
October 15, 1998

Dear Fellow Shareholders:

Large-company stocks continue to perform much better than small-company stocks. During the third quarter, the differential widened as stocks of the largest companies supported the S&P 500 Index. Year to date, the S&P 500, which is capitalization weighted (i.e., the biggest companies have the biggest impact on the return) has increased 6.1%. The equally weighted S&P 500, however, has declined in the mid-single digits year to date while smaller companies have fared much worse. The Russell 2000 Index of small companies declined 20.1% in the quarter and 16.2% year to date. The Russell 2500 Index of medium-sized companies fell 19.1% in the quarter and 14.5% year to date. Investors are selling small stocks because they want to get rid of small stocks. Value is not part of the equation.

We recognize that shareholders wish to outperform every quarter of every year. And worse, do not like to lose money. We would like the same; however, it is an unrealistic goal. We work to outperform over time and yet we are losing money today. It's a crummy feeling, although some small satisfaction is derived from having provided substantially less downside than the small- and medium-sized stock indices. We continue to work to provide equity-like rates of return by investing in small- and medium-sized company stocks as well as in other parts of a company's capital structure, e.g., their preferred stock, convertible bonds, or senior debt. Meanwhile, we are in a boat and the tide is going out. We cannot stay on shore, but we work to continue to stay closer to shore than comparable boats. Please see the tables at end of letter for more detailed performance information.

We live in a world of vicious global competition with more than a whiff of deflation in the air. This has led to negligible pricing power for corporations. According to Prudential Securities in June, declining prices are negatively impacting 40% of the industries covered by the firm's analysts, versus 26% in the prior year. It remains to be seen how far the deflationary trend goes. Meanwhile, as a result of continued low unemployment, wages continue to increase. Weak pricing combined with higher wages result in lower corporate margins, and therefore lower corporate earnings over the near term.

Individual investors have tremendous influence on our economy today. With unprecedented levels of household assets committed to the stock market, both in taxable and pension accounts, investor capitulation could turn our economy upside down. This phenomenon would be guided by a difference in expectations versus reality. For example, if somebody determines that they need \$750,000 to retire in 20 years, that could be accomplished by investing \$4,000 each year and watching

it compound at a 20% rate. But if market returns decline, investors will have to save more and/or spend less—a negative to our economy. If investors vacate the stock market and invest in medium-term Treasuries at 4.5%, then they will need to save \$24,000 each year, an additional \$20,000. Where would this money come from? Those who cannot afford to make up the difference might accept less money to retire. Others might save more. Either way, people will be spending less; a clear negative for the economy that points the way to a stock market-led economic contraction.

Since we invest in both stocks and bonds, Morningstar and Lipper place Crescent in the Hybrid and Balanced fund categories, respectively. According to Lipper, Crescent is in the top decile of fund performance in this category for the five-year period ending September 30, 1998. During the past five years, large companies' stock prices have compounded 9.1% better than the stock prices of smaller companies (S&P 500 vs. Russell 2500). Since Crescent is one of only a couple of funds in this category that invest in small- and medium-sized companies, we feel that our high ranking has withstood severe pressure, given the underperformance of smaller versus larger capitalization stocks. We feel we are better able to understand smaller companies and offer more value in that we have better access to their management, the businesses are usually less diversified, and Wall Street provides less research.

We cannot predict when wind will be behind smaller company stocks, but it will happen. Stock market leadership regularly changes hands between small- and large-capitalization stocks, as you can see by looking at the last 25 years. Small-cap stocks outperformed from 1974 to 1983 and again from 1991 to 1994, while big-cap stocks outperformed in 1973, from 1984 to 1990, and again from 1995 to the present. Over the 25-year period, small-company stocks returned 13.8% versus 13.1% for large-company stocks (Source: Ibbotson). We do not know when the small cap rebound will occur. When it comes, though, it will come very quickly. Small-company stocks increased 27.7% in January 1975 and 28.7% in the first quarter of 1991 following similarly dramatic declines in small-company stocks.

One support for the small-company stocks is the \$80-\$90 billion dollars in cash that Donaldson, Lufkin & Jenrette estimates currently resides in leveraged buyout funds. This cash could be leveraged and potentially produce \$250-300 billion in buying power to invest at excellent rates of return in the beleaguered small-stock sector.

Should one be invested in the stock market only when the stocks are rising? Yes—that is, if somebody could. Nobody has ever successfully “timed” the market. Most investors prefer to see stock prices appreciating before they invest and usually sell when they get scared, which is usually after experiencing a measurable decline

in the value of their portfolio. As a result, the average investor underperforms stock indexes, missing many large market moves on the upside, while still participating in the downside. For the 72-year period 1926 to 1997, large-capitalization stocks have returned 10.6% while small-capitalization stocks performed better, returning 12.0% (Source: Ibbotson). Using Ibbotson data for large-company stocks, we looked to see what returns would have been if investors missed the best month in each of the last 72 years and, instead, during those months had their money invested in Treasury Bills. The return over the period would have been just 2.6%, a negative real rate of return if you subtract inflation. We strongly believe that trying to swing in and out of stocks will, over time, be detrimental to your net worth. The cash that resides in our portfolio has resulted from not finding companies that meet our strict investment parameters, not from trying to time the stock market.

As a result of the continuing poor relative performance, at the end of September, small-company stocks are dramatically cheaper than large on such valuation measures as price/earnings, cash flow multiples, and price/book. For the first time in almost three years we are seeing numerous opportunities. We have 20% in cash and equivalents to deploy in such opportunities but are acting cautiously, as such low valuations do not guarantee that stocks we are considering cannot drop further before rebounding. Our intention is to invest the cash over time and price. In other words, we will purchase additional shares as a stock price declines (assuming no change in fundamentals) and time passes.

As a result of stock declines in the quarter, the companies we own now trade at much lower multiples. Crescent's P/E, based on 1998 estimates, is now 13.4x and much less expensive than the stock market, as can be seen in the table below.

<u>Ratios (Weighted Average)</u>	<u>Crescent</u>	<u>Russell 2500</u>	<u>S&P 500</u>	<u>Lehman Bros. Gov't/Corp.</u>
<i>Stocks</i>				
Price/Earnings 1998 est.	13.4x	20.7x	24.4x	—
Price/Earnings 1999 est.	10.4x	15.6x	20.0x	—
Price/Book	2.2x	2.3x	4.0x	—
Dividend Yield	1.9%	1.7%	1.6%	—
<i>Bonds</i>				
Duration	3.5 years	—	—	5.6 years
Maturity	6.2 years	—	—	10.4 years
Yield	9.9%	—	—	5.1%

The median market capitalization of companies held by Crescent is \$348 million. Listed below are Crescent's ten largest holdings, excluding short-term investments,

as of September 30, 1998. These investments account for 33.4% of the portfolio's net assets.

Common Stock

Midas, Inc.

NCR Corporation

Storage Technology Corporation

AMERCO

Foremost Corporation of America

Prime Retail, Inc. REIT

Conseco, Inc.

Ventas, Inc. REIT

Bonds & Notes

U.S. Treasury Inflation-Indexed Notes, 3.375%, 1/15/07

Advantica Restaurant Group, Inc., 11.25%, 1/15/08

Crescent had the following net asset composition at September 30, 1998.

Common Stocks, Long	50.0 %
Common Stocks, Short	(1.1)%
Preferred Stocks	5.0 %
Bonds & Notes	26.0 %
Cash & Other	20.1 %
Total	<u>100.0 %</u>

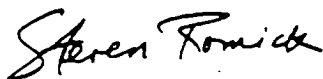
U.S. Government Bonds have exploded in price, dropping the yield on the 30-year to 5%. Unfortunately, as a buyer of corporate bonds, we have not participated in this rally. We have always exchanged the interest rate risk of the long Treasury market for the credit risk of medium-quality corporate bonds and broken convertible bonds. Yield spreads on these and all non-government bond asset classes have widened tremendously, i.e., the extra return required to own a corporate bond has increased versus a U.S. Treasury Bond with the same maturity. CS First Boston's High Yield Index spread has widened almost three percentage points in the last three months to offer yields 6.9% better than Treasuries. Also according to CS First Boston, higher quality credits have seen spreads widen over the same period, almost 0.5% to offer yields 1.3% better than Treasuries. The pricing makes no sense. We observe a disconnect between the stock market and corporate bonds. Many corporate bond yields are at levels not commensurate with that company's stock price. With many corporate bonds offering yields in the mid-teens, one would expect the underlying common stocks to have prices approaching zero as the very economic viability of the enterprise is called into question. Instead, those companies' stock prices are comparatively high. If the stock prices accurately reflect

prospects, then those bonds are heading higher. If the bonds more accurately reflect the future, then the stock must go lower. The yield spread can widen before it narrows if high-yield funds are forced to sell due to redemptions.

Many of our investments trade at levels far below their private market value. As one example, Pinkerton's, the global security service company, trades at \$13.81, down 42% from its peak in April. Pinkerton's is not highly sensitive to a weak economy. In fact, the company is being hurt today by the high level of employment. Pinkerton's is having difficulty finding qualified personnel willing to work for a wage that allows the company a reasonable profit on their guard contracts. As a result, Pinkerton's has deliberately slowed their growth, not willing to bid for a contract that will provide an inadequate rate of return. In a weaker economy, Pinkerton's profitability should increase as their cost of personnel declines and they more actively solicit new business. Pinkerton's has a market capitalization of \$170 million, including cash and debt. The company should generate pre-tax free cash flow of at least \$30 million next year. Paying \$170 million and receiving \$30 million equates to a 17.6% pre-tax rate of return. Few companies have such a market position, high rates of return on capital and free cash flow characteristics. We are confident that the value of Pinkerton's today will provide excellent rates of return in the future.

Versus other potential investments, common stocks offer certain psychological advantages. Stocks are liquid and you can buy and sell them five days a week. There are the disadvantages as well. Stocks are liquid and you can buy and sell them five days a week. If the value of your home were printed in the daily paper, there would be times when you would be sick to your stomach. However, if the price dropped and covering your household expenses were not an issue, you would be unlikely to sell. You live in the house and you know what its worth. We strive to understand our companies' businesses, get to know their managements, and determine their fair valuation. There will be volatility in prices. The Leuthold Group estimates that stock valuations have traded at a median price/earnings multiple of 14x since 1926, but how often is it 14x? The valuation can be 8x earnings or 20x earnings. As a result, we built a substantial cash position as valuations increased and are slowly beginning to put the money to work as prices decline.

Respectfully,



Steven Romick
Portfolio Manager,
FPA Crescent Portfolio