

Credit Crisis

To begin with, I believe FPA Capital Fund and FPA New Income are well structured to weather this credit-crisis storm. FPA Capital stands with nearly 43% in liquidity that we believe should help it withstand the crisis and provide us with the necessary capital to use at the appropriate time. FPA New Income's credit quality has never been better, and with over 66% of the Fund invested in short-term government/Agency securities, it too is well positioned to both protect and grow your capital.

This letter will provide a background as to what policies and procedures have been taking place at First Pacific Advisors and within your Funds as this credit crisis developed.

As this credit crisis has unfolded, it has required a constant level of attention and analysis since, in my opinion, it is without precedence in my 37-year career and, I believe, since the Depression. During the past two years, I have tried to prepare the Funds and all of our clients for this period. This crisis has developed in ways that few have truly understood until just recently. In our opinion, the magnitude and consequences of this crisis have been moderated by outside capital infusions. If it were not for these capital contributions by several investment entities, some of our largest financial institutions would be endangered or gone by now. It is our opinion that these early saviors have invested unwisely, as most of these early investments have proven to be premature and costly. They have not extracted sufficient compensation for the liquidity they are providing. As this crisis develops, we believe the providers of liquidity will require substantially more compensation to convey their precious liquidity.

On December 14, I placed a halt on all equity and high-yield buy orders for the accounts and funds that I oversee. This was the direct outcome of a conference call we had with our legal firm, Paul, Hastings, et al. The initial purpose of this call was to determine whether there were grounds to challenge the Bush/Paulson plan to bailout subprime borrowers. Since there was very little detail about the plan at that time, I was concerned that the "sanctity of contracts" might be in the process of being violated. In their opinion, this was not the case. A long and involved discussion began concerning bank capital ratios, valuation of complex securities and the rating agencies. Rarely do attorneys take a position but in this case, after our discussion, they recommended that we maintain our liquidity and confirm our firm's lines of credit. I explained to them that we had no lines of credit nor do we require any since the firm is highly liquid, without any debt on its balance sheet. We have done our homework and we are prepared.

Out of that conference call came the conclusion that valuation issues for complex securities were going to become center stage by December 31 and that the re-intermediation process of bank lending would actually work to lessen credit availability. This last point is a subtle one. It derives from the fact that, over the past six years, more credit has been created outside of the banking system than within it. MacroMavens' Stephanie Pomboy estimates that approximately \$5 was created outside of the banking system for every \$1 created within it. The process was a direct outcome of the structured-finance industry that was critically assisted by the credit-rating agencies. Without the credit agency participation, this crisis would be considerably less in its intensity. The common underlying elements of this crisis have been the search for higher profits or investment returns than what could be generated by more normal investment products. It was the search for higher investment returns in a low investment return world that drove investors to "high-quality" investments that provided perceived "excess" returns. In all of these decisions, risk was relegated to the background. This process has been pervasive and we are now just learning its magnitude. At FPA, we worked tirelessly to avoid these hazardous and potentially fatal decisions.

Since December 31, there have been never-ending disclosures of excess and betrayal of trust by many investment and financial organizations. In a word, it has been disgraceful. I would like to remind you that much of what you are witnessing today was covered in my speech to the CFA Society of Chicago on June 28 titled, "Absence of Fear," that appears on this website. None of the issues or problems that are being disclosed has occurred at First Pacific Advisors. FPA New Income is at its highest level of credit quality ever and I believe it is one of the first, if not the first fund in the country, to disclose the valuation level "rankings" of its securities under the new FAS 157 rules. In the Fund's September 30, 2007 Letter to

Shareholders we noted that we had no Level 3 investments, and Level 1 securities accounted for 80% of assets. This did not happen by accident. For the past two years we have been culling risk out of the portfolio and we have reduced our number of qualifying commercial paper names by approximately 75% before this crisis unfolded. Our entire fixed-income team is to be thanked for their diligent work.

On January 17, we held a follow-up conference call with John Douglas of our legal firm, Paul, Hastings. John is a former Chief General Counsel of the FDIC. We reviewed what was discussed on the previous conference call and the conclusion was that the crisis was unfolding as expected and that the initial timeframe, January and February, was still a reasonable approximation of when real stress would likely develop. This timeframe is subject to change since the circumstances are also changing. We are seeing new dynamics to this crisis. As an example, Merrill Lynch wrote off \$3.1 billion of bond insurer protection that was involved with credit default swaps. When I conveyed this to John, his first reaction was, "Oh my God." Subsequently, I have learned that only \$1.9 billion was related to ACA Capital Holdings and the other \$1.2 billion relates to other bond insurers. ACA Capital has over \$60 billion of CDS swaps outstanding with less than \$450 million of available cash, as of December 31. On January 20, ACA received a second forbearance from its counterparties that extends to February 19. This is the first major technical default in the CDS market. Where it leads, I do not know. It is not positive. This is just another example of the excesses that have developed in our credit system. As a side note, Ambac Financial Group Inc., another bond insurer, was downgraded to AA from AAA by Fitch on January 19. This led Fitch to adjust 137,990 municipal bond ratings and 114 non-municipal issues insured by the company.

We continue our buy halt and we review it on a weekly basis. It would have been far easier for us to say nothing about this halt and proceed in a confidential manner. The purpose of reporting this is to try to convey the urgency and the importance of this credit crisis, along with its potential impact on the capital markets. I went public with this policy in the press shortly after implementation of the halt in December. No one will be able to say that we did not take a position or attempt to hide our thoughts. I should also say that, during the last two months, I have had numerous phone conversations, as well as visiting with many other thoughtful investment professionals, to discuss the elements and aspects of this crisis to see whether we may have missed something. I do not believe we have.

Outlook

How does one provide an outlook in such a chaotic environment? Consensus earnings and economic growth expectations have been too optimistic for too long, and still are (this comment applies to Federal Reserve Chairman Bernanke as well). Their positions seem totally unbelievable and do not reflect the current environment. Since our December 14 conference call, it has been my opinion that the odds of recession have shifted to or are nearly at 100%. Don't look to the economists for an accurate forecast since their consensus forecasts have never predicted a recession in the last 40 years. The general consensus is that the U.S. economy will experience a slowdown for two quarters and then it will begin recovering in the second half of 2008. The Federal Reserve rate cut today of 75 basis points may add to this expectation; however, we again consider this an overly optimistic viewpoint.

The genesis of this crisis came from the excesses in the housing market. The decline in home prices is unprecedented so we do not know how consumers will react. It is our opinion that the credit crisis will spread into credit cards, auto loans, leveraged loans and commercial loans, and should stretch into 2009. Unless the structured finance market reopens soon, we should continue to experience continued credit contraction. Even if Fannie Mae and Freddie Mac are given broader lending authority, the size of the problem dwarfs their capability.

The general hope is that the Fed, along with regulatory changes and fiscal policy stimulation, will be able to contain and soften this credit contraction. Given that this crisis was not a function of high interest rates or restrictive monetary policy, it seems like an optimistic view that lower rates and a few changes of regulatory policy, along with a potential \$100-150 billion tax cut, will save the day. This crisis is a function of a credit bubble that financed an asset bubble that is now in the process of deflating. Until overpriced assets, as well as excess and unsound leverage, are allowed to clear the system, the recovery from this

credit crisis should be delayed. As I wrote in the September FPA New Income Shareholder Letter, “future Fed policy actions may prove rather ineffective in dealing with these challenges.” The word “challenges” was referring not only to the credit contraction but also to high oil prices and a weak dollar. I also referred to Chairman Bernanke as “Greenspan Lite” because his initial rate cuts were examples of what an Alan Greenspan policy might have been. Again, this crisis is not about the level of interest rates but of excesses in lending and borrowing on inflated assets. The process of clearing these unsound practices is analogous to allowing a body fever to run its course, when appropriate medication is unavailable. The Fed’s medication is likely to be ineffective in dealing with this economic fever. Misguided policies could make the situation better in the short run but worse in the long run. This refers to short-term fiscal policy stimulation that was referred to in a recent Wall Street Journal opinion piece as “feel good economics.” Our problems and challenges that we are witnessing currently are the outgrowth of similar unsound monetary and fiscal policies of the past.

My conclusion from the December 14 conference call was that the Fed would likely cut the Fed funds rate dramatically if the issues cited unfolded in January and February. The conclusion was that the rate would be at 3.5% or lower by March or no later than the end of March. This expectation was not discounted in the futures market at that time. It is now. Given recent events and the current yield curve, it appears that the funds rate will likely be at 3% or less before the end of the year.

Since the initial cut in the funds rate, we have witnessed only one significant positive response in the capital markets. On September 18, after the rate cut announcement, the KBW Bank Index rallied nearly 5% in one day. Subsequent to the additional announcements of rate cuts, Fed open door financing operations, potentially more aggressive Fed rate cuts and the announcement of a tax cut, this index has continued to set new lows that now take it back to 1997 levels. I am using this as a metric to measure the market’s response to policy initiatives. Thus far, it does not look positive.

This has been a very negative, cautionary and difficult commentary to write. Despite this crisis, we are continuing to research individual companies and our potential target list of companies is expanding. We will consider deploying capital both in equities and high yield when we are being more than sufficiently compensated for the potential risks we may be accepting. This process will take time, patience and discipline. These are attributes that we have demonstrated on many earlier occasions.

One last thought, we are intensely focused on not letting our emotions and fears overcome our logic and reasoning. We will continue to be methodical in our process that has kept us from making many of the mistakes that are now being disclosed. We have liquidity, and we will deploy it when we believe the odds and circumstances are in our favor. I will remind you of the old saying that I have voiced on many prior occasions, “You never know the value of liquidity until you need it and don’t have it.” Many company managements are now getting the opportunity to learn this truism.

Thank you for your support and confidence during this challenging period.

Sincerely,

Robert L. Rodriguez
Chief Executive Officer
First Pacific Advisors, LLC

January 22, 2008