Reaction to New Morningstar Stewardship Grades

Morningstar recently announced their revised Stewardship grades. The FPA Fund family has been included as one of the Top Ten Fund Families for stewardship by Morningstar (number 10), and the overall stewardship grades for FPA Paramount Fund and FPA Perennial Fund were raised from a “B” to an “A;” however, FPA Crescent’s overall grade remained unchanged at “C” and FPA Capital Fund and FPA New Income were downgraded from “A” to “B.”

Despite our number 10 fund family ranking, we are disappointed by Morningstar’s results. Our review of Morningstar’s analyses revealed some problems with their process and inconsistencies in their results for the Fund Families included in their Top Ten list. We sent a letter (included below) to Morningstar in an effort to have them reconsider some of their grading methodology. It is clear to us that their “one-size-fits-all” approach is deficient in several areas. At this time Morningstar is unwilling to reconsider their methodology but, ironically, they also do not want to see us change how we oversee the FPA Funds. We agree and we will not compromise our successful stewardship efforts in order to fit into a third party’s model. They did tell us that as new information becomes available they will be reviewing the results of their revised methodology to see if there are areas to improve their grading. We are waiting for a formal written response from Morningstar and will update you on their comments as soon as they are received.

At FPA we take our stewardship role seriously. Part of our responsibility is to educate our Fund shareholders by responding in a frank and open manner when we are confronted with serious issues that affect you and your investment in the FPA Funds. By allowing you to read our response to Morningstar, we trust that you will gain further insight into our culture at FPA. Rest assured that nothing has diverted our focus, and the growth and protection of your capital are still paramount in our thinking. We continue to be grateful for the trust you have placed in us.

October 15, 2007

Morningstar
225 West Wacker Drive
Chicago, IL 60606

Re: Morningstar’s Stewardship Grade of the FPA Funds

I am writing on behalf of the FPA Funds and their adviser, First Pacific Advisors, LLC, regarding your recent release of revised stewardship grades and methodologies. We have historically maintained an open dialogue with the analysts at Morningstar on a variety of topics, including the stewardship grading process, qualitative fund evaluation, and tax efficiency. We appreciate the effort and thought that is required to develop a stewardship grading methodology and recognize the enormity of the challenge of maintaining consistency across firms and funds that have diverse ownership structures and strategies. However, it appears that there are some shortcomings to your one-size-fits-all model and some inconsistent application of grade criteria between fund families. We feel these shortcomings and inconsistencies misrepresent the high stewardship standards enforced by the Boards and the adviser to the FPA Funds. Our review was limited to the top 10 Fund Families from your recent announcement. One of our most significant observations is that in some areas, namely Board Quality and Manager Incentives, you allow little or no room for subjective observations to override the model when funds and/or advisory firms have structures that deviate from the norm, but in the broad area of Corporate Culture, you seem willing to qualitatively assess the different approaches taken by each fund family. It is puzzling to us how you are able to subjectively analyze cultural factors so easily, yet seem unable to do so in other areas.

Corporate Culture
It is clear to us that you believe this is an area of utmost importance for grading, and we wholeheartedly agree. It appears that your analysts have taken many subjective factors into consideration before assigning a grade. By reading how a number of different firms achieve an “A” grade while utilizing very

different approaches, we are encouraged that Morningstar analysts have the ability to weigh the benefits of a number of different management and operational structures that seem to work well for each of the entities being graded. For example, some of the advisers to the top10 families are publicly traded and some are not; some managers own equity in the firm, some do not; some funds have independent board chairs, some do not; some funds have a super-majority of independent board members, some do not; some managers have performance-based compensation models, some do not; some funds have low relative fees, some do not. Yet, even with all of these differences, the analysts have been able to justify "A" grades in this category for all of the top 10 families. We applaud you for your thoughtfulness and wisdom in assessing this area.

Board Quality

In our review of this category and Manager Incentives below, we found a far less subjective analysis. For example, three of our five FPA Funds received lower grades because they do not have an independent chairman (Capital, Crescent and New Income); however, three of the five independent directors are members of all five Boards, including the chairmen of Paramount and Perennial. The independent directors simply chose not to elect an independent chairman for a number of reasons including that they have adequate influence in setting the Boards' agendas, adequate access to management, and that the corporate culture remains very strong.

In your analysis of Capital, Crescent and New Income your analyst states "…we'd suspect that Bob Rodriguez/Steve Romick plays a big role in setting the fund's agenda, but that's unclear." If your analyst had taken the time to ask, he would have realized that Bob and Steve only play a very minor role in setting the Board agenda. In addition, we have seen no evidence that an independent chairman actually improves the quality of a fund. This is one of the issues the SEC is debating right now as it ponders its much-maligned governance regulation. We are sure you are aware that of your top 10 fund families, only 5 have an independent chairman, which raises serious doubt about whether an independent board chairman truly makes a difference of any significance.

Manager Incentives

Again, here is a category where your strict application of a "best practice" framework does not do justice to the grading of overall manager incentive. In addition, there seems to be some inconsistent interpretation of fund disclosures. For example, your number one family, Clipper, is managed by Chris Davis and Ken Feinberg. (From what we know of Messrs. Davis and Feinberg, they have our respect. We use them and the other managers mentioned below as examples to support our argument, not to criticize them.) As equity owners of Davis Advisors, they clearly must derive a significant portion of their income and net worth from the value of the equity in their firm. In addition, Chris Davis receives no incentive compensation or bonus for his participation on Clipper. Most of the compensation earned by Ken Feinberg (three of the four types listed) have no relation to the performance of Clipper. We think it is absurd to be, as your analysis of Clipper reads, "…pleased that Christopher Davis is not receiving bonus compensation, and Feinberg's pay depends on long-term performance (emphasis added)" when just prior your analysis of Clipper reads "It's impossible to say whether the managers' stake in the advisor is financially more meaningful than the fund-share awards that they receive." How can Feinberg's pay be dependent on the long-term performance of Clipper? How does no incentive compensation for Davis create the type of Manager Incentives you are looking for? These gentlemen receive an "A" for the Manager Incentives category, yet the managers of the FPA Funds only receive a "C" for this category. All of the FPA Fund managers are equity owners of the adviser which is no different than Messrs. Davis and Feinberg.

The same inconsistency is seen in your analysis of Diamond Hill and the incentive for its CEO, Ric Dillon. As with Davis and Diamond Hill, the managers of the FPA Funds, as equity owners of the management company, receive compensation not only from their participation in the management of the fund, but also from the profits or profitability of the firm. Managers who own their business will tend to have a much greater incentive and longer time horizon for stewardship over both the business they manage and the funds they advise. This long-term incentive is to properly manage both entities because the value derived by the owner/manager's equity is based on the quality and performance of their business and the funds, which ultimately benefits fund shareholders. Your desire to see fund performance-based compensation may be appropriate for non-owners, but the reality for those firms where the managers are significant owners of the business is that they will not have any meaningful fund performance-based compensation structured as you would like to see it. The bottom line is that if they are not good stewards and their business does not perform the value of their organization will be impaired.

Clipper, Davis, Diamond Hill, Oakmark and FPA are all firms where the managers (or at least the lead managers) would appear to derive the majority of their value from the sustained profitability of the firm and the entire range of products they offer, not from a strict fund performance incentive plan. In fact, only two families in your top 10 have manager incentive programs that meet your definition of ideal, and none of those fund managers own their business. When 80% of the highest ranked families do not have Manager Incentives as you would like to see them, this raises a question about the validity of the criteria used to measure your stewardship ideal.

Steven Romick and I have had several lengthy conversations this year with Morningstar analysts regarding stewardship. We initiated these discussions because we wanted to know how Morningstar views the FPA Funds from a stewardship perspective and to provide our insight on how to characterize firms that may not look like your ideal. Your analysts volunteered that the FPA Funds should score even higher under your new grading system because of changes to how the various factors are weighed. The only issue of significance raised by your analysts was the amount each manager has invested in the funds they manage. As of mid-year, each of the lead managers of the FPA Funds had increased his ownership above the $1 million threshold (Bob Rodriguez was already there on both FPA Capital and FPA New Income). The other managers of the FPA Funds have also increased their ownership.

With the recent announcement of your new stewardship grades, not only did FPA Crescent remain unchanged at “C,” but FPA Capital and FPA New Income were downgraded to “B.” Bob Rodriguez has led Capital and New Income for more than 20 years and, along with FPA, he has championed the high ethical and stewardship standards that govern the management of the FPA Funds. The same can be said of Steven Romick’s stewardship over FPA Crescent Fund, for he too has been a champion for shareholders and high ethical standards.

Your organization is highly respected by the investing community and serves a very important function of educating the investing public. Our reason for bringing these issues to your attention is simple – we feel that the inconsistent application of your stewardship grades, in the two areas noted above in particular, unfairly penalize our firm and unfairly benefit others. While most fund families would be ecstatic to be in your top 10, we feel slighted. We do this not so much to criticize Morningstar, but to continue our fight to protect the interests of the shareholders in the FPA Funds and the partners of First Pacific Advisors, LLC.

To be perfectly clear, we feel your overall grading of FPA Crescent at “C”, and FPA Capital and FPA New Income at “B,” is unacceptable given some questionable criteria and the inequitable application of your measurement metrics across different fund families, most notably in the areas of Board Quality and Manager Incentives. Steven and I are prepared to discuss a re-examination of your conclusions regarding our stewardship over these Funds. We request a timely response.

Sincerely,

J. Richard Atwood Chief Operating