

Dear Shareholders:

The FPA Crescent Fund increased 2.51% in the fourth quarter and gained 6.64% for the year. The S&P 500 returned 4.93% and 13.69% in the same periods, respectively. The average stock in the Russell 3000, however, increased just 5.45% for the year.

Investors, at the moment, are in love with America and the S&P 500. Of course, one region is almost always outshining another and the U.S. had its star turn last year. Since Crescent takes its quest for value overseas too, it's important to note that other regions didn't fare so well. The MSCI EAFE index, a widely used benchmark of stock performance outside the U.S., declined 4.90% for the year. We're happy to report that our foreign investments overall ended the year in the black.

We wish we had made more money for our investors (ourselves included) but it's not in our DNA to commit capital when the potential profit doesn't adequately outweigh the prospects for loss. This was the case last year, which explains our 54.3% average risk exposure. This doesn't mean companies that aren't particularly cheap can't increase in value. They can and do, particularly in a world awash with easy capital. We might flip a coin ten times and get tails every time, but that doesn't mean we should bet on that. On the other hand, since it is our own calculation of risk and reward that dictates our action, there's always the possibility we could be wrong, i.e., that stocks continue to rise faster than their earnings and central bank action lacks any consequence. There are times when we are focused on making money and there are times when we place more weight on protecting capital. This time, it's the latter.

In Q4, businesses perceived to be of the highest quality performed the best, a pattern consistent with the prior three quarters. The Fund's top five winners, listed below, added 2.26% to its return and reflected a continued flight to quality. The exception was Naspers which as we discussed in our prior letter, is a stub trade offset by a short in Tencent. Please refer to the 2014 Q3 letter for more detail.

The losers detracted 0.99% from Crescent's return in the quarter. The decline in energy and commodity prices was the biggest driver of this negative mark. Noteworthy too, is that four of the five losers have a foreign domicile.

Winners	Losers
CVS Health	Orkla
Oracle	Occidental Petroleum
Covidien	Canadian Natural Resources
Naspers	Sberbank (various issues)
Express Scripts	Gazprom

Investments

Winter is here and with the FIS Alpine Ski World Cup season underway, skiing struck us as a good metaphor for the markets given the treacherous terrain value investors are trying to navigate these days. Competitors ski different mountains in varying conditions over the course of the season and many runs are far from ideal. On some days, you ski in a blizzard not seeing more than a few feet in front of you. On others, it's icy and you find yourself sliding down the slope on your back. And then there are the days when the sun has turned the mountainside into slush. There isn't an athlete in the world that fares well in all conditions and even the best of them have their bad days. But, over the course of a season, the great skiers overcome the downturns and prevail. If one were to look at a full economic/market cycle as a season, then investing can be viewed through the same goggles. It's been rough weather for some time for deep-value investors, particularly skeptical ones like us. Nevertheless, we take comfort in knowing our process is strong and that over a full-market cycle, we believe will prevail as we have in preceding cycles. In fact, during the two years in which Bode Miller won the World Cup Championship, he actually only

reached the podium 25 times out of a potential 360 slots, suggesting that it is difficult to judge skiers (and value managers) solely on short-term performance.¹

Given the market's run, you may wonder if we were wrong to have not been more fully invested. You would have been much better off investing in an index fund rather than with an active manager, particularly one with our conservative bent. In fact, 2014 was the worst year for active managers since 1997. Part of the reason just 14% of managers outperformed the market is that there was little breadth.² Large-cap stocks dominated. Apple alone, the largest market cap company, rose 40% and added 1.3% to the S&P 500's return. However, the average stock didn't fare nearly as well, returning more than eight percentage points less than the S&P 500.³ The narrow breadth didn't break any records but it was reminiscent of 1999 when the S&P 500 was up 21.04% and yet more than half the stocks in the major indices declined in price.^{4,5}

Below, we posted a few charts to paint a picture of the challenging environment value investors are enduring.⁶ With data pulled from NYSE-listed companies, one can see a snapshot that's anathema to our crowd. The median NYSE Price/Earnings ratio (P/E) is now more than 20x, a post-WWII high.⁷ The median Price/Cash Flow is also at a high, while the median Price/Book is "just" at its third highest but not far off of its peak. Since the dataset is as of June 30 each year, those ratios were only higher at year-end 2014. The fourth chart shows that the historic difference between high and low P/E's (the 1st and 5th quintile) is low. As pointed out by Jim Paulsen at Wells Capital, "during widespread valuation extremes (e.g., 1962, 1969, and today), P/E multiple dispersion tends to be relatively low."⁸

Median P/E



Median Price/Cash Flow



¹ Mr. Miller won the World Championship in 2005 and 2008. A podium finish is 1st, 2nd, or 3rd.

² Morningstar

³ As mentioned in first paragraph, the 2014 unweighted return of the Russell 3000 was 5.45%. Morningstar

⁴ Morningstar

⁵ Bebar, Jill, (1999). Wall St.'s record century, http://money.cnn.com/1999/12/31/markets/markets_newyork/index.htm

⁶ Economic and Market Perspective. Wells Capital Management. James W. Paulsen. January 8, 2015.

⁷ Price-to earnings, or P/E is the price of a stock divided by its earnings per share.

⁸ Economic and Market Perspective. Wells Capital Management. James W. Paulsen. January 8, 2015.

Median Price/Book



P/E Dispersion



And here's one last look at valuation. It's now 50% pricier to buy the market for the average person than it was just a few years ago. The chart below shows how many hours someone must work to buy even one share of the SPDR S&P 500 ETF.⁹ U.S. stock ownership stands at 48%, a record low, so it's no wonder quantitative easing has had a greater impact on Wall Street than it has on Main Street.¹⁰

Number of hours of work required for people in the U.S. to buy one unit of the SPDR S&P 500 ETF (based on median earnings)



When we aren't actively accumulating positions, we are still putting in long hours educating ourselves as to the merits of various businesses. Inactivity can be challenging for both the portfolio manager and the client.

As famed investor Charlie Munger recently explained, "Part of the reason we have a decent record is we pick things that are easy. Other people think they're so smart that they can take on things that are really difficult. That proves to be more dangerous. You have to be shrewd and you have to be patient. You have to wait until something comes along which, at the price you're paying, is easy. That's contrary to

⁹ BLS (The chart assumes people work 5 days/week, 8 hr/day)

¹⁰ Gallup. <http://www.gallup.com/poll/162353/stock-ownership-stays-record-low.aspx>

human nature, too. Just to sit there all day doing nothing but waiting.... For an ordinary person, can you imagine just sitting there for five years doing nothing? It's so contrary to human nature. You don't feel active. You don't feel useful, so you do something stupid."¹¹ In short, our money is invested alongside yours so we're willing to look stupid for a time rather than act stupidly.

Rather than letting the market and its price fluctuations drive us, we steer a process that will hopefully allow equity-like rates of return over time while avoiding permanent impairments of capital. We do this by seeking knowledge. As American inventor and businessman Charles Kettering once said, "There is a great difference between knowing and understanding: You can know a lot about something and not really understand it."¹² It's easy to know a lot of facts about a business but we really seek an understanding of the metrics that will determine a company's success or failure. We firmly believe that if we understand a business first and then invest when its price becomes attractive, we will perform well over time.

UTX

UTX is an example of such a business. As part of our research process, we look at a number of companies and industries each year. As you can tell from the fund's relatively low turnover, most of that research does not result in a purchase or sale. We regularly nix potential investments because we find them too expensive or too difficult to understand. When we pass on investments solely due to valuation, we are left with "on deck" opportunities. These are companies that the group has thoroughly researched but decided that the price wasn't attractive enough to warrant purchase. We keep track of these companies and patiently wait for the day when they become available at a price that represents good, long-term value. UTX was one such opportunity that presented itself during the short-lived market dip last October.

UTX is an industrial conglomerate with leading positions in aerospace systems, aerospace engines (Pratt & Whitney), helicopters (Sikorsky), elevators (Otis), climate control (Carrier) and fire/security systems. Each division is a leader in its respective field and features important long-term competitive advantages. UTX generates roughly 50% of its profits from aerospace and 50% from commercial buildings. The strength of the operating businesses has allowed UTX to earn an average return on invested capital in the mid 20's through the recent economic cycle (i.e., the last 6 years).

Based on our estimate, UTX was available at an owner's yield of approximately 7% so we established a position. The company's current valuation presented a reasonable entry price to a wonderful collection of businesses. What's more, we think earnings will grow faster than GDP and we anticipate company executives will prudently manage capital over the long-term.

We hope to hold businesses like UTX for a long time and welcome the chance to add to our position at lower prices.

High Yield

Oil has declined by more than half in the last year. With energy companies representing 14%-15% of the high-yield bond index, it shouldn't come as a surprise that we are beginning to troll the energy sector. We have a few prospective investments on the table but have only pulled the trigger on one thus far. We'd like to be assured of a return of our capital without having to make too large a wager on the price of oil. Should oil prices remain low for some period of time, we expect additional opportunities to increase our investments. Our chosen path is littered with the bonds of the forced seller, which is how we ended up with large exposure to the debt of finance companies in 2008/9. The bonds of oil-related businesses have yet to reach prices that offer the best combination of yield and collateralization and a significant margin of safety given conservative expectations for the price of oil.

¹¹ Daily Journal Corp. annual meeting September 10, 2014.

¹² Marc Faber Doom Boom Gloom Report, March 2012

Economy

The economy got an immediate shot in the arm from falling oil prices. The average American household spent almost \$3,000 in 2013 at the pumps so the dramatic decline in oil prices has created annual savings of about \$1,000. That money is now finding its way to Wal-Mart and similar stores rather than being swallowed in the tank to get to them.¹³ This affects the economy the same as a tax cut, resulting in about a trillion dollar benefit.

There will, of course, be intermediate-term ramifications as many energy companies cut capital spending jobs in the field and, in turn, suppliers are forced to make their own cuts. Some sovereign nations, from Nigeria to Venezuela, will get slammed and America itself is not immune. The Manhattan Institute reported in a 2014 study that “in recent years, America’s oil and gas boom has added \$300-\$400 billion annually to the economy – without this contribution, GDP growth would have been negative.”¹⁴ We can’t say for sure but the slowing effect of a weak oil and gas industry may just be starting. Only time will tell if the fall in the price of oil is temporary or permanent.

Low oil prices push inflation lower, with certain developed economies already experiencing deflation. This, in turn, takes pressure off of central banks to raise interest rates, giving them more latitude to keep their foot on the gas. Since the U.S., Japan and now Europe either don’t have the balance sheets or the necessary structure to engage in fiscal policy, aggressive monetary policy has been the default result.¹⁵ Not enough time has passed to know the ultimate outcome of the unprecedented quantitative easing of the Fed, the BOJ and now the ECB.¹⁶ Nevertheless, we fear the medicine more than the disease and worry about what all of this means, at some point in the future, for the health of the world economy. We espouse less of a view but do admit to having a pit in our stomach.

Along those lines, it’s surprising - with the price of oil down 55% in just a few months - that there haven’t been any significant losses reported at financial and/or trading institutions. Given the natural hedging of utilities, airlines, E&P companies and others, it’s remarkable that we haven’t seen the headlines of parties on the other side of those transactions reporting significant losses.¹⁷

Conclusion

Not only is the stock market at a new high but so is the dollar and that’s despite continued low interest rates. It does beg the question: Are stocks in developed economies only as good as their respective central banks allow them to be? At some point, the market intervention will end, hopefully plying us with opportunity, but we are careful for what we wish for.

We are investors who have had the good fortune of like-minded people like you placing their hard-earned money alongside ours. We hesitate to call that a profession as investing is something we enjoy doing. Frankly, we would do it anyway if we were out on our own. That’s why we look more at how we perform over 5, 10 or 20+ years and we don’t particularly worry about what happens over the near-term. Right now, we continue to feel like it is summer in the Rockies and we’re looking at the slopes hoping for snow.

Respectfully submitted,

Steven Romick

President

January 26, 2015

¹³ U.S. Energy Information Administration. <http://www.eia.gov/todayinenergy/detail.cfm?id=9831>

¹⁴ http://www.manhattan-institute.org/html/pgi_04.htm#.VL7Nik0tHGh

¹⁵ By lack of structure, we refer to the fact that although monetary policy is the domain of a central authority (ECB), fiscal policy is conducted in separately in each country.

¹⁶ BOJ = Bank of Japan; ECB = European Central Bank

¹⁷ E&P = Exploration and Production