

FBR Small Cap Financial FBRSX

Morningstar's Take | 07-27-09 | by Ryan Leggio

FBR Small Cap Financial investors should hang tight.

The last few quarters have been quite dramatic for financials sector investors, to say the least. The Dow Jones U.S. Financials Small Cap Index fell more than 65% from the June 2007 through March 9, 2009, and has recovered more than 60% since that time, though there is still a lot of ground to make up. This fund suffered much less than the index and the average fund in the category during this period thanks to a healthy cash stake (it was up to around 60% at the market's bottom) and strong stock-picking from longtime manager David Ellison. The fund has lost 22% since June 2007, compared with almost twice that for the index.

We think owning the fund will continue to pay off now that it appears the worst is behind the sector. For one, cash is now under 10%, which means shareholders will substantially participate in further market advances. The cash balance held the fund back earlier this year as it took time for Ellison to deploy it. In addition, Ellison is one of the few managers in the sector who have managed a fund out of the last financial calamity (in the early 1990s at Fidelity Select Home Finance FSVLX). This experience should help Ellison separate the winners from the losers as the credit crisis abates, similar to what he did in 1992. The last best time to own financial stocks was between 1992-96, and Ellison thinks we are entering a similarly rewarding period for investors. This optimism is why he has shifted the portfolio in to what he admits are "ugly" names, including KeyCorp KEY which has significant commercial real estate exposure.

It is important to keep in mind that a recovery from here may not be a steady one over the next few years. But for those who are patient and comfortable with volatility, there isn't a better choice for small-cap financial exposure.

Ryan Leggio, Esq., is a fund analyst with Morningstar.

Morningstar Rating

★★★★★

Kudos

- Impressive long-term record.
- Experienced management.
- Focuses on absolute as well as relative returns.

Risks

- The fund's mandate is very limited, even within the financials category. It should perform well when small-cap financials rally and should lag the category when larger-cap stocks are in favor.
- Dramatic in- and outflows of cash may adversely affect the fund's tax position and performance.
- Above average fees.
- Can lag peers for long periods.
- Financial industry faces unprecedented uncertainty.

Strategy

This fund invests in small banks and thrifts with plain-vanilla business models. Manager David Ellison seeks stocks that are trading at low P/E and price/book ratios that have steady growth prospects. Also, he looks for company management teams focused on maintaining high-quality loan portfolios.

Management

David Ellison has run this fund since its 1997 inception, and he also manages FBR Large Cap Financial FBRFX. Prior to joining FBR Investment Services in late 1996, he managed Fidelity Select Home Finance FSVLX for 11 years and posted strong results. Ellison has a significant portion of his net worth invested in this and other FBR offerings.

Inside Scoop

This fund invests almost exclusively in small banks and thrifts. Its manager is a seasoned financials stock-picker and boasts a strong record here. This fund does a good job playing its niche.

Role in Portfolio

Specialty. This fund has a very narrow mission within the financials category, so it should play a very small role in a diversified portfolio.

FBR Small Cap Financial FBRSX

Year	Total Return (%)	+/-Category
YTD	10.64	-3.55
2009	—	—
2008	-8.73	35.18
2007	-22.18	-10.54
2006	11.80	-5.10

Data through 07-31-09

For More Information

888.200.4710
www.fbrfunds.com

**Important Disclosure****Average Annualized Total Returns**

as of 6/30/09

	1 Year	3 Year	5 Year	10 Year
FBR Small Cap Financial Fund <i>Investor Class</i> (FBRSX)	4.09%	-9.76%	-2.16%	8.50%
NASDAQ Banks Index	-24.66%	-21.50%	-11.89%	-1.88%
Russell 2000® Index	-25.01%	-9.89%	-1.71%	2.38%
Morningstar Specialty Financial category rank	9%	17%	15%	5%
# of funds in Specialty Financial Category	126	112	102	58

Total annual operating expenses were 1.49%.

Past performance is no guarantee of future results. The performance data quoted represents past performance and the current performance may be lower or higher than the performance data quoted. The investment return and principal will fluctuate so that investors' shares, when redeemed, may be worth more or less than their original cost. The performance data does not reflect the deduction of redemption fees and if reflected, the redemption fee would reduce the performance quoted. To obtain performance data current to the most recent month-end please call 888.200.4710 or visit www.fbrfunds.com.

Investors should consider the investment objectives, risks, charges and expenses carefully before investing. This and other important information can be found in the Fund's prospectus. To obtain a free prospectus, please call 888.200.4710 or visit www.fbrfunds.com. Please read the prospectus carefully before investing.

Investments are focused in the financial services industry which may be adversely affected by regulatory or other market conditions such as rising interest rates. Investing in mid and small capitalization companies present a greater risk of loss than investing in larger, more established companies.

Indices are unmanaged and have no management fees or operating costs that reduce reported returns. The volatility and other risk characteristics for the Fund will differ from the volatility and risk characteristics of the indices.

Morningstar Specialty Financial category consists of those portfolios that seek capital appreciation by investing primarily in equity securities of U.S. or non-U.S. financial services companies, including banks, brokerage firms, insurance companies, and consumer credit providers.

NASDAQ Banks Index is a capitalization-weighted index of domestic and foreign common stocks of banks that are traded on the NASDAQ National Market System.

Russell 2000® Index is an unmanaged total return index of the smallest 2000 companies in the Russell 3000 Index, as ranked by total market capitalization.

P/E ratio is the measure of a security's market price per share divided by earnings per share.

Price/Book ratio is the measure of a security's market price per share divided by book value.

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