FPA International Value Fund
Five-year Review Commentary

Dear Fellow Shareholders,

As the Fund recently reached its five-year milestone, we thought it was appropriate to look back at what has transpired in terms of performance as well as portfolio developments since the inception of the Fund on December 1, 2011. While not a full market cycle,[1] we believe five years is a reasonable length of time to provide some relevant perspective. We should point out that some of the comments below were provided by our product specialist team. We take advantage of this opportunity to thank them for their continued support.

To reiterate the fourth quarter update, the Fund has appreciated by an annualized rate of 6.42%, net of fees and expenses, versus 4.50% for the MSCI All Country World Index (ex-U.S.) (Net) (the "Index") since inception. As of December 31, 2016, the Fund's expense ratio was 1.28% and has been higher at times in the past five years. Since inception, cash exposure has averaged 32%, and has fluctuated from around 10% to more than 40%, depending on the availability of suitable investment opportunities.

Long-term performance perspectives

To begin, we believe it is reasonable to conclude that the Fund has achieved its two objectives. The first was to "deliver above-average capital appreciation," with about 200bps, or more than 40% of excess performance relative to the Index. We use the Index as an average because it is the closest proxy to our all-cap international universe. We set out to deliver that first objective "over the long-term." While the last five years have not been a full market cycle, we agree that it starts to be a reasonable amount of time to judge performance. Candidly, we are surprised that the Fund has delivered such positive alpha despite the relatively high cash holdings, and the absence of a true market downturn,[2] which we thought would have happened over five years.

The second objective was to "minimize the risk of permanent impairment of capital[3]." Unfortunately, there are no good statistics to demonstrate that. Even so, we believe investment risk was reduced by consistently buying with a margin of safety of over 30%, and limiting ourselves to "investable" countries.[4] We would also highlight the average cash exposure of more than 30%. This means the portfolio would have in our view likely fared well in a downturn. More importantly, it means the Fund was uniquely positioned to take full advantage of a depressed market. Lastly, past portfolio metrics consistently highlighted our holdings had less leverage and higher returns as compared to the Index.[5] That is because we seek to only invest in high-quality, well-run, financially robust companies.

Stock selection has been strong, despite having higher portfolio turnover than originally anticipated. While we stressed that holding periods are dictated by the time it takes for the discount to unwind, we typically expect to be invested for five years, which would theoretically translate into a portfolio turnover of 20%. In practice, it's been north of 40% on average since inception, which amplifies the risk of mistakes and increases the tax hit on returns.

In the past five years, we made more than 70 investments for the Fund, of which only three stand out as disappointments.[6]Taking them in order of importance, the first one was **Prada**, which resulted from the

[1] We consider that a full market cycle includes a true market downturn, which we do not think we've experienced in the last five years.
[2] We explain later in the commentary why we take the view that there has not been a true market downturn in the last five years.
[3] Per the Fund's policy statement. The Fund's policy statement is available online at www.fpafunds.com.
[4] Buying with a "margin of safety" is when a security is purchased at a discount to the portfolio manager's estimate of its intrinsic value. Buying a security with a margin of safety is designed to protect against permanent capital loss in the case of an unexpected event or analytical mistake. A purchase made with a margin of safety does not guarantee the security will not decline in price.
[5] This applies to Return on Equity, and even more so to Return on Capital Employed given the lower leverage.
[6] We included names for which either the intrinsic value or the market value of the investment declined by over 30% (margin of safety).

fact that management in our view inexplicably refused to manage cost inflation despite weaker demand for luxury fashion products. The second was **Aggreko,**[7] where a new CEO broke with the company's long-standing focus on returns in the face of a slowdown in emerging markets. The third was **Fugro**. While management performed in line with expectations, the sharp fall in oil prices severely impacted the business. Given the recent developments in commodity markets, though, any capital destruction may ultimately prove to have been temporary in this case. For reference, we addressed these mistakes and highlighted some of the lessons we learned in past commentaries.

The three aforementioned disappointments accounted for more than 70% of the negative contribution to the Fund's performance in the past five years. This calculation is adjusted for currency effects on high-performing holdings like **Adidas** in Germany or **Hypermarcas** in Brazil; includes **KSB**, which has yet to play-out (although value hasn't been impaired); and naturally excludes recent additions to the portfolio. Excluding KSB, the percentage would be roughly 80%. The quality of our selection process is also reflected in the annualized 12% return from the invested portion of the portfolio since inception, more than twice that of the Index. More broadly speaking, we think our research-driven, bottom-up approach also led us to be on the right side of some bigger issues, including the eurozone crisis, banks (particularly in Europe), emerging markets, cyclicals, and Brexit.[8]

Considering our small team, the strong stock selection speaks to the strength of our institutional knowledge of businesses and management teams around the world; the effectiveness of our research funnel that starts with reverse roadshows overseas; and the quality of our due diligence, analytical, and valuation process.

The portfolio also delivered positive characteristics that we had not anticipated. While we often highlighted the possibility of short-term volatility, for the past five years, the Fund has in fact been about 20% less volatile than the Index, with a standard deviation of 11% versus more than 13%, respectively. In addition, the up-capture ratio has been 83%, compared to a down-capture ratio of about 70%. Lastly, the maximum drawdown[9] in the five-year period has effectively been in line with that of the Index. Yet this period corresponds to the time when we leaned into a downturn in cyclicals, particularly commodity-related businesses. It also coincided with the strengthening of the U.S. dollar.

As we noted earlier the Fund has not experienced a full market cycle. While the Index came down by about 25% from mid-2014 to early-2016, we view this drawdown as a function of 1) a commodity bust, and 2) the rise in the U.S. dollar. To the first point, we recognize that downturns can be driven by the demise of a specific type of business, but we believe a broader-based correction (across sectors and geographies) would be a more relevant test for the Fund. This is particularly applicable to this cycle, given that extremely low rates and aggressive monetary policies by central banks have strongly contributed to the market rally in the past few years. To the second point, the aforementioned drawdown was only about 9% in euros. If we shorten the period to start on May 10, 2015, we observe a more significant correction in excess of 25%. However, we do not see this as a true market downturn given that more than half the decline was in fact reversing a sudden 30% jump in the first quarter of 2015. The "cone chart" (table 1) below more clearly illustrates what we mean. To assess the Fund's performance over a full cycle, we would prefer to have gone through a true market downturn, meaning a broad-based correction – and without meaningful currency contribution.

Sources of frustration

While positive, the Fund's historical performance has been frustrating in two ways. First, while we started with a foreign large-cap value portfolio given the opportunity of the eurozone crisis in early 2012, and delivered a meaningful portion of the annualized excess performance by investing in sizeable global businesses, Morningstar has now categorized the Fund as foreign small-cap blend. This classification may correspond to where we still find opportunities in the current market environment, but it makes little sense given our all-cap, go-anywhere value approach. It could also prove confusing in our view to

[7] Unlike with Prada, we do not believe Aggreko has experienced permanent capital destruction, even though we impaired its value by more than 20%. We define permanent capital destruction as a reduction of intrinsic value in excess of the margin of safety at purchase.
[8] Brexit refers to the June 23, 2016, referendum whereby British citizens voted to exit the European Union.
[9] From the "peak date" of July 4, 2014 to the "valley date" of Feb. 12, 2016 (as per Morningstar terminology).

prospective clients who might invest with us based on the current category, only to realize after a while that the Fund migrated to another one.[10]

To provide some perspective, we would note that Morningstar's foreign large-cap blend and foreign large-cap value categories have both returned an annualized 5% in the period from Dec. 1, 2011 to Dec. 31, 2016. By contrast, the foreign small-/mid-cap blend has returned almost 8%, and outperformed almost[11] every non-U.S. category. It means that while our approach has been absolute value (with the resulting cash component), downside-focused, and go-anywhere, we're being measured against a fully-invested, higher-risk, growth-oriented investment style. We think this is not a very relevant way to analyze how we invest.

Table 1: Index 5-year performance chart (in euro):

Source: Bloomberg Data.

Second, in certain circumstances we found that some of our clients didn't take advantage of the transparency we provided. In addition to publishing quarterly commentaries, and letting cash fluctuate with the opportunity set, we've discussed the weighted average discount of our holdings in prior commentaries. Yet we saw many clients exit at the end of 2015 when we said the portfolio was trading at its largest estimated discount to intrinsic value, which in our view presented an investment opportunity. On the flip side, many purchased the Fund when cash was over 40%, 50% of assets were invested in 10 names, and the discount was at a trough, a less opportune time to invest.

Presumably, one way to avoid these frustrations would be to manage for that and have a restricted portfolio with a low tracking error. Unfortunately, that would not be consistent with our investment approach. We focus on delivering performance, and for that we take a benchmark-agnostic approach. We invest across market caps, sectors, and geographies – and only when presented with a significant margin

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[10] We would add that it would take years to come to this realization by only looking at the Morningstar category.
[11] The foreign small/mid growth category is marginally ahead of small/mid blend over the period.

of safety. Our willingness to go where others do not is ultimately an important contributor to alpha generation, as illustrated by the Fund's consistently high active share, with an R-squared of 77%.[12]

Anyone investing in the Fund should think of it as hiring a service, rather than buying an asset class or some other piece of a broader allocation strategy. In fact, we'd argue that a passive or quantitative product might be better suited for such needs. Our motto is and always has been to do what is right from an investment standpoint, rather than abide by some arbitrary set of guidelines. That means the profile of the portfolio may change over time, sometimes dramatically. Because of this, we do not think it is very helpful to compare the Fund to other mutual funds, or some backward-looking, quantitatively assigned category.

Historical portfolio developments

As we look back at the past five years, we can't help but be intrigued by what our bottom-up discipline has meant in terms of portfolio developments. We launched the Fund in late 2011, and were almost immediately presented with a compelling investment opportunity. Macro-political fears over the future of the eurozone meant that most companies based anywhere in Europe were seen as toxic, including large-cap businesses that by definition are bigger and generate a significant portion of their cash flows outside of Europe. We were able to buy businesses that were high on the quality curve with little expectations of positive profit growth. The opportunity was effectively multiple arbitrage and thus carried limited risk. Forecasting risks were reduced, and the weighted average multiple of the portfolio was high due to the high quality of our holdings.[13] Subsequently, our investments returned 37% in 2012, and 31% in 2013 (both in U.S. currency).

As share prices converged towards estimated intrinsic values, we sold out of those earlier investments, causing both cash exposure and concentration to increase. In fact, we asked shareholders to approve changing the Fund from a diversified investment company to a non-diversified investment company in 2013, so we could concentrate further on the few bargains we were still able to find in the market. By early 2014, we had more than 40% of our assets in cash, and almost 50% in only 10 stocks, which is as much portfolio concentration as we were willing to tolerate.

At that time, we were presented with another set of bargains due to the slowdown in growth in China; subsequent weakness in commodity markets (plus the other odd sectors like luxury goods); and difficult times for related regions, like Australia, and Brazil to a much greater degree. As a result, we made several investments in cyclicals, emerging markets, and related businesses. In this instance, the opportunity came from taking a long term, through-cycle view, with higher forecasting risks, and a portfolio with a lower weighted average multiple, because new holdings were generally lower on the quality curve.

In hindsight, we stepped in too early, as is common in value investing. As a function of our small size, concentrated approach, and the shortage of opportunities (everything else continued to rally), we also re-deployed a large portion of our assets into these deeper-value names. This had a material negative impact on the Fund's performance in the subsequent months (corresponding to the maximum drawdown mentioned above), but the same names became large contributors to the Fund's stronger returns in 2016.

Last summer, Brexit offered us a short-lived opportunity to buy a handful of UK stocks at compelling prices, but since then we have seen continued increases in prices across the board. This has restricted our opportunities, leaving us mainly with companies that are too small for the bigger funds now gathering the lion's share of asset flows. Such companies often operate businesses that have attractive business development opportunities in the long term, well beyond the capital markets' typical two-year view. In this latest portfolio development, the investment opportunity comes from proprietary research and fundamental thinking, as well as superior management execution, with once again generally higher multiples.

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[12] R-squared is the statistical measure that represents the percentage of a fund or security's movements that can be explained by movements in a benchmark index.

[13] As a reminder, we typically value businesses on a multiple of normalized profits of 8x to 15x, from "sustainable" to "best-in-class", depending on the underlying fundamentals of the business, the quality of management, and the strength of the balance sheet.

It would be hard to fit all these portfolio developments into one style box. Ultimately though, there are key common denominators. We always sought to invest in quality businesses that we believed could deliver through-the-cycle returns in excess of normalized cost of capital; that were well managed, both operationally and financially; and that had conservatively managed balance sheets. And we only invested when their stocks were trading at depressed valuations. Whether the discount came from quality (i.e. multiple) arbitrage, normalization of earning power, or long-term business development opportunities was of little importance to us. And whether the resulting portfolio metrics showed a lower market cap or a higher multiple of next-year's earnings (which is meaningless in isolation) was completely irrelevant.

This raises what we think is an important point. Growth, value, and quality styles continue to differentiate most approaches across the industry. They typically mean riding stocks with positive earnings momentum, looking for the lowest multiples of forward profits, and investing only in the best businesses, respectively. Yet none of those things make sense in isolation. We're not sure any of them require all that much insight from fund managers either, to be frank. Instead our approach starts with a couple of simple truths: 1) capital appreciation comes from buying assets for less than they're worth, and 2) the value of a business is its perpetual stream of cash flows discounted back to present time. In order to assess this value, we need to consider what the fundamentals of the business look like over a multiyear period, and try to quantify what that means in financial terms.

To do that we must be able to research and understand the business. We need to trust management actions, and have the support of a robust balance sheet. From there, if we find that we can buy a business at less than 70% of its appraised value, we are interested in becoming shareholders. We think it gives us the prospect of compelling long-term capital appreciation, while taking on limited, duly underwritten risks. Which specific part is being underappreciated by the market is of little importance, and it's likely to vary across individual investments over time, and as we move through the cycle. Our discipline makes us "quality" by virtue of our focus on fundamentals, and "value" because we invest at a discount, but whether external observers put us in one box or another at various times ultimately has no meaning. In fact, we can see how being tied to a particular set of metrics could box a manager into making decisions that could limit, if not hurt, capital appreciation over time, and/or expose investors to excessive, arbitrary risks.

A note of caution to investors

We also think there might be note of caution to be drawn from the above discussion on market cycles and the value of an unconstrained approach. While the past few years have been a prolonged upcycle across capital markets, we were still provided with several investment opportunities. We were able to take advantage of macro-political fears; sector and geography-specific downturns; and occasional one-offs. Now nothing seems severe enough to rattle the market. The general mindset seems to be, "this is the time to get back into equity because it feels safe," although that sounds like an oxymoron. We would also point out that there's a long list of looming risks, including: the shift in politics across western democracies; the rise of authoritarianism; the Middle East dislocation and the associated refugee crisis; the possibility of a European Union break-up; Brexit; heightened currency tensions; capital control in China; escalating tensions in the South China Sea; planned interest rates hikes; a likely acceleration in inflation, and more. By contrast, expectations of profit growth are high and appear to factor in favorable macro developments, and low interest rates have pushed multiples to levels that may no longer reflect business fundamentals.

There has also been material asset consolidation combined with the rise of passive and quantitative strategies. As market corrections have faded from memory, portfolio managers and fundamental analysis have become obsolete in favor of metrics, size, and liquidity. Several layers of compliance/risk controls have been put in place effectively mandating that fund managers buy into overpriced assets. These controls also appear to prevent them from leaning into volatility and buying on the way down, while potentially forcing them to monetize losses. Such "stop-loss" requirements can also act as multipliers in the event of a correction, including for large, high quality names that may be viewed as defensive.

All this has given us even more confidence in our absolute approach. As we struggle to find opportunities that meet all our criteria, we will monetize holdings of stocks that we believe no longer offer a high margin of safety, and let the cash build in the absence of suitable replacements. Once again, this is only a

residual output of our process, but we would highlight a couple of benefits that come with the flexibility to hold cash. First, cash is basically a function of the ability to sell, which means being able to monetize gains rather than being forced to give them up in the next correction. While there is an element of short-term volatility in that risk, it can materialize through “take-unders” by private buyers. On that note, we would point to the many new funds that have been raised by private equity firms in the past few months, and the amount of dry powder these participants have generally accumulated. Second, it gives us the ability to take advantage of unique buying opportunities at times when other public equity market participants cannot. We cannot stress enough the importance of the forward excess returns that can be generated in such market conditions.

Besides rising liquidity, we would expect further concentration on the few ideas left that we believe are truly compelling from an absolute value perspective. In so doing, we hope to continue delivering on the mandate we set out for the strategy of generating above-average long-term capital appreciation while attempting to minimize the risk of permanent impairment of capital, and doing so by investing in high quality companies.

Once again, we thank you for your confidence, and we look forward to continuing to serve your interests as shareholders of the FPA International Value Fund.

Respectfully submitted,

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