Yale SCHOOL *of* MANAGEMENT
New Haven, Connecticut

Thrifts, Community Banks, and Savings & Loans

Strong Housing Market Drives Stock Performance

***It's A Wonderful Life* (1947)**
Source: Republic Studios.

February 4, 2002

John M. Dusza	S&P 500 – 1,130.20
john.dusza@yale.edu	NASDAQ Bank Stock Index (CBNK) – 2,055.87
	Proprietary Thrift Index (DMACX) – 716.20
Brian D. McNulty	10-Year Treasury Yield – 5.03%
brian.mcnulty@yale.edu	Fed Funds Target – 1.75%

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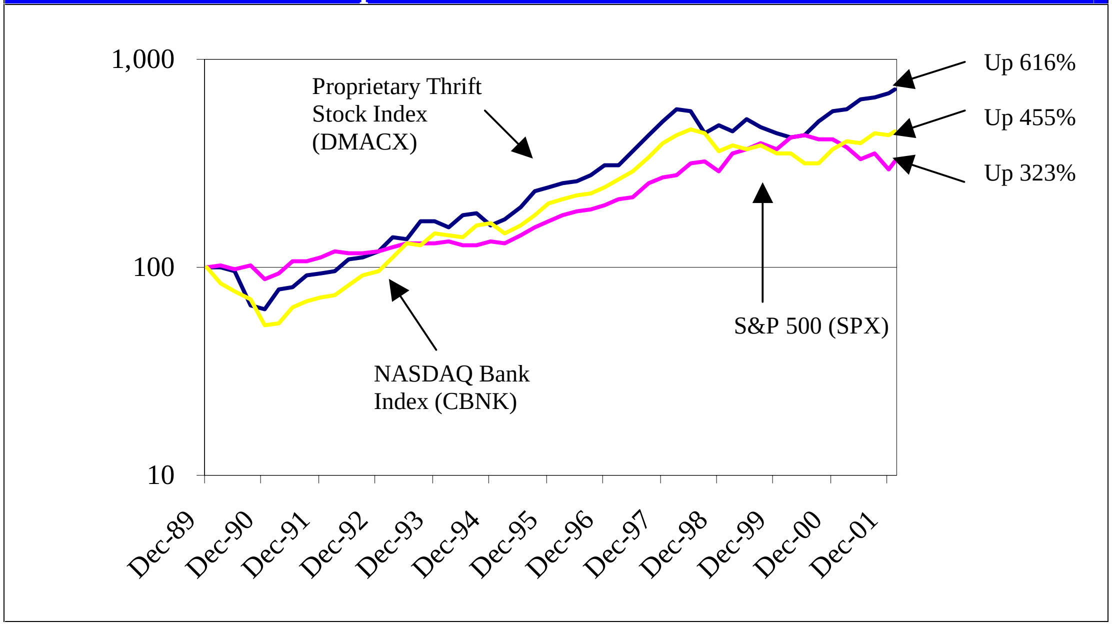
Thrifts Have Outperformed the Market Over the Last 12 Years



Source: Bloomberg, Yale School of Management.

Small and Mid Cap Banks Still Attractive; Outperformance Should Continue

- Over the past 52 weeks, S&L/thrift stocks in our coverage universe (500 million to 1.5 billion market capitalization) have significantly outperformed the S&P 500.
- Earnings have been better than expected due to falling interest rates and a strong housing market. In addition, many portfolio managers considered these stocks "safe havens" in a volatile market.
- Despite their significant outperformance, we believe this group continues to look attractive for investors with an intermediate time horizon of 12-18 months.
- The stocks in our Thrift/S&L group currently trade at a discount to the S&P 500 of 40%.
- Dividend yields are above average at 2.3%.
- Based on our expectation of a slowly recovering economy, continued low interest rates, and a stable housing market, this group should continue to outperform the overall market.
- Assuming the group will trade at a 25% discount to the market, we expect the group to deliver a total return including dividends in excess of 20% over the next 18 months.

A Note About The Dusza/McNulty Proprietary Thrift Index (DMACX)

The DMACX is a value-weighted index that was started on January 1, 1990. It includes all thrifts, community banks, and savings & loans with a market capitalization of less that $1.05 billion in 1990 dollars. Once a member's market cap exceeds this value they are removed from the index. It is rebalanced annually.

A Snapshot of Our Universe

Fundamental Statistics of Stocks In Our Thrift Coverage Universe										
Name	Ticker	Current Price	2001 EPS	P/E	Est 2002 EPS	Est P/E 2002	Price / Book	1-yr Return	Dividend Yield	Market Cap ($ millions)
IndyMac Bancorp	NDE	23.83	2.00	11.9	2.39	10.0	1.70	-3.6%	0.0%	$1,440
People's Bank	PBCT	22.00	1.24	17.7	0.92	23.9	1.45	-12.9%	6.2%	$1,350
Washington Federal	WFSL	28.33	2.14	13.2	2.44	11.6	1.86	17.8%	3.4%	$1,630
Webster Financial	WBST	33.07	2.77	11.9	3.24	10.2	1.61	18.3%	2.1%	$1,630
Downey Financial	DSL	46.11	4.25	10.8	4.37	10.6	1.77	0.6%	0.8%	$1,300
Commercial Federal	CFB	24.49	1.93	12.7	2.17	11.3	1.58	12.0%	1.3%	$1,140
MAF Bancorp	MAFB	30.41	2.56	11.9	3.00	10.1	1.60	10.9%	2.0%	$700
Capitol Federal Financial	CFFN	21.85	1.02	21.4	1.15	19.0	1.58	40.8%	3.3%	$1,560
Independence Community	ICBC	25.93	1.58	16.4	2.07	12.5	1.72	59.8%	1.7%	$1,510
Staten Island Bancorp	SIB	18.83	1.15	16.4	1.37	13.7	2.13	61.7%	2.1%	$1,180
Universe Averages				**14.4**		**13.3**	**1.71**	**20.6%**	**2.3%**	

Source: Bloomberg, Yahoo! Finance, Yale School of Management.

IndyMac Bancorp (NDE) is a technology-based mortgage company with a community banking network in southern California. Its market cap is $1.44 billion and its 2001 return on shareholders' equity (ROE) was 16.5%.

Peoples Bank (PBCT) primarily serves Connecticut, where it has 144 branches. Its market capitalization is $1.35 billion and its 2001 ROE was 9.5%.

Washington Federal (WFSL) has 108 branches in Washington, Oregon, Idaho, Arizona, Utah and Nevada. Its market cap is $1.63 billion. 2001 ROE was 14.8%.

Webster Financial (WBST) primarily focuses on Connecticut where it has 114 offices. Its market cap is $1.63 billion; 2001 ROE was 13.9%.

Downey Financial (DSL) is primarily involved in residential lending through its 100 branches in California. Its market cap is $1.3 billion. Last year's ROE was 17.75%.

Commercial Federal (CFB) is based in Omaha, Nebraska with 200 branches in 8 states from Minnesota to Kansas. Its market cap is $1.14 billion. 2001 ROE was only 3%, but its net income rose 51% last year.

MAF Bancorp (MAFB) serves the western Chicago suburbs through 23 retail banking branches. Market cap is $700 million. 2001 ROE was 14.75%.

Capitol Federal Financial (CFFN) is located in Topeka, Kansas and serves central Kansas as well as portions of Kansas City through 34 branches. Market cap $1.56 billion, ROE 8%.

Independence Community (ICBC) has 65 branches in metropolitan New York and northern New Jersey. Market Cap is $1.51 billion, 2001 ROE was 10.25%.

Staten Island Bancorp (SIB) serves metropolitan New York and northern New Jersey through 33 branches. Market cap is $1.18 billion, 2001 ROE was 12.35%.[1]

[1] Yahoo! Finance.

Introduction

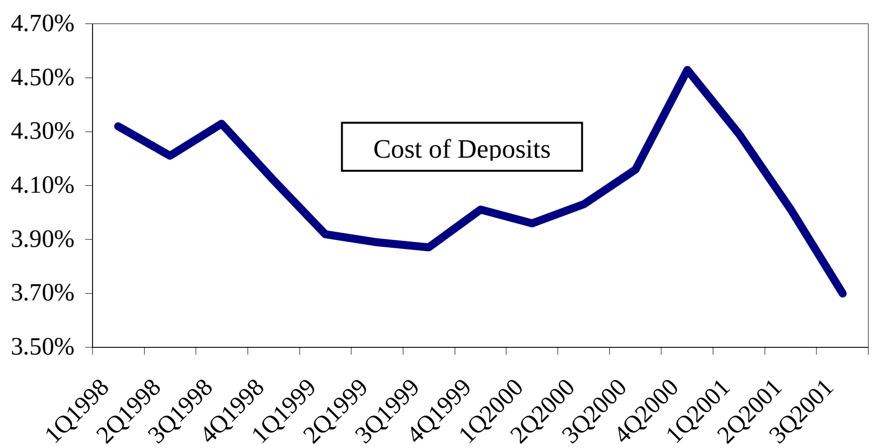
Savings and loans (S&L's), thrifts, and community banks are in the business of taking deposits and making loans, traditionally home mortgages. Recently, many have diversified into other financial services areas including corporate and consumer lending, credit cards, brokerage, and insurance, but residential lending remains the "bread and butter" business for most thrifts. The Office of Thrift Supervision is the primary regulator of these institutions, which are also governed by the FDIC. While they have flexibility in product and service offerings, there are restrictions on loan concentrations. A federal savings and loan may not make loans to one borrower or related entities greater than 15% of its unimpaired capital and surplus. Many are more conservative.

These institutions profit from both fee income (from mortgage fees and checking accounts) and the spread between their cost of funds (from savings and checking accounts and CD's) and their lending rate (mortgages and other loans). During the past year, the Federal Reserve has cut short-term interest rates from 6.50% to 1.75%, and consumer deposit interest rates have fallen accordingly. Meanwhile, the residential real estate market has remained exceptionally strong, as new home starts and resale prices enjoyed healthy gains last year despite the recession. As a result, stocks under our coverage have significantly outperformed the market over the past 12 months.

Stock Price Drivers

Historically, this group has traded on (a) interest rates and (b) the general economy, which impacts both credit quality and loan demand. To a lesser extent, these stocks have traded on (c) industry consolidation activity and (d) fundamental earnings improvement. During past recessions, most notably 1990-91, the real estate market (both housing starts and resale prices) also slumped. As a result, credit quality deteriorated and impacted earnings and balance sheets. During periods of declining economic growth, these stocks should under perform and should outperform during periods of positive economic growth, making them economically cyclical and sensitive.

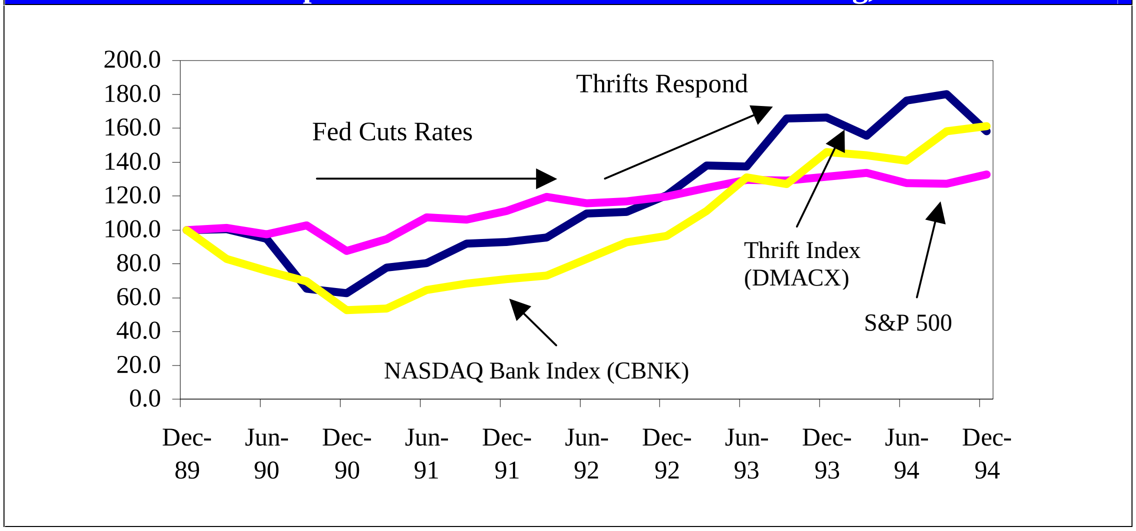
Deposit Costs For Thrifts Continue to Plunge



Source: Merrill Lynch, Yale School of Management.

Falling short-term interest rates, however, act as a significant positive for earnings and alleviate balance sheet pressures from bad loans. As a result, Fed easing has historically been a buy signal for the group and Fed tightening has been a general sell signal -- or at least a reason to be cautious. Actual stock performance in past cycles hasn't exactly followed the Fed's easing activity, but rather responded with a lag. Although the Fed started cutting rates in late 1990, for example many bank stocks didn't bottom until 6-12 months later. During 1992-93 as the Fed kept short-term rates low and the economy slowly recovered, this group enjoyed explosive outperformance.

Thrifts Outperformed Market After Last Fed Easing, 1990-94



Source: Bloomberg, Yale School of Management.

A third driver is industry consolidation. Although bank merger activity has been low recently, there is clearly a lot of room for further consolidation. There are currently over 10,000 financial institutions in the U.S. As the industry consolidates further, acquisition premiums could get priced into the market, lifting stock price to book value ratios. According to a report from Gartner Inc, nearly half of the financial institutions in the U.S. today will no longer be in business by 2007: "Massive industry consolidation will be driven by technology advances, international competition, [and] mergers and acquisitions."[2]

Last, improving profitability has lifted valuations within this sector and could be expected to further raise PE and price/book ratios going forward. Due to increased technology (ATM's, Internet banking), product and service as well as geographic diversification, and better balance sheet risk management (from mortgage and other asset securitizations) profitability levels have generally risen within the sector and earnings have become less volatile.

The Remarkable U.S. Housing Market

Although they have diversified into other lending markets, residential real estate continues to dominate thrifts' assets. Last year 82% of the top 15 traded thrifts' loan

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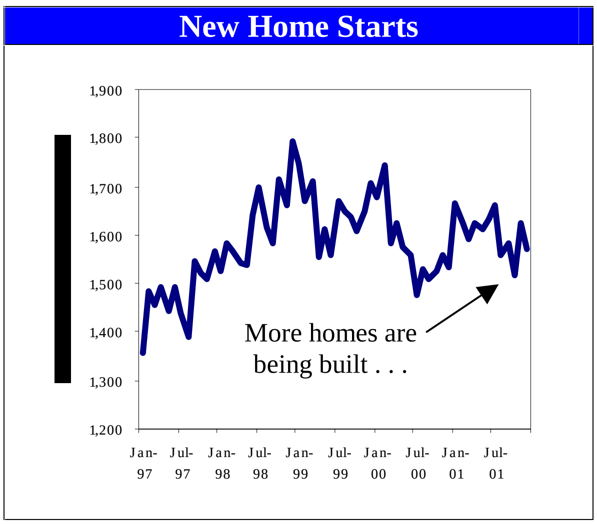
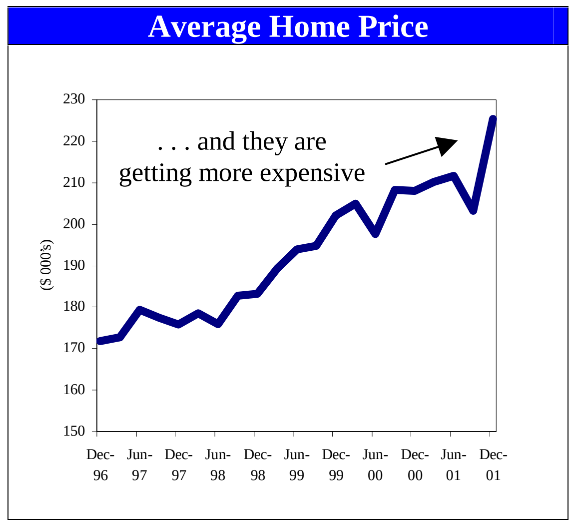
[2] American Banker, July 21, 2001. Gartner. "Half of Banks to Vanish by 2007"

portfolios were secured by completed real estate.[3] Given the resilient housing market, it is not a surprise that operating results for this group exceeded expectations. During one nine day period from January 16 through January 25, 2002, 100 banking companies with assets between $1 billion and $11 billion reported earnings. 38 banks set earnings records, while another 49 reported higher earnings from a year earlier.[4]

Last year, new home construction rose 4%, home sales rose 6% and mortgage debt outstanding rose 10% despite rising unemployment and recession. Much of this can be attributed to falling mortgage rates, which fell under 7% as the 10-year treasury yield fell under 5%, but it may also reflect other economic developments. For example, Americans may have been more confident investing in real estate than investing in the post tech bubble stock market. According to a Business Week poll, 39% of Americans believe real estate is the best investment they can make, but only 20% favored the stock market.[5]





Source: U.S. Department of Commerce, Bureau of the Census, Yale School of Management.

Looking ahead, we believe the housing market will continue to grow. In the last decade the mortgage market has grown 6-10 percent per year and should continue to grow at this rate. Over the next decade the U.S. population will add over 13 million new households, slightly faster growth than during the 1990s. The current home ownership rate is approximately 68%, suggesting further upside potential, especially given the strong desire and financial incentive to own a home offered by federal income tax deductibility of mortgage interest. In addition:

- Home values should rise faster this decade than during the 1990's as demand rises and supply is squeezed by growth limits and land scarcity in major metropolitan and suburban areas.

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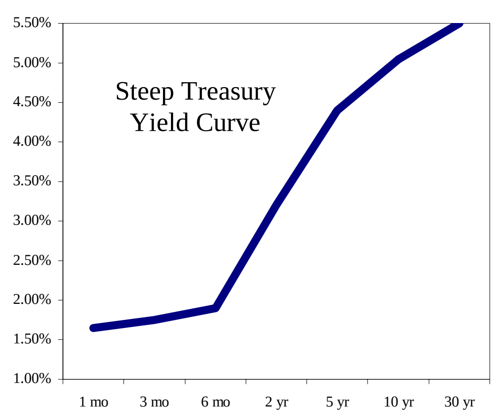
[3] FBR Research Brief, November 26, 2001.
[4] American Banker, January 25, 2002. John Reosti and Katie Kuehner-Hebert. "4Q: What Recession? Small Banks Post Record Profits"
[5] Fannie Mae, January 22, 2002. Transcript of speech by Franklin Raines at National Press Club.

- Consumers will double their investment in housing from $11 trillion today to $22 to $25 trillion by the end of the decade. This will require more than twice as much mortgage capital ($11-$14 trillion by the end of the decade vs. $5 trillion today).
- Under these projections, consumers will need 16 million new homes built. To finance and refinance these homes, consumers will borrow $16 trillion in mortgage loans.[6]

Economic Outlook: Best of Both Worlds for Thrifts

Similar to the economic recovery following the 1991 recession, we believe that the current recovery will be lackluster. Although initial new jobless claims have stabilized and fallen recently, the unemployment rate continues to rise. Because it is a lagging indicator, the unemployment rate may rise even if the overall economy improves this year. This should put pressure on consumer spending, which has been remarkably resilient during the past 12 months. In the fourth quarter of 2001 consumer spending grew at a 4% annual rate.[7] Another factor likely to be a drag on the economy is high debt levels. Corporate debts remain at record levels in relation to GDP. A slumping stock market, strong dollar, and high profile bankruptcies should also act as headwinds to mute any economic rebound this year.

Bond market predicting economic recovery . . .



. . . but all signs point to low inflation

- Most recent GDP deflator was negative
- Crude oil prices have fallen below $20/barrel, down more than 30% year over year
- AIG-Dow Jones commodity index down more than 20% year over year
- U.S. dollar at multi-year highs versus other major currencies

Source: Reuters, Wall Street Journal, Yale School of Management.

Nevertheless, it is clear that the economy is beginning to improve. Certainly, the exceptionally steep treasury yield curve suggests that economic growth will resume in the near future, but falling crude oil prices and the most recent inflation numbers suggest the Fed will be in no hurry to raise rates. An environment of moderate economic growth and low inflation should enable the Fed to keep short-term interest rates low. Overall, we believe the current environment is very similar to the end of the last recession. During the subsequent recovery, the Fed kept short-term rates at 3% from September 1992 to February 1994, during which bank stocks enjoyed a spectacular rally.

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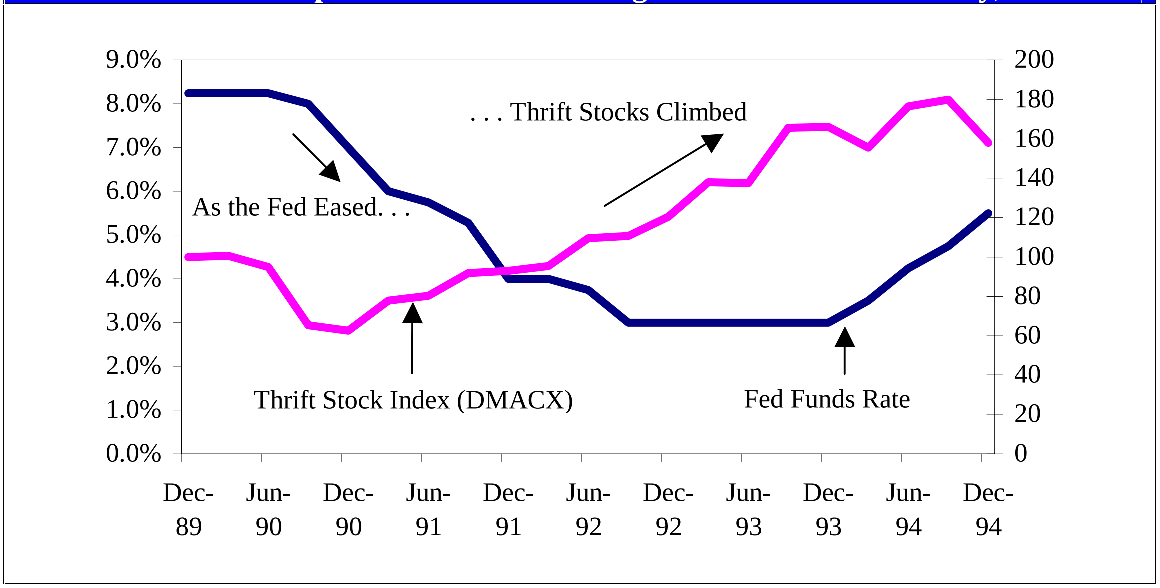
[6] Fannie Mae, January 22, 2002. Transcript of speech by Franklin Raines at National Press Club.
[7] The Economist, January 26, 2002.

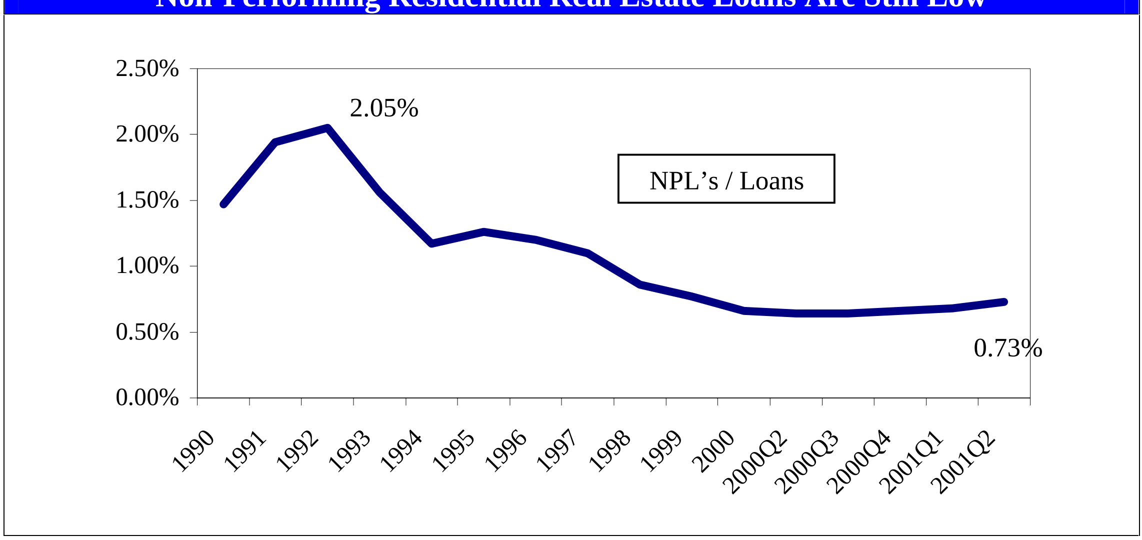
Fed Funds Rate Helped Bank Stocks During Last Economic Recovery, 1990-94



Source: Bloomberg, Yale School of Management.

Due to the solid housing market, credit quality at most thrifts has remained excellent. Although charge offs may continue to drift higher with rising unemployment, it would be off an extremely low level. According to one leading industry analyst: "In discussions with management teams across the country, residential portfolios are holding up very well, and all other segments of their loan portfolios are stable. Any increase [in non performing loans] comes off an unsustainably low base, with some companies reporting no net charge offs for years, and most non performers are real estate secured, thus limiting charge offs."[8] If indeed the economy is beginning to recover, the most significant threat to credit quality may be past.

Non-Performing Residential Real Estate Loans Are Still Low



[8] FBR research report, November 26, 2001

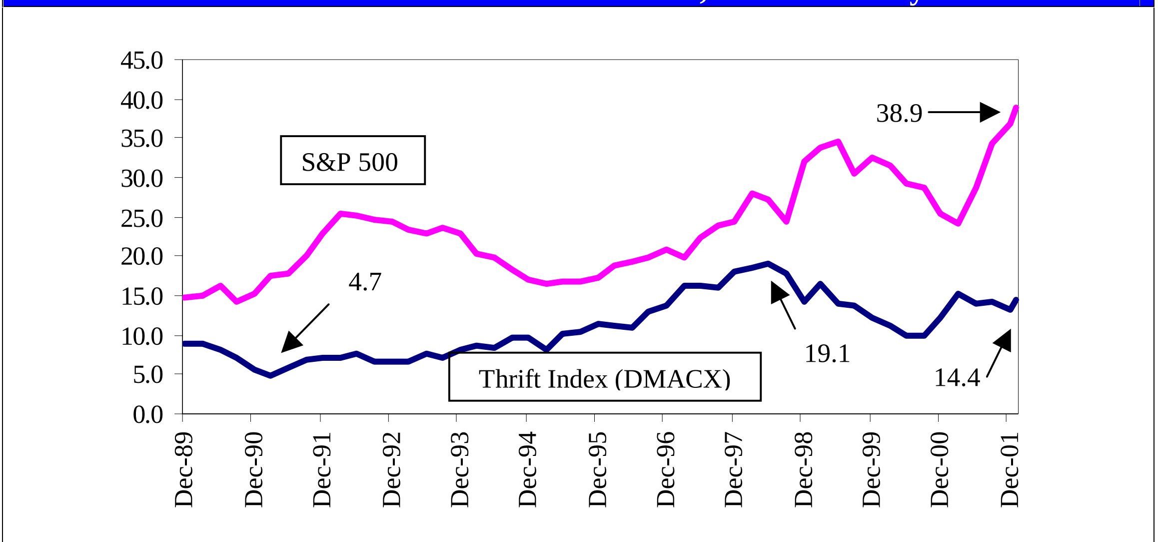
Source: SNL Securities, Yale School of Management.

Low inflation, continued low interest rates and a slowly recovering economy, should support credit quality and lending activity going forward. This would be the best of all worlds for small and mid cap bank stocks. Now is the most attractive time to take positions in these companies since the end of the 1991 recession.

Valuation

Over the past decade, our proprietary thrift index has traded at a P/E ratio between 4.7 in the spring of 1991 and 19.1 during the summer of 1998. More important, it has traded at a discount to the S&P 500 ranging from 73% (late 1992) and 18% (1997). Currently, based on expected 2002 earnings estimates, our index trades at a 39% discount to the market.

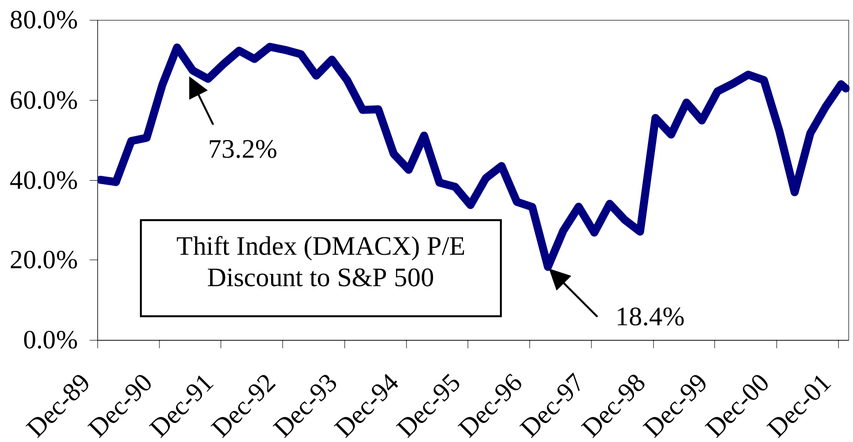
P/E Ratios of S&P 500 vs. Thrift Stocks, 1990 – January 2002



Source: Bloomberg, Yale School of Management.

Our bullish outlook for the sector rests on the sector closing the valuation gap further. If the S&P 500 remains at the same P/E level and our group rose 18%, our index would trade at a 30% discount to the market. We believe this is reasonable given the historical relationship between the group and the overall market. (We are using forward looking earnings for this comparison since most recent S&P 500 earnings have been impacted by one time charges).

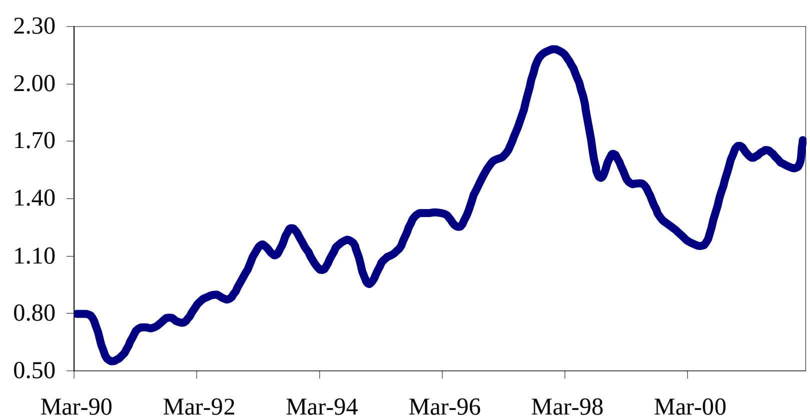
Discount of Thrift Stock P/E's to S&P 500



Source: Bloomberg, Yale School of Management.

At 16 times 2002 earnings, the group would be trading near the high end of its historical range established over the past decade. However, there is a precedent for multiple expansion. From 1992 through 1997, the average P/E ratio for our coverage group more than doubled. This is particularly impressive since it occurred during a period of rising short-term interest rates. We would not expect such dramatic multiple expansion during the next few years, since P/E and price to book ratios are not nearly as depressed as they were in the early 1990s, but we do think the group can reasonably trade at a modestly higher multiple to earnings and book values, especially given their strong earnings momentum.

Price to Book Ratio For Thrift Stock Index (DMACX), 1990-2002



Source: Bloomberg, Yale School of Management.

Risks

- Trading at only 13 times this year's expected earnings and around 1.75 times book value, we do not believe valuation is a major risk for this group, especially since earnings growth this year is expected to be around 15%.

- Earnings and cash levels are more than sufficient to allow further dividend increases and continued share repurchase activity.

- Equity levels are generally much higher than required, and would act as "shock absorbers" if loan losses continue to increase modestly.

- The major risk for these stocks is the residential housing market. Despite a 60% decline in the NASDAQ from its peak in March 2000 to its current level, there has been relatively little spillover into other markets, including real estate.

- If the U.S. housing market were to decline, credit quality would suffer and these stocks could fall significantly.

- The main risks to the housing market at this point are (a) continued economic weakness that drives unemployment higher than expected, and (b) sharply higher interest rates.

Conclusion

For value-oriented investors, we believe the small and mid cap bank stocks are very attractive and likely to produce a 20% total return over the next 12-18 months. Although it is cyclical, the group has defensive characteristics as well. If the economic recovery is weaker than many economists and investors expect, this group should continue to appreciate.

Important Disclaimer

Please read this document before reading this report.

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