Small-Cap Fund Management Discussion

Longleaf Partners Small-Cap Fund produced a gain of 2.5% for the second quarter but lagged its benchmark, the Russell 2000 Index, which returned 3.1%. Year-to-date (YTD), the Fund returned 14.9%, versus the Index's 15.9%. The Fund outperformed the Russell 2000 for all longer time periods.

Cumulative Returns at June 30, 2013

	Since Inception	20 Year	Ten Year	Five year	One Year	YTD	2Q
Small-Cap (Inception 2/21/89)	**1196.45%**	**921.41%**	**181.90%**	**66.25%**	**24.88%**	**14.92%**	**2.53%**
Russell 2000 Index	787.68	448.53	148.45	52.25	24.21	15.86	3.08

See page 16 for additional performance information.

Saks, which we purchased in the market decline in 2011, gained 19% for the second quarter and 30% for the first half of the year, making it the largest contributor in the quarter and the second largest YTD. Although the luxury retailer's high-end shoppers are sensitive to large stock market downswings, they are less vulnerable to the challenges of high unemployment and slower economic growth that affect most consumers. During the second quarter, Saks' price rose sharply on news that the company had hired Goldman Sachs to explore strategic alternatives, including a sale of the company. In addition, investment in store renovation and the online retail business began to show positive results.

The Fund's largest holding, Texas Industries, continued to add meaningfully to performance and is the largest contributor YTD with its 28% gain. The Dallas-based cement and aggregates company has had large volume growth and improved pricing in Texas, with demand exceeding capacity in some local markets. As we mentioned in the first quarter, the company is bringing additional capacity on line to capture the incremental demand and has additional upside potential when a recovery in California generates additional earnings.

The Fund's position in Quicksilver declined 19% for the second quarter and 33% for the first six months of the year, making it the largest detractor for both periods. The oil and gas exploration company had positive news that it closed on an agreement to sell 25% of its Barnett Shale assets to Tokyo Gas at a price that is in line with our appraisal. Several challenges, however, weighed on the stock, including failing to refinance all of the company's debt and persistently weak natural gas liquids prices.

We sold two positions. Madison Square Garden's share price approached our appraisal, helping to make it a large contributor year-to-date. We made 114% on the investment during the two years that we held it. The company's multi-year arena renovation has been successful, and the increased value of the television rights for the Knicks and Rangers became clearer.

We also sold Lamar Advertising as it reached our appraisal. We bought Lamar in 2011 at an average cost of $26, trimmed the position as it grew, and fully sold it in the second quarter at an average price of $48 per share. Lamar's strong outdoor advertising positions in its markets helped revenue growth as the economy recovered. Management's effective cost control and decision to explore converting to a REIT also caused the stock's move to value.

Strength in the small capitalization segment of the market over the past several quarters has resulted in a dearth of on-deck companies that meet our discount requirements. Consequently, the Fund's P/V finished the second quarter in the mid-80s%. Following portfolio sales and trims, cash climbed to 40%, reminiscent of levels reached briefly in 2005 and 1997, and caused the Fund's relative underperformance in the quarter. To the extent that our investment partners have spending or rebalancing needs, we believe this an opportune time to use the Small-Cap Fund as a source of funds. We are confident that over time we will identify businesses that meet our criteria, either through general market volatility or individual company opportunities. In the meantime, our management partners are taking action to build corporate values and gain value recognition.