

FPA Crescent Portfolio

July 15, 1999

Dear Fellow Shareholders:

Being a contrarian investor means taking advantage of other people's misfortunes, but what do you do when the misfortune is your own? Last year we were faced with the challenges of investing in small-cap stocks as that sector lagged the stock performance of large companies, and yet, we still managed to provide returns that were both profitable and ahead of the Russell 2500 and the Russell 2000. The first half of 1999 has been much better for small-cap stocks, but our returns are lagging these indices for the year-to-date period. This can be attributed to a few things: (1) A manager is not always in sync with the market every month, quarter, or even every year. (2) Not every investment decision will prove to be a winner. (3) We have a few relatively concentrated positions, and a large change in price in a couple of these positions will impact our NAV, for the positive and negative. (4) The investment that we maintain in busted convertible bonds to achieve equity rates of return generally moves up or down in price with less volatility than common stocks. In the first quarter, when small-cap stocks were weak, we beat our small-cap benchmarks. However, in the second quarter, as small-cap stocks vigorously rebounded, we lagged. We continue to focus on our long-term returns with less concern for the noises during small intervening segments.

Because of a focus on short-term results, most investors don't make the same return in stocks as the market averages over a multi-year period. An individual hypothetically invests \$10,000 and watches it double to \$20,000 within the year. Then, in the following year, feeling confident, they buy another \$30,000 in stocks. They now have a \$50,000 portfolio, assuming the unlikely scenario that they have no tax liability. Should they lose 20% of this amount, they would have wiped out 100% of the gain of the prior year. Feeling discouraged, they might give up investing in the stock market until they get sucked in during the next bull market go-around. The average stock investor usually completes only a negligible amount of research, with little understanding of the company's financials. For some reason they might drive 20 miles to save \$20 on a bicycle, but they will invest \$10,000 on a stock tip. The same emotional rationale applies to investors in mutual funds. This perverse psychology is common when emotions guide investment decisions, and is equally applicable to stocks as well as mutual funds. Many investors habitually chase the returns of the highest-performing funds – yet these funds also have, on average, greater volatility. Witness today the rapid growth in assets of the Internet sector funds. How likely is it that they will remain shareholders when more rational pricing returns to Internet stocks?

As a fund manager, we are always intrigued by the prospects of the latest concept stock. We have the luxury of listening to the CEO personally tell us why their company has such a wonderful future. We prefer to focus on a good business, in a growing industry, that is broken, but imminently fixable. We will pursue only such investments if we believe that management has a proven capability. To determine this, we try to track down current and former employees, colleagues, customers and suppliers in a grassroots effort to add value to the research equation. This is not, however, a substitute for investing in a good business. We paid too much last year for

Ventas, Inc., a Real Estate Investment Trust that owns land underlying nursing homes. We underestimated the impact of governmental changes in Medicare reimbursement, Ventas' primary tenant's operating capabilities, and, even without the Medicare cuts, their growth opportunities. In other words, the business that we invested in was not as good as we thought. We have maintained our investment and even added to it at lower prices, believing that the value of the real estate that Ventas controls is greater than its current stock price.

Sometimes we find it challenging to be a rational voice in a crazy environment. We find ourselves in that frustrating position today. Many companies that have no earnings are seeing ridiculous price increases in the stock market, e.g., the Internet companies. As one example, witness eToys Inc., the toy "e-tailer." This company went public at the end of May at \$20 per share, only to close that day at \$76 – a market valuation of almost \$8 billion for a company with \$30 million sales for the twelve months ending March 1999! Toys 'R' Us, Inc. with its \$11 billion in sales and substantial real estate ownership has a market capitalization of \$5 billion as of June 30, 1999. Since May, eToys has seen its price drop to a current \$40, still a crazy \$4 billion capitalization. This stands in stark contrast to a large position of ours, Consolidated Stores, Inc., which is also in the toy business. They own KB Toys, with 1,329 locations nationally, and \$1.6 billion in sales. They too have an e-tailing concept, KBkids.com. Consolidated Stores' market capitalization is currently \$1.8 billion, dramatically less than eToys, and has an additional \$1.6 billion in toy sales, advertising for their web site in all 1,329 locations, the convenience of being able to return the product in their stores, and the ability to buy toys cheaper. If this doesn't seem cheap enough, consider this: Consolidated Stores' primary business is not even toys. They are the largest retailer of closeout merchandise in the country and operate retail stores under the names Mac Frugal's, Pic 'n Save, Odd Lots, and Big Lots. With the 1,165 closeout stores that they operate, nobody comes close to competing with them. The closeout business should earn them a \$1, while the toy business, excluding Internet start-up costs, should earn \$0.30. This has been a tough year for both businesses, and we view their "normalized" earnings as being higher. If their toy business, including the e-tailing component, is worth \$900 million, a not unreasonable valuation, then Consolidated Stores stock at \$16.50 per share has \$8 of value in it from the toy business, leaving \$8.50 for the closeout business, or just 8.5x depressed earnings. To make matters even more attractive, Consolidated Stores has provided shareholders with high returns on equity and has a highly incentivized management team that owns gobs of stock, which means that they care what happens to their stock price. The Chairman alone has almost 4 million shares. As you can surmise, we find Consolidated Stores to be a terrific opportunity.

Midas, Inc. has been a large position for quite some time. We initiated our position in this great American brand name back in January of 1998 in the \$16 - \$17 range, soon after it was spun out of Whitman Corp. Subsequently, the company radically improved its balance sheet, sold their company-owned stores, added services, improved their ad buying and visibility, and announced a makeover of the entire chain to be completed in the fall of 1999. Wall Street applauded their success and the stock price doubled by March of this year. We trimmed back some of our position, recognizing that the easiest time was behind it. We maintained a 5% position, because, although they had picked the low hanging fruit in cutting costs, tremendous opportunities exist on the horizon. We noted a couple of months ago that exhaust (i.e., mufflers) sales have slowed dramatically. We knew that as this knowledge became more widespread, the stock would suffer. We were not, however, comfortable trying to sell our investment, pay taxes and hope that we would be able to repurchase our position at a reasonable price. As an investor in small-cap stocks, we know the pitfalls of trying to trade. Too often you end up paying taxes, unable to rebuild your position, only to watch the company meet with future success and its stock price increase dramatically. We have made the decision that Midas is a company that we wish to hold for the next few years, given its current price and prospects. We believe that it has just scratched the surface in improving its franchise operations and is just beginning to improve its distribution system, which, is being restructured and should drive increased sales of products to their franchises and to other non-Midas

customers. The opportunities in this distribution business are substantial. Meanwhile, the company should earn \$2.30 and \$2.60 this year and next – price/earnings ratios of only 12.2x and 10.9x respectively.

In the second calendar quarter, we accumulated a position in CKE Restaurants, Inc., purchasing both the common stock and the convertible bonds. CKE owns a number of restaurant chains and almost 4,000 restaurants, with Carl's Jr. and Hardee's as its largest and best-known brands. Carl's Jr. has been a successful operation since Bill Foley took over as chairman in 1994 and installed new operating management shortly thereafter. Their Hardee's restaurants were purchased in two transactions in the last couple of years. Company management is now putting in Hardee's the same policies that benefited Carl's Jr. Unfortunately, the turnaround is taking longer than Wall Street would like and sellers have pushed CKE's stock price down from \$40 last year to its current price of \$16.25 at June 30. Current consensus estimates give the stock price/earnings ratios of only 11.8x and 9.6x for 1999 and 2000, respectively. The convertible bond, with its 12.1% yield-to-maturity and option to share in the appreciation of the equity, is currently the larger investment.

The table below reflects how much less expensive Crescent's portfolio is relative to other indexes.

Ratios (Weighted Average)	Crescent	Russell 2500	S&P 500	Lehman Bros. Gov't/Corp.
<i>Stocks</i>				
Price/Earnings 1999 est.	13.4x	21.9x	28.2x	
Price/Earnings 2000 est.	11.0x	19.3x	25.8x	
Price/Book	1.7x	2.6x	5.2x	
Dividend Yield	1.6%	1.4%	1.2%	
<i>Bonds</i>				
Duration	3.3 years			5.5 years
Maturity	5.0 years			10.0 years
Yield	10.5%			6.3%

Our ten largest equity positions represented 35.2% of the portfolio as of the end of 1999's second quarter. Listed below are Crescent's ten largest holdings, excluding short-term investments, as of June 30, 1999.

Common Stock

Michaels Stores, Inc.
 Foremost Corporation of America
 Midas Inc.
 Storage Technology Corporation
 Arrow Electronics, Inc.
 IHOP Corp.
 Fritz Companies, Inc.
 AMERCO

Bonds & Notes

U.S. Treasury Inflation Indexed Notes, 3.375%, due 1/15/07
 Centertrust Retail Properties, 7.5% Convertible Notes, due 1/15/2001

Crescent had the following net asset composition at June 30, 1999.

Common Stocks, Long	63.3%
Common Stocks, Short	-1.5%
Preferred Stocks	4.3%
Bonds & Notes	29.1%
Accrued Income	0.8%
Cash & Other	4.0%
Total	<u>100.0%</u>

The economy continues to perform well and shows little signs of inflation, although we continue to believe that it is only a matter of time before inflation rears its head. Of greater concern is the wealth effect that appears to have more importance to the health of the economy than in the past. Margin debt is at historic highs and has had its largest percentage jump in 50 years (Source: Barron's). Furthermore, "the market value of equities owned by households exceeds the value of their real estate holdings, while at the time of the 1987 crash, real estate was nearly 3x as large," according to Sanford Bernstein. The stock market does go down in value. When it does happen, how people feel about a decline in the value of their portfolios (more significant for those with margin debt) and how such a drop in net worth impacts their purchasing power are critical questions, and unlikely to perpetuate a positive economic outcome. We therefore continue to maintain our conservative posture, recognizing that we have been doing this for fourteen years and expect tenure at least three times that length.

What will we do when stock market performance returns to "normal"? What is "normal"? We are not sure what normal is, but we know that it is not – the 20% plus rates of return that we have seen over the past decade. Portfolios owning companies with real assets at low price/book ratios and low price/earnings ratios will benefit. Portfolios owning busted convertible bonds with high yields will also benefit. Crescent owns such investments and we will continue to seek equity rates of return with less risk than the stock market. Equity rates of return do not always mean performance equal to stock market performance in any given period, but they should provide such over time. We have done better than that long-term, and we endeavor to provide you with the same well into the future. Thank you for your confidence.

Respectfully,



Steven Romick
Portfolio Manager,
FPA Crescent Portfolio