

---

October 24, 2000

Dear Fellow Shareholders:

During the third quarter ended September 30, 2000, the Crescent Portfolio increased 6.8% and beat the major market averages. The Russell 2500 increased 2.4%, while the S&P 500 and Nasdaq Composite declined 1.0% and 7.4%, respectively. From the market peaks reached in March, Crescent's relative performance has proven more substantial.

The stock market has begun to reclaim some of its lost rationality as the second quarter proved that a business' economic value has a place in modern portfolio theory. A tremendous number of e-companies have seen declines of 90% or more as investors have come to realize that those companies' prospects were not as bright as originally hoped. We believe we are seeing a leadership change from growth to value. Despite a recent rebound in many growth stocks early in the third quarter, we do not believe that we have seen the market hit its nadir. The stock market does not hit bottom without broader pessimism.

It is surprising to see that margin debt has only contracted 10% or so given the kind of index declines we have seen. The technology laden Nasdaq has turned in the worst performance, declining 44.5% from peak to trough. Yet, customer margin debt reflects the continued stock market optimism and stands near \$250 billion, six times the level seen earlier in the decade and double the level reached just two years ago.

Despite share price declines, many companies remain priced to perfection today with little margin of safety. We believe IBM is a good example. It is valued like a growth company, trading at 25x earnings at its \$112.63 quarter-end price. This lofty valuation exists, in part, because of the company's ability to hide behind the cloak of Federal accounting regulations. IBM has had non-recurring gains on sale of assets that they have used as a reduction to selling, general, and administrative expense. Pension income has benefited reported earnings as well. Both gains on sale of assets and pension income are a function of a strong stock market and are not operating earnings. One cannot count on the recurring nature of such income and therefore should value that portion of the earnings stream at a deeply discounted value. IBM cannot continue to grow earnings at the 26% clip it has achieved over the past five years while revenues grow only at a 6% rate. Worse, operating cash

flow is lower today than it was three years ago and that, in turn, is lower than the operating cash flow reported five years ago. IBM's overstated earnings and slow revenue growth are not indicative of a growth company. It is undeserving of such a high P/E. We began to short IBM shares during the third quarter at an average price of \$121.13, and the position is equivalent to 0.6% of net assets.

The carnage seen in some sectors of the stock market has been significant. Take a peek at some of these brand name examples not held in the Portfolio, their stock declines from their 12-month highs, and their still lofty valuations.

<u>Company</u>	<u>Price Change</u>	<u>Price/2000 Earnings</u>	<u>Price Book</u>
Amazon . . . . .	-66%	Negative	Negative
Etoys . . . . .	-93%	Negative	Negative
Intel . . . . .	-45%	24.6x	7.6x
Lucent . . . . .	-63%	41.1x	3.7x
Microsoft . . . . .	-49%	33.1x	7.0x

Compare the very high Price/Earnings and Price/Book ratios of the above companies to the following recent purchases in our portfolio as of September 30, 2000. These companies reflect our desire not to buy companies "on the come." We prefer to buy companies that have already come...and gone, but we expect to return.

<u>Company</u>	<u>Price Change</u>	<u>Price/2000 Earnings</u>	<u>Price Book</u>	<u>Percent of Net Assets</u>
Celanese . . . . .	-30%	19.5x	0.3x	3.6%
Lincare . . . . .	-27%	13.3x	2.9x	1.7%
Pittston Brinks . . . . .	-31%	14.1x	1.1x	3.5%
Ross Stores . . . . .	-40%	7.5x	2.6x	1.9%

The data listed above for our recent portfolio additions do not tell the whole story. We reviewed Pittston Brinks in our second quarter letter so we will review Celanese, Ross Stores, and Lincare in this missive.

*Celanese* is a world leading chemical company with number one or number two market share in almost every product category. Hoechst, a German conglomerate, purchased Celanese in 1987 and then spun it off to shareholders in late 1999.

---

Celanese is suffering from a difficult chemical environment today. High oil prices drive their raw material costs higher, constricting the margins of all chemical companies. Because of this and some excess capacity in their various product lines, Celanese has not captured the imagination of Wall Street. Its stock trades at a 70% discount to stated book value of \$55 (excluding intangible assets the company still trades at a 44% discount). Once a more “normal” cost environment is attained, our analysis shows that Celanese has the potential to earn \$3.50 - \$4.00 per share — attractive earnings for a stock that trades at just \$17. We are not the only ones to find the stock attractive. Celanese’s management has put their money where their mouth is purchasing, since the spin-off, more than \$20 million worth of stock for themselves and repurchasing 9% of the shares outstanding. We expect that the stock will begin to move as excess capacity is absorbed and oil prices decline or as time passes and the company is able to achieve price increases. We cannot pinpoint the date when this will happen but even if it takes four years to double our money, that would still be a 19% compounded rate of return.

*Lincare* is one of two companies that dominate the respiratory therapy business, i.e., the home delivery of oxygen. They have grown their revenues and earnings 24% and 21% respectively over the last five years. This has been achieved despite frequent and dramatic Medicare cuts. They are the best company in the industry with the fastest growth rate and the highest return on capital. They have averaged a 23% return-on-equity over the past three years. The one outstanding risk that we are cognizant of is the risk that plagues all health care delivery companies from hospitals and nursing homes to respiratory therapy companies — government investigations. The government is always looking for incidences of fraud. Lincare has put together a terrific internal compliance program to control wanton actions. Nevertheless, it is a real risk. During the quarter we purchased our position at \$25.07, down from a high of \$43.50, giving us a current year price/earnings ratio of only 11.3x at our cost. We feel that this provided us adequate downside protection and tremendous upside potential. In fact, as of this writing the stock has traded above \$40 and we have substantially reduced our initial position. It now accounts for 1.0% of net assets.

*Ross Stores* is one of the leading off-price apparel retailers. For the last five years they have grown their revenues and earnings at a compounded rate of 14% and 41% respectively. They have averaged an unleveraged 28% return on equity (ROE). Given this terrific history how could this company be trading at 7.8x 2000’s earn-

---

ings estimate? Frankly, we do not know. A weak economy would certainly hurt the company; however, Ross had half of their sales in California in the early 1990s when the state went through a depression and yet did not lose money and still earned a 15% ROE. Management has been actively repurchasing their shares, buying 19% of the outstanding over the last 7.5 years. It is not often that you can find such an attractive business trading at such an attractive price.

As you can see from each of these three examples, although we are value investors, we insist on owning growing businesses. Companies that are not growing fail to attract the best employees and do not have the ability to control their costs in the same fashion as a growing entity.

We have been increasing our exposure to the retail sector, after reducing it earlier in the year. Retail stocks have underperformed the market in 2000 due to slowing growth rates, higher energy costs, higher rent, and overcapacity in some sectors. This has combined to give retail its lowest valuation as a group since 1987 (source: Sanford Bernstein). The companies that we have chosen to invest in the retail sector include our four largest retail investments: Charming Shoppes Convertible Notes, Consolidated Stores, Michaels Stores, and Ross Stores. If the economy is indeed slowing, all retail will be impacted but so will the rest of the stock market. We believe that the retail stocks that we own will outperform, given their current valuations, should the economy weaken.

Technology purchases will be impacted by a weak economy as well. How could they not? We have read that more than 50% of corporate capital budgets are spent on technology. If technology slides further in a weakening economy, we intend to have more of a presence in that sector than we have in the past. We expect to accomplish this with the added help of our associate Dennis Bryan who has been a very successful technology investor over the past decade, and a member First Pacific Advisors' team since 1993.

Crescent currently reflects the lowest valuations that it has seen since its inception and is dramatically cheaper than the comparative stock indexes below. It is important to recognize that the companies we hold are not just cheap but, as stated earlier, have been growing their earnings at double-digit rates.

<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 TTM . . . . .	12.6x	24.6x	28.5x	—
Price/Earnings 2000 est. . . . .	9.6x	23.3x	27.6x	—
Price/Book . . . . .	1.2x	2.6x	5.2x	—
Dividend Yield . . . . .	1.4%	1.4%	1.1%	—
<i>Bonds</i>				
Duration . . . . .	2.4 years	—	—	5.4 years
Maturity . . . . .	3.6 years	—	—	9.7 years
Yield . . . . .	16.8%	—	—	6.8%

Our ten largest equity positions represented 37.1% of the portfolio as of September 30, 2000. Listed below are Crescent's ten largest holdings, excluding short-term investments, as of September 30, 2000.

#### **Common & Preferred Stocks**

Fritz Companies  
 Consolidated Stores  
 Crown American Realty Trust 11% Preferred  
 Plains Resources  
 Celanese  
 Pittston Brinks  
 Michaels Stores

#### **Bonds & Notes**

Centertrust Retail Properties, 7.5% Convertible Notes, due 1/15/01  
 Charming Shoppes, 7.5% Convertible Notes, due 7/15/06  
 CKE Restaurants, 4.25% Convertible Notes, due 3/15/04

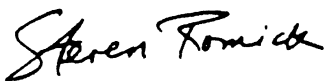
Crescent had the following net asset composition at September 30, 2000.

Common Stocks, Long . . . . .	61.0%
Preferred Stocks . . . . .	4.7%
Bonds & Notes . . . . .	23.1%
Accrued Income . . . . .	0.5%
Common Stocks, Short . . . . .	(1.9%)
Cash & Other . . . . .	12.6%
<b>Total . . . . .</b>	<b>100.0%</b>

---

Our fixed-income portfolio has a 16.8% average yield-to-maturity. We will not tell you that the portfolio is without risk but we do believe that the high current yield justifies the risk assumed. Hutchinson Technology convertible bonds were purchased at the end of the second quarter with an 18% yield-to-maturity. Its yield-to-maturity is now 8.3% after appreciating 29.5% during the quarter.

We maintain our commitment to own growing businesses with excellent free cash flow and respectable returns on capital. We make this commitment with the caveat that some companies we own will not have the desired free cash flow and returns on capital at purchase. That is usually why the stock price has declined. We frequently buy companies that have stumbled and we expect them to get back on their horse and ride at a gait similar to what they have done in the past. We will not own a Yahoo, AOL, etc. This does not mean that such businesses cannot increase in value. They can and, in fact, have done so dramatically. However, we do not understand the valuations paid. This does not mean that we cannot understand the business. We think we do. We just do not know what the economics will be ten years hence. To value a business, any business, one must present value the future stream of cash flows. As analysts we must have conviction that we know what the future cash flows will be. To try and determine the usually foggy future, we must have a comfort level with a company's revenue growth, future margins, and future capital needs. This is quite difficult to do for companies that have stable businesses with long histories and impossible for us to do with new businesses operating in a rapidly changing environment. We will stick with what we know. It appears to have finally begun to pay off again in the most recent quarter and we look forward to more of the same in the future.



Steven Romick