

# FPA CRESCENT PORTFOLIO

October 19, 1997

Dear Fellow Shareholders:

Happy Anniversary. Ten years ago today the stock market plunged more than 20% in one day, “Black Monday,” October 19, 1987. For many of us this is but a distant memory. For others, it is something that impacted somebody else; after all, ten years ago U.S. equity funds had investments of “only” \$211.6 billion. Today that number has increased nine-fold to \$1.9 trillion. Although fund performance has certainly aided this increase, new contributions account for well over \$1 trillion. How much of this “new” money has seen a market correction? Even in 1987, the stock market ended the calendar year in the plus column. We must look back to 1977 to see a double-digit market decline for a full calendar year. We do not wish to ruin the party with such negativism: while the bartender is still pouring. We want the party to proceed while we continue to invest in inexpensive companies, and we want and want and. . . . The issue as we see it is that we like to buy on bad news and there just is not much of that around these days. As a result, we continue to preach conservatism.

Small-capitalization companies picked up steam in the third quarter. Small caps had been undervalued compared to large caps, but in this single quarter that gap substantively dissolved. The predominantly large-cap S&P 500 index increased 7.6% during this period, while the small-cap Russell 2000 index increased almost twice as much at 14.9%.

The comparative returns for Crescent and its relevant benchmark indices are shown below.

<u>Time Period</u> <u>(Calendar Year)</u>	<u>FPA</u> <u>Crescent</u> <u>Institutional</u> <u>Class</u>	<u>FPA Crescent</u> <u>Institutional</u> <u>Service Class</u>	<u>Balanced</u> <u>Benchmark</u> <u>60% Russell 2500/</u> <u>40%LB</u> <u>Gov't/Corp</u>	<u>Lehman</u> <u>Brothers</u> <u>Gov't/</u> <u>Corporate</u>	<u>Russell</u> <u>2500</u>	<u>S&amp;P</u> <u>500</u>
Period Ended 9/30/97						
Year-To-Date .....	22.2%	20.7%	18.9 %	6.4 %	27.2 %	29.7%
Third Quarter .....	9.2%	9.0%	10.0 %	3.5 %	14.4 %	7.6%
Annual						
1996 .....	22.9%	—	12.6 %	2.9 %	19.0 %	23.3%
1995 .....	26.0%	—	26.7 %	19.2 %	31.7 %	37.5%
1994 .....	4.3%	—	(2.0)%	(3.5)%	(1.1)%	1.3%
From Inception* .....	19.5%	20.7%	14.5 %	6.7 %	19.6 %	21.7%

\* Inception is 6/2/93. Returns from inception are annualized. The annualized performance of the Russell 2500, Lehman Brothers Government/Corporate, and S&P 500 indices begins 6/1/93. The data quoted represents past performance and is not indicative of future performance. An investment in the Portfolio may fluctuate so that an investor's shares when redeemed may be worth more or less than their original cost. All returns assume the reinvestment of dividends and distributions. The table presents the performance of the Institutional Class shares which have been in existence since Crescent's inception. The performance of the Institutional Service Class shares will vary based upon the different inception date and 12B-1 fees assessed to that class.

People do not seem to think that the market will go down, just as in 1974 they did not think it would go up. At that time, they thought that we were in an economic and stock market Armageddon—with high inflation, a recession, and declining stock prices. In contrast, we currently live in a world of low inflation, low economic

growth, and rapidly rising stock prices. We belong to the Equity Sect of Buddhism and this is our Nirvana. We do not believe that business and economic cycles have been abolished. We do know that we will continue to be here, as an anchor in future choppy seas.

Our economy has experienced tremendous productivity improvements which have allowed corporate margins to expand, and thus, more sales dollars to fall to the bottom line. This has aided in keeping inflation at historically low levels. We do, however, run the risk, as Morgan Stanley economist Stephen Roach said, "that investors (due to productivity improvements) are initially rewarded beyond their wildest dreams, but those rewards could eventually be wiped out by the powerful reflex reaction of a worker." The recently resolved United Parcel Service strike might be an early warning signal. Currently the United States stands at full employment. According to Federal Reserve Chairman Alan Greenspan, if the economy continues its growth path, that there will not be "wage pressures . . . strains credibility. The law of supply and demand has not been repealed."

We are not willing to assume risk for risk's sake. It is important to balance the desire for excellent returns with the need to preserve principal. This is a delicate balance. Proper investing requires seeking the upside, but not forgetting about the downside. We have seen mistakes in both directions, i.e., investors so concerned about making a ton of money that they do not consider the downside. Other investors have such fear of losing money that they forget about the upside. Either way, mediocre returns will be the result. We view the trade-off simplistically. We would not jump six feet from the roof of one 50-story building to another (without our lives being threatened, that is). We would, however, consider jumping from building to building at the first floor level if there was a pot of gold on the other side and grass below. That would be an intelligent risk. That is what we try to do and here are a couple of examples.

During the quarter, we purchased a position in AMERCO. You probably are more familiar with their largest subsidiary, U-Haul. AMERCO is the largest factor in the "do-it-yourself," one-way and local moving business. With their fleet of 89,000 trucks, they dominated their nearest competitor, who has a little more than a third as many trucks. AMERCO is also our nation's second largest manager of mini-storage facilities with 19.8 million square feet. Other assets include a property and casualty insurance company, a life insurance company, and a tremendous amount of net operating loss carryforwards (NOLs) that can shelter future earning. The value of these assets, if sold in the private market, would probably fetch something between \$50 and \$70 per share, and we acquired our position at \$27, a 55% discount from the mid-point of that range. Furthermore, the company has the potential to earn \$3.50 per share over the next couple of years, a 7.7x price/earnings multiple. Finally, it trades near book value. The management of this family-owned company has been pre-occupied the past six years with in-fighting amongst family members, resulting in a loss of focus and deteriorating profitability. In the past twelve months, resolutions have finally been reached that currently allow the company to refocus on its business. Our conclusion is that there is not much downside with a lot of potential for upside.

Although, in recent years, investors appear to have come to believe that stocks are safer than bonds, we continue to find excellent opportunities in the fixed income arena. We reviewed the rationale for our investment in the Charming Shoppes convertible bonds in our letter dated September 30, 1996. We originally purchased the bonds at \$100 (par) in July of 1996. We have collected our 7.5% coupon while we have been waiting for their business to improve and for the stock to appreciate. The turn has taken longer in coming than originally thought and the stock has declined 16% from the level where it had been trading when we purchased the bonds. Meanwhile, as of this writing, the bonds are trading at \$101, a 10.4% total return from our initial purchase and 27 percentage points better performance when compared to the common stock. Even though the stock has not performed as well as our original expectations, we have still achieved an adequate return. We did analyze the risk and reward

correctly and determined that the bonds were a better value. Furthermore, we believe that the potential reward is still there and that we will capture 50% of the upside of the stock from current levels. Therefore if the stock trades at \$10 per share in the next two years, these bonds should trade near \$135. Meanwhile, the credit risk remains minimal, we collect coupon interest and own a bond in a company that has stockpiled enough cash to offset two thirds of the debt on its balance sheet.

Crescent's portfolio characteristics reveal that we hold securities that are, on average, much less expensive than the stock market.

<b>Ratios (Weighted Average)</b>	<b>Crescent</b>	<b>Russell 2500</b>	<b>S&amp;P 500</b>	<b>Lehman Bros. Gov't/Corp.</b>
<i>Stocks</i>				
Price/Earnings 1997 est. ....	16.5x	21.8x	21.9x	
Price/Earnings 1998 est. ....	15.0x	19.0x	19.1x	
Price/Book .....	2.4x	3.0x	4.0x	
Dividend Yield .....	1.1%	1.3%	1.6%	
<i>Bonds</i>				
Duration .....	4.4 years			5.2 years
Maturity .....	6.6 years			9.8 years
Yield .....	8.2%			6.3%

The median market capitalization of companies held by Crescent is \$367 million. Listed below are Crescent's ten largest holdings, excluding short-term investments, as of September 30, 1997. These investments account for 32.9% of the portfolio's net assets, an increase of 4.6 percentage points since June 30. We view this positively in that we prefer to have a greater concentration in our favorite investments. In the future, we would hope to see this percentage increase even further.

#### **Common Stock**

NCR Corporation	3.8%
AMERCO	3.8%
Storage Technology Corporation	3.8%
Foremost Corporation of America	3.5%
National R. V. Holdings, Inc.	3.1%
Price Enterprises, Inc.	2.7%
Reebok International Ltd.	2.5%
Michaels Stores, Inc.	2.5%

#### **Bonds & Notes**

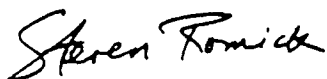
U.S. Treasury Inflation-Indexed Notes, 3.375%, 1/15/07	4.7%
Flagstar Corp. 10.875%, 12/01/02 Senior Notes	2.5%

Crescent had the following net asset composition at September 30, 1997:

Common Stocks, Long .....	53.8 %
Common Stocks, Short .....	(2.8)%
Preferred Stocks .....	4.5 %
Bonds & Notes .....	23.7 %
Cash & Equivalents .....	20.8 %
Total .....	<u>100.0 %</u>

The stock market continues its upward ascent. The perception that interest rates will remain low allows for a sustainable level of valuation that is high by historic standards. A rise in interest rates or a decline in corporate earnings would certainly cause a stock market decline. I am not forecasting a level of inflation that would drive interest rates higher, nor do I see a recession on the horizon that would cause earnings to decline; however, we have had neither in so many years that we will eventually get one or the other. As the bumper sticker says, "Change is inevitable, except from a vending machine." We will continue to invest, regardless of the outlook for inflation or corporate earnings, as long as we continue to find opportunities where we are "paid to play."

Respectfully,



Steven Romick  
Portfolio Manager,  
FPA Crescent Portfolio