

SLIM PICKINGS

Dear Shareholders and Friends,

Mr. Stock Market is really making it hard for us these days, in contrast to a year ago. At this time last year, we were in the process of reducing FPA Capital Fund's liquidity and non-high-yield bond allocation from nearly 22% to 10%. We are now at 27%, with an additional 3% that might be added with the pending acquisition of Celanese AG for cash. This level may rise even further with cash inflows.

During the past two weeks, the investment team took an even more rigorous review of the market to uncover any potential investment candidates. I reviewed all 1,382 companies that are included in the Russell 2000 Value Index. Out of these, excluding the seven we already own, I was able to identify eighty-eight possible candidates. Nearly half of these were excluded upon further examination. The remaining companies were reviewed further, with the goal of identifying those that would be potentially buyable today. This narrowed the list down to five. In a meeting with my associates, they eliminated four because they had already examined them and found issues that precluded them from being considered for investment. They also had reviewed this list for other candidates that I might have missed. Steven Romick identified four companies, but he said that he was not terribly excited about any of them. I must say this outcome was depressing.

Each of us went back and did further screens to see if we were overlooking any companies. My traditional screen identified seventy candidates. This result was approximately one-fourth of what was identified at this time last year, and it was also the lowest qualifying number of companies since the spring of 1998. The candidate list was reduced further when a more realistic minimum market capitalization of \$700 million was used. Only twenty-eight qualified and of those, we already owned three. Rikard Ekstrand did a somewhat different screen but came to the same conclusion.

Dennis Bryan took another slightly different track and looked at companies with market capitalizations between \$600 million and \$4 billion that were trading 60% or more below their respective 52-week highs. During the last two years, he would routinely identify approximately 200 companies out of over 1,300. Today, only five show up. To add further support to this conclusion, just take a look at the new daily low list of companies to see that there are virtually none on it.

However we slice and dice Mr. Market, the result is the same, Slim Pickings. What we believe this process demonstrates is that the stock market has recovered to such a degree that current valuations are discounting some very optimistic expectations. As you might recall, throughout last year we held a very optimistic view concerning the strength of the economic recovery. As this minority point of view became more widely accepted, we felt it would be reflected in the stock market by considerably higher share prices. Now that this has occurred, investors are again raising their forecasts so as to justify current share price levels. While these expectations may prove to be correct, we believe the ratio of reward versus risk is not high enough to warrant risking your capital. In other words, we do not see a sufficient margin of safety.

We believe today's market environment is virtually the opposite of last year's, when investor fear was very high. Now that investor confidence has returned, as demonstrated by the large net inflows into equity funds in 2003 versus the net outflows in 2002, we prefer to let others use their liquidity at these elevated risk levels. In the short run, our strategy of letting liquidity build may lead to FPA Capital Fund's underperforming the market. As we have written so many times in the past, to achieve superior long-term performance, one must be willing to accept periods of short-term underperformance.

Sincerely,

Robert L. Rodriguez and the FPA Capital Fund team
January 18, 2004