

FPA Crescent Portfolio

July 20, 1998

Dear Fellow Shareholders:

The largest and most expensive companies had the best performance in the first half of 1998. The 50 largest companies in the S&P 500 returned 22.5% in the period, while the smallest companies lost 2.0%, as measured by companies with a market capitalization less than \$250 million. Not only was “bigger” better, so was “more expensive,” as companies with the highest price/earnings ratios (P/Es) had richer rates of return on average than their poorer cousins. According to Sanford Bernstein, companies in the top quintile of forward P/Es (29x or greater) outperformed those in the bottom three quintiles by 16%.

One can correctly conclude that investing in out-of-favor, small- to mid-sized companies was not the best place to be. Nevertheless, during the second quarter, Crescent had a positive return of 0.7%. Although this might seem paltry, it compares favorably to small- and mid-capitalization indexes, which lost between 4.7% and 4.2% (as measured by the Russell 2000 and 2500, respectively). Crescent now has better year-to-date performance than both indexes. See the tables at end of letter for more detailed performance information.

Even though the stock market favors more highly valued companies, we continue to adhere to the methodology that has proven successful in the past; therefore, Crescent maintains a portfolio with characteristics that are much less expensive than the market. The P/E, based on 1998's estimates, is 22% cheaper than the average of the two stock indexes below and 27% cheaper than 1999.

Ratios (Weighted Average)	Crescent	Russell 2500	S&P 500	Lehman Bros. Gov't/Corp.
<i>Stocks</i>				
Price/Earnings 1998 est.	18.5x	22.6x	25.0x	
Price/Earnings 1999 est.	14.2x	17.6x	21.2x	
Price/Book	3.0x	2.8x	4.5x	
Dividend Yield	1.6%	1.3%	1.4%	
<i>Bonds</i>				
Duration	3.9 years			5.5 years
Maturity	6.5 years			10.3 years
Yield	8.4%			5.9%

Overstated corporate earnings and aggressive stock option plans, two troubling trends, point to greater valuations than what is reflected by the already high P/Es in the stock market. In a departure from a more conservative time, investors now view S&P 500 earnings two ways: operating and reported, i.e., net of write-downs. Twenty years ago, one could find very little divergence between the two. Corporate earnings in 1997 were widely reported as having increased 9%, but if write-downs were included, reported earnings growth would drop to only 6%. Write-downs continue, some reasonable and others less so – unusual considering the strength in our economy.

We do not denigrate all extraordinary charges, just those that corporate managers take to write-down assets to manage earnings. When an asset is written down, it lowers the depreciation expense to be taken in the future years thereby increasing and possibly overstating future earnings. The past five years have seen operating earnings average 8.6% greater than reported earnings, as companies have taken “one-time” charges for “non-operating” items. Therefore, when comparing valuations to 20 years ago when operating and reported earnings were essentially the same, we conclude that the market is 8.6% more expensive than it appears. We remain mindful of this as we closely analyze a corporation’s financial statements to determine the true free-cash earnings.

The second trend of concern, the liberal use of stock options as a substitute for cash compensation has boosted earnings growth these past few years by a low-end estimate of 2%. Stock options and earnings growth have a cozy relationship. Simple multiplication points to how a management’s bread is buttered. If a company grows quickly, a larger P/E x higher EPS = greater Stock Price = Happy Management. This desire for a high stock price frequently provides management the incentive to achieve the highest possible quarterly earnings – a just cause, but only if executed in a responsible, truthful fashion. More companies have tried to control their stock price in recent years using aggressive accounting procedures. Subsequently, their stocks plummet as they are forced to restate their earnings.

When an employee receives stock options, there is no impact on the corporation’s earnings, as there is no charge to the income statement. Meanwhile, the public shareholder’s ownership stake becomes diluted. We have nothing against options; we do advocate their proper accounting. Since corporate profits have been overstated in recent years by options and write-downs, combined with the unusually long economic expansion, we believe that earnings expectations for the next few years are too high. As valuations expand, the margin of safety begins to disappear. The higher the P/E multiple, the lower the margin of safety.

In our last quarterly letter, we quoted some of Warren Buffet’s remarks from his annual report, and we suspected that he found current market levels challenging. It has been suggested that our interpretation was incorrect, as Mr. Buffet’s Berkshire Hathaway has found a company to buy – General Re. Taking a closer look at Berkshire Hathaway’s acquisition of General Re, we have greater reason to be cautious in today’s environment. For the first time, Mr. Buffet made a major acquisition for stock, not cash. This implies that he feels his currency, i.e., Berkshire Hathaway’s stock price, is overinflated when compared to General Re. This is like travelling today in the Pacific Rim, where with our strong U.S. dollar we can find fantastic bargains in rupiahs, ringitts, bahts, etc. Furthermore, by folding General Re into Berkshire Hathaway, Mr. Buffet’s positions in Coca-Cola, American Express, Freddie Mac, and others are diluted by 20%. In other words, each Berkshire Hathaway shareholder now owns fewer shares in each of these companies. It appears he has found a way to reduce his exposure to the stock market and avoid a tax liability.

Other successful investors today are taking a conservative path, e.g., Ian Cumming and Joseph Steinberg, Chairman and President, respectively, of Leucadia National Corp., a \$2.2 billion investment holding company. These gentlemen have successfully bought and sold companies over the last 20 years, growing their book value from \$0 to \$29 – 29% compounded growth in equity. Recognizing their abilities, investors have driven Leucadia’s stock from pennies to \$34 over the same span, a 38% compounded annual return. They are now considering Leucadia’s partial or total liquidation. This unusual step is being considered because, as they wrote in their annual report, “During the 90s, mining for value has become increasingly difficult. Prices are higher still and more money is created every day as the markets of the world continue to rise. An undervalued asset is like finding a needle in a haystack. We are going

blind. Higher prices inevitably mean lower returns. The consequences of miscalculation or mistake become more deadly as prices increase. Extreme caution is in order.”

Nevertheless, there appears to be value in smaller companies. Small companies appear to be approximately 20% cheaper than the largest capitalization companies. As a result, the median market capitalization of companies held by Crescent is \$441 million. Listed below are Crescent’s ten largest holdings, excluding short-term investments, as of June 30, 1998. These investments account for 30.3% of the portfolio’s net assets.

Common Stock

Storage Technology Corporation
Midas Inc.
NCR Corporation
Green Tree Financial Corporation
Foremost Corporation of America
AMERCO
Prime Retail, Inc.
Pinkerton’s, Inc.

Bonds & Notes

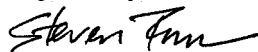
U.S. Treasury Inflation Indexed Notes, 3.375%, 1/15/07
Advantica Restaurant Group, Inc., 11.25%, 1/15/08

Crescent had the following net asset composition at June 30, 1998.

Common Stocks, Long	50.1%
Common Stocks, Short	(1.0)%
Preferred Stocks	2.8%
Bonds & Notes	22.0%
Cash & Other	26.1%
Total	<u>100.0%</u>

While the stock market reaches new highs, and ignores the unsustainable margins, we continue to preach conservatism. Caution is a scarce commodity these days since the stock market has provided “easy” money the past few years. A recent *Business Week*/Harris Poll showed that only 28% of investors believed that future stock market returns of less than 10% were likely, down from 44% just two years prior. Although we believe that we are in the ninth inning, it could be a 15-inning game. Not knowing the duration, we will continue to swing at only the best possible pitches.

Respectfully,



Steven Romick
Portfolio Manager,
FPA Crescent Portfolio