

FPA Crescent Portfolio

January 29, 1997

Dear Fellow Shareholders:

The stock market gave investors a wonderful gift, turning in 1996 fourth quarter performance of 5.6% (Russell 2500) and a full year return of 19.0%. The FPA Crescent Portfolio ("Crescent") performed well last year. Averaging less than 60% in stocks, we still managed to approximate the returns of the S&P 500 and outperform the Russell 2500 and our Balanced Benchmark by 3.9% and 10.3% respectively for the year.

The comparative returns for Crescent and its relevant benchmark indices are shown below.

Time Period	FPA Crescent	Balanced Benchmark 60% Russell 2500 40% LB Gov't/Corp	Lehman Brothers Gov't/ Corporate	Russell 2500	S&P 500
<i>Period Ended 12/31/96</i>					
Quarter	6.8%	4.6%	3.1%	5.6%	8.5%
<i>Annual</i>					
1996	22.9%	12.6%	2.9%	19.0%	23.3%
1995	26.0%	26.7%	19.2%	31.7%	37.5%
1994	4.3%	-2.0%	-3.5%	-1.1%	1.3%
<i>From Inception*</i>	17.3%	12.3%	6.4%	16.1%	18.0%

*Inception is 6/2/93. Returns from inception are annualized. The annualized performance of the Russell 2500, Lehman Brothers Government/Corporate, and S&P 500 Indices begins 6/1/93. The data quoted represents past performance and is not indicative of future performance. An investment in the fund may fluctuate so that an investor's shares when redeemed may be worth more or less than their original cost.

I do not fancy myself an economist but I do know that increasing inflation leads to higher interest rates and higher rates are the stock market's enemy. An inability to predict interest rates plagues me. If somebody had told me a year ago that the ten-year treasury note would increase 0.85%, from 5.57% to 6.42%, I would have said stocks would not be a good place to invest for that period. Thankfully, I am not a market timer. Presently, inflation remains low and likely to continue for the near term due to increasing productivity, an ever more competitive marketplace and bargain-conscious consumers. The risks of this theory are many and include trade protectionism keeping prices artificially high, tension in the Middle East causing higher energy prices, and low employment leading to higher wages. Longer term we continue to believe that stocks are the best place to invest.

The past fifteen years have offered U.S. stock returns in the mid-teens, but with price/earnings and price/book ratios high and dividend yields and interest rates low, we feel that risk management is extremely important in the shorter term. Many forget that stocks have returned on average 10% per year in this century and of that return, close to 4% came from dividends. This means that capital appreciation accounted for just over 6%. In anticipation of a reversion to the mean at some point, current income (although not tax advantaged) will play a more important role as part of future total return. With our complement of high-yield and convertible bonds, we feel we have cushioned our downside. While this moderates our upside in a bull market, Crescent's returns have still beaten the broader stock averages since its inception.

The U.S. stock market continues to do well, in part because such alternative investments as commodities, bonds, real estate (excluding REITS), and emerging markets have not offered reasonable performance these past few years. U.S. stocks' excellent performance, however, has been concentrated in relatively few large companies. Smaller companies did not perform nearly as well. The Russell 2000, the most widely used small capitalization index, increased only 16.5% in 1996, lagging the S&P 500. The smallest companies in the Russell 2000 performed even more poorly. Investors' greater comfort level with larger companies has led to continued increases in money directed to S&P 500 index funds. This trend becomes a self-fulfilling prophecy: cash flow into index funds requires additional purchases of larger capitalization companies; which in turn drives prices of those companies higher and leads to further index outperformance. This can continue for an indeterminable period, but when investors want out -- watch out. The exit doors are too small to let everyone out at once. With the thirst for large companies unquenched, small companies trade with slightly lower valuation characteristics. Smaller companies on average, trade today at around a 10% discount to larger companies (Source: Leuthold). This is where we maintain our focus.

Two small companies that we have owned for a while but where we have recently increased our positions and which are worth noting are National R.V. Holdings, Inc. and Michaels Stores, Inc. National R.V.'s recreational vehicles (RVs) are generally purchased by people in their late 40s to mid 60s. With the aging of the baby boomers, the RV industry's favorable demographics should offer excellent growth into the next millennium. We have invested according to this theme for some time. Prior to owning National R.V., we owned one of their competitors, Coachmen Industries, Inc., for a couple of years. From our \$6 cost, Coachmen's stock appreciated to a point of full valuation and we finished liquidating our position last year with an average sale price of almost \$23 per share. National R.V. has been increasing profits along with their market share these past few years and we expect this to continue as a result of new manufacturing capacity, line extensions, and favorable demographics. National has an extremely high ROE, substantial insider ownership, and a balance sheet with very little leverage. Earnings per share growth should be 15 - 20% over the next couple of years and the stock, currently priced at \$14, trades at only 11.2x and 8.8x 1996 and 1997 earnings projections, a substantial discount to both the stock market and its peer group.

Michaels is the nation's largest retailer of arts and craft supplies with more than 450 stores and over \$1.3 billion in sales. This is the place to go if you wish to buy such things as paints, felt, beads, and styrofoam for your children's school project or your creative endeavor. Whereas National R.V. is more of an undiscovered investment, Michaels Stores had already been discovered and subsequently disposed of. This controversial stock traded as high as \$46 in 1994 and has since declined to \$12 at year-end 1996. Michaels' rapid growth in stores during the '90s proved unmanageable. At one point in time Michaels had well over 50,000 different items in the store and no point of sale computer system to monitor that inventory. The company now has a new management team, led by Michael Rouleau. The number of items in the stores has been reduced to 40,000 and a point of sale computer system has been rolled out to all stores. Management now knows their fastest-selling items and can use that information to improve their merchandising. If a customer comes in and they are out of stock they have lost a sale; therein lies an opportunity. Under prior management, suppliers shipped 55% of the products directly to the store. In such circumstances, the store is subject to minimum orders and might receive 12 packages of purple beads when only two packages are sold in a typical year. This leaves the store with too much inventory, higher financing costs, and a lower gross margin. Mr. Rouleau intends to have the majority of items shipped to the stores through their distribution centers. Assuming new management is successful in this turnaround, earnings per share could easily exceed \$2 in the next few years. At current prices, the company is trading below book value and at a single digit price/earnings multiple on normalized earnings. If the chairman exercises an option in the next month, insiders will control 30% of the company with 15% (\$47 million) purchased over the preceding ten months. The chairman and his family have put their money where their mouths are. Ours is now there too.

The average yield on our bond portfolio has declined. Many bonds have performed well and we have not swapped them to higher yielding instruments, given that the yield advantage over treasuries is the narrowest it has ever been. We do not wish to own a highly leveraged debt security late in an economic expansion when we are not paid to take the risk. In 1991, less than investment grade bonds traded as much as 10 percentage points better than treasuries. Currently, the spread is in the 3 percentage point range and therefore our investment in high-yield bonds is lower than it has ever been as we await opportunities, at 12.5% of net assets.

Our fixed income investments are frequently a by-product of our equity research. As an example, we have established a position in the 10.875% Michaels Stores Senior Notes due 2006. If we like the stock, we had better like the bonds. At our cost we expect to receive a yield to maturity of 11.9% for the next 9.5 years. We feel this will be quite competitive with what the stock market will offer over that period of time. Meanwhile, we continue to seek fixed income investments that offer us equity-like returns with reasonable risk. Our comfort with equity analysis and our failure at interest rate forecasting lead us to prefer credit risk rather than interest rate risk.

We maintain our value orientation as reflected in the table below, but Crescent's average price/earnings ratio has increased from the third quarter, given the strong performance of our equities in the fourth quarter.

Ratios (Weighted Average)	Crescent	Russell 2500	S&P 500	Lehman Bros. Gov't/Corp.
<i>Stocks</i>				
Price/Earnings 1996 est.	15.9x	23.0x	18.2x	
Price/Earnings 1997 est.	11.9x	17.2x	17.2x	
Price/Book	2.2x	2.6x	3.4x	
<i>Bonds</i>				
Duration	4.6 years			5.1 years
Maturity	6.0 years			9.5 years
Yield	9.7%			6.4%

*All index data courtesy Frank Russell Company except for S&P 500 price/earnings ratios which are IBES. Crescent Price/Earnings ratios exclude companies valued on basis of cash flow (e.g., real estate companies). Crescent Earnings exclude non-recurring writedowns.

Listed below are Crescent's ten largest holdings, excluding short-term investments, as of December 31, 1996. These investments account for 26.9% of the portfolio's net assets:

Common Stock

Mac Frugal's Bargains Close-outs, Inc.
Maxim Group, Inc.
Michaels Stores, Inc.
Pinkerton's, Inc.
Price Enterprises, Inc.
Semi-Tech Global Ltd.
U.S. Facilities Corp

Corporate Bonds

Alexander Haagen Properties, Inc. 7.5%, 1/15/2001 Convertible Sub Notes
Charming Shoppes, Inc. 7.5%, 7/15/2006 Convertible Sub Notes
Trump Atlantic City Associates 11.25%, 5/1/2006 First Mortgage Notes

Crescent had the following net asset composition at December 31, 1996.

Common Stocks, long	53.6%
Common Stocks, short	-4.0%
Preferred Stocks	3.7%
Corporate Bonds	18.1%
Cash & Equivalents	24.6%
Cash held as collateral for securities sold short	4.0%
Total	100.0%

As inflows into Crescent continue, it is likely that you will see two things occur. First, cash will expand as a percentage of assets until we find opportunities. We do not invest for the sake of being invested, preferring to complete our homework. Nor do we simply buy more of everything we own. Some positions are closer to their fair value and, given some additional price appreciation, will soon be sold. Second, the number of positions will expand for a period of time. Our goal is to maintain between 30 and 40 stocks in our portfolio, but we might add some new positions before older positions are completely liquidated. As cash inflows moderate, so will the number of positions.

We feel stocks are fully valued shorter term and are closely watching what we determine to be the three pillars of support for the stock market: earnings growth, low interest rates, and mutual fund inflows. A change in any of these three could create shorter term volatility in the stock market and opportunity for Crescent.

Respectfully,

A handwritten signature in black ink, appearing to read "Steven Romick". The signature is fluid and cursive, with a long horizontal stroke at the end.

Steven Romick
Portfolio Manager,
FPA Crescent Portfolio