FPA New Income FPNIX

A notable practitioner of fundamental analysis that keeps its eye firmly on risk.

Morningstar's Take FPNIX

Morningstar Rating	★★★★
Morningstar Analyst Rating	Bronze

Morningstar Pillars

Process	Positive
Performance	Positive
People	Positive
Parent	Positive
Price	Positive

Role In Portfolio
Supporting

Fund Performance FPNIX

Year	Total Return (%)	+/- Category
YTD	3.35	-0.73
2018	2.30	1.38
2017	2.67	0.94
2016	2.53	0.45
2015	0.15	-0.04

Data through 9-30-19

7-15-19 | by Eric Jacobson

Despite a sometimes-racy looking portfolio, strong management and a careful process have made this strategy a haven from losses and bond-market excess. Those elements support its Morningstar Analyst Rating of Bronze.

The fund looks to gain at least 100 basis points on CPI over five-year periods, positive returns over 12-month stretches, and has a high-quality mandate. Meanwhile, its duration has been short for years, and while its managers have broad freedom, they've said it's unlikely they would take that measure much higher absent a major shift in the market.

Despite this fairly constrained framework, the fund features an eclectic mix of bonds. Comanagers Tom Atteberry and Abhi Patwardhan hunt for deals that may look cheap because they're too small for the needs of a larger manager, or that may look risky but carry specific collateral features making them much more safe and predictable than they appear. Moreover, the team won't buy anything without robust issue-by-issue research and that can't pass extreme stress-testing while still offering significant value.

That mix has evolved. In September 2013, for example, the fund's 30% in mortgage securities was spread among subsectors such as GNMA interest-only tranches, relocation mortgage loans, and nonagency residential mortgage pools. In the years since, the team has mostly eschewed corporates and made a large shift into asset-backed securities (50% as of March 2019, up from 6% in September 2013) including specifically chosen collateral in the credit card, CLO, auto (prime and some subprime), and equipment-related subsectors. The team has also been trimming credit risk, bringing low-quality and nonrated debt to 6.4% from 18% at the end of 2016.

While the fund has struggled with its goal of beating CPI by 100 basis points over five-year cycles, it has performed well versus its (unique) short-term bond Morningstar category peers over the trailing three- and five-year periods ending June 2019. Moreover it has been among the group's least volatile, generating some of the fixed-income market's highest Sharpe ratios.

Process Pillar Positive | Eric Jacobson 07/15/2019

The fund looks to earn positive returns of 100 basis points beyond CPI over five-year periods, positive returns over 12-month stretches, and must keep at least 75% in debt rated A or better. The rigor and depth of its research and strategy earn the fund a Positive Process Rating.

Comanagers Tom Atteberry and Abhi Patwardhan hunt for deals of a size that works well for this strategy, but that may look cheap because they're too small to gain the attention of a more traditional manager. They target high-quality debt, including cash, Treasuries, and highly rated MBS, CMBS, and ABS; the rest can include more-credit-sensitive sectors, including high-yield and lower-quality securitized bond structures. As such, they have historically bought an eclectic mix of bonds. That's left the fund with allocations that sometimes look very risky on the surface, but which the team believes carry specific collateral features that limit the risk profile of the fund's admittedly quirky mix. They also won't buy anything without performing robust issue-by-issue research and that can't pass extreme stress-testing while offering significant value. Meanwhile, its duration has been short for years, and while its managers have broad freedom, they've said it's unlikely they would take its rate sensitivity much higher absent a major shift in the market.

The majority of the fund's holdings are very short-term and highly rated. As of March 2019, the fund carried an effective duration of 1.7 years and only 6.4% in low or nonrated holdings. Its biggest shift in recent years has been a ramping up of holdings loosely classified as ABS to 50% of total assets as of March 2019, from around 15% at year-end 2013. That included 11% in high-grade CLOs--a notable increase from 2% in September 2016--and 8% in securities backed by subprime auto loans; both figures, however, have been trimmed from more recent highs as managers Tom Atteberry and Abhi Patwardhan have cut back on risk.

The ABS stake was rounded out by securities backed by collateral from other various subsectors in March 2019. Other exposures included 14% in mortgage pass-throughs (mostly 10- and 15-year seasoned loans), Ginnie Mae interest-only project-loan tranches with prepayment penalties (4.6%), which Atteberry has argued carry little refinance risk or interest-rate sensitivity, and re-performing nonagency residential mortgages (7%).

Atteberry has held some high-yield bonds since early 2013, predictably focusing on short-term names. But while the fund did have trouble with some energy holdings in 2015, they constituted a relatively small allocation in the portfolio. As of March 2019 corporates overall composed a modest 5.2% of the portfolio.

Performance Pillar Positive | Eric Jacobson 07/15/2019

The fund has scored more than 30 consecutive years of positive returns in part by deftly navigating volatile markets. Its short duration helped shield it during 2013's taper tantrum, for example, and a shift toward cash and high-quality bonds helped the fund return 4.3% in 2008 while many of its peers posted losses.

We moved the fund to the short-term bond Morningstar Category from the nontraditional bond group in mid-2018 in recognition of its better fit there, including a modest 1.7-year duration (March 2019) that has stayed in a close range for many years. But while its returns do look better in that group over recent years, the fund's Positive Performance rating is based primarily on its volatility-adjusted track record.

Although the fund has had mixed success keeping its return at more than 100 basis points above CPI over five-year cycles, its three- and five-year returns placed in the best third of the short-term bond Morningstar Category through June 2019. Moreover, the fund has historically been among the fund universe's least volatile, which has helped it earn Sharpe ratios that typically clock in higher than all but a few bond funds in Morningstar's database over most trailing periods.

People Pillar Positive | Eric Jacobson 07/15/2019

Tom Atteberry joined FPA in 1997 and has led this fund since 2010 after comanaging it with Bob Rodriguez, who retired in 2016.

Atteberry was joined by Abhi Patwardhan in November 2015, who had also been named director of research earlier that year. Patwardhan joined First Pacific Advisors in 2010 and is considered Atteberry's successor. The broader team includes Joseph Choi (since 2014) and Prakash Gopinath (2015) and is further supported by research specialist Nazanin Pajoom and veteran mortgage specialist Julian Mann. The team hired Ryan Taylor in September 2017 who started with a focus on credit, and Felix Moy in May 2019 to focus on corporate debt trading, bringing the team to three credit specialists and the overall team to eight.

That's not a large team, but a focus on both value and deep margins of safety has historically narrowed that universe to a manageable size. Given the fund's style the largest risk seems to be difficulty researching a big number of corporates after a fire-sale sell-off. That said, Atteberry's record and temperament provide assurance he'd steer far from risks for which he lacked sufficient resources to underwrite.

Manager ownership is strong here, and we have long considered Atteberry among the industry's best. Patwardhan has also impressed since coming aboard, helping underpin the fund's Positive People rating.

Parent Pillar Positive | Eric Jacobson 07/09/2019

FPA's lineup hasn't had the kind of consistent success for which it was once known, but it still lives up to its slogan--investors first--and deserves a Positive Parent Pillar rating.

Generational change, investing missteps, and an unfavorable market for value investing have taken a toll. Four of five of its mutual funds still ranked in the top fourth of their peer groups over the 20-year period ending April 2019, but none of them did over the trailing decade. Most of the strategies have seen significant outflows.

Yet, this remains a group of uncompromising value-oriented investors co-led by J. Richard Atwood, firm CFO, and Steve Romick, FPA Crescent FPACX manager and one of the industry's most unique and successful value investors. There have been personnel changes in recent years that bear watching, but some younger, experienced investors, including Romick's comanagers Brian Selmo and Mark Landecker and FPA New Income's FPNIX Abhijeet Patwardhan, are hitting their strides.

The 65-year-old firm exhibits many other shareholder-friendly behaviors. Portfolio manager co-ownership is strong and shareholder communications go beyond boilerplate performance recaps. The firm avoids scandal and remains wary of fads and trends. New strategies, such as 2018's FPA Flexible Income FPFIX, are rare and usually logical evolutions of their existing disciplines. It's a trustworthy steward.

Price Pillar Positive | Eric Jacobson 07/15/2019

FPA instituted an expense waiver in mid-2016 to hold down the fund's costs. It has been extended multiple times and currently expires at the end of January 2020, but FPA has telegraphed no plans to change it. Its waiver-included 0.50% price tag (excluding certain investment-related expenses) registers as competitive versus other no-load short-term bond funds.