

FPA US Value Fund, Inc. (FPPFX) Webcast 2Q 2019

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(00:00:00)

Moderator: Hello, and welcome to today's webcast. My name is Christina and I will be your event specialist today. All lines have been placed on mute to prevent any background noise. Please note that today's webcast is being recorded. During the presentation, we will have a question and answer session. You can ask text questions at any time. Click the green Q&A icon on the lower left-hand corner of your screen, type your question in the open area and click Ask to submit.

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It is now my pleasure to turn today's program over to Kristina Surkova. Kristina, the floor is now yours.

Kristina: Thank you. Good afternoon and thank you for joining us today. We would like to welcome you to FPA US Value's First Half 2019 Webcast. My name is Kristina Surkova, and I support the Fund on the client service side. The audio, transcript and visuals replay of today's webcast will be made available on our website FPA.com.

In short order, you will be hearing from Gregory Nathan, the portfolio manager of the Fund. As a reminder, Greg took on the management of this fund on September 1, 2015.

As part of today's agenda, we will cover fund highlights, market commentary, performance and portfolio activity, and then open it up to

question and answers. At this time, it is my pleasure to hand the call over to Gregory Nathan. Greg.

(00:01:56)

Gregory: [Please reference slide 2] Thank you for that introduction. The backdrop for investing in large, growing companies continues to be relatively attractive to other asset classes, but less so on an absolute basis given how much valuations have risen in the first half of 2019. The 10-year US Treasury rate at approximately 2% remains near all-time historical lows. The unemployment rate is low. The US economy is still growing, albeit at a slower pace than in 2018, due in part to Chinese tariffs, to China's slowdown, and economic problems in the EU and UK. After a greater than 16% median price increase in the first half of 2019 for the S&P 500, valuations of US equities are less attractive than where they began the year. The S&P 500 finished the second quarter trading at nearly 18 times forward earnings estimates, up from just over 15 times at the start of the year. A large part of this move in valuation can be attributed to longer-term interest rates declining. The 10-year US Treasury yield declined from approximately 2.7% at the beginning of the year to 2% at the end of the second quarter.

One of the biggest drivers of return differentials in the market is the valuation spreads we are continuing to see widen out between companies the market perceives as having structural, above-average, long-term growth, i.e. current winners, versus companies whose terminal values are more in question often due to technological disruption, i.e. potential losers.

Therefore, it is imperative to avoid investing in potential losers where fundamentals are eroding and instead stick to the high-quality companies we believe have sustainable competitive positions that should result in above-average organic growth over the long term.

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[Please reference slide 2] Regarding today's agenda for the call, first we are going to walk through the Fund highlights. Then we will touch on our investment philosophy and process. This will be followed by an update on the Fund's performance, portfolio activity and a summary of the new, more diversified portfolio structure we implemented during the fourth quarter of 2017.

If you are unable to participate in the live webcast and/or do not get your questions answered, please feel free to reach out to Kristina Surkova in Client Services to arrange a call with me.

[Please reference slide 3] Regarding the Fund highlights, the primary objective of the US Value Fund is growth of capital over the long term. Our goal is to outperform the S&P 500 over full market cycles, which we define as an approximate seven-year period.

[Please reference slide 4] Here is a summary of my professional background with 17 years of industry experience. My interests are well aligned with fellow shareholders and in fact, in the first and second quarters of this year, I further increased my investment in the Fund at opportune times. Additionally, I frontloaded my 2019 401(k) funding, investing the maximum amount in mid-January. I hope this gives you a sense of my confidence in the Fund.

[Please reference slide 5] Now we would like to walk you through our investment philosophy. The most important thing in investing is to avoid permanent capital impairment. Permanent capital impairment can result from: investing in a business whose profitability is structurally declining; paying too high of a multiple for a company; investing in a company with too much financial leverage that can't make it through a tough business cycle without having to restructure. Thus, we focus on finding quality companies in healthy, growing industries, at attractive valuations, with low financial leverage. We want the portfolio to have an

appropriate level of diversification by number of investments and industry exposure.

We define quality as companies that have strong and enduring competitive positions—growing businesses within growing industries. A growing industry is key because without it, there will typically be poor earnings growth and investment returns.

Lastly, we want our companies to have high returns on capital and a robust free cash flow generation.

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We prefer companies with good management, which we define as those who make the right operational and capital allocation decisions to put the company in the best position to achieve sustainable, above-average revenue and earnings growth over the long run. However, one of the reasons good businesses are offered at attractive prices is because of poor management. Therefore, we will consider such companies, provided there is not a structural impediment to replacing management, and there is a large enough discount to our estimate of intrinsic value.

Bottom line, the quality of the business followed by valuation are the most important investment criteria.

A current example of this would be Lowe's, a home improvement retailer, which in the past year got a major upgrade in management. Newly appointed CEO Marvin Ellison was an executive at Home Depot in charge of the company's US stores from 2002 through 2014. During his time at Home Depot, Ellison helped oversee the chain's turnaround. We believe Ellison will apply his best practices and learnings from his time at Home Depot to help optimize Lowe's operations.

It is worth noting that we made our investment in mid-2017 under the old management team that was underperforming. The discount was large enough to invest in the company at that time. Luckily, an activist investor disclosed a stake in January 2018. By the end of March 2018, the former CEO announced his retirement and just two months later we had our new, highly capable CEO in place.

[Please reference slide 6] Let me walk you through the key parameters as to how the portfolio is constructed.

The Fund's multi-cap strategy affords us the ability to invest wherever the best opportunities arise. At least 80% of the portfolio will be invested in US companies. At the same time, we have the ability to make opportunistic foreign investments.

Appropriate diversification—individual positions will not exceed 5% of total assets at the time of purchase.

Generally fully invested—the reason for this is the portfolio is made up of what we believe are undervalued, high-quality companies that should compound in value over time, therefore cash will usually not exceed 10% of the portfolio.

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[Please reference slide 7] The foundation of our portfolio construction process stems from our investment objective of seeking long-term growth of capital. At the same time, we have a goal of generating investment returns that exceed the S&P 500 over full market cycles, all while minimizing the risk of permanent capital impairment.

We are of the view that the world is dynamic, with change taking place seemingly faster than ever before. Therefore, it is critical to have a diversified portfolio to mitigate unforeseen risks, namely disruption to business models. While we consider investing in all industries at any given time, we will not invest in all industries if that means taking undue risk and/or negatively impacting long-term returns.

We deconstruct the S&P 500 whereby, in the famous words of Bing Crosby, we are trying to accentuate the positive, eliminate the negative, latch onto the affirmative and don't mess with mister in between.

We start by eliminating or underweighting unfavorable sectors due to relative inferior quality, lack of above-average growth and/or unattractive valuation.

From the remaining sectors that meet our criteria, sector weights are based on long-term industry fundamentals coupled with the relative attractiveness of various companies within those sectors, centered on business model sustainability, normalized long-term earnings growth, and valuation. We consider select investments outside the US and/or S&P 500 that offer compelling risk-adjusted returns. The goal is to be as close to fully invested as possible, provided we can find the requisite high-quality companies at attractive valuations.

Cash is a by-product of what is left over from having investments in the industries and companies we view attractive, at the relative position weightings we deem appropriate based on sector risks, coupled with our estimate of the companies' prospective returns over the long term.

[Please reference slide 8] It is important to note that the portfolio construction process changed in the fourth quarter of 2017. The current

portfolio construction process is very different from the manner in which we constructed the US Value Portfolio over the first nine quarters of operation. For the past seven quarters, we have operated using the portfolio construction process I just described.

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Over the first nine quarters, the portfolio was constructed in a much more concentrated, purely bottoms-up manner by sector and company compared to the much more diversified manner which begins with a top-down view of the overall market and sectors within it. Specifically, we averaged 27 disclosed investments over the first nine quarters compared to an average of 64 disclosed investments over the past seven quarters.

What is interesting to note is that many investors have a view that in order to outperform the market over time, you have to run with a concentrated portfolio. However, the numbers do not support that. For example, from 2016 through 2018, the S&P 500's cumulative return over those three years was 30.4%. The top 50 contributing stocks to the index's performance had a median return of approximately 75%. The next biggest 50 contributors had a median return of nearly 65%. Additionally, the next largest 50 contributors had a median performance of over 55%. The top 150 contributing stocks had a median return of nearly 65%. The

top 250 contributing stocks had a median return of nearly 55% and made up about half of the index at the beginning of 2016. However, the greatest 100 detracting stocks had a median return of negative 30% and made up about 20% of the index at the start of 2016.

Another key point to make is that the top contributing stocks over these three years were in a variety of industries, including technology, healthcare services, financial services, banks, aerospace and defense, entertainment, and pharmaceuticals, just to name a few. Moreover, the same is true about the greatest detractors. Therefore, the main takeaway to me is that one can certainly outperform, and outperform meaningfully, with a diversified portfolio. However, what it comes down to is a good batting average, i.e. having more of those stocks in your portfolio that are in the top 250 and as few as possible in the bottom 100. Avoiding big losers is just as important as picking winners.

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Another crucial reason I concluded the portfolio needed more diversification was many companies which I have followed for years that seemed to have predictable business models were all of a sudden becoming unpredictable. Management would regularly give excuses and try to convince investors that these were short-term issues. Too often, I

would listen and remain invested in these companies, only to be disappointed again.

However, what is continuing to happen is disruption across more industries moving at an even faster pace. To manage this risk better, we needed to operate with a sense of less conviction and more paranoia. As public investors, we can only know so much. Placing too much faith in management, who are human and thus are often wrong, is not the answer.

We determined what is part of our solution is to have more positions and less conviction in our investment theses. Thus, when a company disappoints us, we are mentally free to sell and move on. I am only married to my wife, and certainly not to any company. Stocks are just stocks, and serve investors only one purpose: to generate good returns. When they cease to do that, they do not need to be in our portfolio. That is the beauty of the public markets. It gives us liquidity to freely buy and sell. Moreover, we take advantage of that while trying to be tax-efficient.

Another significant point I want to make is that over the first three years, the portfolio was significantly underweight technology due to above-average valuations relative to the index. Not only is this the largest sector in the S&P 500 but it is one of the highest quality due to its

consistent above average revenue and earnings growth. This is a major reason for the Fund's underperformance over those first three years.

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Now, the Fund has a more in-line weighting of technology compared to the S&P 500, and we expect this to continue to benefit the Fund's performance going forward. This is certainly one of the core reasons for our meaningful outperformance in the first half of 2019.

[Please reference slide 9] Staying on this topic for another moment, I think it is important to explain in more detail why we have such large exposure to information technology and communications services. These are our two largest sector exposures that are both tech-related and, combined, make up approximately 45% of our disclosed investments.

It is imperative to emphasize, we are value investors who seek to find high-quality companies that have the ability to organically grow revenue and earnings at above average rates over the long run. In addition, we invest in these companies at what we believe are compelling valuations.

Over my 13-year career as an analyst from 2002 to 2015, I was able to generate investment ideas with market-beating returns by fishing for stocks trading at below-market multiples. That is because if you look at

the chart on the left, global earnings across a multitude of sectors grew at similar rates as the tech sector did from 1985 to 2012. Therefore, if you fished in a global pond across industries and market caps and you focused on buying quality stocks trading at below-market multiples, you had good odds of outperforming the market over time.

However, beginning in 2012, this all changed. Technology earnings growth began to outpace non-tech earnings, and over the past few years, tech earnings growth has exploded while non-tech earnings have flatlined. Many companies that historically exhibited growth no longer were.

When I transitioned from a successful analyst to a portfolio manager, my portfolio construction process was simply to create a concentrated portfolio of my best ideas. Just as I was an analyst, I would be completely bottoms-up because historically, there was not any sector that exhibited significantly better growth than others did for a sustained period. And I would buy stocks at below-market multiples because you were generally not getting more value paying up for the higher-multiple stocks, as most could not maintain above-average growth rates. This is why value or lower-multiple stocks generally performed as well as higher-multiple growth stocks from 2003 through 2015, which you can see on the graph on the right.

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Keep in mind, very few things last forever. Economic principles remain true even for tech companies, which are at risk of disruption by competitors over time. Just look at Oracle for example, which continues to lose market share and grow slower than its end markets.

Thus, we are not advocating putting all of our eggs in one basket. There are high-quality companies in non-tech sectors, which we think have the ability to grow at above average rates for several years. However, they are rare, and those that do exist often have expensive valuations. As a result, about 46% of the disclosed portfolio is in non-tech sectors. Therefore, in total, about half of our disclosed invested portfolio is in tech-related sectors and half is in non-tech. Given where valuations are currently across industries, we are comfortable with this composition. However, we would probably be inclined to increase our exposure to tech on any market weakness because that is where most of the growth is, and that is where we believe most of it will likely be for the next number of years. Should that change, expect the portfolio's composition to as well. We want to invest wherever the growth is, at compelling valuations. We are mentally flexible and our portfolio will flex accordingly.

[Please reference slide 10] I think it is worth understanding US Value's portfolio characteristics compared to the S&P 500. While US Value is reasonably diversified, with 60 investments, 52 of which are disclosed, we are more concentrated than the S&P 500. US Value has 32.4% of the disclosed portfolio invested in its top 5 holdings compared to 16.5% for the S&P 500. Our top 10 disclosed investments make up 49.7% of the portfolio compared to 21.6% for the index.

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Probably one of the greatest differentiators for US Value is our willingness to eschew entire sectors of the market. To that point, US Value currently does not have any disclosed investments in 5 of the 11 sectors that, combined, make up 21.5% of the index. These sectors are materials, consumer staples, energy, real estate, and utilities. This goes back to the earlier point of trying to minimize exposure to inferior parts of the market where we do not see good value.

Another key differentiator is over 10% of our portfolio is invested in foreign equities while the S&P 500 has zero. Today you can see that the median and weighted average market cap of our portfolio is considerably higher than the index. That is because some of the largest companies in the index, such as Alphabet, Amazon, Microsoft, Facebook and Apple, are

some of our largest positions. This also contributes a great deal to our portfolios approximate 38% disclosed overlap with the S&P 500.

We believe these are some of the highest quality businesses we have ever come across, and they share an ability to grow revenue and earnings at above average rates for many years to come.

In terms of comparative quality, there are a few metrics you can look at to give you a sense, but don't tell the entire story.

The companies in [the] portfolio over the past two years have grown revenue and earnings faster than the S&P 500 by approximately 5% and 10% respectively. At the same time, based on consensus estimates over the next couple of years, expectations are for revenue and EPS to grow at a similarly faster rate of 5% and 6.5%, respectively. This is a material difference when compounded over many years.

[The Fund's] companies also have about 4% higher return on equity and carry less financial leverage, meaning that on an unlevered basis, return on capital for [the Fund's] portfolio of companies is even higher.

As you can see, the 12-month forward P/E of [the] portfolio compared to the S&P 500 is at a bit of a premium. We would argue that this valuation premium is well-deserved, if not too small.

To illustrate this point, let me highlight two companies, one which is our largest investment and the other a former position.

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[Please reference slide 12] Alphabet, which is our largest position, continues to enjoy robust growth. When we made our first investment in the company in March 2016, backing out its net cash position at the time, it was trading at approximately 18 times forward unlevered after-tax core Google earnings, which excludes losses from its other bets.

Over the last three years, core Google revenue has grown over 80%, earnings have increased over 50%, R&D is up over 70%, and capex is up nearly 140%. Over that time, despite the significant increase in investment into its various businesses, it has generated over \$75 billion in free cash flow or nearly 20% of the enterprise value at the time of our initial purchase.

Since that time, the stock is up 53.5% and as you can deduce, the entire return stems from organic growth, free cash flow generation, and reinvestment within various businesses with potentially very high future returns on investment.

The investment return was not driven by multiple expansion. In fact, Alphabet's multiple has derated while its growth remains well above

average. This partly explains why we continue to have such a large position in the company.

Conversely, there is Whirlpool, a company in which we made our first investment in October 2015 at \$155. We traded the position well, selling out in late 2017 into early 2019, earning an approximate 11.5% IRR. However, the stock ended the second quarter at around \$142. This company has been a perpetual disappointment, unable to deliver on its projections.

When we first bought the stock, it was trading at approximately 13.5 times 2016 earnings of \$11.50, although management in early 2016 had forecasted \$14.00-\$14.75 in EPS. Management had laid out a plan to grow earnings at a 10%-15% rate for several years to come, such that EPS was expected to be over \$20 by 2020. In mid-2018, management cut earnings guidance yet again. For 2019, Whirlpool is expected to earn \$14.75 per share. The stock is down nearly 10% almost four years later.

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Clearly the market has lost confidence in management and/or the long-term earnings power of the business. This is what you might call a classic value trap. Luckily, we got out in time and made a respectable return, but this is a cautionary tale of what can go wrong when a stock

seduces an investor by a seemingly cheap multiple for above-average projected growth.

I use these two examples because this gets to the heart of being a value investor and why, when constructing a portfolio, it is critical to have a reasonable level of diversification since there will usually be investments that disappoint.

Many people say value investing does not work any more. However, to say that, one must first define value.

We define value as the relationship of business quality relative to the price you pay for it. Business quality means the ability to generate sustainable, above average earnings growth over the long term. In this example, Alphabet was the better value. In order to see that, you had to have the correct long-term view. That is because when we bought Alphabet, on an unlevered after-tax basis, it was trading at an approximate 50% higher multiple on 2016 earnings estimates compared to Whirlpool. However, looking out just a few years to 2019's now expected earnings, we can see that we purchased Alphabet's core Google business at an unlevered after-tax multiple that was actually lower than Whirlpool's. Therefore, when people say value investing does not work anymore, our response is it sure does.

However, we have found trying to find value by leading our quest looking for low-multiple stocks is not a good approach. Instead, we focus on finding quality businesses within growing industries. From there, we estimate its long-term earnings growth and earnings power. As a result, we can have a view as to what an appropriate multiple is for the company and what a good purchase price is.

We believe we will be able to continue finding value by taking a long-term view and hopefully being right on those views much more than we are wrong. Moreover, by using this approach to construct a reasonably diversified portfolio, we are confident this will generate long-term growth of capital, with returns exceeding the S&P 500 over full market cycles.¹

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[Please reference slide 11] Now here is the portfolio sector breakdown as of June 30. There are disclosed investments in 6 of the 11 sectors in the S&P 500. Combined, these 6 sectors—which make up 78.5% of the S&P 500—are 90.7% of US Value’s disclosed portfolio. Relative to the S&P 500, the portfolio is overweight communication services, consumer discretionary and industrials, has a generally in-line

¹ Past performance is not indicative of future results and there is no assurance that the Fund’s investment objective will be achieved or that the strategies employed will be successful. As with any investment, there is always the potential for gain, as well as the possibility of loss.

weighting in information technology and financials. The Fund is underweight healthcare.

To reiterate, the 5 sectors the Fund currently does not have any direct exposure to are materials, consumer staples, energy, real estate, and utilities. Collectively, these five sectors make up 21.5% of the S&P 500.

[Please reference slide 12] Regarding the portfolio's holdings, we'd like to point out a few highlights.

We believe our companies operate within secularly growing industries. We believe our companies have a strong position within their respective industry due to various competitive advantages. A majority of these companies are among the leaders in their respective industry.

[Please reference slide 13] We put together this slide to highlight the differentiation of US Value's portfolio compared to the index. Here we show you a few of our largest technology investments compared to the S&P 500's largest consumer staples products companies—a sector we have no disclosed exposure to. Looking at metrics such as ROE, which shows you that all these businesses are quality in nature, but that doesn't tell you how the businesses will perform going forward.

As you look at consensus estimates for revenue and EPS growth, you can see a stark contrast between the two groups, whereby these large tech companies are generally growing at well above-average rates while these consumer staples stocks are growing at average or below-average rates.

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When looking at valuation, you can see that Alphabet and Facebook trade at a bit of a premium compared to the big three consumer staples companies, but are growing much faster. Apple trades at a meaningful valuation discount, despite similar expected growth, to the likes of P&G, Coca-Cola and PepsiCo.

The bottom line is we believe most consumer staples stocks at current prices offer return-free risk, while we think three of our largest tech investments will generate above-average earnings growth, translating into above-average investment returns over the long run.²

[Please reference slide 14] Lastly, on the left-hand side is US Value's performance net of fees. As we already discussed, during the first nine quarters of management, we constructed US Value's portfolio very

² Past performance is not indicative of future results and there is no assurance that the Fund's investment objective will be achieved or that the strategies employed will be successful. As with any investment, there is always the potential for gain, as well as the possibility of loss.as the possibility of loss.

differently compared to the last seven quarters. Additionally, we further changed our portfolio's composition throughout 2018 to end the year with a more in-line weighting of technology-related investments in the Fund. [We believe] maintaining that exposure throughout the first half of the year is a major reason why we have been able to generate outperformance in both the first and second quarters of 2019.

We continue to believe technology is an area we should invest in, given multi-year secular trends related to the internet, digital and mobile revolution that represent the vast majority of growth in our global economy.

In closing, we believe we have a portfolio construction process that positions us better than ever before to achieve our investment objective of long-term growth of capital and, at the same time, hit our goal of outperforming the S&P 500 over full market cycles. We have witnessed a lot of change in the economy and political landscape over the past few years. At the same time, we have learned a lot over the first few years managing this fund, and we look forward to delivering value for fellow shareholders over the coming years.

Again, if you are unable to participate in the live webcast and/or do not get your questions answered, please feel free to reach out to Kristina

Surkova in Client Service to arrange a call with me. Thank you for your confidence and continued support; we truly appreciate it. Now back to you, Kristina, to poll for questions.

(00:27:58)

Kristina: Thank you, Greg. We want to thank those of you who submitted questions in advance. We will cover them first and then turn to questions that might be submitted during the presentation.

And first question is: what is the average discount to intrinsic value in your portfolio?

Gregory: I appreciate the question. To answer precisely, you would need to tell me what kind of economic growth we will see over time, how our companies will grow within the context of those macro conditions, as well as what the risk-free rate of return is, which is tied to US Treasuries.

I think what you're asking is essentially how undervalued our portfolio is and what kind of prospective return we believe we can achieve going forward over the next few years.

If we take a step back and look at where we began 2019, the 10-year US Treasury rate was 2.7%. The S&P 500 was trading at approximately 15 times forward consensus estimated earnings while our portfolio was trading at 16.5 times. At that time, for the next two years,

consensus forecasted revenue and earnings growth for the median S&P 500 company was 8.5% and 10.6% respectively. For our portfolio, it was 11.7% and 14.4%, respectively.

I felt the portfolio was very undervalued at that time. As a result, we were nearly fully invested with just 2.1% in cash. In late 2018 and early 2019, I was buying shares of the Fund and frontloaded my 401(k) contribution in January. Six months later, the S&P 500 trades at approximately 18 times forward consensus estimated earnings, while our portfolio trades at approximately 21 times. However, the 10-year US Treasury rate declined to 2%. Now, consensus estimated revenue and earnings growth for the median S&P 500 company is 6.6% and 12.7% respectively. For our portfolio, consensus is 11.6% and 19.2% respectively. What you see here happening in the market is slower revenue growth expectations being more than offset by the decline in the risk-free rate of return.

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If you look at our portfolio, consensus expectations for our companies' revenue growth has not changed. However, the median multiple has expanded nearly 30% or almost 5 points.

I wish I had a crystal ball to know exactly what the normalized economic growth and long-term interest rates will be in the future. Today, a case could be made that interest rates will be lower for longer. Conversely, a different case could be made for rising rates over time. This will undoubtedly affect the P/E multiple for the market and our portfolio companies.

We are of the simplistic view that even if rates were to decline from here, there is not a ton of multiple expansion left for the US market. This is a long way of saying we still like our portfolio companies, but they are not as cheap on an absolute basis as they were at the beginning of the year. Our cash balance is 5.2%, which includes 0.7% of option premium from writing covered calls against 13.4% of portfolio. This gives us a little more downside protection and dry powder should we see a pullback in the market.

I last purchased shares in the Fund on June 3, and have not sold a share this year.

Kristina: Thank you, Greg. Next question is about where are you finding value currently?

Gregory: [Please reference slide 11] If we go back to slide 11, which shows the disclosed sector exposures of the portfolio, you can easily see where we

are not finding value. That is in materials, consumer staples, energy, real estate and utilities. We define value as the relationship of quality to price. We define quality as the ability of a company to have sustainable above-average long-term organic revenue and earnings growth coupled with current or future high return on invested capital.

[Please reference slide 9] If we go back to slide 9, you will see that the vast majority of economic growth is tech-related. Therefore, that is where we are spending our time fishing. There are a number of companies we have on our wish list where the growth is very good but the valuation is not attractive. Other companies like Alphabet, which are in the portfolio, have very good growth and an attractive valuation. We would love to be able to diversify the portfolio more by owning more great businesses, but not at the nosebleed valuation at which some of them currently trade.

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Over time, most great businesses have some sort of hiccup, which can present buying opportunities if one is ready to act.

Kristina: And additional question: what are your thoughts about banks?

Gregory: Well, we currently own Bank of America, JPMorgan Chase, Citigroup and Morgan Stanley. In total, they amount to 6.6% of the portfolio. [Please reference slide 12]

The way we analyze the big banks is similar to how we would analyze any other kind of business. First, you need to think about revenue growth, which is a function of units times price. If you look at the big banks, with the exception of Wells Fargo because of its reputational issues, they are gaining deposits—i.e. units—within the consumer and community banking segment. This is one of the largest divisions of the big banks.

There are a few key reasons why most of the big banks are gaining deposits. First, they have the means to invest more in technology than small community banks. Consumers increasingly want to bank digitally through a mobile app, and when there is an issue, they want to be able to speak to someone 24/7.

Second, they are able to lend across many verticals including mortgages, credit cards and autos. As a result, they have a more holistic view of your banking needs and financial health. This allows big banks to present to the consumer offerings that are more customized, which should help translate into continued gains in banking wallet share.

In terms of price for this segment, it would be net interest margin. The current flat yield curve has hurt this. We think over time this should normalize, but we lack a view on timing.

If you think about the cost side of the business, the big banks are being smart about how they manage their expenses and use their resources. Increasingly, if banks have a good presence in a local market, they are closing superfluous branches and opening new ones in markets where they lack a meaningful presence. For example, I bank with Chase. Close to where I live in Los Angeles, a couple of years ago there were four branches I could go to, and now there are two. However, if you are a Chase Sapphire client, you can use any non-Chase ATM fee-free. This is a win-win for the bank and consumer.

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Moving to some of the big banks' other segments, several of them have very good, growing wealth management businesses. These include JPMorgan, BofA's Merrill Lynch and particularly Morgan Stanley, where it makes up approximately 44% of its profit. The drivers of this business are the growing wealth creation, as can be seen by record equity markets and asset prices such as real estate.

Other businesses such as global banking and markets are cyclical in nature and have been a bit weak recently. However, these continue to be good franchises and should grow with GDP over time.

The big banks' balance sheets are in the best shape they have been at in years. They continue to be overcapitalized, which depresses their ROE. Over time, they should be able to increase their payout ratios and dividends.

When we look at valuation, Citigroup and Morgan Stanley trade at the lowest levels due to their greater mix of revenue and profit tied to global banking and markets. With the exception of JPMorgan, which trades at approximately 11 times forward earnings, the others trade at 8-10 times forward earnings, and they all sport an approximate dividend yield of at least 2.5%, which is higher than the 10-year US Treasury rate.

In summary, we continue to like the big banks at these levels, given their solid fundamentals, and believe they deserve to be part of a diversified portfolio of value-oriented US equities.

Kristina: We'll pause briefly to check for additional questions.

What is your opinion about tobacco and vaping? Sorry.

(00:36:02)

Gregory: Sure. So we generally don't want to discuss our views on things that are not in the portfolio. That would include tobacco, vaping and cannabis companies. That being said, as it relates to the cannabis side, valuations there are quite rosy. Not to say that we would never potentially get involved in something like that, never say never, but today it's not on our radar. Tobacco—first of all, I have issues with tobacco on a personal basis, but aside from that, it is not a healthy, growing industry and so it's just not something that we would consider investing in.

Kristina: Do you see earnings growth, especially in tech, slowing in the second half of the year and into 2020? If so, how would that potentially affect the portfolio? Could you be caught off-guard in a wave of tech earnings downgrades?

Gregory: Yes, look, I mean it's clear that right now, the economic growth for the entire economy is slowing down. Some of it's due to potentially some issues that can be resolved in the future such as our tariffs with China, and China's growth overall. So that could be a (thumb roll @ 00:37:32).

And in terms of tech slowing down, I mean we believe the things that are propelling tech growth are very much secular in nature, and these trends are going to last for a long time. And so if we see business models

eroding, we will potentially readjust our views and sell. Right now, the companies that we're invested in, we have a lot of confidence in. That being said, we closely monitor everything that we're invested in and if there's reason to change our view, we'll change our view.

(00:38:14)

Kristina: There are no other questions at this time. Thank you for listening to FPA US Value's First Half 2019 Webcast. We will now turn it over to the system moderator for closing comments and disclosures.

Moderator: [Please reference slides 16-18] Thank you for your participation in today's webcast. We invite you, your colleagues and shareholders to listen to the playback of this recording and view the presentation slides that will be available on our website within a few days at FPA.com. We urge you to visit the website for additional information on the Fund such as complete portfolio holdings, historical returns, and after-tax returns.

Following today's webcast, you will have the opportunity to provide your feedback and submit any comments or suggestions. We encourage you to complete this portion of the webcast. We know your time is valuable, and we do appreciate and review all of your comments.

Please visit FPA.com for future webcast information, including replays. We will post the date and the time of the prospective calls to

forward to end of each current quarter and expect the calls to be held three to four weeks following each quarter end.

If you did not receive an invitation via email for today's webcast and would like to receive them, please email us at crm@fpa.com.

We hope that our quarterly commentaries, webcasts and special commentaries will continue to keep you appropriately informed on the strategy.

We do want to make sure that you understand that the views expressed on this call are as of today and are subject to change based on market and other conditions. These views may differ from other portfolio managers and analysts of the firm as a whole and are not intended to be a forecast of future events, a guarantee of future results, or investment advice.

(00:40:09)

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You should consider the Fund's investment objectives, risks, charges and expenses carefully before you invest. The prospectus details the Fund's objectives and policies, changes and other matters of interest to the prospective investor. Please read the prospectus carefully before investing. The prospectus may be obtained by visiting the website at www.fpa.com, by email at crm@fpa.com, tollfree by calling 1-800-982-4372 or by contacting the Fund in writing. **FPA Funds are offered by UMB Distribution Services, LLC.**

This concludes today's call. Thank you and enjoy the rest of your day.

(00:41:18)

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