

# FPA Crescent Portfolio

January 22, 2002

Dear Fellow Shareholders:

The fourth quarter of 2001 ended with a bang, if not salvaging a horrendous year for equity investments then at least making it less bad. The stock market's returns for the year ranged from +2.49% for the Russell 2000 small-cap index to -21.05% for the technology-laden Nasdaq. To give a sense of the volatility experienced last year, the aforementioned indexes increased 21.09% and 30.13% in the fourth quarter, respectively. We feel fortunate to have prospered in a difficult environment. Crescent increased 36.14% and 14.52% for the year and the fourth quarter, respectively. Despite having the majority of our investments increase dramatically last year, we are not as smart as we appear. For that to be true, we would have to have been as dumb as we appeared as we suffered poor returns during the speculative years of 1998 and 1999. Our diligent adherence to paying an inexpensive price for good, growing businesses paid off last year, a year when most value managers made money.

Preferring to ride the gift horse off into the sunset rather than peering into his proverbial mouth, we cringe when we complain in the face of what was an exceptional year for your portfolio. But whine we must. The bear market has lost its footing as the bulls run roughshod over the landscape. From the depths of the valuation lows reached in September, the stock market has increased spectacularly. Stock valuations have gone from being inexpensive to fairly valued – at the very least. We feel a bit like shoppers at Tiffany's. There are a lot of beautiful things but not much that is inexpensive.

Some believe that the economic recovery was delayed by the events of September 11. We believe that the resulting fiscal and monetary stimulus, the likes of which we have never seen packed into such a short time, will drive us out of the recession sooner than would otherwise have been expected. We agree with most economists who are currently looking for an economic recovery in the second half of 2002. We expect, however, that the profit recovery will be weaker than anticipated. Optimism is good; however, there is too much too soon. Consumer demand continues to be weak. Corporations do not have pricing power in the current environment colored by whispers of disinflation. In addition, corporations' recent large investment in property, plant, and equipment has delayed the need for capital spending.

As previously stated, we find the stock market to be somewhat pricey. The Price/Earnings (P/E) ratio for the S&P 500 is 29x – the most widely used valuation measure for the most widely used benchmark index. Not only is this almost 2x greater than the historic median, but as we have argued in the past, the quality of corporate earnings is low, thereby making the denominator in the P/E equation overstated and, in turn, the ratio understated. Enron's precarious financial situation, although an extreme example, speaks to the hidden liabilities of many American companies.

In the second half of 2001, we both increased our stake in technology and changed the mix to companies to those whose businesses and stock prices have been more negatively impacted in the current environment. Our focus has been on owning businesses with good market shares and pristine balance sheets. The P/E valuation of these companies appears, on average, to be quite high. The business of technology reflects poor current economics. Demand is weak in the face of tremendous supply that had been added in the latter half of the 1990s. We believe that as demand gradually recovers the supply will be absorbed setting the stage for the industry to return to a "normal" level of earnings. The investments we made were inexpensive, predicated on our estimate of their normal earnings. We do not believe, in most cases, that technology companies will recapture either their past peak margins or the excessive valuations achieved in the last speculative cycle. We did not reach the level of investment that we had hoped, so the fact that Crescent's technology investments have moved up significantly and that we have begun taking profits leaves us somewhat bittersweet.

The basket of three oil service businesses that we invested in and subsequently discussed in the September 30, 2001 letter increased more than 30% in the fourth quarter. Despite the handsome appreciation, we have yet to sell a share. We feel that natural gas prices will be substantively higher a few years from now and the three investments we have made (Patterson-UTI, Ensco, and National-Oilwell) have a lot more price appreciation in front of them. In almost every year of the twentieth century, more energy was consumed than in the prior year. The slow, but inexorable pace should continue. We caution, however, that publicly traded companies with exposure to commodity prices are prone to trade with some volatility. What for some may be hard to stomach, we try and capitalize on by making an investment when a stock price craters, and opportunistically selling calls against our position to help protect our downside.

The valuations listed in the table below continue to reflect that Crescent continues to trade at a discount to the comparative indexes, albeit less of a discount. The discount has narrowed when compared to earlier periods for two reasons. One, the stocks held in Crescent have experienced substantial appreciation. As a result, we have been taking some gains. Two, as we have looked to reposition the portfolio some of our more recent investments appear pricey on current earnings, but we find them to be inexpensive on our estimates of the aforementioned “normal” earnings. (This is also true of those investments that are taking longer than we would have hoped to get to “normal.”) Support for this statement can be found by comparing the P/E and Price/Book ratios of year-end 2001 to those of year-end 2000. Although Crescent’s 2001 projected P/E has increased 121%, Price/Book has increased just 17%. Nevertheless, you may correctly conclude that our portfolio is relatively more expensive today than it was a year ago. We have lowered our common stock exposure from 62.5% at year-end 2000 to 47.1% at year-end 2001 as we patiently consider prospective investments. You should expect us, as value investors, to continue to maintain lower P/E and Price/Book ratios than the benchmark indexes.

<b>Ratios (Weighted Average)</b>	<b>Crescent</b>	<b>Russell 2500</b>	<b>S&amp;P 500</b>	<b>Lehman Bros. Gov't/Credit</b>
<i>Stocks</i>				
Price/Earnings TTM	27.2x	33.9x	29.0x	
Price/Earnings 2002 est.	20.8x	25.1x	23.2x	
Price/Book	1.4x	2.3x	3.7x	
Dividend Yield	0.8%	1.3%	1.4%	
<i>Bonds</i>				
Duration	2.9 years			5.4 years
Maturity	6.8 years			9.1 years
Yield	12.0%			5.2%

Surfing (as a very stretched metaphor for investing) can be dangerous, with sharks, coral reefs, and unintended encounters with a very hard fiberglass board contributing to the challenge. There are a lot of sharks poaching in the Florida waters off of Miami. The downside to surfing there is too great. Similarly, we seek to avoid investing in those companies that have questionable accounting practices, that overstate their reported earnings but whose cash flow is relatively poor. We will surf in coral waters but only with a reasonable amount of water covering the reefs. Similarly, we will invest in common stocks but with sizeable discounts to our estimates of their private market value. Unfortunately, we can do nothing about the occasional bump of the surfboard and in our stock investments we expect the occasional bump as well. To reduce risk we continue to seek those equity investments that trade at least at a 33% discount to where we feel they are likely to trade in a one- to two-year time frame, hopefully providing a gain of 50%. Unless we find such opportunities, the portfolio will remain in cash.

Our ten largest equity positions represented 25.0% of the portfolio as of December 31, 2001. Listed below are Crescent's ten largest holdings, excluding short-term investments, as of that date.

Common & Preferred Stocks

Patterson-UTI Energy  
Celanese  
Michaels Stores  
Big Lots  
National-Oilwell  
EnSCO  
Joy Global  
Trinity Industries

Bonds & Notes

American Greetings 11.75% Sr. Sub. Notes, due 7/15/08  
Hutchinson Technology 6% Convertible Notes due 3/15/2005

Crescent had the following net asset composition at December 31, 2001.

Common Stocks, Long	47.13%
Preferred Stocks	2.32%
Bonds & Notes	11.39%
Accrued Income	0.35%
Common Stocks, short	-8.05%
Cash & Other	46.86%
Total	<u>100.00%</u>

Patience is not only a virtue, it is insurance against losing money. Our goals continue to be to provide consistent absolute returns with less risk than the stock market. Averaging less than 60% in stocks since our inception, we have compounded at 13.36% – better than the Russell 2500 mid-cap benchmark. Our present large cash position is a function of not finding ideas that meet our risk/reward parameters. It is not a top-down call on the stock market. At the end of the day, we do not care about the level of the stock market. We just want to own what we want to own good businesses at very attractive prices. If not, as is presently the case, cash will build.

The balance of our portfolio will continue to be largely comprised of high-yield and convertible bonds and the occasional convertible preferred stock. We believe that the opportunities in these bond market sectors are attractive and we are spending considerable time researching prospective investments. We have a long history at First Pacific Advisors of investing in various RV and manufactured-housing companies – two currently depressed sectors. We recently purchased the 9.5% convertible preferred of Fleetwood Enterprises. Fleetwood manufactures RVs and homes. We believe that these two businesses that have been depressed for the last couple of years have seen the worst. By owning Fleetwood we own an option on its potential stock price appreciation while receiving a 9.5% current yield.

The stock market has not declined three consecutive years since before World War II. Whether 2002 will become the first such year in the last sixty to be a bookend in such an unenviable streak is less important than investing our capital in good businesses at what we believe to be intelligent prices. We care about the price of stocks on two occasions. When we buy and when we sell. The periods in between are not much more than noise. We look forward to attractive entry levels and continue to wear earplugs to block out the noise.

Respectfully,

A handwritten signature in black ink, appearing to read "Steven Romick". The signature is fluid and cursive, with a prominent initial "S" and a long, sweeping underline.

Steven Romick