Longleaf Partners Funds | *Advised by Southeastern Asset Management, Inc.®*

To Longleaf Shareholders

Broad uncertainty about economic growth – in the U.S., China, and most prevalently in Europe – weighed down global stock markets over the last three months. The S&P 500 was down 2.8%; the Russell 2000 lost 3.5%; and non-U.S. markets took a bigger hit as EAFE declined 7.1%. While the Small-Cap Fund appreciated in the quarter, Partners and International declined. These results reversed the relative standing of each Fund for the year-to-date, leaving Small-Cap ahead of the Russell 2000 but Partners and International behind their benchmarks. Within the indices and Southeastern's portfolios, stocks tied to broad economic expansion such as commodities, materials, and industrials suffered. However, most of our holdings' appraisals grew or were little changed, because our models already assumed slow growth over the next few years and revenue declines in Europe through 2014.

With the recent market schizophrenia, we trimmed holdings that had approached their values or become overweight. Conversely, as certain stocks declined relative to their appraisals, we added, as did a number of our management partners. We also identified a few new qualifiers, primarily in names we have previously owned, where we typically have a deeper knowledge.

Cumulative Returns at June 30, 2012

	Since Inception[1]	Ten Year	Five Year	Three Year	One Year	2Q
Partners Fund (Inception 4/8/87)	**1186.83%**	**57.04%**	**-16.19%**	**51.87%**	**-5.65%**	**-5.22%**
S&P 500 Index	729.75	68.13	1.09	57.70	5.45	-2.75
Small-Cap Fund (Inception 2/21/89)	**938.15**	**146.13**	**9.47**	**87.60**	**1.28**	**2.96**
Russell 2000 Index	614.69	96.75	2.73	63.46	-2.08	-3.47
International Fund (Inception 10/26/98)	**155.06**	**37.90**	**-31.65**	**7.32**	**-22.31**	**-9.34**
EAFE Index	51.96	65.13	-26.99	18.98	-13.83	-7.13

[1] *During the inception year, the S&P 500 and the EAFE Index were available only at month-end; therefore the S&P 500 value at 3/31/87 and the EAFE value at 10/31/98 were used to calculate performance since inception. All returns include reinvested dividends and distributions but not the deduction of taxes. Current performance may be lower or higher. Prior to 2010 the Partners and International Funds used currency hedging as an investment strategy. Past performance does not guarantee future results, fund prices fluctuate, and the value of an investment at redemption may be worth more or less than the purchase price. The annualized expense ratios for the Longleaf Partners, Small-Cap, and International Funds are 0.91%, 0.91% and 1.27%, respectively. The risks associated with an investment in the Longleaf Partners Funds are detailed on pages 15 to 17 of the Prospectus. These risks include stock market risk, investment selection risk, corporate ownership risk, non-diversification risk, non-US investment risk, small cap risk (particularly with respect to the Small-Cap Fund), focused geographic risk, and derivatives risk.* ***Call (800)445-9469 or go to southeasternasset.com for current performance information and southeasternasset.com/mutual_fund_documents/prospectus for the Prospectus and Summary Prospectus, both of which should be read carefully before investing to learn about Fund investment objectives, risks, and expenses. Funds distributed by Rafferty Capital Markets, LLC.***

Average Annual Returns at June 30, 2012

	Since Inception[1]	Ten Year	Five Year	Three Year	One Year
Partners Fund (Inception 4/8/87)	**10.66%**	**4.62%**	**-3.47%**	**14.95%**	**-5.65%**
S&P 500 Index	8.74	5.33	0.22	16.40	5.45
Small-Cap Fund (Inception 2/21/89)	**10.54**	**9.42**	**1.83**	**23.33**	**1.28**
Russell 2000 Index	8.79	7.00	0.54	17.80	-2.08
International Fund (Inception 10/26/98)	**7.09**	**3.27**	**-7.33**	**2.38**	**-22.31**
EAFE Index	3.11	5.14	-6.10	5.96	-13.83

Portfolio Discussion Norms

Volatile quarterly performance often accompanies concentrated investing. Over Southeastern's almost four decades, the twenty or so positions we have owned at any given point have fallen into three categories in client discussions. The first are those holdings that are rarely mentioned because their gains make them obvious winners such as DirecTV, FedEx, DineEquity, tw telecom, Fairfax, or Vodafone today. Most names fall into the second category, which also receives little attention. These companies generally are meeting operating expectations, but their stocks have not appreciated significantly. The large majority of discussion focuses on the third category, the few names that are in the penalty box at the time either because of real or perceived business challenges or management issues often highlighted in headlines. We expect and welcome discussing holdings that are most out of favor. We think it is important, however, to put those names in the context of what is normal within our investment approach. We will not be right on every investment. Over the long run if we are right on two-thirds of our picks, and wrong without losing substantial permanent capital on the other third, we can achieve our inflation plus 10% goal as long as we adhere to our margin of safety discipline. Given portfolio discussion norms, we will not elaborate here on Disney, Travelers, Abbott, Texas Industries, tw telecom, Vail Resorts, Scripps Networks, and Henderson Land – the largest contributors to second quarter performance. Instead, we review the recent events, investment case, and broader lessons from our most controversial name. Although Chesapeake Energy is only in the Partners Fund, its recent visibility has generated discussions with shareholders across the three Funds.

Chesapeake Energy (CHK)

Summary of 2Q: Chesapeake is an exploration and production company with a leading acreage position in three of the top U.S. gas plays and four top U.S. liquids plays. The stock fell 20% in the quarter. As natural gas declined in April to its lowest price since 1998, below $2.00/mcf, the media raised questions about CEO Aubrey McClendon's potential conflicts, board oversight, and CHK's ability to meet its 2012 cash flow needs. At its lowest point, the stock fell 42% from the end of March. Almost all of what was reported was previously known, but the rapid onslaught of stories blurred the lines between perception and reality. To best represent our clients' interests, we became more active to push the board and McClendon to focus on what mattered – de-risking the balance sheet, managing costs and reducing discretionary spending while gas prices stayed at uneconomic levels, and focusing on operating the company rather than convincing the world of the long-term case for natural gas. The stock's decline, pressure from Southeastern and Carl Icahn, and a looming proxy vote brought the most significant governance changes that we have ever witnessed at a company.

- They split the chairman and CEO roles;
- They ended the controversial Founders Well Participation Program (FWPP) early;
- They reduced board compensation and benefits;
- They replaced four board members, with three nominees from Southeastern and one from Icahn, and replaced a fifth member with a new chair;
- They vetted the new, independent chair with Southeastern and Icahn;
- They will replace an additional director at the conclusion of a current audit committee investigation.

In total, the nine board members will consist of seven nominees pre-approved and/or submitted by Southeastern, including Lou Simpson who joined in 2011. The board fully embraces its duty to represent shareholders' interests. Each member has a record of overseeing corporate assets and holding management accountable for value growth and recognition. Most have indicated their view of CHK's upside by significant share purchases since their appointment.

Our process and case: Throughout the controversy, nobody has questioned the quality of the company's assets. McClendon has done an excellent job building a portfolio of some of the best oil and gas acreage in the U.S. at attractive prices. Given the headlines, however, many have asked how CHK meets our "good people" criteria. As a first mover in leasing many shale plays and in pioneering horizontal drilling and fracking, McClendon has long been controversial. From the outset of our investment, we required even more due diligence than normal. Through our multiple industry, client, professional, and personal contacts, we gained insight about McClendon and arrived at a different conclusion than the image currently portrayed by CHK short sellers and much of the media. Also ignored in the criticism is that in 2011, McClendon was recognized as one of only eight public company CEOs who have been in place for over two decades and have earned a 20%+ yearly return for shareholders over that time.

As with every investment, from the outset we had to weigh CHK's positives against its negatives. We fought against the FWPP behind the scenes well before it dominated headlines. Other negatives were not nearly as dramatic as recently characterized and had been available for years in the public domain to those who took the time to do their research. All of the leadership controversy is now moot. We go forward at CHK with one of the best and most vested independent boards that we have seen. They will be well informed and will make decisions only in the best interests of owners. Combining the new governance with some of the best physical assets we have owned makes us enthusiastic to have CHK as a core holding in the Partners Fund.

Lessons learned: Our conviction about CHK does not mean we are complacent about our path of ownership. We have learned two important lessons as our investment has unfolded. First, we recognize that in commodity businesses, being a low cost provider is not enough of an advantage for an overweight position since the commodity price is subject to going below the cost of production for an unpredictable period of time. Second, we learned a lesson that reinforces the importance of being a long-term investor who tries to work productively with management when change is warranted. We had much more influence in the tremendous governance transformation than we would have otherwise had if we had initiated our investment with guns blazing. The board and management listened to, trusted, and addressed our views knowing that our only agenda was to benefit long-term shareholders.

Context Beyond the Quarter

The second quarter serves as a microcosm of the much broader and longer lasting safety bubble that began inflating in the 2008 bear market. Whether measured by net flows of $1.2 trillion from U.S. equity funds into bond funds over the last 4.5 years, or the fact that dividend yields are materially higher than 10 year U.S. Treasuries for only the third time post-World War II, the flight to safety has had a dramatic impact on equity valuations. Investors are avoiding volatility at an arguably high cost. They prefer U.S. or German bonds yielding less than 2% to corporate earnings yields at 6-9%, as measured by S&P 500, Russell 2000, and EAFE P/E estimates. They are paying large premiums for long-life stable income via owning toll roads or airports in private infrastructure funds. They have pushed stocks with high dividend yields and stable earnings to or through fair values and abandoned the margin of safety priced into competitively entrenched businesses with high returns on capital but with more cyclical earnings and/or any debt. As with all investment bubbles, while it lasts, participants are rewarded, but when it collapses, which is always unexpected but predictable, the capital losses can be tremendous. This may be particularly true when investors think they own safety. If bonds begin to migrate to their 50 year average yield-to-maturity of 6+%, the bond price devastation will be substantial.

Many Longleaf shareholders have been our partners long enough to remember other periods when our intrinsic value investing approach was out of favor, causing disappointing relative returns. Those clients' patience was rewarded by the strong outperformance when these periods reversed. When the current safety bubble bursts, our holdings should again greatly benefit. Our investment philosophy and rigorous discipline have been the mainstays that enabled us to generate our long-term successful results. We believe our unwavering investment process is more relevant than ever.

- Require investments to qualify on business, people, and price.
- Constantly test our assumptions and investment cases, making any necessary adjustments to appraisals and portfolios.
- Take advantage of macro market movements to improve the risk/reward profile of portfolios by trimming more fully valued holdings and investing in more discounted names or holding cash until we find qualifiers.
- Be introspective and analytical about the world around us and our experience at each company to make future decisions better informed.
- Maintain our commitment to client alignment via our substantial investment in the Longleaf Funds. (In addition to our normal personal inflows, the portfolio management team invested a substantial amount into Longleaf Partners International Fund in the second quarter.)

We are grateful for your partnership and enthusiastic about the Funds' current opportunity for future compounding.

Sincerely,

O. Mason Hawkins, CFA
Chairman & Chief Executive Officer
Southeastern Asset Management, Inc.

G. Staley Cates, CFA
President & Chief Investment Officer
Southeastern Asset Management, Inc.

July 12, 2012