

# LETTER TO SHAREHOLDERS

Dear Shareholder:

The first quarter was looking good for a couple of weeks and by “good” we mean bad. The stock market declined as much as 8.4% intra-quarter.<sup>1</sup> We want the bad news to wreak more havoc so that we may put capital to work. Instead, 2007’s first quarter ended in the black with most stock indices increasing marginally, flat to up a couple percent. FPA Crescent increased 2.20% for the period.

We continue to invoke our discipline to maintain our investment integrity. We try not to pay more than 65% of a company’s intrinsic value, depending on the quality of the business. Capital is sloshing around the markets like wine in a half-empty jug. And, those taking swigs may have over-imbibed. We trust in our temperance. We cannot, in good faith, invest in a fashion that differs from our traditional threshold in the ratio of risk to reward. We argue risk assumed does not justify investment, in most cases today, despite there being attractive relative value opportunities, i.e., stocks that could have upside of 30% or so as long as the consumer continues to show strength, the economy does not break down, and interest rates remain low.

Risk tends to get discussed only after a negative event. The discussion of risk in subprime lending resulted from a rise in delinquencies, early payment defaults, and the subsequent bankruptcy of a number of companies with New Century as the poster child. These discussions should have occurred in prior years as subprime lending grew from \$110 billion in 2000 to \$805 billion in 2005.<sup>2</sup> Subprime’s share of purchase mortgage originations had risen to 20%, up from just 7% in 2000.<sup>3</sup> Although some investors talked about the powder keg that was subprime, most either ignored it because it was under their radar or embraced it because companies in that sector had exhibited tremendous earnings growth in recent years. We first discussed this risk in our 2005 second-quarter letter,

and have avoided most financial service companies since.

We do not think the end to the story has been written. It appears to us that, in part due to the profligate borrowing by people who should not have qualified in the first place, there are more than 2 million vacant homes for sale today, ~1.7% of the total housing stock versus an average of 0.9% since 1980. The last peak was 1.1% in 1989. This means that there are approximately 900,000 more vacant homes than normal.<sup>4,5</sup> Some will argue that home prices will decline as a result, but we do not feel capable of making that call, given the many cross currents at work. Nevertheless, the surplus of vacant homes for sale will likely put pressure on the economy, as liquidation of excess inventory is apt to keep home prices in check, thereby limiting homeowners’ ability to refinance. The monetization of one’s home has been a big engine of growth for the economy since 2002. Home equity withdrawal at an annualized rate ranged between \$600 billion to more than \$1 trillion from 2003 to 2006, compared to the average of less than \$250 billion in the period from 1991 to 2003. We cannot say how much of that homeowners have spent, but if we assume just one-third and that home equity withdrawal has averaged \$450 billion above normal these past few years, then the economy has had an annual benefit of \$150 billion, or roughly 1.2% of the 3.5% trailing 3-year GDP growth, or 34%. These are just rough numbers to show what impact a slowing housing market could have on the economy and its subsequent effect on corporate earnings. We have assumed an environment of stable home prices, but declining prices would obviously have a greater impact. This serves as just one example of the risk that the stock market does not seem to take into account.

We appreciate that we have not fully invested the capital entrusted to us, but we seek to generate high risk-adjusted returns. The only way we know how to do

<sup>1</sup> The Russell 2000 declined from a February 22, 2007 high of 829.44 to a low of 760.06 on March 5, 2007.

<sup>2</sup> Flanagan, Christopher. “The Rise and Fall of Subprime: Anatomy of a Boom-Bust Cycle.” JPMorgan 19 March 2007.

<sup>3</sup> CS Homebuilding Team. Presentation. Credit Suisse. 2007.

<sup>4</sup> Stifel Nicolaus. Consumer Finance Report. April 2, 2007.

<sup>5</sup> Data calculated using statistics from the U.S. Census Bureau. Using statistics from the National Association of Realtors suggest that the surplus of vacant homes for sale is 1.3 million units above average.

that is to buy on sale. We recognized years ago that, at times, we may reservoir cash as we await opportunity. Rather than feel the cold steel of a gun to our head forcing us to be invested at all times, regardless of the tradeoff between risk and reward, we will at times select to hold cash with its almost 5% rate of return until better upside presents itself. This philosophy has yielded results for our portfolios over time. We exercise such patience expecting the future (not measured in a year or two) to afford more of the same.

Investing in this fashion has tended to create somewhat less volatility than the stock market. FPA Crescent's standard deviation (a traditionally used measure of volatility) is 2.91, as compared to 4.75 for the Russell 2500. FPA Crescent has outperformed its relevant equity benchmarks since inception, despite its lower volatility. Interestingly, volatility has proven to be the enemy of investor returns. Morningstar conducted a study last year that "illustrated investors' tendency to buy high and sell low....By factoring in the timing of investors' purchases and sales, investor returns depict the returns earned by a typical investor. In aggregate, the data show that investor returns have generally lagged those of funds' published total returns....Moreover, a fund's volatility appears to be a key determinant in whether its investor returns are good or bad."<sup>6</sup> For example, a \$100-million fund increases 15% in the first quarter of a year while the market increased just 5%. \$400 million of capital is added on the first day of the second quarter and is held for the entire year. The fund returns 0% for the balance of the year and thus ends the year at \$500 million. The fund's published return for the year would still be 15%, while Morningstar's "investor return" in this case would be just 3% (20% of the capital returned 15%, while 80% of the capital returned 0%). If the stock market increased in the latter nine months of that year, given the fragile state of investor emotions, this fund would unlikely remain \$500 million for long.

Most investors seem to be scared into and out of the stock market. After the stock market has declined for a period, many panic and sell. After the stock market has appreciated many of the same people

believe it safe to buy stocks, mutual funds, etc. The timing here is key as it is *after* a rise or fall that investors choose to buy or sell. This nonsensical path to making less money than one otherwise could runs contrary to logic, but remains prevalent nonetheless. The virtue of patience is that we will wait and act, rather than react. Patient investing also leads to lower portfolio turnover, leading to a couple of clear benefits.

Lower turnover generally means that investors should understand their companies better. If there are 100 companies in the portfolio and your turnover is 100%, then a manager needs to know 200 companies. With more than one division for the average company, how can that manager really understand what they own? We prefer to take a page from the Weizmann Institute in Israel. Not so well-known outside of Israel and the scientific community, Weizmann has forged a tremendous reputation by keeping its focus on the long term, with each scientist focusing on what might be just one idea at a time. Weizmann claims a larger patent and royalty stream than any academic institution in the world, even more than all of the other academic institutions in the U.S. put together. The scientists behind satellite receiver smart-cards, amniocentesis, the first effective drugs to treat multiple sclerosis, and so much more have been able to ply their trade without having to worry about how their science will translate to commercial profit. The mathematical algorithm that allows a satellite receiver to unscramble a coded signal was invented in 1979, two decades before satellite television became ubiquitous. Some of these scientists have shared with us that they would not have been successful had they been required to show economic results in a short time frame. By focusing on the long term, they are able to eliminate the day-to-day distraction that plagues other research organizations.

Our investment philosophy shares some similarity. We are myopically focused on the long term and, although we do not look at just one idea at a time, there are just 41 long common stock investments in the portfolio. Short-term market gyrations are nothing more than opportunities to allow us to either enter or exit a position, subject to valuation and fundamentals.

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<sup>6</sup> Benz, Christine. "How Did Investors Really Do?" Morningstar 13 November 2006.

We realize that many of our investors care about what happens to the portfolio in a given year, month, or even day, but recognize that we do not. We concern ourselves more with what our returns will be over the next five and ten years.

This focus on a longer time frame will help explain our continued emphasis on energy stocks. The business of energy production is one of declining supply and increasing demand.<sup>7</sup> Oil companies are discovering, on average, less than one third of what the world consumes. Discoveries have been on a declining trend since the early 1960s peak, while consumption has exceeded discoveries for more than 20 years. Meanwhile, the cost to produce a barrel of oil has increased due to the higher cost of raw materials and energy itself. Energy is needed to produce oil, whether it be to inject steam into a well or transport crude across the Atlantic. The energy cost per barrel has increased from 1:20 twenty years ago to 1:4 today. This means that it now takes the equivalent energy of one barrel of oil to produce four barrels. Harder to find and costlier to produce; such a recipe will likely keep a floor under the price of oil not far below current prices, barring a recession which would curb demand. To make it all the more attractive, many of these stocks remain inexpensive despite healthy run-ups the last few years. We do not know what will happen to the price of oil over the short term and the subsequent impact that may have on the companies we own in the sector, including, EnSCO International, ConocoPhillips, GlobalSantaFe, Rowan Companies, Patterson-UTI Energy, Chevron, National-Oilwell Varco, and Plains Exploration & Production. Nevertheless, like the Weizmann scientists, we remain focused. We believe the future will bring better economics and higher valuations for the aforementioned companies, a future that is not entirely dependent on higher oil prices, although that is something we believe is quite likely.

Buying and selling the companies in your portfolio less frequently also usually results in better

tax treatment as investments held for more than a year are taxed at a 15% Federal rate, as compared to the maximum 35% rate for ordinary income. Investments held for longer than a year allow for the compounding of your dollars in a tax-deferred fashion since no money need be shared with our silent partners at the U.S. Treasury. According to Morningstar, the Fund's tax adjusted return for the past 10 years is 89% of the total return.<sup>8</sup> That means that an investor would have retained 89 cents of every dollar he earned in the Fund after federal taxes.

We have recently accumulated a position in the bonds of beauty supply chain Sally Beauty Holdings. The company sells shampoo and conditioner, hair color, skin and nail products, etc. through more than 2,500 beauty supply stores selling to the retail customer and over another 800 outlets selling to the wholesale customer. Sally Beauty was recently spun off from Alberto Culver Holdings, a company we have followed since the early 1990s. We believe business value substantially exceeds the debt value and the stock market supports that statement as Sally Beauty's equity trades publicly, valuing the enterprise at almost twice the debt level. Assuming the stock market is correct, we are able to buy a bond at a 52% loan-to-value and still receive a 10.1% yield-to-maturity.<sup>9</sup> This is an equivalent yield and a greater margin of safety than the billions of subprime mortgages that have been written in recent years. Sally Beauty's business has high returns on capital and low capital spending required to maintain the stores. We dug out old Alberto Culver Annual Reports to see how the Sally Beauty division fared back in 1991 and saw that they were able to grow through what was our most recent consumer recession. The business currently generates free cash flow and we expect more in the future thanks to improving comparable-store sales and the addition of new stores. Management has committed to using available cash flow to reduce debt. Should things go as we expect, we would be surprised to see these bonds remain at current prices. As cash flow increases and

<sup>7</sup> Usually supply refers to the recoverable amount of oil and gas. In this context, we allude to the non-renewable nature of fossil fuels by including discovered and non-discovered.

<sup>8</sup> Morningstar Mutual Fund Analysis, March 21, 2007, based on performance through February 28, 2007 (9.93% after tax/11.20% pre-tax = 88.7%).

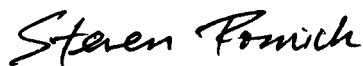
<sup>9</sup> Market value (3/31/07) = \$1.656 billion. Debt value, net (12/31/06) = \$1.767 billion. Enterprise value = \$3.423 billion. Presumably, private market value is generally greater than public market value, thereby making the margin of safety possibly even greater.

debt declines, and assuming a constant yield on equivalent-maturity U.S. Treasury bonds, the yield on the Sally Beauty bonds should also drop. As a result, we would expect these bonds to appreciate over the next couple of years, yielding more than the current 10.1% yield-to-maturity and better than what we expect the stock market to return.

We feel fortunate to have discovered the Sally Beauty bonds, given that less than investment-grade bonds currently yield on average 2.58% over government debt, a historically tight spread.<sup>10</sup> The lack of anything other than relative value in the high-yield bond market continues to be the case for what we see in the stock market. I guess this means more time to

practice exercising our patience. We wonder if it is like eating a muffin? Some people eat the muffin's top first, whereas we put it aside to savor later — the gastronomic corollary to the virtue of patient investing.

Respectfully submitted,



Steven Romick  
President  
April 23, 2007

The discussion of Fund investments represents the views of the Fund's managers at the time of this report and are subject to change without notice. References to individual securities are for informational purposes only and should not be construed as recommendations to purchase or sell individual securities. While the Fund's managers believe that the Fund's holdings are value stocks, there can be no assurance that others will consider them as such. Further, investing in value stocks presents the risk that value stocks may fall out of favor with investors and underperform growth stocks during given periods.

Fund shares are presently offered for sale only to existing shareholders and to trustees, officers and employees of the Fund, the Adviser, and affiliated companies, and their immediate relatives.

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<sup>10</sup> Lehman Brothers