Dear Shareholders:

Overview

Crescent returned 4.55% in the third quarter, and 8.25% in the year-to-date period. The stock market (S&P 500) returned 6.35%, and 16.44%, respectively, fueled by a market rally that has not been supported by fundamentals. At the end of 2011, we believed that economists and Wall Street analysts were generally too optimistic with respect to 2012 expectations. Since then, we've been proven correct. United States (and EU) GDP is far lower than expected. The U.S. deficit (and thus our national debt) is larger than projected. And predictions of corporate earnings turned out to be too optimistic. In fact, analysts now expect third quarter earnings for the S&P 500 to come in below 2011 levels.

The third quarter's winners and losers are as follows:

2012 Q3 Winners & Losers

Winners	Losers
Google Inc.	ATP Oil & Gas Corp.
Aon plc	Wellpoint Inc.
Ensco plc	Hewlett-Packard Co.

Our macro commentary will be included in the Q4 commentary. Our views remain unchanged from the discussion in our Q2 commentary, so we refer you to that letter if you'd like to review our assessment.

Investments[1]

We spend a lot of time talking about what we buy, but it is equally important to discuss what we sell. Since we did not initiate any new, larger positions during the third quarter, we'll instead elaborate on our investment process by discussing a couple of investments we scaled back.

Walmart

Walmart's earnings met or exceeded expectations in the last year and concerns about its ability to grow dissipated, triggering renewed investor interest in the company. Not much changed in Walmart's fundamentals, but the stock price and P/E[2] moved higher. With our investment having exceeded our return expectations and greater downside risk accompanying the higher stock price, we scaled back our stake. We'll use Walmart to illustrate how an investment can come full circle – from buy to sell. Our original thesis, laid out in our 2010 Q4 commentary, is reprinted below.

> *Walmart (WMT) seems anomalous in a world where stocks have rebounded so dramatically from the stock market's 2009 bottom. Walmart's stock averaged $48.59 in February 2009…. At that price, it traded at a TTM[3] and*

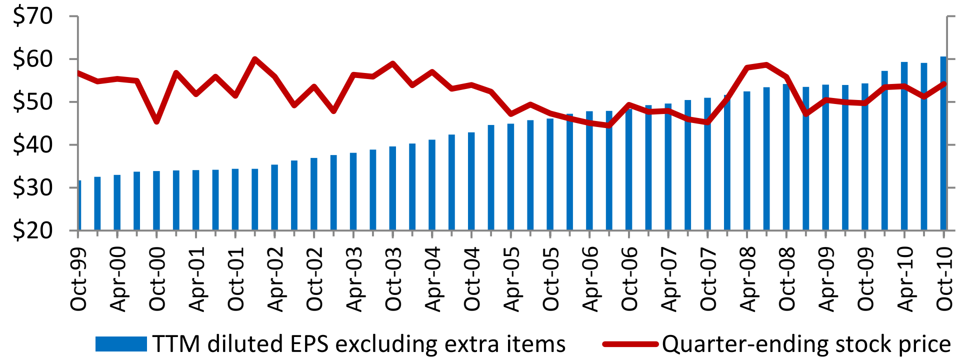
[1] The portfolio holdings as the most recent quarter end may be obtained at http://www.fpafunds.com/docs/fpa-crescent-fund/crescent-12-09.pdf?sfvrsn=2

[2] P/E is a valuation ratio of a company's current share price compared to its per-share earnings.

[3] Trailing twelve month

Forward P/E[4] of 14.5 and 13.0x, respectively. Walmart closed 2010 at $53.93 per share – more dear in price but cheaper in valuation – trading at a lower TTM and Forward P/E of 13.3 and 12.1x, respectively.

Walmart
10/31/99 to 10/31/2010[5]



With more than 8,000 stores in 15 countries, in excess of 2 million employees, and more than 200 million customers each week, most everyone has heard of Walmart. And yet it seems relatively ignored by investors – a big change from a decade ago, when the market deemed its growth expansive enough to justify it trading ~40x earnings (both trailing forward). Investors may be disappointed in its stock price over the last decade, but we don't feel there's much to complain about as far as its revenues and earnings growth go. Revenues grew at a 9.4% rate, while earnings per share compounded at 11.5%.

So where does that leave us, and how do you make money in a company that already has revenues exceeding $400 billion and a market capitalization approaching $200 billion? We now feel that Walmart has grown its way (via earnings) into its stock price. <u>We view Walmart as an infinite duration bond with a rising coupon – a "bond-like equity."</u> We believe Walmart can grow at an acceptable rate well into the future and that the company will pay a fair dividend, as well as opportunistically repurchase shares, which should provide a high single-digit to low double-digit total return over time – not bad in the context of low single-digit interest rates.

Components of Walmart Potential Return

	Low	High
Revenue growth	5.0%	7.5%
Operating income growth	5.0%	7.5%
Share repurchase	2.0%	4.0%
Dividend yield	2.0%	2.5%
P/E increase/(decrease)	0.0%	0.0%
Potential return	9.0%	14.0%

Source: FPA

We do not know if the above scenario will play out as exhibited, but we take comfort in the following:

- *Revenues have grown 5%, 8% and 9% in the last 3, 5, and 10 years, respectively. More than 25% of Walmart's sales come from overseas, and we expect foreign economies to continue to grow better than our own.*

4 A measure of the price-to-earnings ratio (P/E) using forecasted earnings for the P/E calculation.
5 Data from Capital IQ.

After dividends and share repurchases, we expect there to be additional free cash flow that will be used to drive the top line.

- *Operating margins are unusually stable, ranging between 5.6% and 6.1% over the past decade. Walmart has exhibited tremendous margin stability, in part due to their stated goal of delivering cost savings to their customers in the form of lower prices. By not taking price into margin, we expect they will be able to pass through price increases in an inflationary environment – an advantage vis-à-vis competitors that keep efficiencies for themselves. We also note that extremely high inflation would hurt unit sales.*
- *Shares outstanding have declined by an average 2.2% per year since 2001 and have accelerated in recent years. In the first nine months of 2010, shares outstanding declined by 5.4%.*
- *The dividend payout ratio has increased in each of the last 10 years, from 17% in 2001 to 29% today.*
- *Incremental returns on capital have been quite good as management proudly exhibited in the company's most recent 10-Q.[6] Return on investment for the trailing twelve month period, adjusted to include rent, increased from 18.4% to 18.6%, and return on assets increased from 8.2% to 8.8%.*

We continued to build our position in Walmart into the early fall of 2011. The stock price declined, reflecting a weak stock market, fears of dollar store competition at the low end, and concerns that Walmart's customers were among the hardest hit by the continued economic weakness. Ultimately, Walmart became a 3.8%[7] position because we believed the company was an excellent "compounder" as we communicated at the end of 2010. Since then, its business has continued to perform as expected, but its stock price has increased ~50% – a significant jump for the largest retailer in the world and a company with a market value now ~$250 billion.

In the last year, operating income has grown 5.7% and the company has repurchased 2.6% of their shares, allowing earnings per share to increase 7.5%. In addition, the company has paid dividends that provided a 3.0% dividend yield on the 2011 Q3 ending price. The sum of these metrics fell into the range of expectations listed in the table included in our 2010 Q4 commentary. Our original estimate of a 9% to 14% compounded return did not include P/E expansion (or contraction). A higher P/E was always the free option, and that option ended up in the money, with Walmart's forward P/E increasing from 11.8x to 14.9x today.[8] However, with a higher P/E comes greater risk of multiple contraction, and we therefore believe it's prudent to maintain a smaller position. Walmart is now just 1.6% of Crescent's portfolio.[9]

Ensco[10]

Whereas Walmart is an example of a type of "compounder" we like to buy, Ensco is an example of a "3:1" — a purchase we make when we believe the potential upside is 3x larger than the potential downside. We have owned Ensco for a number of years, and it has also been discussed in the past, along with our investments in other oil service companies.[11] Ensco is an average business with no long-term competitive advantages. It seems that to effectively compete, a rig company only requires capital and a contract with an Asian shipyard. Such ease of market entry convinces us that a company that builds a rig and then leases it should not expect to earn more than a 10% to 12% long-term return on capital. In a tight market, demand exceeds the number of rigs available, and return on capital rises above the long-term average. At such times, one generally expects to see new orders for rigs. As those rigs come to market a few years down the road, day rates, and thus returns on capital, decline.

Earnings at Ensco and other oil service companies are currently above our expectations for normal returns on capital due to a shortage of available rigs. Capital and time will correct that. Currently, there are lots of rigs under construction. In 2013, 35 new jackup rigs will be built and delivered, an increase of 8% to the current worldwide fleet of 426. Additionally, 21 new floater rigs will be built and delivered, an increase of 7%

[6] Wal-Mart Form 10-Q for the quarter ended October 31, 2010.
[7] As of October 31, 2011
[8] Bloomberg
[9] As of October 15, 2012
[10] As of September 30, 2012, FPA Crescent Fund held a 1.4% position.
[11] Please see 1Q 2010 and 2Q 2010 commentaries.

to the current worldwide floater fleet of 295. Worldwide oil consumption & production grows at about 1% per year so we believe this level of growth in the offshore rig fleet will ultimately reduce profitability and returns.

We have reduced our position in Ensco and other oil service companies, albeit with the recognition that this period of "excess" earnings can continue for quite some time if the price of oil remains high.

Our goal when investing in commodity businesses is to 'buy assets and sell earnings.'

Capital intensive, cyclical businesses often trade at discounts to the value of the underlying assets when their respective industry is in distress (companies are either losing money or earning less than what's expected in a more normal environment). When earnings rebound, the market seems to forget that the businesses are cyclical. Investors begin to value them on earnings as if another downturn isn't in the cards. Our average cost in Ensco reflects rigs purchased at a discount to a fully depreciated replacement value. Since then, its stock price has increased, along with day rates (and earnings). The company is now beginning to be considered more on a P/E basis, while at the same time, the value of the underlying rigs has begun to trade through their replacement value, reflecting the value of existing contracts and hope for a continued robust demand environment. As our margin of safety[12] has declined, we have reduced our exposure, consistent with our initial thesis and the manner in which we invest in such industries.

Japanese Yen

As bad as the United States is or seems, Japan, it can be argued, is worse. When we're asked when America's problems will catch up with it, we plead the 5th. It's inevitable, but impossible to time. Japan, however, is far enough along that we believe its fiscal problems will start making headlines sooner rather than later (Please don't ask us to define "soon").

Despite a deteriorating balance sheet over the last five years, the Japanese Yen has appreciated almost 25% versus the USD, while interest rates, as measured by the 10-year government bond, have nearly been cut in half, to 0.8%. According to a recent IMF Country Report, Japan's worsening fiscal condition has been a trend for the past two decades, during which the net public debt has increased nearly ten-fold.[13] The same report further states, that "Japan's net public debt is higher than in almost all other advanced countries, and unlike in many other advanced countries, is projected to rise further. Even a relatively small increase in the sovereign risk premium would make fiscal consolidation more difficult, pose challenges to financial institutions, harm growth prospects in Japan, and could spill over to global risk premia and growth."

With this in mind, we have recently begun purchasing over-the-counter derivative instruments that are intended to be profitable if the Japanese Yen weakens or Japanese interest rates rise. Since we have purchased options, our losses are limited to the purchase price of these contracts and are sized accordingly. The potential payoff could be substantial and quite asymmetric if either the exchange rate or interest rates revert to historical levels or something akin to five years ago, when the Yen traded at 115 to the U.S. Dollar and the 10-year Japanese Government Bond (JGB) was 1.7%.

Considering that we have, at best, only a vague notion of when Japan will take over the headline baton from the PIIGS[14], each of the instruments we purchased has a multi-year life (including one as long as ten years). That allows us to structure the trade by placing greater emphasis on the "if" part of the thesis, rather than the "when."

[12] Buying with a "margin of safety," a phrase popularized by Benjamin Graham and Warren Buffet, is when a security is purchased for less than its estimated value. This helps protect against permanent capital loss in the case of an unexpected event or analytical mistake. A purchase made with a margin of safety does not guarantee the security will not decline in price.
[13]IMF Country Report No. 12/208, Japan, August 2012
[14] Portugal, Ireland, Italy, Germany and Spain

High Yield / Distressed

If it was slim pickings as of our last missive, it's even slimmer now. We have an investment in the second liens of a bankrupt exploration and production company, as we mentioned in our Q2 commentary. We also now have a small stake in the same company's debtor in possession (DIP)[15] financing. It continues to be a fluid situation, but the dynamics of the process will likely present an opportunity to refinance a costly and value-eroding DIP facility, which we believe should facilitate the company's emergence from Chapter 11 and maximize the recovery value to our second lien bonds.

Closing

We continue to be haunted by Mr. Bernanke's admission that we "have been in the process of learning by doing." One can always hope that academic work translates to the field, but we think it's unlikely. Instead, we expect unintended consequences to create future dislocation, and with it, opportunity. We're ready, and we'd prefer it occur sooner rather than later.

Respectfully submitted,

Steven Romick
President
October 18, 2012

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The discussion of Fund investments represents the views of the Fund's managers at the time of this report and is subject to change without notice. References to individual securities are for informational purposes only and should not be construed as recommendations to purchase or sell individual securities.

FORWARD LOOKING STATEMENT DISCLOSURE

As mutual fund managers, one of our responsibilities is to communicate with shareholders in an open and direct manner. Insofar as some of our opinions and comments in our letters to shareholders are based on current management expectations, they are considered "forward-looking statements" which may or may not be accurate over the long term. While we believe we have a reasonable basis for our comments and we have confidence in our opinions, actual results may differ materially from those we anticipate. You can identify

[15] A debtor who files a Chapter 11 bankruptcy case becomes the debtor in possession (DIP).

forward-looking statements by words such as "believe," "expect," "may," "anticipate," and other similar expressions when discussing prospects for particular portfolio holdings and/or the markets, generally. We cannot, however, assure future results and disclaim any obligation to update or alter any forward-looking statements, whether as a result of new information, future events, or otherwise. Further, information provided in this report should not be construed as a recommendation to purchase or sell any particular security.