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October 15, 1999

Dear Fellow Shareholders:

Please allow us to remind you in advance of the following letter that we maintain a consistent, clear investment philosophy. Therefore, as our objectivity may be called into question, we have put forth our best effort to provide you a balanced and reasoned appraisal of today's investment environment. We will not be a participant in today's speculative investment game. This has and may continue to lead to short-term investment underperformance, but it will serve those shareholders well who have a long-term orientation. Speculation loses to a disciplined value philosophy over the long-term.

The stock market is narrower than at any point in time since the early 1970s, and the most speculative. This means that fewer stocks are driving the stock market averages; 10 stocks made up 97% of the S&P 500's nine month return! Unfortunately, those stocks are, on average, not our own. It seems that the only companies whose stock prices have performed well the last couple of years have been growth companies especially those companies with significant revenue growth as earnings are of secondary importance. The faster a company is growing, the better. Valuation is not relevant. If you own good, growing businesses at reasonable prices, but your companies are not growing at warp speed, you are not doing very well in this environment. Worse, the smaller the value company you own, the poorer the performance. Investors just do not care about small/mid-cap value companies today. To highlight that difference, the Leuthold Group of Minneapolis points out that through August, the year-to-date performance differential between small-cap growth and small-cap value is 36.9 percentage points—the biggest spread since they began collecting this data in 1985.

The speculation in this market can be measured a number of ways. Valuation levels are at highs. Not only are price/earnings ratios high, but those companies that do not have earnings, but do have extraordinary revenue growth, e.g., Internet companies, are trading at ridiculous levels as a multiple of revenues. Another statistic that validates today's rampant speculation is the percentage of shares on the New York Stock Exchange that changes hands each year. By year-end 1999, if present trends continue, more than 80% of the shares on the NYSE will have changed hands, slightly more than in 1998. This stands in stark contrast to 1990 when share turnover was just over 40% and to 1970 when it was not even 20%. (Source: *Business Week*).

We would like to re-emphasize the point that our companies are growing. The year-over-year earnings growth of our portfolio (1999's First Call consensus estimate versus 1998's actual) is 12.3%. This number is biased downward by companies in the early stages of a "turn around," and upwards by companies in the latter stage.

As a contrarian investor, we seek growing businesses that have stumbled—that is our opportunity. However, all of our companies do not “turn” at the same time. There is a seasoning process. Our portfolio appears to be somewhat less seasoned than it has in the past. We believe that our portfolio of companies has growth prospects at least in line with other stock indexes, and yet, our portfolio trades at less than half the price (please refer to the table below). The important thing to consider in an environment where the stock prices of companies you own are not reflective of their business fundamentals is whether or not the company is growing, increasing shareholder value. As long as this is the case, we will make money. Even if we are right on the business, that does not mean that a company’s valuation and its business fundamentals will move commensurately.

Our portfolio now has a price/earnings ratio of 12.0x, more than 50% cheaper than the Russell 2000 and Russell 2500, and 57% cheaper than the S&P 500. For additional comparisons between our portfolio and the indexes, please see below.

<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 1999 est. ....	12.0x	24.7x	28.0x	—
Price/Earnings 2000 est. ....	10.0x	17.3x	22.4x	—
Price/Book .....	1.5x	2.4x	4.9x	—
Dividend Yield .....	1.9%	1.5%	1.3%	—
<i>Bonds</i>				
Duration .....	3.2 years	—	—	5.4 years
Maturity .....	4.8 years	—	—	9.9 years
Yield .....	12.2%	—	—	6.5%

In our opinion, it appears that the only way the type of companies that we own will get recognized by the stock market is in a private market value transaction i.e., a takeover or leveraged buyout. An example of this would be Securitas’ acquisitions of our stake in Pinkerton’s, Inc. when it was purchased at \$29 per share earlier this year, 70% greater than where it had been trading the day before the announcement that it was being purchased. Acquisitions, mergers, and buyouts are potential catalysts for better relative performance of small- and mid-cap value portfolios. In the last twelve months there were 800 such private transactions, up from 450 three years ago. (Source: *Business Week*).

We lament the injustice of the environment, and yet have no control over it. We can change the way we invest, or we can maintain the consistency of style that has prevailed for so many years. The latter is our obvious choice. We will continue to

own companies like National R.V. Holdings, Inc. This company, in our opinion, is the best manufacturer of recreational vehicles—with the greatest sales growth, earnings growth, highest quality product, and highest margins. We first started buying the stock at \$8.56 in 1996. We had sold a good portion of our position in 1998 after it increased 173% (average purchase price vs. average sale price). National's stock price closed at \$25.75 at the end of 1998. At that time, analysts expected the company to earn an estimated \$2.40 per share in 1999. Such a company with three-year compounded growth in revenues and earnings in excess of 50%, a three-year average return on equity of 30% and no debt is trading at only 10.8x? We reasonably thought this was a good value. Since then, the company has reported two bang-up quarters and is due to report a third, and analysts have increased their earnings estimates to \$2.79, 16% greater than the original \$2.40 estimate, and 32% better than 1998's \$2.11 per share. This stock, of course, was a huge winner for us. Wrong! You certainly would think so; instead, as an example of investors ignoring small-caps, the stock ended the third quarter at \$19.75, down 23% year-to-date! Maybe the depressed valuation is explained by some forecasting a slowdown for the RV industry. We do not see this happening in 2000. As baby boomers age, they enter their prime RV buying years, 45-65. The growth in this segment of our population is estimated at around 3x the national average. We continue to hold National with its extremely low price/earnings ratio of 7.1x 1999's earnings, and have, in fact, added to our position at the current price.

Although we wrote of Midas, Inc. in our last shareholder letter, its stock declined 27% in the third quarter and, given our large position, we thought it deserved another visit. We originally purchased Midas in early 1998 in the \$16-18 range and watched it increase to \$35 early this year. We began selling our position in the low \$30's, but never felt the stock became so expensive as to warrant liquidating our position. We think that Midas' stock decline can, in part, be attributed to the challenging environment in the exhaust (i.e., mufflers) industry. Exhaust is a declining business, experiencing mid-single digit declines the last few years, but currently is feeling the pain of mid-double digit declines this year. This can be attributed to: unseasonably warm winters in the two prior years (salt on the roads corrodes mufflers); a good economy, where more used cars are being scrapped for new purchases; and improvements in technology, i.e., mufflers are now made of more durable stainless steel. We knew that Midas' exhaust business (37% of sales) was declining, but felt new services and better advertising would offset the rate at which it had been declining. We still feel that this will be the case, albeit somewhat slower than we anticipated. Midas maintains its leading position in auto services with 2,100 stores in North America. Midas franchises all but a very few stores, leaving the large capital investment requirement to the franchisees. This leaves them:

- \$65 million in advertising power, the ability to sell additional services through their existing dealer network;
- a store base that should be completely updated with new signage and paint by early 2000, the opportunity to grow their store base;
- the ability to increase the sale of product to their dealers (currently only 65% of dealer sales, when in the past it had been in the high 80% range);
- hidden value in real estate that they have controlled for years, a more streamlined distribution system (18 distribution centers to 8-10); and
- a more streamlined manufacturing system, the opportunity to broaden their distribution capabilities by selling to third-party customers.

We expect Midas will earn \$2.28 per share in 1999, 13% better than 1998's earnings, and the stock at \$20.63 trades at only 9.0x those earnings. We believe this to be an incredibly low price. Apparently, the chairman agrees; he purchased stock in March through an option exercise invested around \$2.5 million at prices more than 50% greater than the current stock price. We like to see management put their money where their mouth is. We can write about this until we get carpal tunnel, but others need to see what we see. Like many other small companies today, Midas is being ignored. Only two small regional brokerage firms follow Midas, but we would expect in the coming year that other, national firms will pick up coverage.

Complaining of the injustice of it all will not do us any good, but investing is in fact different in today's environment—different than at any point in time that I have seen it in my fourteen years of investment experience. Today, a dollar of revenues is worth more than a dollar of earnings. Internet companies lose money on average, and yet command ridiculously huge valuations predicated on what the margins on their future revenues might be. One must push a pencil very hard to come up with a scenario where these stocks are even fairly valued. eToys, Inc., as an example, is estimated to have somewhere around \$125 million in revenues in 1999 and their market valuation is almost \$8.5 billion. If eToys has 10% of the toy market five years from now (unlikely) and a 6% operating margin (maybe?), then the company would earn \$0.90 per share five years from now. With its stock price trading at \$82, the price/earnings multiple would be 90x—five years hence! I had a conversation with the CEO of an Internet company that is expecting to have an initial public offering in the beginning of 2000. This CEO pointed out that they are losing \$7-8 million per month as they are deliberately pricing their product to lose money, because they know that investors want to see the sales potential. The CEO believes that they have a few years to figure out how to get profits. We do not trivialize the

Internet, we are just not willing to pay ridiculous prices for businesses. As we discussed in our last letter, our investment in Consolidated Stores, Inc., which owns Kay Bee Toys and 80% of KBkids.com, provides us with a dramatically cheaper way to be invested in the Internet. We believe that future relative performance of Consolidated Stores and eToys will prove our point. As we stated earlier, we will not participate in today's speculative investment game. This does not mean that our portfolio cannot be invested in today's dynamic cyber environment. We can. Our investments, though, will be thoughtful and reasonably priced, as in the case of Consolidated Stores.

This is an environment where even companies that have a great historic growth record can sustain high price/earnings ratios in the face of poor recent results. How much would you pay for a company whose earnings look like this?

	<u>EPS</u>	<u>% Change in EPS</u>
1996 .....	\$1.43	+ 21%
1997 .....	\$1.49	+ 4%
1998 .....	\$1.41	- 5%
1999 estimated.....	\$1.30	- 8%

Whatever your answer may be, it probably was not 37x 1999's estimated earnings, but that is where Coca Cola, Inc., whose earnings history you see above, is currently trading. We will continue to invest in a portfolio of low price/earnings ratio companies that are indeed growing, rather than the large-cap high p/e "growth" brands or the Internet stocks whose valuations at these levels may as well be measured in terms of barometric pressure, since traditional measures have so obviously been discarded.

Our ten largest equity positions represented 37.6% of the portfolio as of the end of 1999's third quarter. Listed below are Crescent's ten largest holdings, excluding short-term investments, as of September 30, 1999.

### **Common Stocks**

Consolidated Stores Corporation  
 Foremost Corporation of America  
 Michaels Stores, Inc.  
 Midas, Inc.  
 Fritz Companies, Inc.  
 Storage Technology Corporation  
 AMERCO

**Bonds & Notes**

Centertrust Retail Properties, 7.50% Convertible Notes, due 1/15/01

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

Michaels Stores, Inc. 6.75% Convertible Notes, due 1/15/03

Crescent had the following net asset composition at September 30, 1999.

Common Stocks, Long .....	63.7%
Common Stocks, Short .....	-0.3%
Preferred Stocks .....	5.0%
Bonds & Notes .....	25.9%
Accrued Income .....	0.6%
Cash & Other .....	5.1%
Total .....	<u>100.0%</u>

At the end of the day, all an investor cares about is how much money he or she made. That is all we care about, too. However, there can be extended periods of time when one style of investing outperforms another. For the last five years, large companies have outperformed small and medium-sized ones. For the last couple of years, growth has beaten value. We intend to stick with our investment philosophy and apply it consistently, over time and across many different markets. If we could predict when Internet stocks would soar, when biotech stocks would fall, when temporary staffing companies would be dead money, then we would be otherwise engaged. Without a crystal ball guiding us, we feel that we have no alternative but to stick with what we know and what has worked so well in the past. Therefore, we will continue to buy small and medium-sized businesses that have solid growth prospects, good returns on capital, shareholder-oriented management, and trade at a reasonable valuation.

Meanwhile, our market outlook remains cautious. Interest rates have been increasing and the 30-year Treasury is at its highest level since November 1997. Consumer debt has been growing much faster than GDP and has been helping fuel the economy.

Respectfully,

Steven Romick  
Portfolio Manager,  
FPA Crescent Portfolio