investors first

Q3 2021 FPA New Income, Inc. (FPNIX) and Flexible Fixed Income (FPFIX) Webcast
October 27th, 2021

Note: Items in brackets [ ] are meant to be clarifying statements but are not part of the actual audio recording of the webcast.

This transcript must be read in conjunction with the corresponding webcast slides, posted on fpa.com. The webcast slide page numbers are referenced below. Please also reference the Important Disclosures at the end of this transcript and throughout and at the end of the webcast presentation.

You should consider FPNIX and/or FPFIX (each a "Fund", and collectively the "Funds") investment objectives, risks, and charges and expenses carefully before you invest. The Prospectus details each Fund's objective and policies and other matters of interest to the prospective investor. Please read the Prospectus carefully before investing.

This transcript must be preceded or accompanied by a prospectus for the Funds. The prospectus for FPNIX dated January 28, 2021, and supplement dated April 19, 2021, can be accessed at: https://fpa.com/request-funds-literature. The prospectus for FPFIX dated April 16, 2021 can be accessed at: https://fpa.com/request-funds-literature. The most current prospectus can always be obtained by visiting the website at www.fpa.com, by calling toll-free, 1-800-982-4372, or by contacting each Fund in writing.

(00:00:10)

Moderator: Hello, and welcome to today's webcast. My name is Sarah and I will be your event specialist today. All lines have been placed on mute to prevent any background noise. Please note that today's webcast is being recorded.

During the presentation, we will have a question and answer session. You can ask text questions at any time by locating the Q&A panel on the left side of your screen, type your question in the open area and click New Question to submit.

For optimal viewing and participation, please disable your pop-up blockers. And finally, should need technical assistance, as a best practice, we suggest you refresh your browser.

It is now my pleasure to turn today's program over to Kristina Surkova. Kristina, the floor is yours.

Kristina: Thank you, Sarah. Good afternoon and thank you for joining us today. We would like to welcome you to FPA New Income and FPA Flexible Fixed Income Funds Third Quarter 2021 Webcast. My name is Kristina Surkova, and I am the relationship manager for the Fund. The audio, transcript, and visual replay of today's webcast will be made available on our website, FPA.com.

In just a moment, you will hear from portfolio managers Tom Atteberry and Abhi Patwardhan and members of the Fixed Income investment team.

Tom Atteberry is a partner at FPA and joined the firm in 1997. Tom has been a portfolio manager of FPA New Income, Inc. since 2004, and a portfolio manager for FPA Flexible Fixed Income Fund since its inception in December 2018.

Abhi Patwardhan is a partner at FPA and has been with the firm since 2010. He has been Director of Research for FPA New Income since April 2015, and portfolio manager for the Fund since November 2015. He has served as a portfolio manager for FPA Flexible Fixed Income Fund since its inception in December 2018.

(00:02:18)

[Please reference slide 2] And now let's talk about what happened during the quarter. Yields have risen in anticipation of change in monetary policy. Bond markets remain expensive, and the portfolios are invested accordingly.

As part of today's agenda, Tom and Abhi will discuss the highlights for both funds, provide commentary on the market, review performance and portfolio activity, and then open it up to question and answers. And now I turn it over to Tom.

Tom: [Please reference slide 3] Thank you, Kristina, and thank you, everyone, for joining us this afternoon for our call. We'll start out with a couple of quick comments on our performance for both the New Income Fund and the Flexible Fixed Income Fund.

Both year-to-date and one-year performance was very good versus not only the Agg but the 1-3 Year Aggregated Index as well, as we're outperforming both.

Looking out five years, and we're going to touch some today on, versus inflation, we're just sort of finding ourselves in line with CPI or CPI plus 100, we're obviously sort of behind. The reason for that is if you look at year-to-date of the one-year CPI plus 100 row, you will see that over the last year, CPI's been about 5.4% and if you add 100 basis points, 6.4%. That's an awful high number to try to overcome given the current interest rate environment we find ourselves in. Having said that, we're doing a significantly better job than either the 1-3 Year Index or the Agg, so we're sort of heartened by that.

(00:04:01)

[Please reference slide 4] Going for a second to look at Flexible Fixed Income, again, it's had a very good quarter, it's had a very good year-to-date, and one-year as we compare ourselves to the Bloomberg Universal index. And then as we look at CPI plus 200, it has that same hurdle it's trying to get over but again, it's not been around for five years so the one-year number is not terribly important. And even the since-inception number, which is only not quite three years yet, we've done fairly well versus CPI. CPI plus 200 we've obviously been short of, but for obvious reasons given the elevated level of CPI. We're very comforted and confident. We like what's gone on so far with Flexible Fixed Income Fund and really, once we get to three years, as the return number and some statistics and stuff, we'll probably start to share more with you.

[Please reference slide 6] So moving forward here, I'm really not going to spend a tremendous amount of time on the highlights of the Fund. We've shown this before. Only to say that we look at it, we're very happy with the growth that has gone on in Flexible Fixed Income. In fact, we're more than happy because it's kind of been faster than we thought it would be. And we continue to price through our net expense ratios to make sure that we're very competitive and both of them sit in the below-average category.[1]

[Please reference slide 7] So I do want to spend a minute here on the general statistics of both funds and how they compare to the indices because that really starts to do the framework for what we're going to discuss for the rest of today. Into the quarter, the duration on the New Income Fund was 1.32 years and the yield-to-worst was 1.00%. So when you take that ratio, it's 0.76. This compares very favorably with either the Aggregate or the 1-3 Year Aggregate Index. We're getting about not quite 65% of the yield of the Aggregate Index and we're getting more than twice the yield of the 1-3 Year Agg, while taking significantly less interest rate risk through duration. And that really shows up in the fact—and when you look at the two indices, that ratio of yields to duration, they're both down not that far off at 0.20 and 0.23. So they're very sensitive to changes in rates.

[1] Source: Morningstar (https://www.morningstar.com/funds/xnas/fpnix/quote).

(00:06:29)

Looking at Flexible Fixed Income below, we're getting about almost 90%—really it's [approximately] 86%—of the yield of the [Bloomberg U.S.] Universal Index, which is the benchmark that it looks at, but we're taking only a little over 10% of the interest rate risk or duration to get there. The result is, again, that yield-to-duration is very attractive with Flexible Fixed Income, and you look at the index, it's not that much different in either the [Bloomberg U.S.] Agg or the [Bloomberg U.S.] 1-3 Year Agg. They're [currently] very sensitive to changes in rates.

[Please reference slide 9] So from this, let's spend a minute on the market commentary, and we're going to start out with what's the debate that is going on, and that debate really is: Is inflation transitory or is it persistent? It's a debate that has started, and started out with the transitory crowds giving their arguments, and then we're seeing the persistent crowd stand up and give their argument.

What we're looking at on this graph is we've done things, we've sort of divided CPI into three components—energy, which is pretty commonplace; and then what is reopening components and non-reopening components. Well, think of the reopening components of this. They're new car prices, used car prices, vehicle insurance, airfares, hotel rates, food away from home—all those things that were very acutely impacted by the pandemic and the recession that went on. The non-reopening is everything else except energy. Looking at this month-to-month data, you see that beginning and that, into the second quarter of 2021, that orange bar which is the reopening components having a very big on month-over-month CPI. If you go the left, and just sort of look at history—this goes back to 2017—those reopening components tend not to be a very big part of inflation and its movement. The blue, the non-reopening components, have been accelerating, but that acceleration is more in the last couple of months, and they are now at levels that are higher than they were if we look back at 2017, ’18 and ’19. And as you would expect, inflation—I mean not inflation, I’m sorry—energy tends to move around a lot. It tends to be a fairly volatile opening—component to CPI.

(00:08:53)

[Please reference slide 10] So we’re going to go from the month-to-month that you see here, and then go to the next slide where we’re going to look at year-over-year, and it’s the same breakdown. And what you notice here is, first off, year-over-year CPI, that white line, has tended to stay elevated for several months. It’s not really moved down; it’s shot up and stayed there. But the components driving it have shifted. That blue set of bars, the non-reopening components, they’ve been growing each month on a year-over-year basis. In fact, now they're back to kind of that peak that you saw right before the pandemic at the end of 2019/the beginning of 2020. Energy, which was a negative driver, the red bars, during 2020 has now become a bigger positive driver—not surprising given that it tends to be a more volatile element. And then the reopening components, which were negative in the beginning of the pandemic, in March, April, May—you see that in 2020—while they perked up and were big in the beginning of the year, they're starting to dissipate.

(00:10:02)

Now, having said all this, yes, we have this inflation. It seems to be hovering around 5% the last couple of months on a year-over-year basis. But there's going to be time really needed to figure out this debate between transitory and persistent, and which one is the winner and which one isn't, and things are still very inconclusive.

[Please reference slide 11] So moving next, how does the market start to think about this? And so the graph on the left is a market consensus of inflation playing out over the next year. So for the US in white, Canada in yellow, the Euro area in blue, the UK in purple, and Japan in red—the dotted lines represent projections—and this is sort of a survey of 47+ economists and what they think. And when you look at this, you realize that as you get towards the end of 2022 into the beginning of 2023, and that white line—US inflation—sort of dwindles itself back to 2%, which is the long-term target of the Fed, something that at this point is sort of telling you, well, this group of people, these market economists, are thinking, ah, this is transitory. That's tending to be the conclusion that they've come to.

But before we take a lot of stock in that conclusion, let's look at the quote on the right, and I'm just going to synthesize. I'm not going to read the whole thing. It comes from an ex-Fed Governor, who basically comes out and says that the Fed does not have an inflation model. It's very effective at helping it in its policymaking decisions. That would seem to predict that the—certainly imply—that the Fed's ability to predict the level and rates of inflation is probably not very good if they don't have a model that can tell them that.

Well, if the Fed doesn't have a model, then all the people on the left-hand side that this graph told us, you might want to imply a conclusion: they probably don't have one either. So there may not be that good of a model that can predict inflation. So what that leaves us with is this debate about transitory and persistent. The only way we're going to figure out the answer is time. It's going to tell. So it's a time-dependent decision and not one that [we believe] you can really have any high degree of confidence can be predicted by either the Federal Reserve or by a group of market economists.

(00:12:30)

[Please reference slide 12] So let's look a little bit at the short term first and then we're going to go branch out to the long term. So, remembering that inflation data that we just showed you on reopening and non-reopening, it all goes through September. And okay, we see those changes, we understand the debate that's going on, so how is the market reacting to it? And so you have two bar charts here. The one on the left is the number of Fed funds rate increases, and the one on the right is what's the implied Fed funds rate for these periods of time. The periods of time that are listed here correspond with Federal Open Market Committee meetings.

The reason that you see this to be October 22nd, [2021] or last Friday, is really to be able to capture your September inflation data, because it did not come out until early in October. And when you look at this, and you look at the blue bars, which is October 22nd, [2021] and the green bars which is the end of July, there's a couple of things that start to stand out. Well, at the end of July [2021], markets thought by the end of the year 2022, there was a slightly better than 50/50 chance the Fed would raise rates once. And that increase would result in the Fed funds rate, implied rate, going to something that looked like a high 20s to maybe 30 basis points. As of October 22nd, that view has now changed to, oh no, there's going to be two increases by the end of 2022. That's the blue bars. In fact, if you kind of creep back a little bit, you'll notice that by June/July of next year, the marketplace currently thinks there'll be one increase. And the result is that the Fed funds rate by the end of next year will be something that looks like a little over—implied rate [we expect] will be something a little over 60 basis points.

(00:14:25)

The other thing that's interesting when you look here is the green bars don't have much of a slope. They're kind of general, and they sort of gradually move up. The blue bars are the more recent representation, much steeper in their ascent.

[Please reference slide 13] So looking at this, let's take a look at how did that impact the Treasury yield curve? Again, keep in mind, this is looking at the end of June, but keep in mind it's looking at the 22 October [2021] because it wants to capture that September CPI data. So those are the two periods. And what you notice when you look at these two periods, that solid or darker green line which is October 22nd [2021] that the yield curve looked at, there's a significant increase in yield in the 2-7 year portion of the curve. It's become much steeper than it was, to sort of reflect that okay, the Fed looks like they may have more Fed funds increases sooner rather than later.

When you look at sort of 10 years and beyond, there's much less of a change. In fact, the 20- and 30-year almost don't change at all. And this might be a reflection of that transitory consensus that inflation's not going to be a long-term problem but maybe just transitory in nature.

How this change has been impacting the portfolio, what we've purchased and how we've allocated things, I'm going to leave to Abhi and he'll speak about that later on in the presentation, but just wanted to bring this to your attention.

[Please reference slide 14] So how is this change that we've seen in the yield curve showing up along with the changes in Fed funds expectations from the market, in breakeven inflation rates, and in real yields? Now, keep in mind, a breakeven inflation rate is you take the yield on a Treasury Inflation Protection—a TIPS bond[2]—and you subtract it from its corresponding nominal Treasury [yield].

(00:16:18)

And so on the left, we've got this breakeven inflation. We've got a 2-year, a 5-year and a 10-year. And then looking at the graph, pretty much through the second quarter until last month, eh, not a whole lot of change. You did see the 2-year decline,[breakeven] inflation rate decline, probably

[2] Treasury Inflation-Protected Securities (TIPS) provide protection against inflation. The principal value of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index (CPI).

reflecting people's thought of, okay, this is a transitory inflation problem not really a persistent one. But the 5- and the 10-year just sort of bounce around with not much happening. And then in that September period, in the beginning of October [2021], all three of them move up to where you've got the 2-year implied inflation rate of 3%, and 2.9% for the 5-year, and a little over 2.6% for the 10-year. All three of those are in 2021 high. That reflects people's view that it's going to be more persistent.

Things that might support that view are the real yield on the right, which is just the price and coupon for a 2-year TIPS bond, a 5-year TIPS bond and a 10-year TIPS bond. For the 5- and the 10-year, not much really changed during the quarter. They move up and they move down, but not much happened. And for the 2-year, it actually becomes more negative, which would reflect an increase in prices which may counter the persistent crowd and think, eh, this is maybe more temporary.

The bottom line of this is that those breakeven inflation rates really were all dictated by nominal yields and not really by changes in people's real yield views.

(00:17:51)

[Please reference slide 15] This is the short-term look. Now I want to focus for a minute on looking long-term at Treasury rates and inflation, and so we have on this graph the green line being US inflation on a year-over-year change, and then you've got a dark blue line which is a 1-year constant maturity Treasury, a red line that's an intermediate Treasury index—roughly 5 years think of—and a long Treasury index that's 20+ years. The data is from 1954 till the end of 2020.

And when you look to the left and just think through 1954 to 19—sort of—79, inflation is on a pretty consistent upward trajectory. It's got a couple of spikes in it, but it's on this upward trajectory. But interestingly, up until 1972, all three of those Treasury indices have a yield that's greater than inflation, or a positive real yield.

Now, when you look at rates, they finally, towards the end of the Seventies, peak in about 1980, and peak at level greater than inflation. So they eventually, the yield catches up and gets ahead of inflation. The other thing just to note is that the intermediate and the short indices in that spike at the very top around 1980 are higher than long. So it actually is an inverted yield curve.

Then you have this very precipitous drop in inflation, and a persistent decline after that from 1980 towards basically sort of 2014-15, it's on a pretty consistent downward trend. And real yields again are positive because the yields are greater than inflation. But that starts to shift when you look to the far right, and you look at it sort of post-2008. All of a sudden, the intermediate index and that 1-year constant maturity index have yields less than inflation. And the long index eventually finds itself having a yield that looks just like inflation. So, as you look to the far right-hand side, you've got this inflation level and yields that looks different. The yields are on top of or less than inflation, versus where you are—where you started—in 1954, and moving from the left-hand side.

(00:20:11)

[Please reference slide 16] So how does this, on the next slide, how does this look if we say let's do an exercise here, and said let's do rolling 5-year returns for that 1-year constant maturity, that intermediate-term Treasury index and that long-term Treasury index? Let's do a 5-year rolling return and let's subtract from that the 5-year rolling inflation rate, what we've seen on the previous page. And a pattern starts to develop that is interesting. Even during the periods on the left-hand side where yield was greater than inflation, by the time you entered the Sixties, the real return that you were getting—whether it was the 1 [year], the 5 [year] or the long [maturity], you know—was negative. Now obviously as you got into the Seventies and inflation accelerated even higher, and inflation was greater than yields, those got very negative. And it wasn't until that sort of '80-'84 period where inflation declines and you had extremely high yields did the return flip around to where you were getting a higher return versus inflation, your real return's quite high.

And then you notice, as you go across the right-hand page, that real return gently declines over time and again, you get to the 2008 period, and that dark blue line which is the one, your constant maturity Treasury, hmm. All of a sudden, it has a real return on a rolling 5-year basis that's negative. And you get sort of closer to 2014, and lo and behold, that intermediate Treasury index's rolling 5-year return, real return, turned negative. Now both of them do sort of tail off at the end, but you see my real return on a rolling 5-year basis has become less and less and less, and then in obviously the short end, the shorter end of the spectrum of maturities, turned negative.

(00:22:10)

So you look at that, and you go okay, I have got negative real returns similar to what I had in the Seventies, in that inflation and yield environment, and I have it today. So looking forward, how best could you cope with this low or negative real return that you're receiving in bonds? [Please reference slide 17] I'd reference how our yield-to-duration looked like for the end of the third quarter, and this graph merely looks at that data back in time, on a quarterly basis back to 2010. And we look at ourselves in the light blue line, we look at a dark blue line which is the [Bloomberg U.S.] 1-3 Year Aggregate Index, the red line which is the Aggregate Index, and then a green line which is the Morningstar Short-

Term Bond Fund category. Now in that one, the data we have is yield-to-maturity and duration, so it's slightly different, but it's going to give us a little more picture.

And a couple of things start to unwind. When you look to the far right, you go wow, whether it's the Agg or whether it's the 1-3 Year Agg, that ratio is low and has been low for quite a while. It's in the 20-25 basis points. When you look at our peers, the index—the peers, the category—it's been less than 50 basis [points]—0.5%—and now it's even declining from there. And in all three of those cases, it's lower than it was in the 2012, '13, '14, '15 period—last time we experienced zero interest rate policy, quantitative easing, and really significant negative real rates.

(00:23:51)

Ourselves in our portfolio, we have consistently been higher. Yes this last year we have not been at 1. It has been somewhat less than 1, but it is still significantly higher.[3] And so when you look at this, if your conclusion is that, and the arguing comes out to where persistent inflation is here to stay, then we're in a better position than either our peers or these two indices. If, on the other hand, it's more transitory in nature, as we've shown in the beginning, our yield-to-worst is higher than the indices,

[3] Past performance in no guarantee, nor is it indicative, of future results. FPNIX does not include outperformance of any index or peer group in its investment objectives. An investor cannot invest directly in an index or Morningstar category.

although we didn't have the data if it's higher than our peer group, and that should benefit us well if it's just a transitory inflation situation.

[Please reference slide 18] So next, we're going to do the same exercise and we just, at this point, we took out the Aggregate Index and really focused on the index that works against our portfolio today, and the peer group, the Short-Term Bond Fund category from Morningstar, and said: what's the rolling 5-year real return? We're the light blue, the peer group is the green, and the index is the dark blue.

And when you look at it, you look at ourselves, even in these very low rate environments where negative real yields have occurred, we've— not all the time but we've been able to do pretty well, at least earning, on a rolling 5-year basis, inflation. We've done better than our peers, and we've done better than the index, definitely. And when you look at the period sort of coming out of 2015 and you look forward, '15 through let's say the end of last year, 2020, you see that our rolling 5-year return on a real basis increased, increased, increased, didn't quite get to 1. And yes, it's tailed off, as would be expected with what we've seen in interest rate policy, but we are still slightly positive, whereas the index or our peer group has definitely turned into a negative territory.[4]

[4] Past performance in no guarantee, nor is it indicative, of future results. FPNIX does not include outperformance of any index or peer group in its investment objectives. An investor cannot invest directly in an index or Morningstar category.

(00:25:56)

So when we put this in combination with the previous slide—and the previous slide really, at times, speaks to more of our objective of trying to get a positive return in a 12-month period—then you go okay, if we can get that positive return in a 12-month period, it goes a long way to helping us achieve an inflation-plus objective over a 5-year period, because we're not trying to play catchup. We're not on every single year trying to beat inflation. We're only trying to do that on a rolling 5-year basis, but we are definitely trying to get that positive 12-month return every year.

[Please reference slide 19] So I'll wrap up with a few things here that are, again, coming back to the more current history and valuation. The graph at the top looks at what did the yield curve do the last time the Fed went on a rising rate policy change? And so it starts 12 months before the first increase, which was December of '15, so this is starting December '14; and ends with their last increase, which was at the end of 2018. Then, as you'd expect, Fed funds rate increases, yield curve flattens out. Not a real shock. More rising at the short end than at the long end.

Interestingly is the chart at the bottom which looks at the 1-3 Year Index, the Agg, we threw the High Yield Index in here to give you a sense of how credit acts in this environment, the Morningstar Short-Term Bond Fund category, and New Income Fund. And in 2014, now we were slightly less than our peer group, and definitely we performed less than the 1-3 or the Agg itself. But when you look at 2016, '17 and '18, our performance is better than the [Bloomberg U.S.]1-3 Year Agg, and it's better than our peer group on a consistent basis. The far right-hand column is just, okay, let's just do an annualized—the whole period of time—and we've outperformed our peer group during this type of environment where you sort of have a rising Fed funds rate. We've outdone the [Bloomberg U.S.] 1-3 Year. Interestingly, we did better than the [Bloomberg U.S.] Aggregate Index itself as well.[5]

(00:28:11)

[Please reference slides 20 - 22] So from that, what kind of valuation are we looking at today? And I'm going to quickly go through a couple of items here to help out. And so these graphs, there's one for the [Bloomberg U.S.] Aggregate Index, the next one's for the [Bloomberg U.S.] 1-3 Year Agg, and then there's one for the [Bloomberg U.S. High Yield] BB portion excluding energy of high yield. And they're all telling basically the same story, and that is we show you the blue line which is yield-to-worst, the green line which is spread, and the sort of dark gray line which is an

[5] Past performance in no guarantee, nor is it indicative, of future results. FPNIX does not include outperformance of any index or peer group in its investment objectives. An investor cannot invest directly in an index or Morningstar category. Please see the end of the transcript for important Morningstar disclosures.

implied real yield. It takes whatever corresponding breakeven inflation rate would be associated with the index and subtracts it from yield-to-worst. And the point of this is in each case when I look at implied yield, and we look at spread, they're all lower today than they were during the period of 2011, ‘12, ‘13, ‘14, ’15, the last time when you had significantly negative real rates. And whether it’s the [Bloomberg U.S.] Agg on this page, or if we look at the next page and we look at the [Bloomberg U.S.] 1-3 Year Agg, it has a very similar look to it, or if we even go the page after that and we look at the [Bloomberg U.S. High Yield] BB. The point of this is valuation is more extreme today than it was the last time—using that 2014-’18 period as being the last time when the Fed undertook a rising inflation—I’m sorry, a rising Fed funds rate policy. So valuation’s more stretched today than it was in the past.

[Please reference slide 23] Two last things to comment on here. This looks, this chart is looking at how we’ve performed and how the [Bloomberg U.S.] 1-3 Year Agg’s performed, and how our peer group has performed over the last 10 years in sort of three buckets of inflation. Where CPI was 1.75% last—we’ll call that low—moderate was sort of 1.75-2.25% kind of brackets, that 2% Fed target moderate, and then high which is anything greater than 2 and a quarter.

(00:30:15)

In a low inflationary environment, we do better than inflation—inflation was about 1.18% and our performance was 1.77%—but we do fall short of the [Morningstar] Short-Term Bond Fund category or the index. This is the [Bloomberg U.S.] 1-3 Year Index.

But when you look at the moderate and the higher, we are higher than inflation on the moderate. We are not quite higher than it is in the high-inflation environment, and we are significantly better in performance than our [Morningstar] Short-Term Bond Fund category or the [Bloomberg U.S.] 1-3 Year Aggregate Index.

The bottom looks at sort of the number of periods and how we did, and I'm just going to focus on the outperformance of inflation. We outperformed inflation over 60 of 76 periods dictated here, and that's 75% of the time our performance was better than inflation. The [Bloomberg U.S.] 1-3 Year Agg, ah, it was sort of about 17% of the time, and the Morningstar peer group was about 50/50, roughly. So we've done a much better job at doing, at outperforming inflation than either the peers or the index. That's the point here.[6]

[Please reference slide 24] And then let me close with just how's the performance been near term. There's two graphs that we're looking at.

[6] Past performance in no guarantee, nor is it indicative, of future results. FPNIX does not include outperformance of any index or peer group in its investment objectives. An investor cannot invest directly in an index or Morningstar category. Please see the end of the transcript for important Morningstar disclosures.

The top one is the third quarter. The bottom one is year-to-date, and that period's obviously ending September 30th, [2021] We just compare ourselves with the [Bloomberg U.S.] 1-3 Year Agg and the broad [Bloomberg U.S.] Aggregate Index. Those are the two that we do.

And when you look at the third quarter [2021], that dotted line at the top, that's the [Bloomberg U.S.] Aggregate Index. It jumps around a lot and eventually, as the Fed funds policies perspectives and inflation perspectives changed, it plunged and ended up being just about negative. It kind of got back to zero. The yellow line, which is the [Bloomberg U.S.] 1-3 Year Agg, tails off towards the end of the quarter, stays mildly positive. But you see just sort of—I hate to use it and say it this way—we're just sort of plodding along, increased a little bit along the way, had much less volatility, and ended up in the quarter better, in a positive position, than the other two—than those two indices.

(00:32:26)

The bottom, which is the year-to-date, the [Bloomberg U.S.] Agg Index has been negative all year and it's sort of stayed there. The [Bloomberg U.S.] 1-3 Year Agg has rolled itself back to just about negative, like 7 basis points worth of positive. And again, we sort of have that plodding, slowly moving along, progressively better performance. It's not fabulous but it's a little over 1%. It's kind of, you know, it's reasonable.

The point being is it tends to be, in these environments, you tend to see us less volatile and you tend to see us just sort of move along and increase rather slowly.

So let me conclude with this, and that is, the answer to the transitory/persistent inflation debate, it's unknown at this time. Market valuation, whether we want to look at today or we want to look at 65 days' worth of history, is just not very attractive. Market valuations very much strained or poor, however you want to put together, it's just not very good.

So how is, fixed income investors, we think the best way to approach this potential change in monetary policy and this debate over transitory or persistent inflation? We think flexibility is extremely important, and these are statements that are similar to what we made in 2013 and '15.[7] Short duration is more important than trying to find a yield that'll get you close to inflation, because you need to protect value and find yourself at least a positive absolute return in order to wait until that real return metric and your ability to beat inflation is better. I think we've shown that through some of the slides today.

(00:34:15)

[7] Historical FPNIX commentaries and webcasts can be accessed through the Fund's website or by contacting the Fund directly: (https://fpa.com/funds/fpa-new-income-fund-webcast-archive); (https://fpa.com/funds/fpa-new-income-fund-quarterly-commentary-archive)

And when we think about the last cycle of increasing Fed funds rate, our approach has paid dividends. We have done well versus the competition and the indices when the Fed undertakes a systematic increasing of Fed funds rate.

And so from those aspects, and sort of concluding points, I want to turn it over to Abhi and really, he's going to highlight a lot more about how these thoughts have worked their way into the portfolio and how we've executed on them.

Abhijeet: [Please reference slide 25] Thanks, Tom. Before we begin, as Tom points out, yields have increased quite a bit in the past few weeks since the end of the third quarter. Everything that we're about to discuss is as of the end of the third quarter [2021], so please keep in mind that these are actively managed funds. The statistics that we report are a snapshot in time, so investors should not assume that the positions we report as of September 30, [2021], or any quarter end for that matter, are the positions that we hold today and maintain throughout the quarter. Markets change, and we adjust our investment activity in response. That has always been the case across the portfolios, but the pertinent example here is that, as we will discuss, we shortened the duration of our Treasury holdings during the third quarter in response to macroeconomic developments and changes in the market during this past quarter.

[Please reference slide 26] So let's start with New Income's performance for the quarter. As shown on the bottom right of this table, New Income returned 40 basis points before fees during the quarter.[8]

The largest contributor to performance during the quarter was the corporate holdings, which is shown in the last line of the table. These holdings include corporate bonds, bank debt and equity. The biggest driver of returns in the corporate holdings was price appreciation. In particular, our investment in a company called Boart Longyear was a meaningful contributor to returns this quarter.

(00:36:12)

Boart Longyear is a provider of drilling services to mining companies, and also manufactures related products. During the third quarter, Boart Longyear completed a restructuring, which we were actively involved in, and which significantly de-levered the balance sheet, and provided liquidity for the company to take advantage of the current positive trends in the mining industry.[9] As a result of this restructuring, this investment was formerly a bond investment and is now an equity

[8] Past performance is not a guarantee, nor is it indicative, of future results.
[9] It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities/sectors listed. This is not a recommendation for a specific security/sector and these securities/sectors may not be in FPNIX at the time of this webcast. The portfolio holdings as of the most recent quarter-end may be obtained at www.fpa.com.

investment. We'll share more details on this investment in our quarterly letter, which should be published to our website soon.

The second largest contributor to performance during the quarter was collateralized loan obligations (CLOs), backed by corporate loans, shown in the fourth line from the top. Most of this return was from coupon payments.

The third largest contributor to performance was Treasury bonds, shown in the fourth line from the bottom. We'll discuss the Treasury position more in a few minutes, but as it relates to the past quarter generically, yields on 3- and 4-year maturity Treasury bonds rose during the quarter. However, the Fund's Treasury bonds, which have maturities of around 3 and 4 years, benefited from price appreciation as they rolled down the yield curve and priced at a newer dated, lower yielding part of the curve. We also sold the 4-year maturity Treasuries during the first two months of the quarter when yields were lower, prior to the increase in yields that happened toward the end of the quarter. That meant we had ended up avoiding losses that could have occurred when yields rose toward the end of the quarter.

At the sector level, there were no meaningful detractors from performance, though there were individual investments in some sectors that detracted from performance.

(00:37:57)

[Please reference slide 27] Before we get into the changes in the portfolio during the quarter, let's quickly recap the relevant takeaways from the market commentary which Tom went through.

First, Treasury yields rose slightly during the quarter. Two, spreads in high-quality bonds haven't moved much. Three, the odds of higher rates going forward have increased, and yet at least as of the end of the third quarter, investors are still not getting paid much to take on duration risk. And number four, spreads in high yield rated debt haven't moved much, which means that in general, we still don't feel like we're getting paid for credit risk.

With that in mind, most of our investment activity in New Income was focused on short duration, high-quality bonds rated single A or higher, where the goal is to avoid the risk of credit losses, and protect ourselves from the risk of mark-to-market losses associated with rising yields.

The pie charts on this slide show the portfolio exposures by investment idea. The recently completed third quarter is on the right, and the second quarter ending in June is on the left. This past quarter, our high-quality investments included asset-backed securities backed by subprime auto loans, corporate loan-backed CLOs, ABS backed by prime auto loans or leases, equipment ABS, and commercial real estate loan-backed CLOs. These investments are funded with a combination of cash on hand, amortization and maturities of existing investments, and selling some of the shortest maturity holdings in the portfolio.

Taking into account purchases and sales, in some cases the exposure to areas where we made investments increased like in subprime auto ABS, which increased from 8% of the portfolio to 12% of the portfolio. In some cases it didn't change, like in the CLOs, or in some cases it went down like in prime auto ABS.

We also made some select credit investments during the quarter, representing situations where we felt like the absolute return profile made sense versus the credit risk and duration risk. These investments rated BBB or lower, and—these investments are rated BBB and lower, and included short maturity bank loans, and newly issued short duration bonds backed by nonperforming residential mortgages.

(00:40:13)

[Please reference slide 28] As shown on the bottom left of this next table, net of repayments of existing credit positions and the sale of a loan, those credit investments left New Income's credit exposure at 6.9% of the portfolio as of September [2021], versus 7.7% of the portfolio as of June.

As of September [2021], 93% of the portfolio was in investments rated single A or higher, or cash and equivalents.[10]

[Please reference slide 29] The next table shows the New Income portfolio broken down by sector. The bottom of the table shows that the portfolio's duration is similar to where it was last quarter, at 1.3 years. The yields have decreased, which is not unexpected as higher-yielding bonds issued when yields were higher have matured or refinanced, and proceeds are reinvested at current market yields. That is also the reason why the Fund's dividend has declined.

The third line from the top shows that the Treasuries represented [approximately] 28% of the portfolio, with an average duration of 2.7 years, and was comprised of bonds maturing in 2.5 to 3 years. at the end of the second quarter, this position was about 22% of the portfolio, but had an average duration of 3.2 years and was comprised of bonds maturing in 2.7 to 4.4 years. As we referenced earlier, we sold the longer 4.4 year Treasuries during the quarter and bought shorter maturity Treasuries. This was all part of adjusting the duration and composition of the Treasury position during the quarter.

[10] During the audio presentation, the presenters stated incorrectly that the credit exposure for FPA New Income, Inc. was 8.1% of the portfolio as of September [2021], versus 7.6% of the portfolio as of June. They also incorrectly stated that 92% of the portfolio was in investments rated single A or higher, or cash/cash equivalents. The actual numbers are shown above.

The Treasury position still contributes a similar number of units of duration to the portfolio, but the position itself has a shorter duration profile and thus is less exposed to the possibility of 4- and 5-year bonds increasing in yield more than 2- and 3-year bonds. Or, in other words, a steeping curve. The tradeoff is that these shorter duration Treasury bonds are exposed to a flattening yield curve, where yields on 3-year Treasuries rise relative to 5-year Treasuries. Offsetting this is that, to the extent that the curve retains some steepness between 0 and 5 years, these shorter duration Treasuries will benefit sooner from rolling down the yield curve, all things being equal.

(00:42:30)

Bigger picture, we've had this Treasury position in some form for about a year. The purpose of the position is to provide some upside return potential to the portfolio in the event that yields decline, which could happen if there are negative macroeconomic events or developments. Based on commentary from Fed officials, and based on what the market has been doing, it seems inevitable that tapering of the Fed's asset purchases will begin this year, and we could see one or two rate hikes in 2022. However, though the odds of higher rates have increased, it's not a certainty. Inflation could prove to be temporary, and there is data showing abatement of some of the big drivers of recent inflation. The robust economic growth that we've seen may not persist.

It's also worth pointing out that despite the optimism we see in the markets, COVID isn't over. It's still out there. Just like the Delta variant set the economy back this year, there could be other adverse developments with this virus. We hope that's not the case, but it could happen.

Also, the recession that we went through wasn't a, quote, "normal" recession—if there is such a thing. This recession was caused by a pandemic, a shock that hasn't happened in this country in 100 years, and the economy and monetary system were much different 100 years ago. So there are no great comps to what we are dealing with today.

In light of that, we think it makes sense to have something in the portfolio that can help the portfolio just in case we haven't reached escape velocity in the economy. Our approach has always been to prepare for the worst and hope for the best. These Treasuries are there in case the worst plays out economically.

(00:44:12)

With that said, we are not making a bet on rates and inflation. To be clear, we do not have a view on what's going to happen with inflation, growth, COVID, etc. We of course see the risk of inflation in rising yields. We also see the possibility that the curve could flatten as yields rise which, by the way, I would imagine is a concern for any short duration bond fund. Importantly—and I can't stress this enough—one of our two investment objectives is to try to achieve a positive return over a 12-month period, and that objective is always at the top of our minds. So from a risk management standpoint, we adjust, and have been adjusting, the duration and size of the Treasury position as economic data points come out and as the market changes, so that we can have comfort around getting to a positive return over 12 months.

[Please reference slide 30] This leads to the interest rate sensitivity of the overall portfolio. Even with the Treasury position, the overall portfolio's duration is still only 1.3 years, which I believe makes this one of the shortest duration funds in the short-term bond category. Part of that short duration is due to the fact that approximately a third of the portfolio is invested in floating rate bonds. Those floating rate bonds should help the portfolio's return if the Fed raises rates.

This chart shows a simulation of the portfolio's returns before fees over the next 12 months, assuming that benchmark yields change by the amount shown on the x-axis. Since many investors are concerned about rising rates, the right half of this chart shows that if benchmark yields, including base rates for floating rate bonds and 3-year Treasury yields, rose by 100 basis points over the next 12 months, the portfolio should return approximately 55 basis points before fees over those 12 months.

(00:46:04)

The far right-hand side suggests that the portfolio could withstand a 175-200 basis point increase in benchmark yields and still deliver a positive 12-month total return before fees. The left-hand side shows what happens if yields decline, and represents scenarios where the Treasury position benefits the portfolio.[11]

[Please reference slide 33] Finally, rounding out the conversation on the rising yield and inflation scenario, this chart shows the projected percentage of the portfolio's principal that is expected to turn into cash because of amortization and maturities. If rates continue to rise, this amortization and maturity profile presents an opportunity for us to reinvest this cash into higher-yielding bonds, which should further support the portfolio's returns in a rising yield environment.

[Please reference slide 35] Next, we'll discuss Flexible Fixed Income, starting with the third quarter performance. The bottom right of this table

[11] Stress Test data is hypothetical and provided for illustrative purposes only, and is intended to demonstrate the mathematical impact of changes in yield. No representation is being made that FPNIX will or is likely to achieve results similar to those shown. Hypothetical results do not reflect trading in actual accounts, and does not reflect the impact that economic or market factors might have on the results shown. Hypothetical results have certain inherent limitations. There are frequently sharp differences between simulated results and the actual results subsequently achieved by any particular account, product or strategy.

shows that Flexible Fixed Income returned 40 basis points before fees during the quarter.

[As of September 30, 2021] the largest contributor to performance was the corporate loan CLOs shown in the fourth line from the top. The second largest contributor to performance was the corporate holdings shown on the last line, and the third largest contributor to performance was asset-backed securities backed by loans to late-stage mostly software companies. These are included in ABS Other shown in the sixth line from the top. The return on all three of these contributors was mostly due to coupon payments, which makes sense if spreads and yields did not move significantly during the quarter.

At the sector level, there were no meaningful detractors from performance, though there were individual investments in some sectors that detracted from performance.

[Please reference slide 36] These pie charts show the Flexible Fixed Income portfolio broken down by investment idea. The third quarter [2021] is shown on the right and the second quarter [2021] is shown on the left.

(00:48:03)

With Flexible Fixed Income, we have a longer investment horizon and are always on the lookout for attractive absolute return opportunities in credit. Unfortunately, as we mentioned earlier, credit is still expensive.

We did find a few opportunities this quarter, and it ended up that about a third of the capital we deployed during the quarter was in credit investments, including lower-rated tranches of CLOs backed by corporate loans, bank debt, asset-backed securities backed by loans to late-stage mostly software companies, newly issued bonds backed by nonperforming residential mortgages, and lower-rated tranches of commercial mortgage-backed securities backed by datacenters.

When we can't find attractive credit ideas, we retain cash or invest in high-quality liquid assets, with an eye on capital preservation, until the market gets cheaper and the investing environment is more attractive.

This past quarter, our high-quality holdings—or sorry, our high-quality investments—were short in duration and included ABS backed by subprime or prime auto loans or leases, CLOs backed by corporate loans, CLOs backed by commercial real estate loans, and equipment ABS. [Please reference slide 37] This next table shows the Flexible Fixed Income portfolio broken down by rating. The bottom left-hand column shows that the credit exposure [decreased to 22.1%] versus [23.7%] the last quarter.[12] Despite making new credit investments in the past few months, a number of our existing credit investments were called prior to

[12] During the audio presentation, the presenters stated incorrectly that the credit exposure for FPA Flexible Fixed Income Fund was "unchanged". The actual numbers are shown above.

maturity, as issuers took advantage of the low yield and spread environment to refinance debt on terms more attractive to them. [Please reference slide 38] The bottom of the next table shows that the yield and duration of the portfolio are similar to last quarter. The overall yield was a bit lower due to some of our higher-yielding investments getting repaid. With respect to duration, approximately a third of this portfolio is in floating rate bonds, which contributes to the short duration of the portfolio.

(00:50:03)

[Please reference slide 39] This chart shows a simulation of the returns before fees for the Flexible Fixed Income portfolio over the next 12 months based on the changes in benchmark yields shown on the x-axis. The far right shows that the portfolio has over 200 basis points of cushion against rising benchmark yields before returns are negative. Importantly, for those comparing this portfolio to New Income, please note that this simulation does not model changes in spread. The Flexible Fixed Income portfolio has more credit exposure than New Income, so there is more spread/duration exposure in this portfolio, which we are comfortable with given the longer investment horizon for this strategy.[13]

[13] Stress Test data is hypothetical and provided for illustrative purposes only, and is intended to demonstrate the mathematical impact of changes in yield. No representation is being made that FPNIX will or is likely to achieve results similar to those shown. Hypothetical results do not reflect trading in actual accounts, and does not reflect the

And with that, we can move on to Q&A.

Kristina: [Please reference slide 41] Thank you, Abhi. And thank you to those of you who have submitted your questions in advance. We addressed many of them in the prepared remarks. There is one question that we will take right now, and then move on to the live Q&A. With CPI up and yields low, how can bond investors beat CPI? Is 100 basis points increase in yields still the appropriate stress test when evaluating opportunities? And I know Tom already covered the first part in the prepared remarks, and Abhi will address the stress test portion now.

Abhijeet: Thank you, Kristina. Yes, just to reiterate what Tom said in the first part, at least for us, the objective is not to beat CPI each and every day. We think that the best approach is if you can preserve capital on an annual basis or 12-month period, then you're putting yourself in a good position to beat CPI over a longer horizon. And I think the data that Tom showed during the presentation demonstrated that our approach of trying to preserve capital, i.e. generate positive returns on a 12-month basis, has in fact put us in a position where we have been able to deliver returns in excess of CPI on a 5-year basis.

(00:52:17)

---

impact that economic or market factors might have on the results shown. Hypothetical results have certain inherent limitations. There are frequently sharp differences between simulated results and the actual results subsequently achieved by any particular account, product or strategy.

As it relates to the 100 basis point test, the question there is referring to our oft-stated duration test, which says that when we are trying to buy bonds, we look for the longest bonds that we can find where we think that we can expect at least a breakeven total return over a 12-month period if we assume the yields rise by 100 basis points over that 12-month period. And the person asking the question is asking whether 100 basis points is a good test, especially in this environment.

The answer is that [we believe] the 100 basis points is really a guidepost that helps us figure out when to extend duration and when to shorten duration, and by how much. 100 basis points isn't perfect. It's a level of yield change that has historically happened often, but it sometimes ends up being the case that 100 basis points is too conservative and in some cases it might be too aggressive. It's not a hard and fast rule, and on the margin, we have to use some judgment to account for what's going on in the world, and I think that's reflected in the comments we made today in the webcast.

It doesn't make sense to put things on autopilot. There's a lot of value in adjusting to market conditions. But the 100 basis point test does a reasonable job of giving us guidance on how to adjust and, importantly, gives our investors guidance on how we'll behave in different environments so that they know what to expect from us.

Kristina: Thank you, Abhi. One more question for you. With the shortage of chips dragging down deliveries of new cars and pushing up used car prices, can you describe the impact on auto loan securities?

(00:54:00)

Abhijeet: Yes, I'll take that question. So, it's an interesting question. I think for us, the way we look at it is that we never want to assume that car prices are going up, and in fact whenever we buy bonds that are backed by auto loans, or in fact auto leases, we always assume that car prices are going down. We tend to run draconian loss scenarios on all of our securities because, to be frank, the yields at which we're buying these bonds are really not that significant, so it's really not worthwhile to make any sort of directional bet on how much cars are going to be worth.

We haven't done the analysis explicitly, but it is possible that as you get lower down in the capital structure of some of these securitizations, that maybe some of those tranches are more sensitive to used car prices. We don't really invest there because the yield just really isn't compensating us for making that sort of bet. We tend to, and the current portfolio reflects this, but we tend to stick to bonds that are near the top of the capital structure, rated somewhere between AAA and single A.

Kristina: Thank you, Abhi. I don't believe we have any other questions at this time.

We want to thank you for listening to FPA New Income and FPA Flexible Fixed Income Third Quarter 2021 Webcast. We now turn it over to the system moderator for closing comments and disclosures.

Moderator: [Please reference slides 44-49] Thank you for your participation in today's webcast. We invite you, your colleagues, and shareholders to listen to the playback of this recording and view the presentation slides that will be available on our website within a few days at FPA.com. We urge you to visit the website for additional information about the funds, such as complete portfolio holdings, historical returns, and after-tax returns.

(00:56:06)

Following today's webcast, you will have the opportunity to provide your feedback and submit any comments or suggestions. We encourage you to complete this portion of the webcast. We know your time is valuable, and we do appreciate and review all of your comments.

Please visit FPA.com for future webcast information, including replays. We post the date and time of upcoming webcasts towards the end of each current quarter, and webcasts are typically held three to four weeks following each quarter end.

If you did not receive an invitation via email for today's webcast and would like to receive them, please email us at crm@fpa.com.

We hope that our quarterly commentaries, webcasts, and special commentaries will continue to keep you appropriately informed on the strategies discussed today.

We do want to make sure that you understand the views expressed on this call are as of today, and are subject to change without notice based on market and other conditions. These views may differ from other portfolio managers and analysts at the firm as a whole, and are not intended to be a forecast of future events, a guarantee of future results, or investment advice.

Past performance is no guarantee nor is it indicative of future results.

Any mention of individual securities or sectors should not be construed as a recommendation to purchase or sell such securities, or invest in such sectors, and any information provided is not a sufficient basis upon which to make an investment decision.

It should not be assumed that future investments will be profitable or will equal the performance of the security or sector examples discussed.

Any statistics or market data mentioned during this webcast have been obtained from sources believed to be reliable, but the accuracy and completeness cannot be guaranteed.

You should consider each fund's investment objectives, risks, and charges, and expenses carefully before you invest. The prospectus details each fund's investment objectives, policies, risks, charges, and any other matters of interest to a prospective investor. Please read the prospectus carefully before investing. The prospectus may be obtained by visiting the website at FPA.com, by email at crm@fpa.com, toll-free by calling 1-800-982-4372, or by contacting the fund in writing.

FPA funds are distributed by UMB Distribution Services, LLC.

This concludes today's call. Thank you and enjoy the rest of your day.

(00:58:47)

[END FILE]

Morningstar Bond Categories

Short-term bond portfolios invest primarily in corporate and other investment-grade U.S. fixed-income issues and typically have durations of 1.0 to 3.5 years. These portfolios are attractive to fairly conservative investors, because they are less sensitive to interest rates than portfolios with longer durations. Morningstar calculates monthly breakpoints using the effective duration of the Morningstar Core Bond Index in determining duration assignment. Short-term is defined as 25% to 75% of the three-year average effective duration of the MCBI.

Morningstar does not adjust total return for sales charges or for redemption fees.

©2021 Morningstar, Inc. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or

distributed; and (3) is not warranted by Morningstar to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. **Past performance is no guarantee of future results.**