

FPA Crescent Fund

July 16, 2005

It's been a bit of a bumpy ride thus far in 2005, though the stock market has been on a tear the last few months. From its April lows, the S&P 500 rebounded 4.7% by June 30 and 8.5% through the third week of July. Our cautious investing stance seems displaced. Returns in the stock market are moving at a pace in line with our oft-cited expectations for multi-year performance compounding in the 4 – 7% range. Crescent returned 4.3% in the first half, ahead of the broad market indices despite holding a large amount of cash.

Playing the lottery statistically marries hope with probable failure. You will not find us in line at the supermarket check-out surreptitiously buying tickets. On the other hand, if somebody gave us tickets we would not decline such a free option on a shortcut to Easy Street. Nobody has proven so charitable to date. Thus, we are left to our own devices as we seek investment opportunities where such options have been ignored or mis-priced. Much of our success over the years has resulted from investing in such companies. Despite a mainframe business that was disappearing, we owned Wang Laboratories in the early 1990s. We valued the company's future cash flows, assuming they would decline each year and ultimately to zero. We were able to purchase Wang stock at a discount on its mainframe business and still got a free option as they owned a digital imaging business to which we believed that investors were not ascribing value. Eastman Kodak ultimately purchased Wang's digital-imaging business, driving its stock price higher. We never know if the option will be exercised in the money (i.e., payoff), but if we purchase the remaining business at a discount, although we may not make a ton of money, we should achieve a reasonable rate of return. Heads we win, tails we win bigger. As more smart investors with more money under their direction crowd the market, it is a greater challenge to find those free options. So, if you see us at the grocery store, know that we will graciously accept gifts of lottery tickets.

With so many U.S. companies sourcing from or selling in foreign markets, we do not believe it appropriate to look at investing today without due consideration as to what is going on outside our borders. The global economy has a strong dependence on the U.S. consumer's continued ability to spend freely. There exists a tenuous co-dependency as the U.S. is, in turn, dependent on its foreign trade partners to provide products that sate the voracious appetite of the American consumer as well as to fund our forever-expanding trade and budget deficits. Former Fed Chairman Paul Volker recently characterized the circumstance thusly, "Contented American consumers matched against delighted foreign producers. Happy borrowers matched against willing lenders. The difficulty is the seemingly comfortable pattern can't go on indefinitely."¹ How and when the global economy rebalances is more complicated and impossible to determine, but yet another potential opportunity to become more invested.

You will not likely find us canvassing emerging markets for investment ideas; but more established economies may provide us with opportunity. We currently have investments in Canada, the United Kingdom, and Sweden and have recently divested assets previously held in France and Germany. As pointed out by our friends at ISI Group, the shrinking globe can be seen by looking at the labels inside Lacoste shirts of fashion conscious Americans, where Designed in France is followed by Made in China...or Made in Malaysia...or Made in India. Your portfolio's direct foreign exposure currently stands at 9.8%. Indirectly, the portfolio has far more foreign exposure if we were to include our investments in U.S.-based multi-nationals.

¹ *Wall Street Journal*, June 9, 2005.

The housing market continues to outstrip the returns of the stock market and, as we have previously stated and believe, continues to be the engine of the U.S. economy. As was recently pointed out in Barron's, David Rosenberg, Merrill Lynch's chief economist, shares the sentiment. We choose to spend some time on this as we believe any weakness in the housing market will provide investment opportunity. We highlight some of the risks Mr. Rosenberg enumerates:²

- Real estate has accounted for 70% of the rise in household net worth since 2001.
- Over 40% of private-sector jobs created since 2001 have been housing related.
- The subprime market has accounted for a 28% share of new mortgage funding in the past six months (vs. 5% five years ago).
- An estimated 42% of first-time buyers made no down payment on their home purchases last year.
- In the hottest areas, adjustable rate mortgages (ARMs) now account for over 50% of new mortgage originations.
- Over 60% of new mortgage loans in California this year have been in interest-only loans or option-ARMs.
- From 1955 to 1995, home prices rose with inflation, or basically 9% in real terms. Since 1996, home values have risen 45% in real terms. End result: a \$5-trillion increase in housing-bubble wealth.
- National Association of Realtors data show 23% of home sales in the past year were "investor" (read: speculative) based; another 13% were second property.

To this we add...³



"Wow—the house I was using as a hideout has tripled in value since I was arrested."

There are currently 439,000 new homes for sale today, a new high. Home *non*-ownership rate approximates 30.9%, a new low. This means that 69.1% of the people in the United States own their own home. Said another way, supply of new homes is at an all-time high, while prospective demand is at an all-time low. If the home non-ownership rate does not change, for a new home to be sold, either an old home must be sold or people will increasingly own multiple homes – not the bet we are willing to make. "If house prices aren't in a bubble – transactions certainly are."⁴ We have seen transactions decline more than 30% in the United Kingdom. We would not be surprised if that were to occur in the U.S. as well. If it were, what will happen to home prices?

We recall *It's a Wonderful Life* when George Bailey's (Jimmy Stewart) Bailey Building and Loan Society was the friendly town lender in Bedford Falls. George knew his customers and understood the value of

² Barron's, July 25, 2005.

³ New Yorker.

⁴ Grant's Interest Rate Observer.

their collateral and their good word – a far cry from the mushrooming mortgage business today whereby loans are made based on some quantitative understanding of a buyer's income and recently transacted home values. A hiccup in either could sow the seeds of what we would hope would be our opportunity to invest our ample available capital.

We live with a flat yield curve today. Long-term rates are not much longer than those at the short end of the curve. That itself does not portend recession but it does reflect the prevailing view that the economy is slowing. The consumer continues to impressively hang in there, thanks to low interest rates, rising home prices and easy lending standards. How long will this be the case is the question of the day. “This year, only about \$80 billion, or 1%, of mortgage debt will switch to an adjustable rate based largely on prevailing interest rates...Next year, some \$300 billion of mortgage debt will be similarly adjusted...But in 2007, the portion will soar, with \$1 trillion of the nation's mortgage debt – or about 12% of it – switching to adjustable payments.”⁵ As interest-only debt (fixed for a teaser period) becomes adjustable, payment shock for the borrower will likely materialize, leaving many borrowers unable to repay their loans as scheduled.

We continue to maintain substantial exposure to the oil service sector, believing that we sit on the cusp of a new era, when supply constraints and growing demand converge to keep oil prices elevated higher than average since oil last peaked in the early 1980s. We believe that day rates for the operators of on- and off-shore oil rigs will see new highs in such an environment. The price of oil per barrel is certainly susceptible to a decline from its price of almost \$60 per barrel. Our portfolio will likely be negatively impacted for a period of time should that occur. Nevertheless, as tax-sensitive long-term investors, we will sleep in the bed we have made, restless at times but, we believe, refreshed looking back at the end of our multi-year holding period. We take some consolation in the fact that the world does not seem to believe in the sustainability in the current level of oil. Were that the case, oil service stocks would have appreciated far more than they have to date. Oil has increased 66.1% in the last year through June 30, but the oil service index has appreciated just 36.6%, more than half as much.⁶

We feel a bit like a stable owner as we explore various prospective investments. We both try to take the measure of a business and its management team except, in the stable owner's case, his business has hoofs and his operator wears silks. If the horse is lame, the jockey's best efforts will prove for naught. If the jockey is no good, the horse will not run its best. As money managers we need to know the horse and jockey. Historically, our best investments have been those where the horse and the jockey have been good.

One horse we continue to believe in is Big Lots, Inc., the nation's largest close-out retailer. When a company like Rubbermaid wants to shift their color palette from teal to eggplant, the unsold inventory in the old color can be sold to Big Lots, whose customers will be happy to purchase the old color at a discounted price. We have followed Big Lots for more than a decade and, in that time; have observed various managements take the helm. Although there have been many good decisions along the way, the bad outweigh the good and the company's margins and earnings are near its lows.

Big Lots had operating margins that averaged 7.4% from 1995 – 1997. If the company gets to just a 6% operating margin, its earnings per share (EPS) would be \$1.40, attractive for a \$13.24 stock price. We believe such operating margins are attainable. We just need the right jockey. In recent years, former CEO Mike Potter led the Big Lots management team to mediocre results. During his tenure 2000 – 2004, the company had an average ROE of 5.0% and earnings that declined. This poor performance did not stop the board from rewarding management at the expense of shareholders. They granted nine million options over the last five years, 8% of the average outstanding shares.

⁵ *New York Times*, June 16, 2005. Thanks to Portales Partners, LLC for pointing it out.

⁶ Philadelphia Oil Service Sector Index (OSX) with dividends reinvested.

Should Big Lots achieve the potential we believe possible, its stock price performance would not be dissimilar to other successful investments we have made, many of which trade in a narrow range for many years until one day Wall Street recognizes that the business has turned and accords it a different valuation. We look back and can point to stocks we have owned that have barely budged for years, suddenly double (or better) in a matter of months. To be fair, we can also point out those that did not. Although we espouse long-term investing, long-term does not mean forever. The board recently named a new CEO who we hope has a positive impact on their moribund business. It is too early to tell. If by next year this time we do not see improvement in various operating metrics, not the least of which is comparable-store sales, we will reconsider our investment in Big Lots. While we wait, it is good to know that Big Lots sells at 35% of revenues, near its 10-year low and the balance sheet is strong with debt to capital of just 8%. Offering some additional support to our investment should management fail in their turn-around efforts, Big Lots may well prove an attractive acquisition candidate for a firm interested in their valuable national footprint and prospects with a jockey of their choice holding the reins.

Management and the board recognize that, as their third largest shareholder, we are not content to watch any further degradation of shareholder value. To that end, we have had conversations with the head of the Board's Compensation Committee whereby we have been promised that future option awards will be predicated on, among other things, return on capital and earnings per share growth. We continue to believe that the horse is good. Hopefully, the new jockey rides well and uses his crop judiciously.

With the stock market experiencing such small ups and downs thus far in 2005, volatility has fallen to an all-time low. We envisage a period of increased volatility in the future. We will not scamper onto a limb to prophesy timing, direction or magnitude, but will confidently state that at some point in time the stock market will decline enough to allow us to invest our cash hoard. Since we cannot assess the timing of such opportunity, we wait patiently with the hopes that our own investment time horizon matches that of our investors. We look at the world as binary – either we invest in the stocks of businesses we believe offer the potential for high rates of return, or we keep it safe. If the Fund had a mattress, we would use that. Since it doesn't, we keep the liquidity available in a combination of high-grade commercial paper and U.S. Treasuries. To take poetic license with the words of Umberto Eco, we hope to learn from our investing experience so that "...our old age is one of wisdom, not of Alzheimer's."⁷

Respectfully submitted,



Steven Romick
President

⁷ *Time*, June 13, 2005.

Portfolio Data as of June 30, 2005

Comparative Statistics

Ratios (Weighted Average)	Crescent	Russell 2500	S&P 500	Lehman Bros. Gov't/Credit
<i>Stocks</i>				
Price/Earnings TTM	20.7x	23.1x	18.0x	
Price/Earnings 2005 est.	16.4x	20.5x	16.9x	
Price/Book	2.3x	2.4x	2.8x	
Dividend Yield	1.1%	1.3%	1.9%	
<i>Bonds</i>				
Duration	2.4 years			3.7 years
Maturity	2.6 years			4.4 years
Yield	8.2%			4.1%

10 Largest Holdings, representing 24.92% of the Fund as of June 30, 2005.

Common & Preferred Stocks

ENSCO International Incorporated
 Patterson-UTI Energy, Inc.
 Countrywide PLC
 National Oilwell Varco, Inc.
 Assurant, Inc.
 Tate & Lyle PLC
 Michaels Stores, Inc.
 AGCO Corporation
 Rowan Companies, Inc.
 Zale Corporation

Asset Composition

Common Stocks, Long	46.27%
Preferred Stocks	1.12%
Bonds & Notes	4.82%
Common Stocks, short	-8.23%
Cash & Other	56.02%
Total	<u>100.00%</u>