
April 16, 2001

Dear Fellow Shareholders:

The last twelve months have had many of the elements of a Shakespearean play — many companies with comedic business models, dramatic stock price declines, and tragic investor losses. During the quarter ended March 31, 2001, the FPA Crescent Portfolio increased 8.19% and beat the major market averages which all showed significant declines. The Russell 2500, S&P 500, and Nasdaq Composite declined 8.67%, 11.86%, and 25.51%, respectively. For the twelve month period ending March 31, 2001, the FPA Crescent Portfolio gained 16.02% versus major declines in every major stock index.

We suggested in our December 1999 letter that the valuations for many of the internet and other technology companies were dangerously overpriced and that “the investing landscape will be littered with investors who have incurred a permanent loss of capital.” If anything, we were probably too conservative in our assessment. Most internet stocks have been meted a horrific punishment as evidenced by the Leuthold Group’s “Internet Debacle Index,” which has declined 82% — more than a \$1 trillion loss of capital.

Not that we have pleasure in others’ misfortune, but it is nice to feel some vindication. We refused to deviate from our dogmatic, value-hewn investing path even through the insanity of the rapid Nasdaq rise. We wish to own what is inexpensive today, not what might be so years from now. This strategy paid dividends for many years but failed us (or we it?) in 1998 and 1999. However, in 2000 our investments, on average, posted positive returns.

We are thankful that the ridiculous technology company valuations have been left behind; however, valuations today remain relatively expensive when compared to historic norms. The technology sector’s trailing P/E is still at a 30% premium to the market while the average P/E in the last three troughs has been 20%, according to Sanford Bernstein.¹ We believe that the earnings denominator of the P/E ratio may be overstated due to employee stock options and aggressive accounting. It might take years to see the technology stock prices we saw just a year ago even if those stocks have seen their lows. In addition to relatively high stock valuations, excess technology capacity and slowing world economies may hamper a recovery.

¹ P/E = Price/Earnings.

Nineteen-year old Benjamin Franklin may have well been talking about Wall Street rather than the people of a small English town on the Thames River when he said, "If you buy any thing of them, and give half what they ask, you pay twice as much as the thing is worth."² Stockbrokers tend to be more focused on commissions rather than returns, while it seems that investment bankers seek to sell whatever it is that will. As an example, of the 49 companies that Bear, Stearns "has taken public since 1998, 13 — more than one-fourth of them — now trade for under \$1 or have been delisted by Nasdaq, according to an analysis by Thomson Financial."³ For this reason, we rarely invest in an initial public offering (IPO). We do not look for what is being sold but what good, growing business we may instead purchase at a discount. We commit to do this regardless of what market gyrations may test our fortitude.

To that end, we have recently accumulated a position in Harnischfeger, the largest manufacturer of heavy coal-mining equipment in the United States. We have effectively created stock in the company by purchasing defaulted bonds. Harnischfeger's bankruptcy resulted from too much debt, an ill-advised paper company acquisition, and a downturn in the coal sector. We expect Harnischfeger to exit bankruptcy in the next couple of months, whereupon our bonds will convert into stock. The conditions that pushed the company into bankruptcy are gone. Harnischfeger will no longer be highly leveraged, with more than three-quarters of its debt being converted into equity. The acquired paper company is gone and the coal business is getting better because of high natural gas prices. As natural gas prices increase, electric utilities and other power-generating companies consider alternatives — one of which is coal. Coal-based power-generating facilities, although not as environmentally friendly as natural gas or nuclear, produce the majority of the electricity in the United States. Stock prices of coal companies have increased in price dramatically as a result. We expect that Harnischfeger will also benefit from this trend. We have created equity at a price equal to 8x what we consider conservative, "normal," fully taxed earnings to be. More importantly, Harnischfeger has a huge tax net-operating loss carryforward that will enable them to have a negligible tax bill for years to come which, if taken into account, means that our estimated average P/E on an after-tax basis is really just a very low 5x.

We have begun to tiptoe into technology by initiating positions in a very small group of technology companies, including Kemet, Advanced Fibre, and Applied Films. As we said, we do not know where the bottom is but we do wish to make sure we have an investment in the sector when technology does rebound. My associate, Dennis Bryan, has a strong technology background and has contributed the idea for each of these investments. These new positions are so small today that it is more important

² The First American: The Life and Times of Benjamin Franklin by H.W. Brands.

³ New York Times. April 15, 2001

to consider their importance as a basket rather than as individual investments. These companies have no debt, have cash on hand, earn money, have fast growth rates in a recovery, and have been purchased at a 71% average discount from their highs. We hope to add to these positions over time and seek additional opportunities:

Believe it or not, we would like to see more investor capitulation in technology land. The *Wall Street Journal* reported that a major technology-weighted fund family with more than \$300 billion in assets saw a 23% decline in their assets under management last year. Almost all of that decline is due to negative returns with less than 2% due to client redemptions. We find it hard to believe that the current technology malaise can end without investor capitulation. Stocks tend to overshoot reasonable valuation levels both on the upside and the downside. We saw the ridiculousness on the upside, but so far have not seen it on the downside. Most technology companies are not being given away even today.

The weakness in the technology sector does not reflect the health of the overall U.S. economy, although the economy is slowing and we may be in a recession. Home sales remain robust, auto sales continue at a reasonably good pace, and retail sales have held pretty well. What is happening to consumer confidence remains the biggest factor, in our opinion. We might see a pickup in the economy in the second half of this year if consumers hang tough. If not, we are looking at 2002 for a recovery at the earliest. A number of variables have caused the slowing we see today. Electric prices are quite high. A friend of mine recently related his own personal energy crisis. Since he is fortunate enough to own multiple homes, my sympathy was oddly missing. Of his three homes in Los Angeles, Park City, Utah, and New York City, his electricity prices have risen 10%, 40%, and 100%, respectively. Note that California, the state with the greatest publicity surrounding its current energy problems has had, to date, among the smallest rate increases. Rising energy prices is a national issue that has made a dent in the consumer's wallet. Just a year and a half ago, many thought that oil played such a small part in the economy that it would not be a factor in inflation. Not only has that proven untrue, but now it appears to be having a negative effect on the economy, and if it is difficult for users today, what is likely to happen during the hot summer months when electric bills are higher? Electric utility price increases hurt corporate America as well, although to a lesser degree than a household. Regardless, when companies find it challenging to invoke price increases today, most businesses will be hurt by rising utility costs. One company we own, Michaels Stores, has told us that they expect that up to 30% higher utility costs will reduce operating income by approximately \$6 million, a 4% negative impact.

The stock market also has an impact on the economy. Not only does it help drive consumer confidence but we have little doubt that the economy has been aided by the stock market wealth creation of the 1990s. The stock market has been a wealth destroyer of late. Meanwhile, the consumer is already financially stretched and now must absorb the layoffs that are being announced almost every day. Layoffs are somewhat overstated in that many of the jobs being cut are in foreign countries — one of the benefits of NAFTA at least as far as Mexico is concerned.

As we conduct research to uncover quality businesses to invest in, we frequently discover companies with business models that make little sense, or have too much debt, or that are unlikely to earn what Wall Street expects due to deteriorating fundamentals. We have taken a number of small short positions in such companies. In our last letter we mentioned three such businesses: Cisco, Computer Sciences and IBM. During the first quarter, Cisco and Computer Sciences declined 58.7% and 46.2%, respectively. IBM increased 13.2% in the same period, although it remains 20.7% below our average cost to establish the short position. We repurchased our Cisco short position last week at \$16.04, but do not believe that Cisco's 30 P/E is inexpensive by any measure other than when compared to itself a year earlier.⁴

Selling short allows an investor to sell shares that they do not own with the hopeful expectation that they will be able to replace them with the same number of lower-priced shares at a future date. By engaging in a modest amount of short selling, we are hopeful that we will be able to dampen the volatility of the portfolio by making money with a portion of our portfolio in difficult market environments. We have been shorting for more than five years and have only 4.0% of our portfolio currently sold short.

⁴ Cisco's P/E (Price/Earnings ratio) is based on First Call's July, 2001 fiscal year consensus estimate of \$.53 per share.

Despite FPA Crescent's advance and the stock indexes declines in the first quarter, FPA Crescent continues to be dramatically cheaper and we believe growing faster than the comparative stock indices below.

Ratios (Weighted Average)	FPA Crescent	Russell 2500	S&P 500	Lehman Bros. Gov't/Credit
<i>Stocks</i>				
Price/Earnings TTM	12.2x	21.3x	23.8x	—
Price/Earnings 2001 est.	11.5x	17.4x	21.1x	—
Price/Book	1.2x	2.2x	3.9x	—
Dividend Yield	1.7%	1.6%	1.3%	—
<i>Bonds</i>				
Duration	3.0 years	—	—	5.6 years
Maturity	5.0 years	—	—	9.7 years
Yield	18.7%	—	—	5.7%

Our ten largest equity positions represented 33.83% of the portfolio as of March 31, 2001. Listed below are FPA Crescent's ten largest holdings, excluding short-term investments, as of that date.

Common & Preferred Stocks

Michaels Stores
 Celanese
 Crown American Realty Trust
 Ventas REIT
 Pittston Brink's Group
 Ross Stores
 Consolidated Stores

Bonds & Notes

Charming Shoppes 7.5% Convertible Notes, due 7/15/06
 Hutchinson Technology 6% Convertible Notes, due 3/15/05
 Harnischfeger Industries 7.25% Senior Notes, due 12/15/25

FPA Crescent had the following net asset composition at March 31, 2001.

Common Stocks, Long	53.45%
Preferred Stocks	5.03%
Bonds & Notes	18.00%
Accrued Income	0.30%
Common Stocks, Short	(4.04%)
Cash & Other	<u>27.26%</u>
Total	100.00%

FPA Crescent's fixed-income portfolio retains equity-like characteristics given its high 18.7% yield-to-maturity. We continue to believe that having an investment in high-yield and convertible bonds is an excellent way to provide good rates of return without perfect correlation to the stock market indices.

Meanwhile, we look forward to a continuation of the same market driving forces since the beginning of time — fear and greed. We like both. Fear is good if we are buying. Greed is good if we are selling. As scents of an economic and technology sector recovery waft to investors, stocks should rise.

Respectfully,



Steven Romick