

WEDGEWOOD VIEW. 2004 ANNUAL REVIEW

1st NATIONAL BANK OF WEDGEWOOD (CONT.)

In our last letter we proposed the idea of creating a powerhouse hypothetical bank – the 1st National Bank of Wedgewood – through what we believe to be best-in-class individual companies. In the first installment of that letter we reviewed our deposit-growing community bank champ (Commerce Bancorp) and our nationwide market share student lending and servicing leader (Sallie Mae).

In this letter we will introduce our seemingly mundane divisions of money management and mortgage banking.

Money Management

Most reasonably sized banks offer fee-based investment management services through traditional trust department divisions. The classic, if not staid, bank trust department has changed more over the past dozen years than ever before. In addition to too much capacity in the investment management/brokerage industry, all industry participants (trusts, independent firms, mutual funds, brokerage firms, etc.) must deal with ceaseless portfolio performance pressure. Once “sticky” client accounts are not so sticky any more. One may argue the merits of too much emphasis on ever decreasing performance time horizons, but the fact (reality) remains: portfolio performance matters. On this score, our money management division truly shines.

Our money management division was never a traditional trust department. This division traces its roots back to 1899 as a full service securities brokerage firm based in Philadelphia. A merger in 1960 with a regional brokerage firm out of Baltimore laid the foundation for the next 25 or 30 years. Starting in the mid-1980's, traditional commissioned brokerage firms began to slowly move away from commission-based revenues to more fee-based revenues. Early fee-based adopters began to offer pure fee-based services and products themselves via in-house mutual funds and individual account money management services. Even though, as late as 1990, commissions accounted for 75% of our division's revenues, this division has been the industry's undisputed leader in offering multifaceted fee-based asset management services - ranging from best-in-class in-house asset management to wholly-owned, yet independently-identified and managed investment management firms of differing asset classes and investment styles.

With the tailwind of outstanding investment performance across all of this division's half a dozen "independent" money managers, growth has been nothing short of spectacular. Over the past five years, assets under management have compounded at a rate of 26%. Assets under management, now in excess of \$360 billion, have grown 53 out of the last 54 quarters and asset management revenues have grown 58 out of the past 59 quarters – amazing!

Investment management fees (as a percentage of firm-wide revenues) have grown from 12% in 1988 to nearly 70% today. Division pre-tax operating margins have doubled over the past decade to 28%. For the just completed fourth quarter revenues, earnings and earnings per share all set new record levels. For the full year assets under management, revenues and earnings per share grew at 36%, 26% and 38%, respectively. It took our money management division 103 years to build the first \$1 billion in shareholders equity. The second billion took little more than the next three years. Compounding is a wonderful thing.

While our division's Private Client Group (traditional brokerage) operating margins are only +16%, the retail distribution capabilities of 1,350 brokers – out of 135 offices – throughout the Mid-Atlantic States continues to leverage the entire asset management product line. Coupled with the performance-driven institutional/consultant marketplace, our money

management division continues to post the highest organic growth rate of any other major asset manager. For the full year, annualized organic growth reached an outstanding (and market leading) 28%.

Double-digit organic growth will continue to be supplemented with acquired asset management firms. In fact, just last month this division acquired a firm with \$6 billion in assets under management, with offices in New York City and Philadelphia.

Given the ever powerful laws of large numbers, we certainly don't expect this division to continue to grow at +25% annual rates. If, as we do expect, this division generates multiyear growth of 15% to 20%, this division will continue to be a star performer of the 1st National Bank of Wedgewood.

Our money management division is Legg Mason.

Mortgage Banking

Of all of the varied financial markets, mortgage debt has been a standout grower. Over the last decade, total outstanding mortgage debt has grown from \$3.2 trillion to \$7.5 trillion – a steady annual growth rate of 8%. Over the course of the same decade, our mortgage banking division has become the envy of their industry. Unlike many of their competitors, who are typically a division of a large regional or nationwide bank, our division has operated with complete autonomy since their founding in 1969. In addition, and again, unlike many of their competitors, our mortgage division has grown without acquisitions. Given the disruptive nature to client service and banking personnel due to the countless bank and thrift mergers and acquisitions over the years, our division has been taking considerable advantage of such turmoil to enrich the depth and breadth of mortgage professionals. The next time you read of a large bank merger, you can be sure that our mortgage division will be on the prowl for top talent.

The net result of possessing a pure mortgage banking focus, combined with industry leading talent, capital and technology, has been a steady increase in market share over the years – particularly over the past ten years. A decade ago, our mortgage division led the nation in mortgage servicing with a 3.3% share. Today, not only are we still the nation’s leading servicer, but with a +10.1% share, our \$800 billion (not a typo!) mortgage service portfolio exceeds the *combined* top 10 servicers from just 1994.

On the mortgage origination front the story is even stronger. In 1994 we led the nation with a 4.2% share in mortgage originations. Currently, we still lead the nation in originations with a 13.2% share, yet our mortgage division has funded more mortgages this past year than the top 25 originators (combined) funded in ten years ago.

As most of us can personally attest, the frequency of a home purchase or a mortgage refinance is affected by numerous variables. Most influential is the level and change in interest rates – particularly with regard to refinancing. The inherently bumpy nature of refinances as well as new mortgage originations will forever be extraordinarily cyclical. To offset this rollercoaster ride, our division has steadily diversified into two other key areas.

As we mentioned before, our servicing portfolio has routinely been a market share leader, yet the contribution to the division’s bottom line has always been dwarfed by originations. Not any more. A large servicing portfolio acts as a natural or “macro” hedge to affect the cyclicity of mortgage originations. This macro hedge concept is intuitively easy to understand. As interest rates rise, the volume of mortgage originations and refinancings, of course, fall. Yet, it stands to reason that home owners will forego the hassle of changing service providers. Those very small sums that mortgage servicers collect (officially called mortgage servicing rights) for the servicing and distribution of principal and interest rate payments, plus escrow payments, become quite valuable as servicers extend the holding period of the servicing rights. Calendar 2006 will likely represent the timeline when our division’s servicing revenue exceeds the origination revenue.

Also key is our division's efforts to continue to further diversify into additional mortgage-related areas, including our mortgage bank. Our mortgage division first entered the banking business in 1999 with the purchase of Treasury Bank. At the time, Treasury Bank only had \$75 million in assets. Over the next three years efforts were underway to build the necessary management team, infrastructure and related systems for very rapid growth. Treasury Bank has not disappointed on this score.

Treasury Bank, as one might suspect, is a focused, mortgage related bank rather than a typical full service bank. Treasury Bank's deposits are composed of broker and retail deposits, plus escrow deposits. Their loans are composed of fixed-rate second mortgages and first lien home equity loans (HELOC). We applaud rapid growth, but only if such growth is commensurate with very high quality. Our mortgage division has done exceedingly well on this score too. Their portfolio credit quality currently is strong with average weighted FICO scores of 732, loan-to-volume weighted averages of 80% and +60 day delinquencies of just 0.09%. Treasury bank should end the year with *\$40 billion* in assets. The company continues to work very closely with regulators and has received approval to grow assets to *\$200 billion* by 2008. We expect Treasury Bank to generate 50% of total company earnings in just two short years.

Our division – Countrywide Financial – is certainly not your father's old mortgage bank.

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