Brande: Good afternoon, and thank you for joining us today. We would like to welcome you to FPA Crescent's Fourth Quarter 2015 webcast. My name is Brande Winget. The audio, transcript, and visual replay of today's webcast will be made available on our website, fpafunds.com. Momentarily you will hear from Steven Romick, Brian Selmo, and Mark Landecker, the Portfolio Managers of our Contrarian Value Strategy, which includes the FPA Crescent Fund. Steven has managed the FPA Crescent Fund since its inception in 1993, with Brian and Mark joining Steven as Portfolio Managers in June of 2013. At this time, it is my pleasure to introduce Steven Romick.

Steven: Thank you, Brande. So going through our usual slide presentation at the beginning, the familiarity of these slides is, I'm sure, there for most of you, and we'll get to some original slides later on.

The philosophy of the Fund remains unchanged: equity-like rates of return with less risk over time. We delivered on our goals over more than two decades, albeit not every period in between. Our focus, as always, is to deliver returns over the long term which encompasses full market cycles.

2015 is a good example of not beating all benchmarks in shorter timeframes. The Fund increased 2.8% in the fourth quarter but declined

2.1% for the full year—only the third year out of 22 in which the Fund has lost money. Although Crescent has not recently outperformed the S&P 500, it has outperformed the broader global indices like the MSCI ACWI Index, and that global index dovetails with the Fund's more global exposure in the last seven years.

We seem to have witnessed the end of the commodity super cycle last year. Price movement of steel, oil, copper, etc. felt like something like the straight line down of this chart. So with broad global indices declining last year, this has had a significant impact on many companies around the world—the commodity index and the commodity price declines I'm talking about—and helped contribute to decline (2:02) in the MSCI ACWI Index, which ended the year down 2%. However that doesn't seem so bad when compared to the year-to-date number through yesterday, with the ACWI Index being down 8%.

Most of the U.S. stocks didn't perform as well as the S&P 500. Just to express the narrowness over a few series of slides, the broader Russell 3000 Index with six times as many companies was up just 0.5% in 2015, and growth outperformed value by more than nine percentage points. We've always argued that high-yield bonds are more like equities than high-grade bonds, and in 2015 we certainly evinced that with the Barclays

U.S. Corporate High-Yield Index declining 4.5%. Again expressing the narrowness in the market, without the top five Index contributors, the S&P 500 would have also declined. Google, Amazon, Facebook, General Electric, and Microsoft contributed almost 3% to the S&P 500 returns last year without which the Index would've declined about 1.6%. We at least own three of the five—Google, GE, and Microsoft.

On average, the bigger a company's market cap was, the better it performed. Companies with market caps greater than $100 billion increased on average 4.4%. Those less than 100 billion but larger than 50 billion increased a couple percent, and everything else declined—particularly smaller companies. Those with less than $5 billion in market cap declined almost 20% last year. Further reflecting the narrowness of the market, the largest 30 companies delivered returns of almost 3%, while the other 470 on average declined 1.5%.

2015 was not a good year any way you cut it. Crescent's winners for the quarter and year contributed 2.1% and 2.3%, while its losers detracted 1% and 2.9%. The more cyclical companies, particularly those with commodity exposure, (4:01) were the weaker part of our portfolio. In hindsight, we thankfully had a small allocation to such businesses.

We had some puts and takes that drove 2015's performance. Of our technology investments, Microsoft and Google performed quite well, but Oracle lagged. Oracle continued to transition its business to the cloud last year but has been proceeding more slowly than either investors or the company expected. Concern about the transition and weak software license sales led to the stock's decline. Given the undemanding valuation and high level of recurring revenue, we used the drop in the share price to increase our position.

Alcoa's stock price was negatively impacted by weak aluminum prices and inventory adjustments in the aerospace supply chain. We support the company's decision to separate its highly engineered value-added aerospace business from its commodity aluminum operations. As the prices declined in the last year, we've double the number of shares we own and are hopeful that the pending spinoff will create clarity and value for the enterprise.

Joy Global was just an outright mistake—a poor investment decision that we wish we could take back, which… unfortunately the market doesn't let us. When analyzing the situation, we gave too much weight to the company's strong market position and attractive aftermarket profile. We failed to appreciate the degree to which the coal market had changed. Many regions in which Joy is particularly strong competitive position are likely to produce significantly less coal going forward. This has resulted in a permanent impairment to our position in Joy. Realizing our mistake, we have been sellers.

Our active long positions lost us money in 2015, down about 1%, behind the S&P 500, but our performance was ahead of the 3% loss in the S&P 500 Value Index and the 2% decline seen in the Global MSCI Index. If one were to call 2014 a wash, this is only the second year of the last ten that our long positions underperformed the S&P. But we've been ahead of the Value Index in every year since 2008 and ahead of the MSCI ACWI Index every year since 2007.

In the last year, we spoke of the importance of gauging performance over market cycles. (6:00) As you can see from these charts, Crescent continues to meet its goal of achieving equity rates of return with less risk in the market. Our returns have exceeded the indices and have done so with less of a drawdown.

Let's look at the Fund's draw-downs versus pertinent benchmarks beginning in the financial crisis when the market declined in excess of 10%. Our quest for value has taken us overseas, and our portfolio is more global than it has been in the past. Almost half of our equity holdings and almost one-third of our equity exposures are foreign domiciled. Since having tilted our portfolio more globally, our draw-downs continue to fall in that 55–65% range over time.

We recognize that value isn't always in vogue, but we aren't going to change our style to accommodate the latest fashion. It never feels good to see a portfolio decline in value—our portfolio too—but over three decades of investing, we appreciate that we can neither time nor always be in step with the market. It wouldn't surprise us that we begin to find more opportunities and further increase our risk exposure but our downside capture could increase.

It's not just where a company is based that's important—and we think globally. It's where a company gets it sales. Less than half the revenues of the companies we own are derived from business conducted in the United States. The market capitalization in our portfolio remains a sizable $112 billion, although the median market capitalization is a much smaller $26 billion. Our companies on average are of good quality, well capitalized, and recently getting cheaper.

The Fund's risk exposure at 61% is higher than 55% that you saw a year ago, a function of beginning to take advantage of price declines, but still below our historic average.

Some of the market tailwinds that we've seen globally aren't structural and will therefore come and go. It is not our birthright to have declining rates throughout our lifetime, yet a persistent declining interest rates to all-time lows has been the biggest driver of asset prices.

Low interest rates can drive you away from conservative bonds or bank savings accounts (8:00) and lead you to assume more risk than might be appropriate for either your net worth or your psyche. That's low rates. How about negative rates that are now found in sovereign debt in other parts of the world? You're negative out to the ten-year in Switzerland, to the six-year in Germany, to the four-year in France, and three-year in Japan. People are willing to pay these countries to store their money. There's no way negative rates don't impact investor behavior, causing people for example to put money in stocks and bid them up—stocks, real estate, and other risk assets.

We can only guess as to what's going to happen next. Listening to interviews with former Fed Chairman Ben Bernanke lead us to wonder if we're also due for negative rates in the U.S., as he has been talking about the idea that the Fed might have no choice but to drop rates below zero for the first time in history.

Part and parcel with low rates is central bank quantitative easing. Central banks at developed economies have seen their balance sheets balloon, and it should be no surprise that stocks around the world have ballooned with it.

Rates haven't been the only tailwind. There have been others like the huge shareholder repurchases in recent years that's been additive to earnings per share growth. Without share repurchases, EPS would've been negative in the third quarter of 2015. The data's not out for the fourth quarter yet.

Companies on average have not been great timers of their purchases. I'm generalizing here, but many have either not optimized or destroyed capital along the way thanks to indiscriminate share repurchase programs. Corporate share repurchases also take supply out of the market, aiding stock market performance assuming constant demand. Companies have repurchased $2.6 trillion of stock in the last five years alone. That's more than what the Fed has spent on QE and equates to about 15% of the market capitalization of the S&P 500.

(10:03) Meanwhile, thanks to M&A activity, companies have been taken out of the market more quickly than ever. Fewer companies to buy reduces supply. Demand picks up when market performance is aided by companies being taken at a premium. This has been more fuel for the stock market. 304 public companies were acquired last year, a record amount that makes stocks feel like an endangered species, and only a very small fraction of that found their way to market via IPOs and offset. Now that we're left with less, the Wilshire 5000 Index should probably change its name to the Wilshire 3704.

Those have been some of the tailwinds, and until recently there hasn't been much in the way of headwinds. So the stock market remains relatively elevated. As you can see, P/Es still aren't particularly low—about 24 times and in the 89th percentile. That's the year end number. At year end 2015, the S&P was valued at the same high levels seen at the market peaks in 2001 and 2007—P/Es around 18–19 times earnings; price-to-sales higher now, 2.1, than it was at prior peaks; and price-to-book that's around three times.

So the question is: what comes next? We saw significant decline after prior market peaks in the market. The question is: what happens to this right side of the chart? On past conference calls, we said that more volatility was likely. That's happened, and we expect that to continue to be the case. It's interesting to us though that people only seem to think about downside volatility. You never hear people say, “Wow, the market’s up 50%. Boy, is it volatile.”

High-yield and distressed debt has been a tool in our tool chest since our inception. However we don’t feel particularly compelled to invest in junk bonds all the time. For good investments in high yield, we want to make sure the adjective “high” is there. As you can see, our exposure to high-yield fluctuates (12:00) and is a function of both yield and spread. It’s been as low as 1–2% in our portfolio and higher than 30%. It’s been on the low end for some time and has just begun to pick up.

We thought we’d chat a bit about high-yield because we hope that yields rise further still and the Fund’s exposure along with it. The Fund’s exposure in high-yield currently stands at 3.9%. As spreads widen between high-yield and Treasuries, we continued to increase our exposure last quarter, but only moderately, as we suspect that there’s more disruption to come.

It’s been mostly energy that’s collapsed. Since the energy sector represented about 13% of issuance at the beginning of the year, it couldn’t help but pressure high-yield index returns. We’ve done a tremendous amount of work on energy, and a lot of members of the team have devoted time to it. We’ve tiptoed into this sector. But as we’ve discussed in past letters and on calls, it's not something where we've yet gained great comfort, mostly due to our own inability to either discern the appropriate price of oil or when it might get there. And although spreads are wider—7.1% at year end versus 5.9% average—yields are still below average—8.9% at year end versus 10.4% average.

A few things could cause this to change. (1) Default rates can uptick. We are still sitting at a low level—just 1.8% for the trailing 12 months. They've been as high as 11% in the past. We suspect they'll rise, although we don't know how high. Junk bond yields would rise along with it, which means of course that bond prices would decline. Once a bond defaults, there's a restructuring or liquidation and some level of recovery. Recently, recoveries in defaulted debt have been about as low as they've ever been—running just around 28% last year, well below an average of slightly in excess of 40%.

The return distribution of a high-yield portfolio can be considered in the context of three variables: gross of starting yield, default rate, and recovery. To aid in understanding our thinking, we lay out a (14:00) range of incremental outcomes beginning with what yields were at the end of 2014 and culminating in the extreme case of yields seen during the financial crisis in early 2009. We used various starting yields, average versus peak default rates, and average recoveries in our scenarios.

So to walk through these cases, you can see Case 1 on the screen right here. We use a 7% gross index yield at year end 2014 and apply the historic average default rate of 3.6% and recovery rate of 41.5%. The net yield to maturity recovery would be 4.9% in that case. However, if default rates were to hit peak levels, then the net yield would decline to 0.6%. And if recoveries were to be below average as they've been recently, then the net yield could become a loss.

Looking at Case 2, high-yield bonds declined in 2015, so the gross yield was higher at year end 2015 than it was at the end of 2014. Using the same default and recovery assumptions as Case 1, Case 2's range of outcomes extends from 0.3% to 6.8%.

Looking at Case 3, rather than using the Index yield, we'll use the yield to maturity of FPA Crescent's high-yield bond book at the end of last year, 13.4%, as our starting point, which was 4.5% wider than the Index. With the same default and recovery assumptions as the prior cases, the range of expected returns if held to maturity improves to 4.8% to 11.3%.

And that leaves us with the pie-in-the-sky what-if scenario. What if yields reach past peaks? Keeping the other assumptions constant, the net yield range improves further to 11–18%. Although we aren't waiting for Case 4, you'll likely find our exposure to junk bonds will rise should yields continue to increase, as was happening in Q4.

We think we are being appropriately prudent rather than greedy. We have seen in the past yields and spreads in excess of 20%. (16:00) We don't know if they'll blow out as much in the future, but we aren't going to get that aggressive until they at least move in that general direction. We recognize we can't pick a bottom, and we welcome the opportunity to add to a position as prices decline. We'd be getting the opportunity to invest additional capital at a better price. However—and this is important—that does mean there could be negative marks in the portfolio. Our Strategy succeeds only if we and shareholders have staying power.

We've seen unprecedented high-yield issuance of $1.7 trillion in the past six years. To put that in perspective, the entire high-yield market is a slightly smaller number—something on the order of $1.5–1.6 trillion. Of that, around 300 billion was issued either triple-C or without a rating—also unprecedented. We expect some portion of this to be our future opportunity set.

It's been easy money for quite some time, but lax underwriting standards usually lead to an increase in defaults. But it hasn't really happened to any great degree—yet anyway. We think defaults will bump up, and maybe it will be due to a recession, or maybe it's because a business never should've had that kind of debt to begin with. Or maybe it'll be that capital isn't available when it comes time to refinance. It's going to be up-ticking over the next few years, but it may take a little bit longer because the bulk of junk bond maturities come in the 2020–22 timeframe—about $750 billion worth, roughly half the market.

Now before I turn it over to Q&A, I'd like to set the stage. If you submitted a question that we don't answer, then some combination of the following conditions may apply: our answer may impact our ability to position the portfolio, and this might pertain to positions that we're either currently buying or selling, or reasonably intend to do so; (2) we don't have either an educated view or a strong view; therefore an answer from us would be of little value to you; (3) we believe that prepared remarks or answers to previous questions have already addressed a topic; and (4) we've received some questions about companies we don't own. (18:01) For the most part we think it is more productive as part of this hour together to focus only on our portfolio. If there are questions we don't have time to get to or should there be questions to which you'd prefer a more robust response, then please reach out to Brande Winget, who leads our Client Service Team. We will do our best to get the information you seek.

So turning to Q&A, I've been speaking, but there's some questions that have come over the transom. Mark and Brian are sitting here with me. And, guys, do you want to start addressing the questions that are coming through?

Mark: I'll take the first one. What is the significance of elimination of positions in Walgreens, CVS, and Express Scripts since 9/30? And I'll use this to talk about some underlying portfolio changes going back to last summer. So those of you who may have listened to the transcripts… excuse me, read the transcripts or listened to the calls maybe nine months ago, you would've heard that we were finding relatively little to do, almost nothing we were excited about buying, and we were basically holding our noses at the valuations of some holdings that we thought were quality companies but we were unsure if they'd be able to eke out significant gain—perhaps equity-type returns at best.

Well, since that time we started to sell down many of our quality positions, and in those buckets we would include Walgreens, CVS, and Express Scripts, who we think are fine companies but whose valuations we thought were somewhat stretched given the underlying risk/rewards of the business. Now whether it be by luck or not, some of the businesses have hit bumps in the road, like Express Scripts, since then, and some of them continued to deliver admirably. The common characteristic, however, that they all shared was that the multiples at the time really were devoid of a margin of safety. And with that in mind, we've seen sales not only of the names mentioned in the question but some of the other "quality or compounder" type names in the portfolio going back about nine months.

Brian: And I'll wrap that in to a couple of other questions (20:01) that we got around valuations and asset allocations. And so the first question is: please talk about valuations and what level it would take to materially decrease your cash balance. I think, as Mark mentioned, a number of holdings in what we'll call quality businesses have gotten to a point or got to a point that were really too expensive for us to hold. And as we would have mentioned on previous calls, it has been true through to date… is that a few areas such as financials, commodities, and light industrial businesses have generally been cheaper. So the portfolio has begun to tilt towards those type of investments with more compelling fundamental valuations.

Now with that said, we don't want to put the entire portfolio into investments or sectors that we think are more commercial or more three-to-one in nature because the risk profile of those type of investments, particularly when they're in one sector or subject to one or two common macro drivers would create too much portfolio-level risk. And that's why you have largely seen the portfolio shift from more expensive, higher quality businesses to less expensive, fundamentally cheap, and probably more commercial and somewhat riskier businesses. And under all of that, we've had a somewhat similar but increasing overall invested exposure.

Steven: There's a number of questions relating to drawdown experience and where it appears to… particularly I think probably more to newer shareholders than long-time shareholders, it appears to be something more significant than it might have been in the past in that we were perceived to be less defensive than we have been. So let me address these.

And as we laid out in our prepared remarks in the downside capture slide, our recent experience isn't terribly dissimilar from points in the past when compared to appropriate benchmarks. (22:01) Our downside capture looks worse relative to S&P admittedly. But as I said before, less than half the companies we own are even in the S&P, and these companies represent almost a third of our capital—capital invested.

Another contributing factor is that value has underperformed growth. Now from the May peak through yesterday, Crescent declined about 11%, 69% of decline of the MSCI ACWI Index. This is not unusual if you look at our history, as many of our long-term shareholders are well aware. There have been points when our downside capture has far exceeded that level. As one example, prior to adding large caps to our toolkit, when we were really more doing more small and mid cap stocks, we had a 300% downside capture in the 1999–2000 period versus the Russell 2500. And yet we still accomplished our goals over full market cycles. We tend to lose a battle or two as long as we win the war.

Now Ryan Leggio at FPA has done a lot of great studies on this and our performance, and he'll make himself available to walk you through this in far more detail if you'd like.

Mark: I'm going to take… There's a question about valuations and what levels it would take to materially decrease your cash balance. So we really start at a bottoms-up level when we invest in these securities for purchase. And Brian might add to this, but what I'll say is, to see us materially increase our exposure overall, I think the two categories that you'd have to see us get excited about are (1) high-yield and (2) quality companies.

So we've already put a fair number of "commercial" opportunities into the portfolio, as we just discussed. And absent that, I think I can generally speak for the team when I say our favorite type of investments would be high-yield and compounders. High-yield because you get contractual commitments and often, if we've done our analysis right, it's almost impossible that we think we lose. Stranger things have happened, but we can often underwrite investments where we say, (24:00) even if the worst case happens, we still think we're protected. And then the compounders we get excited about because of the multiyear runway for potential compounding returns. The commercial is sort of the buffer that's fit in the middle. Unfortunately that's what we're finding the most… the opportunities at the moment, but we're unlikely to make that the bulk of the portfolio.

So what we need to summarize would be either high-yield blowing out in sectors aside simply from energy, and we'd have to see the quality companies start to come off a bit more than they have.

Steven: If we had an entire portfolio of the more commercial opportunities, the entire portfolio would be a lot more volatile than it is. And we like to have a balance of different kinds of investments in the portfolio. We don't generally tilt it to entirely one place or another.

A question was asked about: if stocks are generally overvalued, why would Crescent net stock exposure not be lower than it presently is. And we have been on record many times talking about the… not in understanding what direction the stock market will ever go. If companies are very, very cheap, you will see our exposure go up. If they're crazy expensive, you'll see our exposure go down. We're not in a place in a context of low rates, and who knows how long rates will remain this low. We're not in a place where stocks are horribly overvalued. One could justify them with low rates if rates remain low, particularly if rates keep going down. So we tend to be more agnostic as to… at this point in time more agnostic as to how we're going to position the portfolio in terms of our exposures—whether we have… we're not willing to be completely disinvested nor completely invested. And whether we're 50 or 60%, a lot of that's just noise in a ten-point spread. So if you really… with these things really cheap, you'll see our portfolio get up to 80% invested, or something of that ilk. And that could be more a combination of stocks and, as Mark pointed out, high-yield bonds.

Mark: So the question… Brian will chime in as well. (26:01) I'll take the first stab. What is your view on the downside of the aero cycle given your investment in UTX? So UTX was actually reviewed on our last conference call, I believe, by Brian. It's got four divisions, one of which is… or two of which, I guess, have some aerospace exposure.

Brian: Call it half aerospace.

Mark: Yeah, half if we…

Brian: Yeah.

Mark: But if you think about the portfolio where we've got aerospace exposure, we've got GE who make engines. We've got UTX. We've got Meggitt and Esterline. Those are the bulk of the aerospace exposure. Now not exclusively, but the majority of the investments we actually own because of the money they make in the aftermarket as opposed to new builds. Esterline's a bit more tilted. They've got the least aftermarket exposure out of all our companies. But if you think about the group as a whole, we made the investment based on the aftermarket revenue. So if you look at a company like GE, UTX, even Meggitt for that matter, when the new build cycle's going on, margins actually get depressed, and cash flows get depressed because it's the equivalent of making CapEx investments that won't pay off for a very long time.

Now we've not made these investments predicated on a bull view that the aero cycle will be longer or stronger than others. We've made it based on the fact that it's tough to get onto platforms, and, once you're on in the incumbent, you're essentially there almost forever, assuming you're in the right part of the plane where it's difficult to swap you out. And so with that in mind, these companies would not escape an aero cycle downturn unscathed, but it's not central to the thesis of why we invested.

Brian, you've got…

Brian: Yeah, the companies are generally well financed, and longer term the demand for aero manufactured parts will go up with average seat mile growth. And certainly the new build deliveries will be cyclical, and they're probably running at a peak, or they may have peaked last year. But over time we would expect the seat miles to kind of continue to grow at 4–6% on a long-term basis, which should provide for nice demand, (28:02) as Mark mentioned, for those aftermarket parts, which is where the majority of profitability lies.

Mark: There's a question: with all the negative rates around the world, are you guys worried about deflation? We're probably the wrong people to ask about macro forecasts or concerns to a large degree. I think we worry about everything. Long-time listeners will know that. But we really take a bottom-up approach each time we look at a potential investment, and so with that in mind it's not something we spend a lot of time or actually any time talking about internally. What we're really focused on is looking at the merits of any particular investment from a bottoms-up basis.

Brian: And where the worries come into the portfolio or position analysis is that there are some businesses that are going to be more fragile in the environment of deflation or inflation or some type of uncontrolled conflict in the Middle East or some kind of spike or depression in commodities. And so those positions will tend to be smaller because we do have general macro worries—maybe not specific. We certainly don't have a hypothesis or thesis about where these macro things will go, but we respect the impact that they could have on various businesses. So what that does is it makes it such that, even if the valuation as currently reported or as one might expect in a 90% likely scenario were to be super compelling, if we're aware of some macro concerns that might disrupt or ruin the investment or the business, we're going to then size the position smaller.

Mark: We basically want to avoid stepping on landmines and having own goals. And so with that in mind, the good analogy would be, if you go back to the past housing boom, housing stocks look cheap at low price-to-book. You could easily fashion a case if they were at a single-digit P/E, but Crescent didn't get involved in housing stocks back then because we were aware that it looked like the housing market was elevated and possibly in the midst of a boom. And you can think we try to use similar analogies (30:00) when we're looking at investments on a bottom-up basis to make sure.

Steven: And to add on to that… this will answer a question that's on the board right now… is it asks our view of MLPs. And we've been very vocal in the past about MLPs. MLPs didn't look… become a very attractive investment for many years, and we've been very negative on them just because we felt that the risks weren't understood. As Brian was pointing out, we tried to analyze what potential risks might be out there and incorporate them into our view as to the future.

So when you look at an MLP and you're buying something that is dependent upon low rates for a couple of different reasons: (1) It attracts people to that investment because of a lack of alternatives bidding up prices, one; (2) low rates give them the ability to leverage their balance sheets and borrow money at very, very low rates. And we've been very concerned. So as we look at all business and try and normalize—try to consider what could happen.

And in the case of MLPs, the question has been… that was asked was what are our thoughts. I mean, and we're underwriting them now. We spend a lot of time across the energy sector, and MLPs of course are included in that. But people were buying MLPs without really taking into account the commodity exposure. Well, what happens if the price of energy declines? What happens to production… how much gas or oil is pushed through a certain pipe? What happens to these leveraged entities? And many of these companies have very poor accounting. You're not always treated equally as an LP versus a GP for those companies that have a separate GP. And there's been some questions surrounding accounting—whether it be treatment of options and hedges or whether… what's the right D&A number that a lot of people are willing to add back.

So these are all questions that we consider as we look at MLPs, but many questions like this—what is normal—are very, very important as we look at any business.

Brian: And the specific question, (32:02) what are the team's thoughts with respect to MLPs relative to other avenues in the energy sector, I'll say we have spent time… I think our challenge has been that, when you peel the onion on most things, whether they're service companies, E&Ps, MLPs, they amount to a lot of different ways to express the view that oil will be $60-plus. And we have had trouble finding something that isn't at the end of the day dependent on that type of view.

Steven: There's a question that says: it seems that since 2014 the market's been rewarding stocks at companies growing revenues, not stocks with companies of real value. I understand this has happened in past market cycles. What would you attribute this situation to today? Well, I think that many of these companies that have been growing revenues do have real value, and many of these companies we've sold. I mean, we've sold some of the companies that we've owned. We've sold at 17, 18 times earnings. They've just gone to 20, 21 times earnings, 22 times earnings. In hindsight, yeah, it would've been better to own those companies in terms of performance attribution. However, it's not what we do. We're not in the business of owning high valuation companies.

So when we think about the opportunity set and what's happening in today's cycle, I mean, we never know when a market's going to peak. We never know when a sector will begin to outperform or underperform. And so going back to February of 2000, I don't know why internet stocks peaked there at that level. They could've peaked a year earlier, and they still would've been expensive and deserved to decline. So these are questions we don't know. We don't know why that's… what we can attribute that situation to today. But going back to what Mark said, at the end of the day what we always come back to is: are we buying good businesses at good prices?

Mark: So there's a question up here: can you name two or three companies who you think are smart purchasers of their own stock? We probably don't want to make (34:00) our lives more difficult for ourselves by calling out which management teams we admire the most in companies we like to buy that aren't currently in the portfolio or maybe even calling out the ones that are. Instead what I'll say is, when we speak to management or companies, what we encourage them to do are use their balance sheet to opportunistically purchase shares. So we don't like managers that are formulaic or purchasers that use an X% of cash flow on a regular basis or they try and target X% of shares outstanding or simply to offset dilution of options. What we really want them to look at is weigh the potential returns from a share buyback versus the other options at their disposal with respect to capital allocation.

And so with that in mind, if one wanted to study who one thinks has been good repurchases of stock over time, look back and see what they did in times of distress with their own balance sheet and their own cash flow, and what they did when their valuations in hindsight look to be rather stretched. That means maybe they were trading one or two standard deviations above where they historically traded. Were they buying back stock then, or were they doing it when they traded one or two standard deviations below, to put some math around it? And I think that would answer the question.

Brian, anything to add?

Brian: I think you said it, but it's important to look at the reasons behind the repurchase—not just the amount or whether they have a policy.

Steven: There's a question: what percentage of your shareholder base by number of investors have been shareholders for less than two years? And I just want to defer that to Brande to get back to. Any questions like that that relate to… structural questions related to the Fund should… are best posed to Brande offline because Mark, Brian, and I just don't know the answer.

Brian: So there have been a couple of questions on OI, which is a holding that has not performed well. I would say it's…

Steven: OI is Owens Illinois.

Brian: Owens Illinois, sorry. It has always fallen in the commercial opportunity category. Unlike Joy Global that Steven mentioned, it is not something

(36:00) where we think the business has been fundamentally impaired at this point. They have experienced a significant headwind in the last year in the strengthening of the U.S. dollar and the weakening of foreign currencies, particularly in Brazil. In addition to that, they have decided to significantly lever the balance sheet in order to make an acquisition, which is not something that we support, and it has created more risk in the investment. And as such, we don't necessarily buy things as they go down just because they go down.

Mark: There's a question… an update on the Jardines given China macro concerns. So the Jardines collectively refers to two Singapore-listed holding companies—Jardine Strategic and Jardine Matheson—which are sister companies and ultimately have very similar exposure to the same underlying assets. And there's some cross-holdings within there.

They have exposure to China, but these are companies that have been around 100-plus years. They're run by management teams that take a very long-term approach, I'll say, to value investing much like we do ourselves. So they've been prolific re-purchasers of their shares as of late, which you've not seen in the past.

So I'll give something away. Someone asked earlier about who was a good re-purchaser of shares. We're in favor of the Jardines buying back shares down here versus let's say when emerging market enthusiasm was running wild a few years ago.

With respect to our concern about China macro, look, there could be a bump in the road. You could even have a multiyear period of an economic slowdown. But the Jardines own franchise assets in the form of iconic buildings, iconic retailers, and a number of other smaller holdings as well. They truly are irreplicable, are wonderful businesses and over time should compound and create value. But we can't tell you with any certainty (38:00) how bad an economic slowdown might be in the near future based on the Chinese.

Brian: And one of the things that makes the Jardines comfortable is that they're well financed and don't have holding company debt such that they'll be able to maintain these positions in iconic businesses…

Mark: Yeah. There's…

Brian: …somewhat independent of how difficult the market conditions are for a year or two.

Mark: I'd say they're moderately levered even at the subsidiary level, and then at the holdco level they essentially eschew the use of debt because they say we want to be able to survive the perfect storm and that's how we compound for generations—by making sure no one generation ever loses the keys to the house.

Steven: I mean, if we… it all comes back to staying power. As a value investor, not knowing the duration of what a prospective investment's going to be in order for it to work out, one must have the ability to… assuming the initial premise remains intact, to have the staying power for it to work out. If one doesn't have that ability, one is destined to underperform over time.

There's a follow-up question on MLPs: would the Fund entertain the senior debt of the MLP's general partner as a safer way to earn attractive income and total return than the MLPs directly?

Brian: Yes.

Steven: I think suffice it to say that, when we look at… Well, Brian kind of jumped in front of that one.

Brian: Sorry.

Steven: But suffice it to say that, when we look at levered companies, we're looking at the debt certainly. Now some businesses can handle more leverage than others. Real estate companies can handle more leverage than certain cyclical industrial companies. MLPs by the nature of the midstream businesses can certainly absorb more debt… can sustain more debt than certain other businesses. But with all the debt that exists out there in many of these MLPs, the debt area is certainly, we know, one of focus.

I mean, Brian and I and one of our members of our team went out to go visit an MLP looking at the debt just last fall. I think we scheduled the meeting, Brian, what? The bonds were about 55. By the time we left the meeting two weeks later, (40:00) they were at 30-something.

Brian: Yeah.

Steven: So, I mean, there is opportunity out there. This is a place to shop, and this is… they're hanging a For Sale sign out there to… but now the question's do we want to go an purchase any of that merchandise. And so we want to make sure as we do the analysis—whether it be debt or equity; again we're agnostic… we want to make sure that the asset coverage is there.

Mark: So there's a question: what's meant by commercial opportunities? And for those of you who might be newer to the fund, rather than boring everyone on the call, we'll direct you to the FPA Fund's website where you can find the Contrarian Policy Statement, and that'll give you a full…

Steven: And they'll give you a full understanding of what we do, why we do it, how we do it, the tools we use. And in that policy statement available at our website, you can see the… you'll see a conversation surrounding 3:1s—3:1 risk/reward companies, with three times the upside to the downside.

That's the section you should focus on when it comes to the commercial opportunities.

Mark: There's a question: are there any investment/market analysts you habitually read or listen to? We enjoy reading Jim Grant, "Interest Rate Observer." Some of us are casual readers of Marc Faber, "Doom and Gloom"; Chris Wood, "Greed and Fear." You can tell none of these from the sounds of the reports are bullish authors.

Brian: Gloom and Doom.

Mark: Yeah. So yeah. So that's a… "Bank Credit Analyst" floats around the office a bit, and there's a publication "What I learned This Week,"

Steven: There's a question that asks us about our cash flows and how they've trended form August till now during the periods of market weakness. I think that's a good question because one should expect in a Fund like ours that, when asset prices are rising, our exposures… we tend to back away. We're not excited. We get more excited when asset prices are down, which is why we have been spending as much time as we have been in high-yield.

(42:01) And so, Elliott, will you pull up Slide 41 please? In this slide that we're going to pull up in just a moment, you can see that our risk exposure began to climb in the early summer and then began to… and we sold into the market strength, but then began to build as the weakness in the market took hold. The Fund's risk exposure was 57.6% at the end of June and dropped to 54.6% in July, but ended the year at 61.2%. You can assume with market malaise this January that we've been more a buyer of securities than a seller of securities.

Mark: There's a question: are you adding to the short book? Steve, you want to… So we have two types of shorts. We have stub trades, and then we have what we'll call just outright shorts.

Steven: Yeah, we're a long Fund that does some shorting. One shouldn't think of us as a hedge fund. We do some shorting. We have some… Mark mentioned some of these paired trades. We've got stub trades that that we'll create by being long—as we talked about in a prior call, long Naspers in South Africa and short Tencent in China, and other trades of that ilk. And we do have a small basket of shorts we put in there, but generally speaking these are companies that are really we think have significant headwinds. They're not good businesses. We don't see them as being good businesses in the future.

What we don't do is short businesses that… or what we hope not to do, is short business that we either don't understand or are good businesses and their stocks just happen to be expensive. We did short a number of highly inflated dot-com companies back in the ’99/2000 range, as a question has been posed. But the businesses we were short were businesses that just didn’t make any sense at all. They weren’t real businesses in our view, and then… not just insane valuations, but they did not have a business model that was sustainable. So we come back to the business model, (44:01) and our highest short exposure in the past has been 11% or so.

Mark: There’s a question: do you have any views on currencies? Do you think the dollar will remain strong, etc.? We generally never have any house views towards currencies. That aside, on the occasional exception, we may be particularly bearish or bullish, but this would be the anomaly on a particular currency. The best example would be—and there’s a question, so I’m going to get to that as well… for example the Japanese yen was the rare case where we actually had a house view. This was incredibly rare. And back when we bought Japanese stocks, we hedged the yen, and in addition we bought a Japanese put.

And the question relates to the put… is what’s the trigger for us to reduce the yen put in the portfolio? And I’ll say for that one I think we’re playing for the tail. And so we wouldn’t have any desire to monetize it in the interim simply because it’s moved to be a position that’s different from our cost basis. It would have to sort of play out for us to unwind it before maturity in a very radical way.

Brian: I'm going to answer two questions in one here. In what sectors are you currently finding opportunity, and what can you discuss or what are your views of large money center banks and their current prices implying about business condition? So we have been buying things in financials, and we have been buying high-yield and distressed debt… I would say are the two areas of purchase… most frequent areas of purchase recently.

In terms of thoughts on money center banks and what their prices imply about fundamentals, I would say the prices imply very dire fundamentals. I'll give just one that I've looked at the other day. So we, as you might know, own a position in Citigroup, and so I'm going to share the following with you. If Citigroup were to… (46:00) if you take 2015's reported pretax, pre-provision earnings and multiply that by three, and then you take the cumulative losses that Citi booked—they didn't actually realize them, but they booked—during the financial crisis, at the end of that three-year period… so you took just Citi's current earnings, assumed they earned it for three years, and offset the great financial crisis reserve build—again losses that weren't all ultimately realized at the end of the day—Citi would lose I think a buck-fifty a share over three years. So, that would leave Citi with better than a 12% equity to tangible assets ratio and have lost money for a few years, but a *de minimis* amount of money. So I'd say the pricing suggests a pretty awful next three years. If that circumstance doesn't come to pass, we think there's good opportunity there. If it does come to pass, that would be the reason why these type of investments—commercial opportunities—aren't ever going to dominate the portfolio.

Mark: So speaking of commercial opportunities, there's a question: will you comment on whether your fundamental view of Qualcomm has changed since its first purchase? So Qualcomm we'll put in the commercial bucket. The earnings, our appraisal of earnings has probably come down since it was originally purchased. Not surprisingly the share prices have come down commensurately as well.

So to fast-forward to where we are today, the stock is… I'm not sure where it closed, but call it circa $45. If you tax the cash because some of it's overseas, let's say they got circa ten bucks of cash in broad strokes. So you're at a $35 share price net of the cash, and we think the earnings once you expense stock-based compensation somewhere between $3 and $4 of cash earnings. So we say… we look at it. It's not an expensive stock. There's some optionality on technologies they're working on that currently are (48:00) not in the revenue base that could be quite significant. You've got an unlevered balance sheet. You've got an opportunity now to repurchase shares at we think are let's say relatively attractive prices versus when the company was purchasing shares when we didn't own it at much higher prices. And it seems like there's some awareness at the board and management level that the company has to be run for shareholders now and not just employees. And so we think it sets up somewhat favorably from a risk/reward perspective, and that basically summarizes where we are on Qualcomm at the moment.

Steven: There's a question: do we have views on the impact of ETFs in less liquid areas such as debt and the impact to your portfolio? Well, I mean, ETFs are an exchange-traded fund, so you need to find a… unlike an open-ended mutual fund, you've got to find a buyer at market. So they aren't necessarily forced sellers of bonds. But there is a question of liquidity out there in the market, period, and when you look at debt. And you have a lot of… there's been a lot of… there's been one particular company in the news that has a high-yield… and it's a high-yield fund that was forced into the unfortunate situation of a liquidation. And we are very cautious as we think about liquidity in our portfolio as we look across it both in the equities and the debt.

But what's happening today in the marketplace is, because of a certain lack of liquidity in debt land… and I think we've talked about this before in a past call… and there's been a lot less liquidity lately in corporate bond land, and not the least of which is one of the reasons is some of the grease that's been existing in the system in the past… is the U.S. primary dealers' holdings of corporate debt used to be as high as almost $300 billion, and now it's dropped by 90%. So when you see a bid-ask in the marketplace, you see a bond that trading 68 by 70, the bid-ask is (50:00) less an indication than it is really an invitation to get engaged in a negotiation. And you will see these bids frequently just gap down on us, and we have seen bonds that we either own or are looking to buy or looking to sell. I mean, bonds that have gapped down 10% on practically no volume, or 20% even on practically no volume. We have one example of a bond where the bonds were reset lower, a $500-million issue that we saw trade down… I can't remember if it was 15 or 20% on a half-a-million bonds trading. And so it impacts our portfolio, but only for the moment if those bonds that… for example a bond trades from 80 to 60, but it's worth par, it's just a mark. It's just a moment in time. And so when we consider what we're going to make over time, that par number is what we're… the 100 is what we're focusing on. You want to add to that, Brian?

Brian: I think Steve's chart shows the decline in dealer inventory or holdings. And if you remember Steve's earlier chart, the high-yield market is probably nearly twice as big as it was back in 2007, and so it's even more illiquid as a percentage of the market when you think about dealers, thus their ability to kind of facilitate trades. I would anticipate that will mean some chunky trades. I mean, it does two things for us. In names that we are known to be asked and known to be buyers, it means we get calls because of our size on large chunky pieces of debt. I will not use the name, but within the last month we bought 40 million of a bond. And there was seller, and we got a probably decent improvement in price because we were able to do that. I think things like that will continue to happen during this distressed cycle.

Steven: We want to be the ones in the position of hopefully taking advantage of the forced sellers. (52:00) And having cash in our portfolio allows us to be in that fortunate position. But that does not mean that our portfolio won't go down along with it for a period of time.

Brian: Yeah, you have a mark. I mean, you have experience in the credit market now where bonds mark 2, 3, 4, 5, points on, as Steve mentioned, almost nothing trading. And when you go looking for the bonds, dealers aren't able to offer them for sale at the last price certainly.

Steven: I mean, a good example of this is looking at our past. Looking back to 2008 and '09, Brian and his background, and he brought to the team deep experience in high-yield and distressed. And one of the companies that he was the point person on and architect of for our portfolio was CIT bonds. And we first bought those bonds back… I can't remember. Is it late 2008, I think it was?

Brian: Yep.

Steven: And we bought them some place in the 65, 68 range. It was the first purchase somewhere in that range, right, Brian?

Brian: Yeah.

Steven: Within three or four months those bonds were trading down into the 30s. So what we owned was going down. But how long did it take for those bonds to get back to par? It was within two years, within a year-and-a-half…

Brian: Yeah, within… yeah, certainly two years.

Steven: …within a year-and-a-half from that low. So it was just a mark. It was just a moment in time. And that can shake the faith of the less resolute. And so if you've done your homework and you have the staying power, these end up being excellent opportunities. And the same can be true of equity… not can be—is true of equities, as it is of debt.

Mark: There's a question: small, mid cap stocks have declined more than larger U.S. stocks. Are you finding them more attractive now, etc.? We've been more active in small cap names than we've been for quite a number of years. You've seen that in the addition of Esterline. There's also been some undisclosed holdings that we've been building but have been accumulating that we'll probably reveal or we definitely will reveal over the coming year. I think we can only hide positions for up to one year, if I'm not mistaken. So those will…

Brian: Yeah.

Mark: Yeah, and then Brian and I are just looking at each other. We actually can't recall off hand which names we publicly disclosed. But there's a number. So we'll probably actually maybe reveal some of these down the road, but for the moment we're going to stay mum on which ones we're accumulating. But, yeah, we're finding more to do in small cap land than we have for years.

Steven: There's a follow-up question on this definition of commercial opportunities, and I just want to reiterate: when you go to the website and go to our policy statement—apparently whoever this person is, he found it—just go look at the section that talks about 3:1s.

Brian: There's a question on AIG. I think that it's a… can we discuss our theme? We're fans of the pressure being put on the company to split up and optimize the underlying operations. It's certainly available at a significant discount to tangible book and probably even a more significant discount if you consider what some of the assets might be worth to third parties. And so we would expect AIG to continue to be good stewards of capital in terms of buying back stock at a discount. And over time that value will out both through the company's actions and, if not that, through the actions of shareholders.

Steven: There is a question: what's the best allocation between equity and bonds going forward in 2016? Well, we never know what's really best in advance. We look for the unloved, undervalued, misunderstood. And as I've said, we're agnostic as to industry, region, or asset class. And just because we start buying something doesn't mean it'll go up. Therefore we are never in a position to answer what's going to perform best over any shorter timeframe. And had we known, going back to that CIT example, it was going to go from mid-60s to the mid-30s, we would've waited. We allocate our capital to what we think is the best combination of what's good quality and out of favor, and then we (56:00) position ourselves to wait until it works out—as long as the thesis again remains intact.

Mark: There's a question: you spoke at length about the Naspers/Tencent positions before it made a lot of sense. It has not done well. What happened? What's your latest outlook? So there's a number of factors that play in Naspers. (1) The South African rand has gone against us, which has not helped. (2) They've got a position in Avito in Russia, which is not insignificant. The ruble has gone against us there as well as with their mail.ru position. And then we've seen the gap widen.

This can, I'll say, in part be attributed… the company actually did a placement—meaning Naspers placed shares—at a valuation we would have preferred them not to have done, to be quite honest. We spoke to management about it. We understand why they did it. We would've preferred that they hadn't. And so these stub trades can move over a period of time. They can wide; they can narrow. So we put it on when it was at a negative. It's gone a bit more negative since then. It doesn't truly make economic sense. Nothing's really changed, so to say, with respect to the thesis.

But I will say, I'll call it, on a net basis, it's been marginal negatives with respect to currencies, with respect to the share placement, and there are some concerns about Naspers' underlying business in South Africa with respect to their TV business. There is some over-the-top competition that's coming from Netflix, for example, launching in South Africa and the like.

Now at the end of the day, Naspers still trades for less than its value simply in Tencent alone. And as we understand it from discussions directly with the company, that Tencent position is not subject to capital gains. So once we deduct debt. we're essentially getting everything for free. So we don't have to have a necessarily bullish view on everything else, which includes classified businesses. And this call is too short to go through it, not to mention we've done it before. So we think… look, ultimately we think the spread should narrow, (58:00) but we can't tell you what the catalyst will be. We never bought it with a catalyst in mind.

Steven: There's a question about high-yield and where would the high-yield… the Bank of America high-yield index be in case 4 and the spread. In the case for example, the spreads blow out to 2000 basis points where they've been in the past. Again we don't know if it's going there.

And then the follow-up question was: high-yield bonds seem to often lead markets down, and the gap hasn't been closing. And, I mean, yeah, that can happen, and maybe it's happening now. We just don't have a view what's leading what. Sometimes high-yield leads equities; sometimes equity leads high-yield. Sometimes Asia leads U.S. We're going to go focus on investments that are of a good quality and a discount in price, and not really focus on what leads what.

Mark: There's a question: please comment on Russian energy and bank holdings. This is a relatively small portion of the portfolio. Even at cost it was a relatively small portion—probably one and change percent at cost. They've gone down largely attributed to the ruble. If you actually were to look in local market terms, the movements haven't been as severe. The Russian energy positions, we've gone through this in the past. We look at them largely as utilities in disguise. They're not really as exposed to the underlying energy prices would be companies in other countries. And by that, the government has a huge take where they take 80%-plus of marginal cost of oil, let's say, above $30 for example. And so they're not as sensitive to the change in energy as would be other companies in other countries—not to mention because they're producing domestically, most of their cost in rubles, which have gone down. And so those are what they are. We haven't added to them in any meaningful way. They were always commercial opportunities.

(60:00) The bank holdings is one bank. It's called Sberbank. It's the leading bank in Russia. Russia's in a bad place economically—whether it be through sanctions, whether it be through their oil price. And Sberbank is sort of holding up, I'll say, thus far like a rock. So we expect Sberbank to come out in an even stronger position than they went into the downturn.

But that said, the position is very modest in size, and it was really part of an overall Russian basket that we invested in. And so we still think the opportunity to make money on these names remains. But they were a somewhat small position, and they're still not a significant portion of the portfolio.

Brian: There's a question on Glencore. It says: Glencore holdings, it scares me. What makes you more confident about it? I'd say first it's important to realize that we own Glencore's senior bonds and not the common stock. So the through our cost into the bonds, the level at which we're creating the underlying Glencore assets, we think is highly attractive. In addition, Glencore has a number of options in pretty decent three-year liquidity runway. And so certainly the commodity outlook is depressed. We're not necessarily big bulls on any of the commodities, but our basis into the assets, should the company restructure and should we get new equity in, call it, a new Glencore out on the other side of a commodity depression, would probably be a very compelling basis into those assets, And then secondly, we're earning an over 1,000 basis point spread to maturity in the event that Glencore were able to pay off its liabilities that came due.

Now that's the specifics on Glencore. I think as you see us make more and more high-yield and distressed investment, that general approach is going to be the same. So a number of the companies that we'll invest in on the high-yield and distressed side (62:00) will be suffering whether it's firm-specific or industry-driven challenges and pressures. And we'll be looking at those from the perspective of (1) what is our yield-to-maturity, and is that attractive in the event that the credit will remain performing; and (2) are we happy to create the underlying assets at the basis or price that we would create them in the event of restructuring in which our bonds were to receive new equity. And so there are a number of companies in the commodity and energy space that we're spending time on. We're focusing on Tier 1 high-class assets. I think something to pay attention to during this downturn is not just the yield-to-maturity but the underlying quality of the asset that you're buying.

And I think in the case of Glencore as well as a couple others, certainly very depressed end markets, but those depressions could last for a long period of time. But when you're able to pick up high-quality assets at a big discount, we think that will be attractive over time.

Steven: Thanks, Brian. Thanks, Mark. I'm going to turn it back to Brande for closing comments. If we haven't gotten to a question and again you need a follow-up answer to or would like more detail or a question that wasn't addressed, please reach out to Brande, and she will make sure that every question gets addressed.

Brande: Thank you, team. To our listeners, we would like to thank you for your participation in Crescent's fourth quarter 2015 webcast. We invite you, your colleagues, and clients to listen to the playback and view the slides from today's webcast, which will be available on our website, fpafunds.com, over the coming few days. 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. We highly encourage you to complete this portion of the webcast. We do appreciate and review all of your comments.

(64:00) Please visit fpafunds.com in the future for webcast information, including replays. We will post the date and the time of the prospective webcasts during the latter part of each quarter and expect the calls will generally be held three to four weeks following each quarter end. We hope that our shareholder letters, commentaries, and these conference calls will help keep you, our investors, appropriately updated about the Fund.

We do want to make sure you understand that the views expressed on our call are as of today, January 29th, 2016, 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. Any mention of individual securities or sectors should not be construed as a recommendation to purchase or sell such securities, and any information provided is not a sufficient basis upon which to make an investment decision. The information provided does not constitute and should not be construed as an offer or solicitation with respect to any such securities, products, or services discussed.

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Thank you again for your participation. This concludes today's webcast.

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