

FPA Crescent Portfolio

July 21, 1997

Dear Fellow Shareholders:

These *are* the good old days. With unwavering demand for U.S. stocks, the market indexes exploded to new highs in 1997's second quarter. Even with bonds and cash offering lower rates of return than stocks, the FPA Crescent Portfolio ("Crescent") returned 8.2% in the quarter and 11.9% for the first half.

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

Time Period (Calendar Year)	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 6/30/97</i>					
First Half	11.9%	7.9%	2.7%	11.3%	20.5%
Second Quarter	8.2%	10.5%	3.6%	15.1%	17.4%
<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>	18.2%	12.8%	6.3%	17.1%	21.0%

*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. All returns assume the reinvestment of dividends and distributions. The table presents the performance of the Institutional Class shares. The performance of the Institutional Service Class shares will vary based upon the different inception date and fees assessed to that class.

The strong U.S. economy in a period of low inflation has provided the platform for extraordinary stock appreciation over the past few years. Many have put forth that we have a new economic paradigm -- moderate growth and little to no inflation. We believe that the business cycle is not dead and that the strength in the economy is merely taking longer to impact inflation.

A number of items has kept inflation low, not the least of which has been our nation's improving productivity. We have higher labor wages but lower unit costs. Five years ago, it may have taken one worker 10 hours at \$8 per hour to make one widget. That would be an \$80 labor cost per widget. With greater manufacturing efficiencies today, that same worker can earn \$10 an hour, 25% more, but only require 7 hours to make the widget for a total labor cost of \$70 per widget, 12.5% less. We can look forward to future productivity increases, although at a slower rate. This will make it more difficult for inflation to remain benign. In light of high factory capacity utilization and tight labor markets, if the economy continues its strong growth path, the Federal Reserve Bank would be hard pressed not to raise rates. We believe that it is likely that we will see consumers lead the way to a strong economy in the second half of 1997, to some extent due to the wealth impact of the stock market's rise.

Although we do not believe that inflation is dead, let us say, for the sake of argument, that it is. We will still have economic ups and downs. How deep will our next recession be when it does strike an economy

that is currently enjoying an expansion in its seventh year? Weak earnings could cause stocks to weaken even in the face of lower interest rates. This makes for a compelling case for bonds outperforming stocks over the next 2-3 years. We will therefore continue to explore fixed income alternatives. Frequently considered alternatives include convertible and high-yield bonds.

Convertible bonds have performed quite well, largely due to the strong stock market. High-yield, or “junk” bonds, have also provided excellent returns. In the month of June alone, \$17 billion of junk bonds were issued, the biggest month ever, and 1997 looks to be another record year for junk bond issuance. To sound a cautious note, the current annualized default rate on high-yield bonds is only 1.54%, slightly less than last year’s and much better than the 2.69% in 1995 and 9.35% during the recession year of 1991. The convertible and high-yield market’s historically high valuation as a result of excellent performance the past few years, similar to the stock market, provides little, if any, margin of safety. As a result, we continue to tread more cautiously than we otherwise might.

I have never experienced such breadth of interest in the stock market. I met a cab driver on a recent trip to NYC, who, not knowing of my profession, told me about his mini-conglomerate which included a taxi in NYC, a restaurant in Florida, and a scuba dive operation in Jamaica. He had also recently started a money management business, given that 18% stock returns per year were a “no-brainer.” People like this cabby, whether through mutual funds or individual stocks, add to the increasing demand that continues to help fuel the stock market’s rise. We have seen this demand for some time in initial public offerings that have generally been oversubscribed. Now, secondary offerings are reflecting extremely strong demand. A recent secondary offering found investors clamoring for shares in an amount 2.5x greater than what was being offered. On the day of the secondary, this company’s stock price increased 6% from the prior day’s close even though it had been public for four years. In light of the current roaring bull market, Morgan Stanley’s Barton Biggs recently mentioned a late 1980s Japanese proverb that seems apropos, “The fools are dancing but the even bigger fools are watching.” Although there appear to be elements of a mania, it currently does not pay as well to be conservative.

Large-capitalization companies have driven stock returns over the past three years (partially at the expense of the small-capitalization companies), with the greatest focus on “one-decision” stocks. Three reasons that investors might share this common desire are: they do not know what else to buy; they recognize the brand name; and the company’s growth rate is such that they will make excellent rates of return on their money. The first two reasons lack a certain soundness. It does not seem likely that a Coca-Cola or Gillette could meet the test of the third reason given that they approach 1972 levels of valuation, at or above 40x current year’s earnings.

Crescent’s portfolio characteristics reveal that we hold securities that are much less expensive than the stock market.

Ratios (Weighted Average)	Crescent	Russell 2500	S&P 500	Lehman Bros. Gov’t/Corp.
<i>Stocks</i>				
Price/Earnings 1997 est.	14.9x	18.7x	19.9x	
Price/Earnings 1998 est.	12.9x	16.9x	20.9x	
Price/Book	2.4x	2.7x	3.5x	
<i>Bonds</i>				
Duration	4.1 years			5.1 years
Maturity	5.7 years			9.6 years
Yield	9.3%			6.6%

Smaller companies continue to trade more cheaply than larger ones, though the difference is not as dramatic as I would like. According to the Leuthold Group, the smaller caps are at about a 12% discount to large caps. We can partially explain small-cap stocks' poorer performance. They have never had the fat to cut that big companies have, so, to a certain extent, they do not receive the same benefits from productivity improvements. Small-cap companies' earnings growth will not have such a relative disadvantage as the unsustainable rate of change in productivity improvements slows. Smaller companies also do not have the same ability to access the worldwide markets either for new business to augment sales or cheap outsourcing to lower costs.

The median market capitalization of companies held by Crescent is \$401 million. Listed below are Crescent's ten largest holdings, excluding short-term investments, as of June 30, 1997. These investments account for 28.3% of the portfolio's net assets:

Common Stock

Coachmen Industries, Inc.
 IHOP Corp.
 Michaels Stores, Inc.
 National R.V. Holdings, Inc.
 NCR Corp.
 Price Enterprises, Inc.
 Reebok International Ltd.
 Storage Technology Corp.

Corporate Bonds

Alexander Haagen Properties, Inc. 7.5%, 1/15/01 Convertible Sub Notes
 Charming Shoppes, Inc. 7.5%, 7/15/06 Convertible Sub Notes

Crescent had the following net asset composition at June 30, 1997.

Common Stocks, long	53.5%
Common Stocks, short	-4.9%
Preferred Stocks	2.9%
Corporate Bonds	21.1%
Cash & Equivalents	27.4%
Total	<u>100.0%</u>

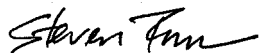
Many argue that the market is efficient and rationally prices securities. We believe this is true over a long-term time horizon, but false from one day to the next. As an example, we have owned a position in Price Enterprises, a real estate company, for approximately 2 ½ years. A couple of weeks ago, the company announced that they were converting to a REIT (real estate investment trust). The real estate, existing cash flow and management remain the same, but on the day of the announcement the stock appreciated 20% as a result of merely changing its corporate form. This is not a complaint since we are shareholders. This serves as an example, however, of Wall Street's rationale where a company's fundamentals do not necessarily correlate with its stock price over the short term. We continue to use a longer-term perspective when evaluating company prospects in the hopes that short-term inefficiencies will contribute to long-term gains.

Sometimes investments fail to meet our original expectations. For instance, we have an investment in Guest Supply, the world's largest manufacturer/distributor of hotel amenities and a relatively young contract manufacturing business. Most large hotel chains, including Marriott and Hilton, purchase their

shampoos, conditioners, etc. from Guest Supply's hotel amenities division. Their contract manufacturing division also makes product for such brand names as Bath & Body Works, Oil of Olay, and Banana Boat. Guest Supply's dominant lodging market share, opportunity to leverage their fixed cost base by growing contract manufacturing, and low valuation based on 1997 earnings estimates made the company what I thought to be a good purchase at \$13. Unfortunately, contract manufacturing is building much more slowly than I had hoped. There is a long lead time to win new accounts and most of their business is dominated by large customers who are squeezing them on price. What I should have recognized is that since the return on capital in their core hotel business has always been quite low, I did not have a margin of safety if contract manufacturing proved difficult. The share price ended the quarter at \$9 1/2 but has since rallied to \$10 1/2. We continue to hold the investment at current prices although it is unclear if this will be a good investment. However, contract manufacturing remains profitable and we believe that the company will grow from current levels. Furthermore, the hotel amenity business continues to gain share and improve returns. As shareholders, you can help. Make sure that when traveling you use as much shampoo, soap and conditioner as possible. This is not an endorsement to raid housekeeping's cart, but your cleanliness could accrue to your financial well-being.

Financial economist Peter Bernstein (in [Grant's Interest Rate Observer](#)) said, "Most of the rise in the stock market is change in valuation, not growth in earnings, and that is what gives us the high returns. Earnings growth runs around 6%. If you are going to get better than that, you have to have increased valuations, which is extremely unlikely without a decline in interest rates." What will send the market down? How much will it decline? When will it happen? We could answer by saying, "I don't know," but that would be too easy – so we will put ourselves on a ledge and say, "It will decline a certain amount sometime." Although a stock market correction is always painful, we look forward to putting your money to work in an environment where the risks do not outweigh the potential rewards. If we wish to be a buyer in periods of maximum pessimism, then I should be cautious in periods of maximum optimism. We do, however, have a high degree of optimism that there will again be pessimism. In the meantime, the market can go higher and for longer than you think. There will be opportunities. Things do change. Patience will be rewarded only over the long term.

Respectfully,



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FPA Crescent Portfolio