Partners Fund Management Discussion

Longleaf Partners Fund delivered a substantial 9.8% in the third quarter, taking the Fund's year-to-date (YTD) return to 20.4%. Both periods surpassed our annual absolute return goal of inflation plus 10% as well as the S&P 500 Index, which gained 5.2% and 19.8% respectively. The Fund's formidable quarter added to our strong one year outperformance. We believe we are well-positioned to deliver additional good relative returns from this point, although the absolute numbers are unlikely to continue at a 20+% annual compounding rate.

Cumulative Returns at September 30, 2013

	Since Inception	20 Year	15 Year	Ten Year	Five Year	One Year	YTD	3Q
Partners Fund (Inception 4/8/87)	**1586.90%**	**623.42%**	**226.39%**	**84.03%**	**61.07%**	**24.13%**	**20.39%**	**9.82%**
S&P 500 Index	953.13	440.25	117.91	107.37	61.18	19.34	19.79	5.24

See page 8 for additional performance information.

Three of the Fund's strongest performers for the YTD made large gains in the third quarter. Chesapeake Energy, the Fund's largest position for most of the year, contributed to performance the most with the combined equity, convertible preferreds, and options rising 25% in the quarter and 53% YTD. Together with new CEO Doug Lawler, the board that we helped seat last June is instilling financial and operating discipline into the company. Over the last sixteen months, the company has reduced SG&A by 20%, sold and announced sales of over $10 billion in non-core assets, decreased 2013 capex by a projected 46%, and promised to live within its cash flow in 2014.

Philips also performed well in the quarter and YTD, advancing 19% and 27% respectively. We applaud CEO Frans van Houten, who completed a large stock buyback at discounted prices and continued delivering higher margins that approached year-end targets. Philips' management team continues to do a terrific job focusing on the company's three competitively strong segments: medical, lighting, and consumer products.

FedEx gained 25% over the last nine months after delivering 16% in the third quarter. The stock increase reflects some degree of confidence that management will execute planned cost cuts at the Express air delivery segment to adjust to the migration of more traffic onto ships and trucks due to high oil prices. While the stock has been volatile over the past year, our appraisal of the company has steadily grown, driven by the Ground segment. Subsequent to quarter-end, FedEx announced a share repurchase plan of 11% of the company.

Other strong performers in the quarter included Level 3, up 27%, and CONSOL Energy, up 25%. At Level 3, since taking over as CEO in April, Jeff Storey has implemented the necessary steps to grow top line and increase cash flow by reducing costs and focusing on higher margin enterprise customers. Brett Harvey, CEO at CONSOL, indicated that management is exploring the sale of assets and could potentially split the company into various parts: natural gas, coal, and infrastructure. Even with meaningful recent stock gains, both companies remain among our most discounted names.

For the YTD, Aon, the world's largest insurance broker and a leading benefits management firm, was among the Fund's largest contributors as the company's lower tax rate and increasing cash flow helped drive a 35% return. Higher interest rates will increase fiduciary income and help close the gap in the underfunded pension. Although nascent, Aon's healthcare exchange for corporate employees is gaining critical mass, most recently adding Walgreen Co in the third quarter. We applaud Greg Case and his team for their customer-focused, shareholder-oriented leadership.

The Fund had only three detractors in the quarter: Mosaic, Abbott Labs, and DIRECTV, with only Mosaic negatively impacting YTD results. We bought and exited Mosaic during the third quarter. Our case changed quickly with the potash industry drama that caused prices to drop. Abbott was down 4% following FX headwinds, concerns over tougher rules for device approval in Europe, and issues at a dairy supplier leading to a meaningful product recall in the baby formula division in China. DIRECTV slipped 3% on increased subscriber churn amidst a challenged Brazilian economy. DIRECTV Latin America remains well positioned to benefit from rising pay-TV penetration in the region, and the mature U.S. business continues to generate higher ARPU (average revenue per user).

During the third quarter, we exited our position in Dell, which added 31% YTD. Michael Dell put his personal gain above other shareholders' interests and eventually won approval of a management buyout well below the value of Dell's free cash flow and assets. We recognized our errors in assessing Michael Dell as a partner, but we believed that fighting for our clients' interests against the first MBO in our 38 year history would generate a better outcome than his initial offer, and it did. Our collective opposition with other institutional owners forced the board to postpone the vote three times to avoid defeat, change the record date, alter voting rules, and secure a higher offer to gain approval of the deal. Southeastern infrequently becomes an activist, but when we do, we cover all expenses incurred out of our own pockets – not the Longleaf Funds' assets. Importantly, fighting for shareholders usually has delivered a superior result.

We sold the Fund's small position in Cemex convertible bonds as well as Murphy USA, the retail station operation that was spun out of Murphy Oil. We trimmed four names - Aon, Berkshire, Chesapeake, and Philips – because either P/V gaps narrowed or position weights grew too large. For regulatory diversification purposes, we made slight trims of CONSOL and Travelers at quarter-end.

Given the Fund's recent strong performance, the P/V of the portfolio is in the high-70s%. While higher than normal, we believe our current P/V ratio is more attractive than it appears because of the above average quality of our investees and the conservatism built into our appraisals in two important ways. First, we continue to use discount rates that are dramatically higher than today's fixed-income rates. Second, at holdings such as Cheung Kong and Abbott, our appraisals reflect longhand multiples far below current private market transaction "comps." With patience and discipline, we will find new qualifiers for the 15% in cash reserves. Our "on deck'' list is limited, but we have several highly qualified opportunities that would become buys with a 10-15% price decline or value accretion. As we use our liquidity to purchase new, discounted investments, the P/V will also become more attractive.

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