Small-Cap Fund Management Discussion

Longleaf Partners Small-Cap Fund had a strong 7.4% gain for the third quarter, but due to the Fund's high cash level, it lagged the Russell 2000 Index, which returned 10.2%. Year-to-date (YTD), the Fund advanced 23.5%, far outpacing our annual absolute return goal of inflation plus 10% but falling below the Index due to the drag that cash imposed on return. Small-Cap exceeded our absolute goal over the most recent one, three, and five year periods. Results for periods of three years and longer were consistently above the Index. We believe that the Fund can continue to generate long-term outperformance over the Index, but we caution investors that the Fund's robust absolute return of the last three years—averaging 20% per year—is not likely to continue for the next three years.

Cumulative Returns at September 30, 2013

	Since Inception	20 Year	15 Year	Ten Year	Five Year	One Year	YTD	3Q
Small-Cap Fund (Inception 2/21/89)	**1292.94%**	**972.76%**	**396.50%**	**189.95%**	**102.63%**	**27.82%**	**23.48%**	**7.44%**
Russell 2000 Index	878.31	455.92	259.77	151.03	69.68	30.06	27.69	10.21

See page 14 for additional performance information.

Wendy's returned 47% in the quarter and 85% YTD, making it a top contributor to performance for both periods. Operations continued to benefit from new management's menu innovation and store revitalization program. The company also announced a plan to sell more company-owned stores to drive higher returns on capital, improve the quality and predictability of earnings, and increase shareholder returns. The Washington Post Company, a diversified education and media company, was another strong performer in both the third quarter and YTD. The investment returned 26% and 67% in the respective periods. In the quarter, management sold the flagship *Washington Post* newspaper for a price that was higher than our appraisal. In addition, cost-cutting at Kaplan Education and price increases at Cable One improved margins and profitability throughout the year. As owner-operators, the Graham family has built value per share over the long-term, and the stock has begun to reflect their work. Level 3 contributed meaningfully in the third quarter, gaining 26%. 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. Even with the meaningful recent gains, the stock remains among our most discounted. The Fund's largest holding, cement producer Texas Industries, remained the top contributor for YTD with a 30% gain. A robust economy in Texas has resulted in volume and pricing increases.

Although the run up in the market has made it hard to find qualifying ideas, we were able to initiate two positions late in the quarter, OCI and Hopewell. Both are based outside of the U.S., where we generally are finding more opportunities.

We sold four positions. Oil and gas exploration company Quicksilver was the Fund's largest detractor from YTD performance, declining 32%. As we noted in previous commentary, several challenges weighed on the company's share price, including low natural gas prices and the company's inability to refinance all of its debt. Uncertainty regarding how and at what price Quicksilver will monetize its non-cash-flowing assets changed our view of the company's prospects, and we sold the stock. We sold Saks on the news that Canadian retailer Hudson's Bay would buy the company for $16 per share. We bought Saks in 2011 for an average cost of $9 and trimmed the position as it grew. Our return in the equity was 85%, while the convertible bonds we owned returned 54%. We sold Service Corp, the country's largest funeral home services company, a long-term holding since 2005. CEO Tom Ryan and his team grew value through excellent operations, especially amidst difficult headwinds of lower mortality rates and changing preferences for lower revenue cremations over burials. The planned acquisition of Stewart pushed the stock price to our appraisal. We made 172% on the investment during the eight years that we owned it. We also sold media company Tribune, whose bank debt we bought a year ago before the company emerged from bankruptcy and our ownership was converted to cash and equity. As the company announced a well-received acquisition and a plan to spin off its publishing operations, the stock quickly approached our appraisal, generating over 75% during our short holding period.

Market strength, particularly among smaller companies, has meant that numerous stocks have moved closer to our appraisals, causing more portfolio sales than normal and a larger challenge to find businesses that meet our discount criteria. As a result, the Fund's P/V finished the third quarter in the low-80s%, and the cash level stood at 45%. We remain confident that we will identify and add new companies that meet our criteria over time. We will be patient, however, and adhere to our proven discipline, which has guided us successfully for nearly 40 years. With the Fund's high cash level and slim opportunity set, our partners should note that if they have current capital needs, it would seem a good time to take money out of the Small-Cap Fund to the extent that doing so does not create a tax liability.

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