

FPA Crescent

January 22, 2007

Dear Shareholder:

In a year where we were quite conservatively postured, 2006 turned out to be an exceptional year for the markets. FPA Crescent returned 12.4%, averaging just 41% net exposure to the stock market. Our historically high return on invested capital does not look attractive prospectively without some sort of market or industry correction that will allow us to increase our market exposure. Our conservatism looks sadly out of place in such a sanguine milieu. The average investor seems comfortable to shoot for 30% gains on individual investments, even though downside may be two-thirds of the upside – not what we would consider a recipe for longer-term profitability. It does appear to be the oft-cited “Goldilocks” economy. Fifteen years have passed since consumers last saw their pocketbooks less weighty. In a recessionary time, people reach for their wallets with less frequency and, when they extract them, the Presidents, blinking from lack of sunlight, are released from captivity more judiciously. Nevertheless, we continue to seek the “fat pitch” without regard to the timing of a recession. We remain confident that we should continue to outperform the market over complete market cycles.

As we review the plot points that composed the story that was 2006, we are struck by its optimism. A better tale could not have been written, for it was a year without bad news. Try as we may, we just cannot derive a list of what really went wrong in the markets. New-home starts declined, but home prices held up and homebuilding stocks bottomed well above their historic lows¹. People remain gainfully employed, with unemployment hovering just above its all-time lows. Corporations continue to book handsome profits. No big banking disasters or corporate frauds sullied the front pages and oil did not cross the \$80 mark, let alone \$100 like some pundits had predicted. The Iraq War remained a constant but, in that it has not escalated, it seems to be interpreted as old news. Against 2006’s cheery backdrop, we were in the minority in selling more than we purchased. The consumer and the economy have, admittedly, performed better than we expected. Today, though, the yield curve has been mostly inverted for going on a year and the most-watched commodity index (the CRB) has declined 21% from its peak. Inverted yield curves usually portend recession and, according to ISI Group, “every 20% decline in the CRB has been associated with a recession, a significant slowdown, or a financial crisis.”

In good times, bad news gets a positive spin; whereas, in bad times, a negative announcement will be viewed in the worst possible light. To illustrate, Home Depot shares increased 4.3% on November 14, 2006, despite having reported third quarter earnings that day that were below consensus expectation. We are not judging the relative merits of an investment in Home Depot; however, we do not often see a company’s stock price rise like theirs did on the same day they disappoint. We asked our trading department to poll the “Street” to help us understand such an anomaly. We learned that it could have been worse, that the nastiest is behind them, and that they are going against easier comps. Oh, and that there is rumored to be a takeover in what would be the first \$100-billion buyout.

¹ Transaction volumes have declined 20-30% in most months of 2006, and yet, despite prices having doubled in recent years, home prices actually increased year-over-year. ISI Group, November 29, 2006.

Too many smart people have sought employment as fund managers or analysts today and they have plenty of capital to invest. We feel like fisherman standing on the crowded banks of a pond where the fish are fewer and skinnier, while more fishermen stand beside us with the latest gear. Continued corporate share repurchases, acquisitions, and buyouts have reduced the number of fish and that trend continues. According to a recent *Wall Street Journal* article, global buyout funds have \$750 billion in cash.² Leveraged a conservative 3:1, that equates to \$2.25 trillion of buying power.³ That's a lot of near-term fuel for the market if that number is even half true. To create opportunity, something – and we do not know what – needs to happen to soak up the excess liquidity and possibly to drive some smart people to more noble endeavors. We cannot identify that something today, but an upset will inevitably occur. It always does.

We can imagine, although do not portend, that a crack in the façade of the investment banks could be a linchpin that creates future opportunity. Much has been made of hedge funds, their high fees, leverage and lack of transparency. That pales, though, in comparison to the public investment banks that, on average, operate with higher fees, greater leverage, and even less transparency.⁴ In a business rife with potential conflicts, investors pay little heed to the inherent risks of their businesses, bidding valuations to 2.5 times book value. These investment banks are effectively public hedge funds with the highest fees in the business where average employee compensation is 58% of gross income!⁵ Most hedge funds would be envious of such high lucrative remuneration. Although, these banks do not provide a clear window into how and where they make their money, investors seem satisfied with returns on equity that average 21%. That looks pretty good on the surface, but the assets of these businesses are leveraged 26x. We posit that the risk assumed is disproportionate to the return achieved. These institutions might argue that they only have a manageable amount of capital at risk and that they are well-hedged; however, we can only take them at their word, since these companies do not open their books up to us. We only invest in good businesses we understand (or at least think we do), and try to buy them at great prices. See table below.

Company	Share Price 1/22/2007	Total Assets	Total Equity	Price/ Book	Assets/ Equity	ROE	Compensation as % of Gross Income	Compensation as % of Equity	P/E TTM
Bear Stearns	\$ 169.31	\$ 334,760	\$ 11,722	2.0	28.6	17.7%	58.0%	49.4%	11.9
Goldman Sachs	\$ 210.49	\$ 798,300	\$ 33,493	3.1	23.8	27.1%	53.1%	65.5%	10.7
Lehman Brothers	\$ 82.25	\$ 473,737	\$ 18,396	2.4	25.8	21.4%	59.5%	62.8%	12.1
Merrill Lynch	\$ 95.59	\$ 804,724	\$ 38,651	2.3	20.8	16.6%	62.0%	58.7%	14.8
Morgan Stanley	\$ 82.23	\$ 1,028,872	\$ 34,172	2.5	30.1	23.2%	57.2%	43.5%	11.6
				2.5	25.8	21.2%	57.9%	56.0%	12.2

We strive for the mispriced option, something in short supply today. Starting in July 2001, we bought Trinity Industries, the largest producers of rail cars, when railcar production had declined 80%. We retained a free option on volumes returning to normal. We started liquidating Trinity

² *Wall Street Journal*, January 2, 2007.

³ \$750 billion equity x 3 = \$2.25 trillion total purchasing power. This assumes, therefore, that new and existing debt would total \$1.5 trillion.

⁴ Sample of Investment Banks include: Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley. See attached Addendum.

⁵ Gross Income = Total Employee Compensation / (Total Employee Compensation + Pretax Income)

in December 2005 through May 2006 at 2.3 times our cost. We began purchasing Countrywide PLC, the largest real-estate brokerage firm in the United Kingdom, in June 2004. At the time, transaction volumes were on their way to declining more than 35% from their peak, but we retained a free option on transactions returning to normal levels, their nascent internet business prospering, and positive changes in UK laws that had the potential to benefit earnings. 3i Group has an offer on the table to purchase Countrywide at 550 pence. We have sold almost three quarters of our position and, with our remaining shares, have voted against the buyout as we believe it too inexpensive at just 11x normalized earnings. We recently purchased ConocoPhillips, which appears fairly valued if oil was in the high \$30 range, rather than its current \$54 per barrel. We believe we have a free option if the price of oil remains constant, let alone should it increase over time as we expect.⁶ We believed that the share price of each of these companies could at least double over a few years should we get paid on our options, with our downside protected should they not come to pass. Unfortunately, in this environment, we have failed to find enough of these businesses to build an entire portfolio. If investments do not meet our hurdle rates, that is, our minimum requirements for return in light of the risk being assumed, we will not invest. There appear to be very few free options available, with the average company's share price more dependent on the business continuing to perform as it has and its executives doing the right thing in terms of recapitalization and/or share repurchase.

We remain committed to the energy sector, although we did substantively change our exposure from year-end 2005 to 2006. Energy investments increased from 13.5% to 16.6%; however, beneath the surface the portfolio changed far more dramatically. We now have greater exposure to global oil production and less to U.S. natural gas production. We also now have exposure to global refining markets, which we did not have before. At the end of 2006, approximately 38% of our energy investments were tied more closely to U.S. natural gas production, as compared to approximately 54% in 2005.⁷ Meanwhile, the weighted average market capitalization of these positions increased to \$38.7 billion from \$6.1 billion in 2005. As energy continues to be our principal position, the sector has appropriately dominated past letters; however, over the shorter-term, so goes the weather, so goes the price of oil, and so goes oil stocks. Our largest position at 4.6% continues to be EnSCO International whose stock price has doubled in the last five years, but whose earnings have more than tripled.

More than 50% of the corporate bond market is now classified as high yield. We find it interesting that when high-yield bonds are performing well, that moniker suffices; however, when there is a rise in bankruptcies they quickly get renamed "junk." The high-yield market will increase in size as the private equity war chests are put to work. There will be a point in time, once again, when bankruptcies will increase and opportunities to put capital to work in the high-yield and distressed space will occur. The aforementioned private equity cash hoard should hasten this process. The billions of dollars that have been raised are likely to lower returns as more competition exists for a finite universe of opportunities. The average price paid to take a company private has increased 20% since 2004.⁸ Although we cannot quote the Debt/EBITDA ratio of recent private market transactions, we have read that the deal leverage has increased as

⁶ The price of oil, adjusted for inflation, is still below where it was in 1972 when there was an artificial shortage of oil. Oil is not a renewable resource and will decline over time. We believe that the price of oil will hit new highs as the world begins to appreciate that we are using more of our fossil fuels than we are discovering.

⁷ The oil versus natural gas exposure is an estimate predicated on what we understand from company conversations, corporate information, and SEC filings.

⁸ Gregory Peters, Morgan Stanley's head of credit research as quoted in *Barron's*, December 11, 2006.

