50 per share, a 37% premium to the current quote.

Conclusion

I remember when Stan first taught me his strategies for intelligent community bank investing. He rhetorically asked: "Why put your savings in a bank, when you can instead buy shares of the bank?" We couldn't agree more. Given the low valuation of community bank stocks and a potential wave of mergers coming, we think Stan's strategy is the right approach at the right time.