

# FPA FUNDS UPDATE

*www.fpafunds.com*

*mutual funds managed by First Pacific Advisors, LLC*

*FPA Capital · FPA Crescent · FPA New Income · FPA Paramount · FPA Perennial*

As of June 30, 2010

## **FPA Capital Fund Commentary**

Among the biggest detractors from performance during the quarter were our technology and oil service investments. Concerns about a slowdown hit these sectors during the quarter. Besides being hit with concerns about the economy, our oil service companies were impacted by the Gulf of Mexico spill and the six-month moratorium on deepwater drilling in the Gulf. We believe that the moratorium on deepwater drilling could be renewed for a shorter period of time after the six-month term, but that ultimately drilling in the deepwater Gulf of Mexico will likely resume since the demand for oil remains. We are already importing the majority of our oil from outside the U.S. and internal production would decline rapidly if we disallow deepwater drilling. The deepwater Gulf of Mexico accounts for 5% of U.S. natural gas production and 1.6% of global oil production, so in the unlikely case that the deepwater Gulf of Mexico does not open up again, the potential positive impact on prices for natural gas and oil could benefit our oil and natural gas exploration companies.

The U.S. economic recovery continues to frustrate investors, economists, politicians, and workers. Investors are frustrated because the strength of the recovery is much less than after other recessionary periods, and, thus, it's difficult to gauge the sustainability of the corporate profit margin increase during this economic expansion. Economists are frustrated because there are so many mixed signals being received from the data they analyze. For instance, rail traffic was up 15.8% in May 2010 versus the prior year, but retail sales for May unexpectedly declined 1.2%. Politicians are frustrated because the American public is losing faith in Congress and the White House, as evidenced by the low poll numbers for both, despite the progressive policies that Washington D.C. has passed over the past eighteen months. The labor force is obviously frustrated because many people who want a full-time job cannot find one today. The best, but imperfect, measure of this is the U6 unemployment rate of 16.6% versus 9.7% two years ago, according to the Department of Labor.

In our opinion, Americans and investors instinctively understand that our Federal government's current enormous budget deficit is not sustainable. For the second year in a row, the Federal government will run a budget deficit of approximately \$1.5 trillion. Moreover, according to a recent Treasury Department report to Congress, U.S. debt will exceed \$13.6 trillion by the end of the current fiscal year, and rise to nearly \$20 trillion in 2015. Add on the unfunded Social Security and Medicare liabilities of at least another \$75 trillion today, and it is clear why investors and Americans are worried.

Unfortunately, we hear and read about fiscal policy decisions that do not bode well for the long-term, sustainable growth of the U.S. economy. Beyond the enormous budget deficits, the new healthcare mandates, and high unemployment, we are also concerned about the potential impact of higher income-tax rates on the strength of our recovery.

From our vantage point, it is clear that the current economic recovery does not compare well to other post-recessionary periods, in terms of new jobs added and real economic expansion. We are also concerned that over the next twelve months the economy will decelerate from its current modest increase. Longer term, over the next few years, economic growth may remain sluggish if anti-growth government policies, such as higher marginal income-tax rates and the introduction of a VAT (Value Added Tax), find favor in Washington D.C. Should our concerns be confirmed, it is reasonable to assume that profit expectations may not be met over the coming quarters for a number of companies. That being said, your Fund's large liquidity position allows us to put capital to work in opportunities that may avail themselves in a declining stock market environment.

Price/Earnings (Trailing 12 mos.)	11.1x
Price/Book Value	1.3x
Debt as a % of Capital	21%
Return on Equity (Trailing 12 mos.)	12%
Median Capitalization	\$2.7 billion
Average Capitalization (\$ Weighted)	\$3.9 billion

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## **FPA Crescent Fund Commentary**

The economic recovery is fragile at best. Ephemeral actions have only put the future on hold. We picture a heavy box with a big red fragile sticker barely held aloft by Messrs. Bernanke and Geithner. As the initial effects of the stimulus fade, U.S. real GDP growth has slowed from 5.6% in Q4 2009 to 2.7% in Q1 2010. This should not be a surprise given the sharp Q4 recovery, but the economy has slowed more than consensus projections, begging the question: Is it real or fleeting? With the past as a guide, one would have expected better. We are not alone in this concern. Recent FOMC minutes reflect that central bank officials expect growth to be slower this year than had been expected, with deflationary pressures still one of their concerns (and ours as well).

We can see the fear of sovereign debt default when comparing the 10-year swap rate to the U.S. Treasury 10-year note yield. The swap rate exceeded the government rate this spring, reflecting that some banks were viewed as a better counterparty than the U.S. government; although positive today, the spread has settled near all-time lows. Our country is ballooning with debt, but the public seems reluctant to look beyond the nation's thin reflection in the fun-house mirror. We don't realize we're bloated and it will seemingly take a heart attack to get us on a diet. But if that's what it takes, so be it. We cast our vote for a crisis that will hopefully yield positive change. As a result, your portfolio remains conservatively postured as we watch the economy try to clear a raft of hurdles, including:

- The eventual end of stimulus funds.
- As many people are no longer able to live rent-free in bank-owned homes and have to once again pay for shelter, we expect a trickle-down effect of reined-in consumer spending.
- Higher taxes.
- A housing recovery that remains in the distant future, leaving mortgage holders with negligible equity in their homes.
- A difficult job market, characterized by persistent unemployment and underemployment and a growing-but-invisible segment of "disenfranchised" workers who aren't counted because they have given up job hunting. Meanwhile, job growth is decelerating.
- The end of unemployment insurance benefits for many out-of-work Americans. Average weeks unemployed have now reached 35.2, exceeding the post WW II high of 21.2 weeks in 1983. Bureau of Labor Statistics.
- Continued consumer deleveraging.
- Little to no lending from banks, coupled with anemic borrowing from customers (either due to lack of desire or lack of qualification).
- High debt loads weighing down state and local governments.

We believe that by having a mandate that allows us to move across asset classes, market caps, and sectors, and to hold cash when others cannot or will not, our investor base is better positioned to avoid the discomfort that might lead to an inopportune sell decision. Regardless of the environment, we consistently aim to distinguish ourselves by using volatility to our advantage, rather than detriment. Instead of composing a portfolio designed to mimic the performance of some benchmark or index, we utilize a deeply held contrarian philosophy oriented towards pushing back on a rising market by reducing exposure, thus allowing cash to increase, while conversely leaning into a falling market and spending that cash by opportunistically accumulating inexpensive securities.

Price/Earnings (Trailing 12 mos.)	12.5x
Price/Book Value	1.3x
Debt as a % of Capital	12.1%
Return on Equity (Trailing 12 mos.)	12.8%
Median Capitalization	\$ 11.3 billion
Average Capitalization (\$ Weighted)	\$42.2 billion

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## **FPA Paramount and FPA Perennial Funds Commentary**

After an excellent first quarter, the equity market reversed its direction in a big way. What were once mid to high single-digit positive returns turned into low to mid single-digit losses year-to-date. High unemployment, a debt crisis in Europe, and a deteriorating housing market all took their toll on the equity market in the second quarter.

Unemployment fell to 9.5% from 9.7%, but it fell because 652,000 people gave up on their job searches and left the labor force. Once again, the populace has lost confidence that there are jobs waiting for them to fill. Private employers did add a net total of 83,000 workers, but this is below the 125,000 needed just to keep up with population growth.

Although the European debt crisis may no longer be the top headline each day, it does not mean the situation has been resolved. Results of the stress tests of European banks, especially those of Greece and Spain, are due to be released on July 23. At that point, we may get some indication of the magnitude of write-downs that the banks must take on their sovereign debt holdings. With many European banks holding Greek debt, if large write-downs are necessary, there could be a negative impact to their balance sheets. This in turn could contribute to a further weakening of the European economies. The end result would be that our trade partners would have a reduced need for our goods and services, thus further hampering a U.S. economic recovery.

As far as new home sales are concerned, the data has taken a turn for the worse. Since the home-buyer tax credit expired at the end of April, we questioned what the effect would be on the housing market. With the May figures, we got our answer and it wasn't pretty. Sales collapsed 33% from April to an annual rate of 300,000. This is the lowest level on record since data collection began in 1963.

In terms of performance drivers for the quarter, there were both positive and negative contributors. On the plus side, O'Reilly Automotive and Lincare Holdings had the largest positive dollar impact on the portfolio. O'Reilly, an automotive aftermarket parts retailer, saw its stock price increase due to increasing confidence resulting from strong same-store sales comparisons and improving margins at the rebranded stores from the CSK acquisition. Lincare, a leading supplier of oxygen to patients in their homes, regained some ground after it announced its first dividend payment. On the negative side, Noble Corp. and CarMax had the largest dollar impact. Noble, a turnkey drill rig and drillship company operating primarily in deep water both in the Gulf and internationally, suffered a setback due to the Gulf drilling moratorium resulting from the BP oil spill. Although Noble has no connection to the spill, the idled rigs are now earning a much reduced day rate compared to what they would have been paid when operational. CarMax, an operator of used-car superstores, saw its stock price go down along with the market as well as some Wall Street skepticism regarding the sustainability of its margin growth rate.

	<i>Paramount</i>	<i>Perennial</i>
Price/Earnings (Trailing 12 mos.)	17.9x	17.9x
Price/Book Value	2.3x	2.3x
Debt as a % of Capital	22%	22%
Return on Equity (Trailing 12 mos.)	14%	14%
Median Capitalization	\$2.2 billion	\$2.1 billion
Average Capitalization (\$ Weighted)	\$3.4 billion	\$3.3 billion

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## **FPA New Income Commentary**

The second quarter revealed a substantial change in the consensus view of how the current economic recovery could perform going forward. As part of this change, investors started to reassess how they viewed and wanted to participate in the risk components of the capital markets. It is quite interesting that one significant component of the risk reassessment came from non-U.S. events. The sovereign debt crises, which unfolded within the European economies, cast doubt as to how the U.S. would progress in the future.

The fears of Europe's financial problems at the government level resulted in a flight to quality out of European government bonds into U.S. government bonds. The value of the dollar increased versus the euro from the end of the first quarter until June 7 and both short- and long-term Treasury rates declined, with the two-year note declining in yield from 1.17% to 0.60% and the ten-year Treasury note declining from 3.99% to 2.94%.

In our opinion, another factor in the flight to quality was the realization that the problems in Europe could lead to lower growth, which would have a negative impact on export sales for the U.S. Exports to Europe represent 18% of GDP, and this is one key area of the economy which was being relied upon to make up for weak GDP contribution from the household sector.

Europe's problems also sharpened the debate over the issue of government deficits and their potential impact on GDP growth and the level of interest rates. At this point, Europe has only begun to deal with the situation and it would appear that shrinking government entitlement programs is one tool that may be used. The various governments are trying to put forth plans to reduce government deficit spending. That being said, policies surrounding the borrowing and sharing of credit risk are also being scrutinized in an effort to keep the highly levered countries from defaulting. While it is early in this process and the results are still uncertain, the European nations are trying to develop a plan to cope with their over-leverage. This is somewhat of a contrast to the U.S., which to date has not articulated a coherent plan of how the various political entities will gain control of their deficit spending. It is our view that investors' appetite for risk diminishes when faced with a lack of direction from policymakers.

In the past we concentrated on the mortgage sector of the bond market for investments and did not focus much on the investment-grade corporate segment of the market. After taking into account the prepayment risk of the mortgages, the yield available was either competitive with or better than the yield found for a corresponding "A"- or "AA"-rated non-financial corporate bond. However, over the past 18 months the Agency mortgage-backed sector of the market has experienced dramatic change. The Federal Reserve and Federal government has exerted tremendous influence on the ownership and pricing of these securities. Additionally, credit has started to play a more key role in the prepayment expectations of these securities. This is very critical when looking at those mortgages issued in 2006 and 2007. For example, in March 2008, 30-day delinquencies for prime mortgages issued in 2007, which represents much of the Agency-backed mortgage component of the market represented a little less than 1.5% of the outstanding amount. That delinquency percentage is currently over 12%. These are the key elements as to why we think it makes sense to shift our emphasis to find investment-grade corporate bonds that may offer a better risk/return profile.

While the spread widening and the high-level credit characteristics point to an opportunity, we are not in a blanket buy strategy. We will still undertake a thorough analysis of each potential idea to ensure that the credit quality supports the bond. At this juncture it is difficult to quantify the total portfolio allocation; however, as with new investment themes in the portfolio, we feel confident that over a reasonable time period a meaningful allocation can be obtained.

Effective Duration	1.2 years
Average Life	2.2 years
Average Yield-to-Worst	2.4%

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