Dear Shareholders:

FPA New Income, Inc. (the “Fund”) had a total return of 0.40% in the first quarter of 2018. As of March 31, 2018, the portfolio had a yield-to-worst[1] of 3.44% and an effective duration[2] of 1.57 years.

Treasury yields continued to rise across the yield curve throughout the first quarter. Over the past three months, there was ultimately a near uniform upward shift in yields across the yield curve, though the shape of the yield curve shifted during that time period. Credit spreads ceased their relentless march lower, at least temporarily, ending the quarter roughly flat compared to the end of 2017. Though spreads are essentially unchanged and interest rates are higher, the market remains expensive, leaving us with a dearth of attractive investment opportunities. The portfolio’s credit-sensitive holdings decreased to 9.9%, compared to 10.9% on Dec. 31, 2017. Meanwhile, we took advantage of higher rates to redeploy capital into longer-duration, high-quality bonds, so cash and equivalents decreased to 6.3% at the end of the quarter versus 7.3% at the end of 2017. We remain cautious about credit risk and seek opportunities to extend the portfolio’s duration as rates allow.

Due to our emphasis on protecting against uncompensated duration risk, the Fund has performed well in comparison to commonly used industry benchmarks. Of note, the Bloomberg Barclays U.S. Aggregate Bond 1-3 year Index, with a 1.94-year duration, returned -0.20% during the quarter. The broader market index, with a 6.08-year duration, returned -1.46% during the quarter. We remain optimistic that our active management of duration will continue to benefit our investors in what has become an increasingly volatile market after a long period of calm.

Portfolio Attribution

The largest contributors to performance during the quarter were corporate bank debt and bonds, primarily driven by a metals and mining investment, followed by GNMA project loan interest-only securities, the latter of which benefited from tighter spreads. Collateralized loan obligations (CLO) were also a large contributor to return, owing mostly to coupon return. The largest detractors from first quarter performance included two- to three-year maturity Treasury bonds and credit card asset-backed securities, both of which declined in price due to rising interest rates. Equipment asset-backed securities also detracted from performance due to the underperformance of a bond backed by commercial aircraft.

Portfolio Activity

The table below shows the portfolio’s exposures as of March 31, 2018 compared to year-end 2017:

[1] Yield-to-worst is the lowest possible yield that can be received on a bond without the issuer actually defaulting. It does not represent the yield that an investor should expect to receive. As of March 31, 2018, the SEC yield was 2.99%. This yield figure reflects the theoretical income that a bond portfolio would generate, including dividends and interest, during the period after deducting the Fund’s expenses for the period (but excluding any fee waivers). The Fund’s actual net earnings for a given period under generally accepted accounting principles may differ from this standardized yield. The SEC yield is expressed as an annual percentage based on the price of the Fund at the beginning of the month.

[2] Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates.

Sector	% Portfolio 12/31/2017	% Portfolio 3/31/2018	Change (bps)
ABS	56.8%	57.2%	+40
Mortgage Backed (CMO[3])	10.3%	11.4%	+110
Stripped Mortgage-backed	7.1%	6.4%	-70
Corporate	7.9%	7.3%	-60
CMBS[4]	3.7%	3.9%	+20
Mortgage Pass-through	2.2%	2.6%	+40
U.S. Treasury	4.7%	4.9%	+20
Cash and equivalents	7.3%	6.3%	-100
Total	**100%**	**100%**	
Yield-to-worst	2.95%	3.44%	+49
Duration (years)	1.47	1.57	+10
Average Life (years)	1.86	2.01	+15

With rates meaningfully higher during the first quarter, we worked to add duration to the portfolio in a manner consistent with our oft-described goal of buying bonds with sufficient yield to produce an expected positive total return over 12 months, assuming that yields would increase by 100 basis points (bps). Moreover, due to low spreads, we have been further stress-testing investments on a case-by-case basis to gauge whether they could produce a positive total return in an environment of higher spreads. This latter test has generally meant that our investment activity has tended more toward plain-vanilla bonds and issuers, eschewing novel asset classes and newer, less seasoned issuers that can surface when markets become expensive.

During the quarter, we invested approximately 14% of the portfolio in a combination of high-quality (single-A rated or higher) asset-backed securities, agency and non-agency mortgages, commercial mortgage-backed securities (CMBS) and investment-grade corporate bonds that, as a group, have an average duration of approximately 2.5 years. Within that, the bulk of the investments were directed toward asset-backed securities and agency mortgages. Asset-backed securities (ABS) investments included auto ABS (the majority of which are backed by prime-quality borrowers), equipment ABS and credit card ABS. The higher-interest-rate environment has begun to resuscitate the agency mortgage market, which had long been plagued by insufficient yield, both on an absolute basis and relative to the duration and convexity, or the change in duration that can occur as rates change. We bought agency collateralized mortgage obligations (CMOs) and pools at prices that we are hopeful will yield attractive returns even if higher rates lead to slower prepayment speeds. These investments were funded with a combination of cash on hand, proceeds from amortization and maturities that occurred during the quarter, sales of existing ABS that had remaining average lives of less than six months, and the sale of a few specific investments that we felt were no longer attractively priced relative to the credit risk and mark-to-market risk.

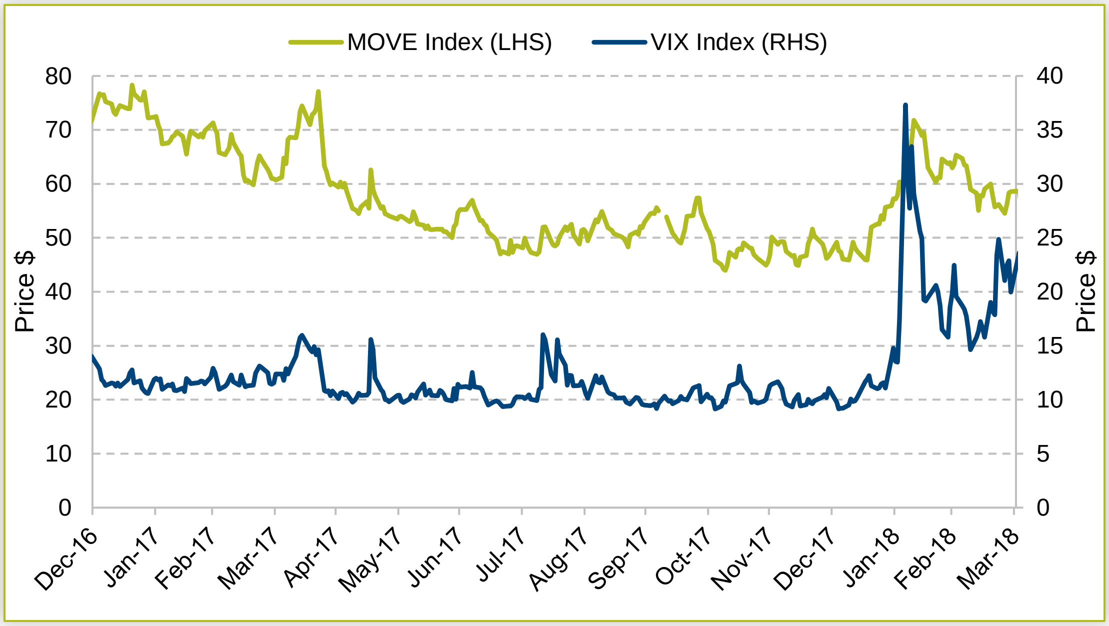
Due to the lack of attractively priced credit opportunities (BBB rated and lower), the portfolio's credit holdings have been decreasing for the past three years. That trend continues today. Though rates are higher (good) and spreads were unchanged this quarter (also good), the absolute level of yield available on credit investments is still short of adequate compensation for credit risk (both fundamental credit risk and structural credit risk). We occasionally find new ideas, and as the market becomes more volatile, we can add to existing positions at attractive prices. However, these investments have thus far been more than offset by the maturation of existing holdings and the occasional active reduction of certain positions. We are hopeful that we are seeing the beginnings of a cheaper market, but until that market materializes, we expect the Fund's credit exposure to continue to decline.

[3] Collateralized mortgage obligations are mortgage-backed bonds that separate mortgage pools into different maturity classes.
[4] Commercial mortgage backed securities are securities backed by commercial mortgages rather than residential mortgages.

Market Commentary

Since the presidential election, markets have been buoyed by optimism of stronger economic growth, and prices for riskier assets had been moving in one direction – up in price (or down in attractiveness, depending on your view). The S&P 500 reached an all-time high on Jan. 26, 2018, and then on Feb. 5 experienced its largest one-day point drop ever and its largest one-day percentage decline in the last six years.

The commonly attributed cause for the February plunge was the return of volatility after relative calm during the 1.5 years following the November 2016 presidential election. As shown in the chart below, the VIX[5] index, a measure of equity market volatility, spiked in February of this year.



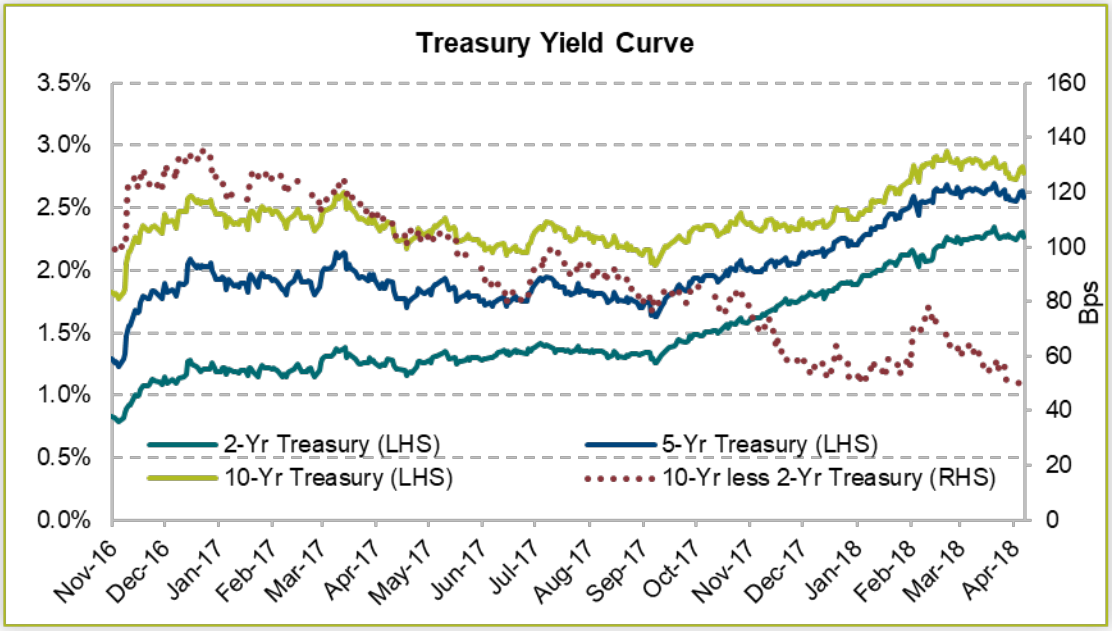
Source: Bloomberg.

The spark for that volatility may never be known, and that should be a reminder to investors that often risks can be unforeseen.

Since that spike, the equity market has been decidedly more volatile, with more recent volatility attributed to the risk of a trade war between the U.S. and China. The chart above shows that increased volatility has enveloped the bond market too, as measured by the Merrill Lynch Option Volatility Estimate (MOVE[6]) Index. The bond market had generally been more volatile since the election, but it too had been less volatile of over the past eight months, with yields moving consistently higher:

[5] The VIX Index is a calculation designed to produce a measure of constant, 30-day expected volatility of the U.S. stock market, derived from real-time, mid-quote prices of S&P 500 Index (SPXSM) call and put options.

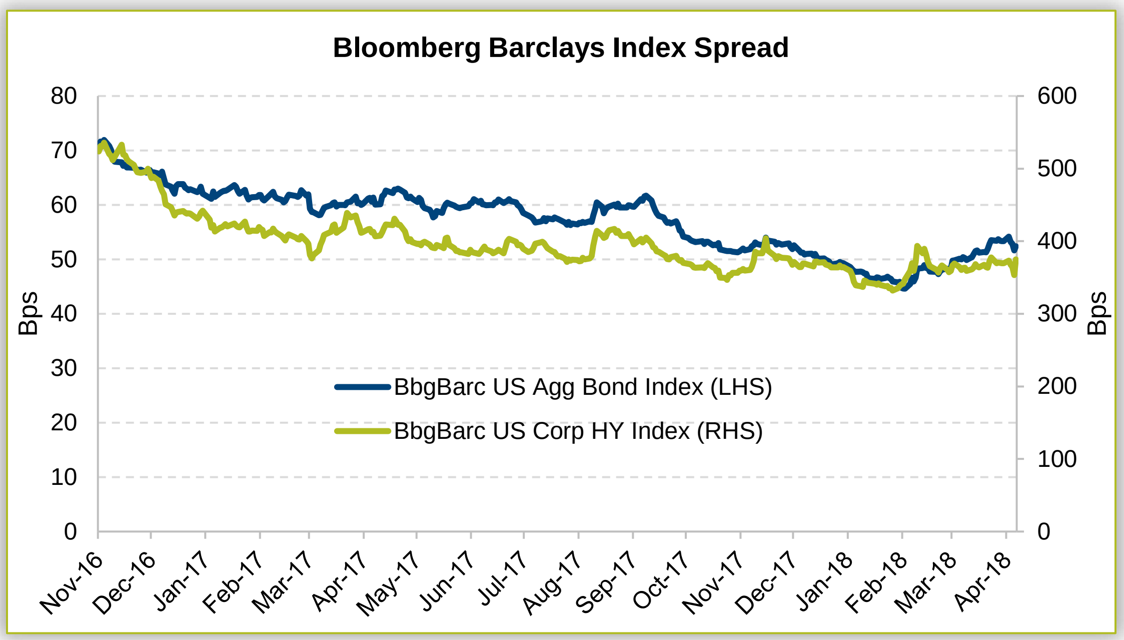
[6] The Merrill lynch Option Volatility Estimate (MOVE) Index is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options which are weighted on the 2, 5, 10, and 30 year contracts



Source: Bloomberg.

With the spike in the VIX and the trade war threat, the rates market has been vacillating between lower rates and a flatter slope (economic growth is at risk), and higher rates and a steeper slope (everything will be fine, there is nothing to see here).

Similar to the rates market, bond market spreads have gone from risk “on” to risk “we’re not sure”:



Source: Bloomberg.

Spreads had trended lower from the election into the beginning of 2018. At the end of January though, spreads widened in both high-quality bonds, as measured by the Bloomberg Barclays Aggregate Bond

Index, and in high-yield bonds, as measured by the Bloomberg Barclays High Yield Bond Index. Spreads on both indices subsequently rallied to levels roughly equal to those at the beginning of this year.

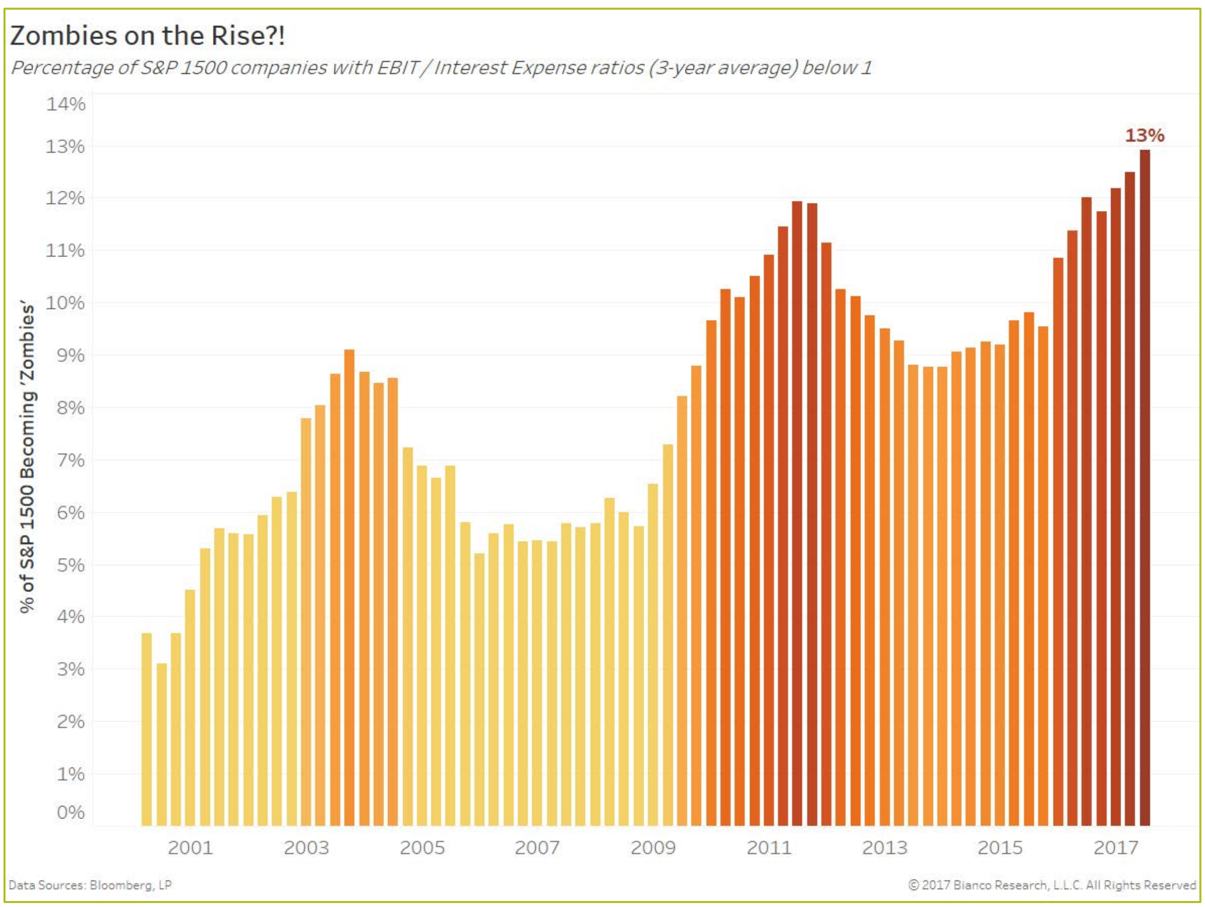
In short, we are no longer in a one-way market. We are hopeful that these changes in trajectories mark the beginning of a more attractive opportunity set for absolute return investors like us. However, with greater opportunity also comes greater risk. High prices in bonds have left fixed income investors more vulnerable to market swings, as low rates have left them exposed to the highest duration on the Aggregate Bond Index since 1989. Investors can no longer count on unidirectional money flows and rallying markets to bail them out of speculative bets and bad trades. We have never made such bets. In contrast to passive strategies, we are hopeful that our active management of this portfolio will leave us well positioned to take advantage of opportunities as they arrive, and to protect capital in the meantime.

Beware the Zombies

Over the course of our fixed income market research, we sometimes come across analysis that we find thought-provoking even though it may be outside the mainstream and might not always offer a neat and tidy conclusion. These ideas at times keep us awake at night as we contemplate whether they could have a negative impact on our portfolio and/or the fixed income markets as a whole.

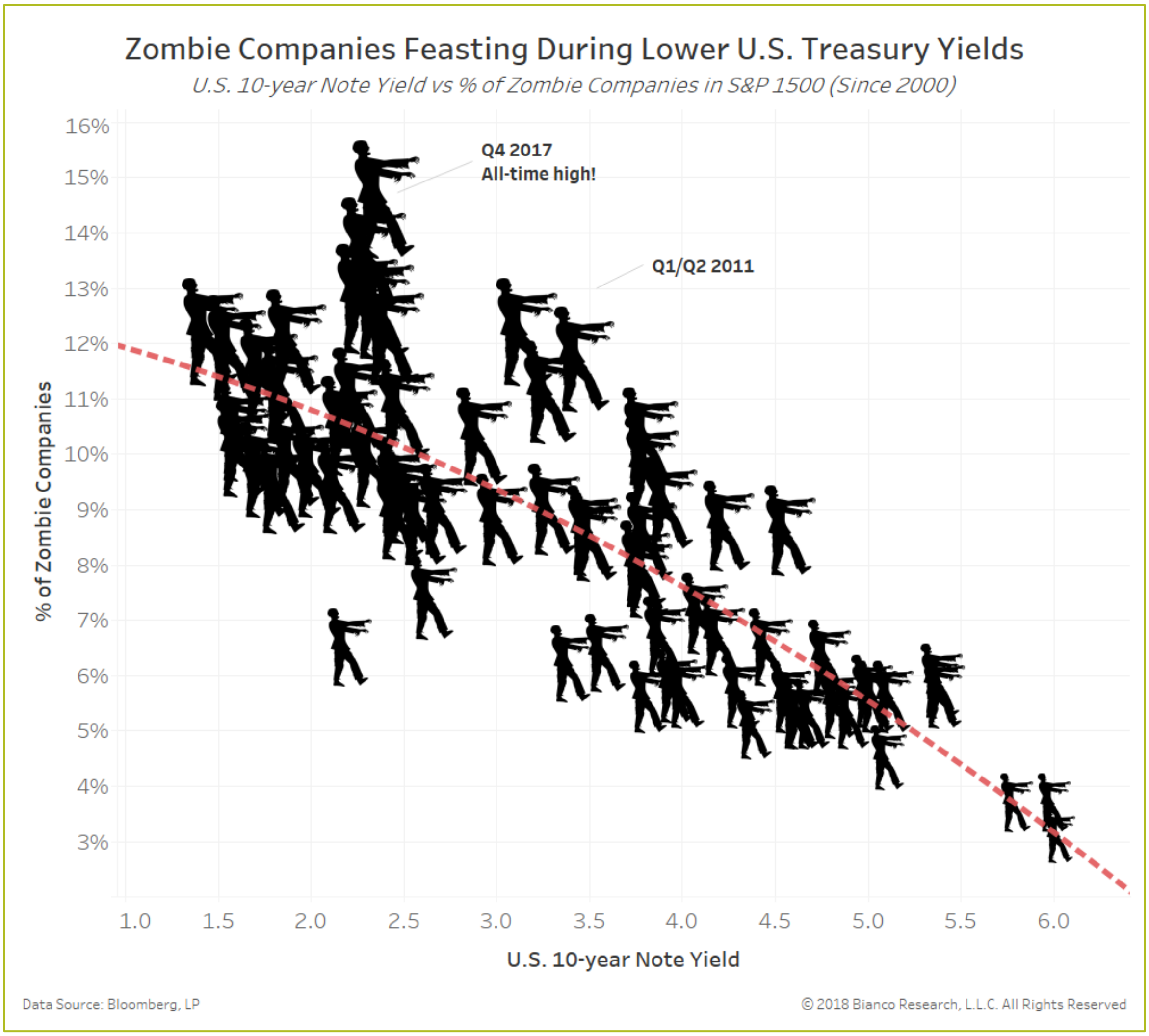
Recently we came across an interesting and cautionary commentary on zombie companies. A zombie company is an entity that spends more on interest than the business earns. In technical terms, a zombie company has a ratio of less than one when calculating its earnings before interest and taxes (EBIT) divided by cash interest expense (using a multi-year period to minimize the effects of one-time negative events).

The graph below depicts the percentage of S&P 1500 companies that are zombies:



At the end of 2007, only 5.7% of companies in the S&P 1500 fit this definition. Ten years later, on Dec. 31, 2017, this type of company represented 13% of the S&P 1500, a higher percentage than during the great recession. Excluding the energy sector from the calculation, zombie companies represented 11.4% of the index, twice the 2007 number.

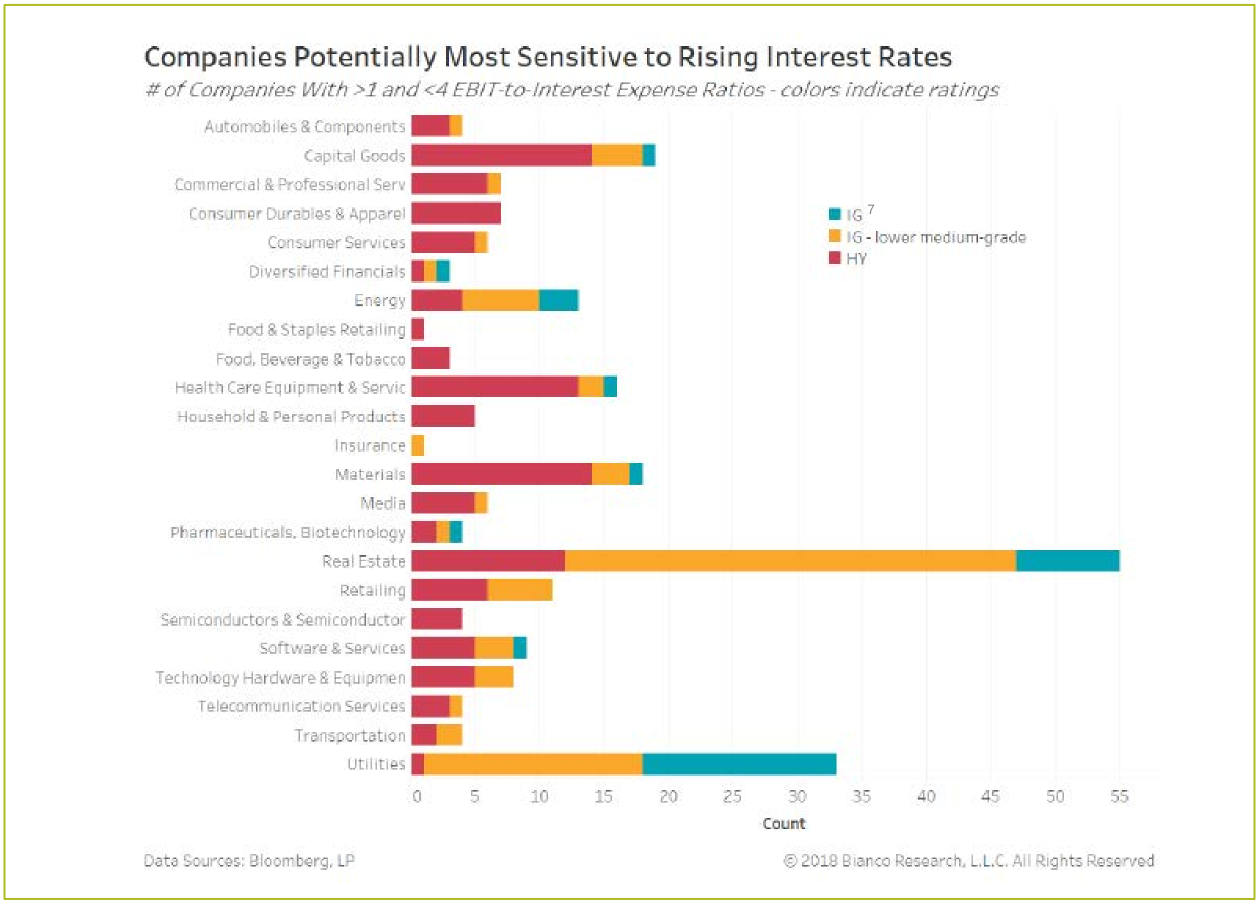
Over the last decade, two policies appear to have helped produce this dramatic increase in zombie companies: Quantitative easing (QE) and the Federal Reserve Bank's zero interest rate policy (ZIRP). Plotting the percentage of zombie companies against the yield on the 10-year treasury since 2000 shows a correlation between lower treasury rates and a higher percentage of zombie companies.



If the expansionary monetary policy tools implemented post-2008 contributed to the rise of zombie companies as illustrated above, what potentially could happen to the number of zombie companies in the system as those same expansionary monetary policies are unwound going forward?

The chart below depicts the number of companies in the S&P 1500 by industry sector that have an EBIT to interest expense ratio of 1-4 times. It further shows the number by credit quality.

Several industries stand out as "at risk" to an increase in the number of zombie companies: real estate, utilities, capital goods and materials. For a variety of reasons, these industries appear to be under pressure from a change in their competitive landscape.



One objective of both of the Federal Reserve's Quantitative Easing (QE) and Zero Interest-Rate Policy (ZIRP) monetary policy initiatives, per then-Chairman Ben Bernanke in November 2010, was to create a virtuous cycle. Lowering corporate bond rates to encourage investment was part of that cycle.

The alternative view of these policies is that the resulting cheap money enabled highly indebted companies to survive (albeit as zombies). Our current economic system presumes that only the strong survive. Weak or poorly run companies are supposed to either perish or be recapitalized and given new management to make them competitive. Zombie companies have a detrimental impact on an industry by dragging down productivity and stymying innovation. In addition, pricing action by the zombie can have a negative impact on stronger companies in that they are unable to optimize profit. Data also suggests that these companies constrain wage and benefit growth for their employees. As QE and ZIRP unwind, resulting in positive real rates for treasury securities, zombie companies will feel pressure from higher debt costs. Those rising costs may finally decapitate these zombies.

Respectfully submitted,

Thomas H. Atteberry	Abhijeet Patwardhan
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April 2018

[7] IG = Investment Grade (AAA, AA, A credit quality); IG – lower medium-grade (BBB), HY = High Yield (BB & below)