investors first

Q2 2022 FPA New Income, Inc. (FPNIX) and Flexible Fixed Income (FPFIX) Webcast
July 28th, 2022

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

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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, 2022, as amended June 30, 2022 can be accessed at: https://fpa.com/request-funds-literature. The prospectus for FPFIX dated April 29, 2022 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.

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Moderator: Hello, and welcome to today's webcast. My name is Sarah and I will be your event specialist today. Please note that today's webcast is being recorded.

During the presentation, we will have a question and answer session. If you would like to ask a question during the presentation, simply type your question in the Q&A box located on the bottom left side of the console. If you experience any technical issues, as a best practice, we suggest you refresh your browser. If that does not resolve your issue, please type your issue in the question box for assistance.

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

Kristina: Thank you. Good afternoon and thank you for joining us today. We would like to welcome you to FPA New Income and FPA Flexible Fixed Income Fund Second Quarter 2022 Webcast. My name is Kristina Surkova, and I am relationship manager for the funds.

[Please reference slide 3] 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 manager Abhi Patwardhan, senior advisor Tom Atteberry, and members of the Fixed Income investment team.

[Please reference slide 4] 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 portfolio manager for Flexible Fixed Income Fund since its inception in December 2018.

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Tom Atteberry joined the firm in 1997. Tom has been a portfolio manager of FPA New Income since 2004 and portfolio manager for FPA Flexible Fixed Income Fund since its inception in December 2018. Effective July 1, 2022, he transitioned into a senior advisor role.

[Please reference slide 5] As part of today's agenda, Abhi will discuss the highlights for both funds, provide commentary on the market, review performance and portfolio activity, will turn it over to Tom for his comments, and then will open it up to question and answers. Abhi, over to you now.

Abhijeet: Thank you, Kristina. During today's webcast, we'll discuss the following topics. We are in the midst of the worst bond market in generations, maybe ever, led by rising interest rates as the Federal Reserve attempts to tame inflation. Our team invests with an absolute value philosophy, which means that when the market is expensive in absolute terms, we aren't willing to take on risk just because everyone else is doing it, and we're disciplined about it.

Because of that, while most of the fixed income market has had a horrible start to the year, both FPA New Income and FPA Flexible Fixed Income have done a relatively good job of protecting capital. Both funds have [performed favorably versus] their [comparable] indices this year, and they have had top-tier performance over the long term too, which we'll show later on.

The silver lining is that higher yields and lower bond prices have made the bond market much more attractive than it has been in years. Due to a more attractive bond market and much better opportunity set, FPA New Income recently opened to new investors. We had originally closed it because the opportunity set was awful. [We believe] that has now changed.

Both FPA New Income and FPA Flexible Fixed Income have [sought to] take advantage of this more attractive market to improve their yield-to-worst and their future return profile. We continue to lean into higher yields by trying to buy longer-duration bonds, whilst selectively buying BBB or high yield-rated debt as well.

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[Please reference slide 6] To kick things off, here is a summary of the two funds. Both funds are absolute return-oriented bond funds and neither fund tracks an index, which gives both funds flexibility in how they invest.

FPA New Income Fund, on the left, in the short term seeks a positive return over a rolling 12-month period. Longer term, FPA New Income seeks an absolute return of CPI plus 100 basis points over a rolling 5-year period. It is largely a high-quality strategy, which means that we have to have at least 75% of the assets in investments rated single-A or higher. Beyond that, we can have zero to 25% of the assets in investments rated BBB or lower. This is a long-only strategy and we don't use leverage to juice returns. Note that the strategy status shows that New

Income is now open to new investors. This fund has previously been soft-closed for about two years.[1]

On the right, over the shorter term, Flexible Fixed Income seeks positive returns over rolling 3-year periods, and longer term, seeks an absolute return of CPI plus 200 basis points over a rolling 5-year period. Key to trying to accomplish this is more flexibility on credit exposure. Flexible Fixed Income can, but doesn't have to, have up to 75% of its assets in investments rated BBB or lower, and has to have at least 25% of the assets in investments rated single A or higher.

[Please reference slide 7] Here we show the yield-to-worst and duration of the two funds as of the end of June [2022].

The table at the top shows that FPA New Income had a yield-to-worst of [approximately] 4.4% and a duration of 1.6 years. We also show the Aggregate Bond Index and 1-3 Year Aggregate Bond Index for comparison. New Income offers meaningfully more yield with a fraction of the duration risk of these indices. In addition, [approximately] 31% of the New Income portfolio is held in floating rate investments, which could add to the yield to the extent that the Fed raises interest rates. That potential

[1] FPA New Income closed to new investors in August 2020.

benefit from rising interest rates is not captured in the yield-to-worst shown here. For reference, these two indices do not own floating rate bonds.

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Flexible Fixed Income, shown in the bottom table, had a yield-to-worst of [approximately] 5.2% and a duration of [approximately] 1.2 years. In comparison to the Universal Bond Index, Flexible Fixed Income offers more yield with a fraction of the duration risk. [Approximately] 29% of Flexible Fixed Income is held in floating rate bonds, which could add to the yield if the Fed raises interest rates. Again, that potential benefit is not captured in the yield-to-worst numbers shown here. The Universal Index does not have floating rate exposure so it does not have this potential benefit.[2]

[Please reference slide 8] Focusing on New Income for a minute, to give a preview of why we think the market and this fund is attractive, this chart shows that the yield-to-worst on New Income is the highest it has been in five years. As described in the bullets at the bottom, that has happened without adding a lot of credit risk and before we've added a lot of duration.

[Please reference slide 9] On to our market observations, we'll spend a few minutes sharing what we've seen in the markets. As a reminder, we

[2] FPNIX and FPFIX do not include outperformance of any index or benchmark in their investment objectives. An investor cannot invest directly in an index. **Past performance is no guarantee, nor it is indicative, of future results.**

don't have views on where the bond market is going and we don't try to make bets on the direction of the market. Instead, we focus on valuation. We share our market observations to give our investors some insight into what we see as we invest.

[Please reference slide 10] To start, inflation is still going strong. This chart shows year-over-year inflation as measured by the CPI less food and energy prices. As shown on the right-hand side, this measure of inflation is around 6% on a year-over-year basis. For reference, the overall headline CPI is approximately 9% on a year-over-year basis. With inflation at levels we haven't seen since the early Eighties, inflation is clearly too high relative to the Fed's 2% target.

[Please reference slide 11] To bring down inflation, the Fed has been aggressively tightening monetary policy to slow aggregate demand growth. As we outline here, after raising rates in the first quarter, on May 4, [2022] the Fed raised the Fed funds rate by 50 basis points and announced that it would begin reducing its bond holdings on June 1, [2022]. Then, on June 15, [2022] the Fed announced an additional 75-basis point rate increase, the largest increase since 1994. Not shown here is that the Fed announced yet another 75-basis point increase yesterday. These hikes bring the cumulative change in the Fed funds rate this year to

225 basis points. That's the largest increase over 12 months since 2006, and 1995 before that.

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The bars on this chart show the market's expectations for the cumulative change in the Fed funds rate from June 30, [2022] onwards, and the green line shows the market's expectations for the level of the Fed funds rate over time. This chart is now a few weeks old but it shows that as of the end of June, the market expected another 180 basis points of Fed funds rate increases, or another 105 basis points after yesterday's increase. The expectation was that the Fed funds rate would reach 3.4% by year end, and then peak near those levels before the Fed begins to cut rates towards the end of next year. The market's expectation of rate cuts in a year is tied to the possibility that the Fed may need to stimulate growth because it has slowed growth too much or put the economy into a recession, which we'll talk more about later.

[Please reference slide 12] As a consequence of all of this tightening, the yield curve has shifted higher in the past three months, and much, much higher since the start of the year. As shown in the table at the bottom, Treasury yields rose 50-85 basis points during the quarter, and 130-220 basis points year-to-date, depending on the maturity. That yield increase has spurred the worst bond market in generations, perhaps ever.

[Please reference slide 13] This chart shows historical total returns on 10-year maturity Treasury bonds or their proxy. As shown on the right, returns on Treasuries [bonds or their proxy] haven't been this bad since the late 1700s.

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[Please reference slide 14] Even when looking at shorter-maturity Treasuries, the returns this year are historically bad. This chart estimates the rolling 12-month return on 2-year Treasury bonds going back to the late 1970s. On a mark-to-market basis, 2-year Treasuries rarely lose money over 12 months and when they have, it hasn't been meaningful. The right side shows that the losses over the last 12 months have been far worse than anything we've seen in 40 or 50 years.

[Please reference slide 15] Bond markets have performed so poorly this year due to valuation. This chart shows historical yields on 2-, 3- and 5-year maturity Treasury bonds. As shown towards the right, Treasury yields were historically low in the past couple of years. As a result, there wasn't much yield to compensate for any changes in bond prices that might occur. We all know that bond prices go down when yields go up. As we showed a moment ago, yields have increased a lot this year.[3]

[3] **Past performance is not a guarantee, nor is it indicative, of future results.**

[Please reference slide 16] This chart puts that yield change into perspective. This charts shows rolling 12-month changes in yields for 2-, 3- and 5-year maturity Treasury bonds. As shown on the right, Treasury yields have increased by 280-330 basis points over the last 12 months, which is the largest increase since 1995.

[Please reference slide 17] This next slide puts a finer point on valuation. The huge increase in yields over the past year has occurred against the background of historically low yields. This chart shows rolling 12-month changes in yield on the 2-year Treasury, in blue, versus the year-ago yield on the 2-year Treasury. Looking towards the right, 2-year Treasury yields were approximately 0.2% when yields started increasing in the last 12 months. The last time yields increased this much was in 1995, when 2-year Treasury yields were around 4%. Without getting too deep in the weeds, when comparing bonds of the same maturity, lower yields make the price of bonds more sensitive to changes in yields. So when yields increased this year, the price of these Treasury bonds fell by more than they would have in the past because the starting yield was so low. On top of that, there wasn’t much yield or income to make up for the price declines, because the starting yield was so low.

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Comparing yield to price risk or duration risk on a bond isn't a novel concept. It's valuation and it's math, and it's something that we focus on. But it's not sufficient to simply do the valuation math. You also have to be willing and able to do something about it.

[We believe] that's what makes our investment approach different. We pay attention to valuation and we try to respond to it. Specifically, when yields were historically low in the last couple of years, we did the valuation and ran the math, and decided that there was too much duration or price risk in the market. So we bought shorter-maturity or shorter-duration bonds that were less exposed to rising interest rates. We also bought a lot of floating rate because they had a better return profile. And at the same time that Treasury yields were historically low, yields on high yield-rated debt were historically low. It made no sense.

We responded by taking on less credit risk. The result is that [the] funds have done relatively well despite all of the turmoil in the market. And the benefits of this approach don't just appear in the short term when the market is getting pummeled. [We expect this favorable] short-term performance [to] compound into attractive long-term performance, which is what we're ultimately going for.

[Please reference slide 18] New Income has performed [favorably compared to] the [Bloomberg] 1-3 Year Aggregate Bond Index and broader[Bloomberg] Aggregate Bond Index so far this year. But New Income has also had better or similar performance to these indices over the past 1, 3, 5 and 10 years. That puts New Income in the top 4% of short-term bond funds over the past year, and among the top third or better of short-term bond funds over longer periods.[4]

[Please reference slide 19] This next chart summarizes the long-term performance. If you had invested $10,000 in New Income 10 years ago, you would have more money in your pocket today than if you had invested in a comparable index or the short-term bond category in general.[5] And we think you would have slept better at night too because New Income had better volatility-adjusted returns during this time, as evidenced by New Income's better Sharpe, Sortino, and drawdown performance shown at the bottom of this slide.

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[Please reference slide 20] To add to the point about volatility, here we compare the drawdown performance of New Income to the S&P 500 and a number of bond indices during recent large equity and bond market

[4] Morningstar Short-Term Bond category percentile rank. Please refer to the end of the presentation slides for a description of the category and the Fund's peer group.

[5] Comparison to indices is for illustrative purposes only. The Fund does not include outperformance of any index or benchmark in its investment objectives. An investor cannot invest directly in an index.

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

drawdowns. The red bars in each chart highlight the market drawdown we examined in each time period.

We believe that bonds are supposed to be more stable, act as a ballast in the portfolio, and just not move around that much. This table shows that New Income does just that. During [the] equity drawdowns or large bond drawdowns [shown on this slide], New Income has mov[ed] much less than markets move.

[Please reference slide 21] This slide looks at the performance of Flexible Fixed Income. Flexible Fixed Income is only three and a half years old so there is less history, but the story is [similar]. Flexible Fixed Income has performed [favorably versus] the relevant indices year-to-date and over the last year and three years. It has also ranked in the top 12% and 25% of its nontraditional bond fund category over those longer time periods.[6] So with this strategy as well, [we anticipate] the short-term [favorable] tperformance [to] compound into attractive long-term performance, which is what we're ultimately going for.

[Please reference slide 22] When you look at the value of $10,000 invested in Flexible Fixed Income three and a half years ago, our Flexible Fixed Income investors now have more money in their pocket than they

[6] Morningstar Nontraditional Bond category. . Please refer to the end of the presentation slides for a description of the category and the Fund's peer group.

would have had if they'd invested in the index or the nontraditional category in general, and with less volatile returns, as shown by the Sharpe, Sortino, and drawdown data in the table at the bottom.[7]

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We'll conclude these comments about performance by saying that over these multi-year periods which we showed, even though in the end our funds have done better than other fixed income investments, there were periods of time where we lagged indices or peers. And during those times, we would tell people that the market is too expensive, you're not getting paid to take risk, etc. That's hard to sit through because it's hard to see other people make more money than you. We spent a lot of time being, quote/unquote, "wrong" before we were right, but I think our results show that if you're disciplined and patient about investing, you end up doing better in the end, and you're better positioned to take advantage of the opportunities created when the market reprices. Which brings us to today and the opportunity in front of us.

[Please reference slide 23] This chart shows the yield and spread on the [Bloomberg] Aggregate Bond Index, which measures investment-grade bonds. As shown towards the right, the yield, shown in blue, has

[7] Comparison to indices is for illustrative purposes only. The Fund does not include outperformance of any index or benchmark in its investment objectives. An investor cannot invest directly in an index.
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increased a lot in the last six months. Part of that is due to the increase in risk-free rates which we showed earlier, and part of that is due to the increase in spread shown in green.

[Please reference slide 24] It's a similar story in short-maturity investment-grade bonds. This is the same chart as before but showing the {Bloomberg U.S.] 1-3 Year Aggregate Bond Index. On the right, we see that yields are up a lot and spreads are up some as well. Most of the increase in yield is due to higher risk-free rates.

[Please reference slide 25] Credit markets, meanwhile, have also become meaningfully cheaper. As a proxy for credit, here we show the yield and spread on the BB component of the [Bloomberg] High Yield Index, excluding energy. We look at this index because it strips away some of the noise from changes in composition of the High Yield Index over the years and provides a more consistent historical view of the market.

On the right, we see that the yield has increased to approximately 7.25% at the end of June, which is about 225 basis points higher than it was at the end of March, and about 400 basis points higher than the start of the year.[8] Whereas in the first quarter of the year the yield on this index

[8] **Past performance is no guarantee, nor is it indicative, of future returns.**

increased mostly due to higher risk-free rates, this past quarter the increase was mostly due to higher spreads.

The net result is that from a historical context, yields on this index are now at 2011 levels and spreads are at 2015-2016 levels.

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Now, some might look at this chart and proclaim that credit markets are cheap. There may be some attractively priced bonds, but we don't share that view that the overall market is attractive because not all markets are created equal.

To illustrate this point, the bonds that exist today are much different than the bonds that existed in 2011, for example. The bonds that exist today were issued in the last several years when everything was frothy. As a result, not only were they issued at lower yields but they were more expensive by other measures. This next chart has an example of that. [Please reference slide 26] This chart shows gross leverage of the broad High Yield Index on the left and debt service coverage on the right. This includes all ratings and industries. Let's acknowledge first that these are butter knife not scalpel types of measurements, but leverage today is meaningfully higher than it was in 2011. Similarly, debt service coverage is meaningfully higher than it was in 2011, with a huge assist from low coupons that exist today. Not captured in this chart are that high yield bonds are generally a smaller slice of the cap structure these days than they were years ago. Coupled with higher overall leverage, that translates to a greater risk of permanent losses, all things being equal. In addition, [we believe] the structure of bonds that exist today are much more dangerous for bondholders than they were before. There are fewer protections for bondholders and more ways for issuers to take value from bondholders. Thinking back to 2011, the universe of bonds that existed back then was issued just after the Great Financial Crisis. Leverage was lower, and bondholders had much better protections. The overall risk versus reward was better then. This doesn't mean that 2011 is a standard against which all markets should be measured. We merely offer this as an example to make the point that yield and spread history can be a useful barometer, but it only takes you so far.

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Are high yield bonds cheaper today than they were last year? Yes. Is risk versus reward compelling? As a general statement, we wouldn't say yes, but that doesn't stop us from looking because it's certainly a good time to look. We have and will invest in credit when we find attractive opportunities.

[Please reference slide 27] Beyond that, we are leaning into today's higher-yield environment by buying longer-duration, high-quality bonds.

Higher yields mean that duration is cheaper, which is to say that there is more yield available per unit of duration risk. We can see that here where this chart shows the duration of the Aggregate Bond Index and the ratio of that index's yield to duration. A higher ratio means that duration is cheaper and there is more short-term protection against a given increase in interest rates. A year ago, this ratio was historically low and duration was more expensive, so we bought less duration by focusing on shorter-duration bonds. Nowadays, duration is cheaper so we are buying more duration by buying longer-duration bonds.

I mentioned this at the outset but it's worth repeating. We don't know where interest rates are going to go. So when we say that we are buying longer-duration bonds, we're not doing it because we believe that rates are going to decline. We're doing it because the risk versus reward is more attractive now, and we illustrate that here.

[Please reference slide 28] With respect to duration, we try to buy the longest bonds that we can find that we expect will have at least a breakeven return over 12 months if we assume that the yield on what we buy increases by 100 basis points over that 12-month period. We show that math in the downside returns on this slide. The upside return is the same math but assumes that the bond's yield decreases by 100 basis points over 12 months.

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The table on the left shows the yield on 1-, 2-, and 3-year maturity Treasury bonds as of June 2021. If you buy a 1-year bond, it doesn't matter what happens with interest rates. You will earn the yield over 1 year because the bond matures. That's why the yield upside return and downside return for the 1-year bonds are the same. If you bought a 2-year Treasury last year at 0.25% and then the yield increased by 100 basis points to 1.25%, you would have had a total return loss of minus 0.7% over a year. That same math gets to an even worse outcome for a 3-year bond. So last year, we were buying bonds with maturities between 1 and 2 years, where the downside math breaks even.

As far as the upside last year, well, to get the upside return shown here, you have to believe that yields could be meaningfully negative because this upside assumes that the yield declines by 100 basis points. For example, the upside scenario on the 2-year Treasury assumes the yield declines from 0.25% to minus 0.75%. It's certainly possible and negative yields appeared all over the rest of the world, but it's not obvious that it could happen.

We repeat this analysis on the right side, but updated with the yields as of June 2022. 3-year bonds now have a positive downside return of over 1% and an upside return of almost 5%, and that 5% upside return doesn't require a belief in negative yields. Even if rates rise—within limits—you can still make money because yields are so much higher now. And if rates decline, the upside return is much better than it was for the same maturity last year. By buying longer-duration bonds, we can maintain or improve a breakeven downside return profile if yields increase by 100 basis points, but the upside return profile is much, much better if yields decline. This is what we mean when we say that risk versus reward is more attractive now.

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Based on this analysis, we have been trying to buy longer bonds that get to breakeven or positive returns using this downside math. Our hope is that we can meaningfully increase the portfolio's duration such that if and when yields decline, the portfolio will have a better total return. [Please reference slide 29] Why might yields decline? This chart shows the difference in yield between 10-year and 2-year Treasury bonds. When this difference is negative—known as an inverted yield curve—a recession has typically followed. As shown towards the right, the yield curve inverted during the first and second quarters of this year. Before this morning, we were going to say that a recession is a possibility. We now know from this morning's GDP data that we are technically in a recession for now. We'll know more when the final GDP data comes out.

Fundamentally, we see why a recession is possible. The Fed is actively trying to slow demand growth. There is risk that they overshoot because the relationship between macroeconomic growth and monetary policy is not a very precise dial. We already see announcements from companies of slower hiring plans, layoffs, and slower spending. In addition, inflation is negatively impacting real incomes and real spending, creating an additional drag on growth. If growth slows too much or there is a true recession and the Fed has to ease to stimulate growth, yields could decline.

We're not betting on it one way or the other. Our goal is to build a portfolio that we think will be fine if bad things happen like if a recession challenges fundamental credit performance or if rates increase, but has upside potential if good things happen like rates declining—well, good for bond prices anyways.

[Please reference slide 30] Let's move on to discussing the portfolios. We'll start with New Income's return for the quarter.

[Please reference slide 31] The bottom right of this table shows that New Income returned minus 0.94% before fees during the second quarter. The largest contributor to performance during this quarter was Ginnie Mae project loan interest-only bonds, which benefited from coupon payments and prepayment penalties offsetting price declines. These are shown here as CMBS Stripped. Beyond that, there were other contributors to performance but none that were meaningful.

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The largest detractor from performance were the corporate holdings due to some combination of wider spreads and higher risk-free rates, which led to lower prices that were only partially offset by coupon payments. In addition, the small common stock exposure saw lower prices in sympathy with the rest of the equity market. As a reminder, these common stock holdings are the residual of restructuring processes that we've been involved with in past years.

The second-largest detractor from performance were the CLOs, and the third-largest detractor were auto ABS. Both are shown under ABS at the top. Most of the CLOs we own are floating rate but higher spreads led to lower prices. The auto ABS bonds are fixed rate. Their prices were also negatively impacted by higher spreads as well as higher risk-free rates. Note that the CLOs and auto ABS were in the middle of the pack in terms of total return during the quarter, but they show up on the list of largest detractors because each was a relatively large part of the portfolio, as reflected in the total return and average weight columns.

Even though the overall return is negative this quarter, we're pleased with the Fund's performance, though I say that with hesitation.

We hesitate because we don't like losing money. Speaking personally, I have a significant personal investment in the Fund, so I feel it, and I'm not enjoying it. But as we showed, we've done relatively well this year and over the long term, and we're excited about the opportunities that we see ahead of us.

[Please reference slide 32] This slide shows the characteristics of New Income as at the end of June. For comparison, at the bottom we show the characteristics as of March. Through our investment activity, we have increased the Fund's duration from 1.3 years to 1.6 years, and the yield has increased a lot as well, from 2.9% to 4.4%. Part of that yield increase is the mark-to-market impact on our existing holdings, but part of it is also due to our investment activity during the quarter.[9]

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[Please reference slide 33] These pie charts show the portfolio broken down by investment idea, with the most recent quarter shown on the right and March shown on the left. There is a slice of the pie dedicated to any individual idea that is at least 4% of the portfolio. The orange Other slice is a total of all the individual ideas that are each less than 4% of the portfolio.

[9] Portfolio composition will change due to ongoing management of FPNIX.
Past performance is no guarantee, nor is it indicative, of future results

When comparing the two charts, it looks like not a lot changed, even though we were active during the quarter. This past quarter, a lot of what we bought was similar to what we've bought in the past—asset-backed securities backed by equipment, ABS backed by credit card receivables, ABS backed by insurance premium loans, agency commercial mortgage-backed securities, and Treasuries. But this quarter, we bought longer and higher-yielding versions of those bonds, and sold shorter versions that we held in the portfolio, which is why the exposures didn't change much.

To give a sense of how we have been adding duration, a year ago, the fixed rate high-quality bonds that we bought—excluding Treasuries—had a weighted average duration and yield of 1.4 years and 0.6% respectively. Those are bonds rated single A or higher. This quarter, the comparable investments we made had a weighted average duration and yield of 2.9 years and 4.1% respectively. So that's the tangible example of everything we discussed earlier about actively pulling back on risk in an expensive market a year ago and then actively leaning in to a cheaper, higher-yielding market today.

[Please reference slide 34] This table shows New Income's credit exposure, with the most recent quarter on the left. About 91% of the portfolio is held in bonds rated single A or higher, Treasuries, and cash and equivalents. 9% of the portfolio is rated BBB or lower. As we mentioned earlier, credit markets are cheaper than they were before but we have not seen a lot that fits for New Income yet. We keep looking though, and we were able to find some BBB-rated BDC bonds that we think have an attractive risk versus reward profile.

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[Please reference slide 35] Putting it all together, this chart is a return simulation for New Income. For each yield change shown on the x-axis, the bars estimate the Fund's return over the next 12 months before fees. This simulation assumes a gradual parallel change in risk-free rates across the entire yield curve and also assumes that we don't make any changes to the portfolio.

As another example of how the risk versus reward in the bond market is better today, let's compare this chart to a year ago[10]. As a downside scenario, the fifth bar from the right estimates New Income could have returned approximately 3.4% before fees if yields increase by 100 basis points over the next 12 months. A year ago, the estimate for that same scenario was 0.6%. The far right-hand side of this chart shows an estimated return of 2.7% if yields increase by 200 basis points. A year

[10] Please refer to https://fpa.com/docs/default-source/funds/fpa-new-income/quarterly-webcasts/fpa-new-income_flexible-fixed-income-webcast_2021-06_watermark.pdf?sfvrsn=faf919d_9

ago, that number was basically zero. On an upside scenario, the bar on the left estimates that New Income could have returned a little over 5% before fees if yields declined by 100 basis points. A year ago, that number was approximately 2%. We could also do the same comparison to last quarter and the numbers would also be higher today across all scenarios. Compared to a year ago, or even three months ago, the portfolio has a better downside return and better upside return, thanks to a cheaper market and our investments to take advantage of a cheaper market. [Please reference slide 38] Turning to Flexible Fixed Income, let's start with returns. The bottom right shows that Flexible Fixed Income returned minus 1.28% before fees during the quarter. There were contributors to performance but none that were meaningful.

The largest detractor from performance were the corporate holdings due to higher spreads and higher rates leading to lower prices, which were only partially offset by coupon payments. The small common stock exposure saw lower prices as well. The common stock holding is a result of past restructurings we've been involved in.

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The second-largest detractor from performance during the quarter were CLOs, and the third-largest detractor were auto ABS. CLOs were negatively impacted by higher spreads, and auto ABS were negatively impacted by higher spreads and higher risk-free rates. We'll note here as well that CLOs and auto ABS were in the middle of the pack with respect to total return, but they each ended up being large detractors from performance because they are each relatively large parts of the portfolio.

With Flexible Fixed Income too, we're not happy about losing money in the short term. Speaking personally, I have a significant investment in this fund as well, so I'm not enjoying the year-to-date return. However, [we believe] the Fund is performing well in comparison to the rest of the market and we won't let these short-term results distract us from the exciting opportunity ahead of us.

[Please reference slide 39] The next slide shows the characteristics of the Flexible Fixed Income portfolio. At the bottom, we can see that the duration is slightly shorter than it was last quarter at 1.2 years versus 1.3 years, and the yield is about 150 basis points higher [than in March 2022] at 5.2% as of June [2022]. While we have bought longer-duration bonds in this fund, we also made more credit investments, which tend to have a shorter duration.[11]

[Please reference slide 40] These pie charts show the portfolio broken down by investment idea and follow the same format for the pie charts we

[11] Portfolio composition will change due to ongoing management of FPFIX.
Past performance is no guarantee, nor is it indicative, of future results

looked at earlier. When comparing the most recent quarter on the right with the prior quarter on the left, there were incremental changes in exposure. Our investments this quarter were split roughly 50/50 between high-quality and credit investments. Those high-quality investments included, among other things, equipment ABS, ABS backed by insurance premium loans, ABS backed by datacenters or cell towers, and nonagency CMBS.

[Please reference slide 41] In credit, we took advantage of lower prices to add to existing positions in nonperforming loan bonds, bank loans, and high yield. We also added a new corporate bond position. These investments were paid for by selling shorter-duration holdings and using cash on hand. The bottom left of this slide shows that Flexible Fixed Income's credit exposure is now a bit under 30% of the Fund versus nearly 29% last quarter.

(00:34:24)

[Please reference slide 42] Finally, this is a return simulation for Flexible Fixed Income, with the same assumptions we used earlier for the New Income simulation. If we assume yields increase by 100 basis points, this simulation estimates that Flexible Fixed Income could have returned about 4.4% before fees over the next 12 months. That compares to about 1.5%

a year ago.[12] If yields decline by 100 basis points, this simulation shows a 5.5% return before fees over 12 months. That compares to 2.2% a year ago. So there's an improved risk versus reward here as well, not just versus last year but versus last quarter too.[13]

And just to note, for those comparing this chart to the same chart for New Income, please note that these scenarios only look at changes in the risk-free rates, not changes in spread. Flexible Fixed Income has more exposure to credit so it is more exposed to credit-related risk, including spread-related risks.

[Please reference slide 44] That concludes our prepared remarks. Before we get to Q&A, last year we announced that Tom will step down as portfolio manager this summer. That transition formally happened a few weeks ago. I'll turn it over to Tom for some parting comments but I'd like to say that Tom has been a great steward of your and our money for many years. The team, and I personally, would like to thank him for his guidance over the years. He put in place a number of foundational pieces that have served us all well, and which will continue to serve us all for a long time. Tom, please go ahead.

[12] Please visit the FPA Flexible Fixed Income Fund Webcast Archive to view previous webcast materials. https://fpa.com/funds/fpa-flexible-fixed-income-fund-webcast-archive

[13] Please visit the FPA Flexible Fixed Income Fund Webcast Archive to view previous webcast materials. https://fpa.com/funds/fpa-flexible-fixed-income-fund-webcast-archive

(00:36:03)

Thomas: Thank you, Abhi, and thank you, everyone, for joining us this afternoon. July 1st represents only the third set of investment professionals managing the FPA New Income Fund in its 38-year history. Consistency and continuity are key components of the strategy. And I just sort of want to reflect on my tenure and contribution to this long-term standing fixed income strategy.

Our approach at FPA is unique in several aspects, some of which Abhi has outlined today, but we'll start with we are truly absolute return in our approach. We do not focus on a benchmark or an index. And credit is defined as BBB+ or lower, and we always use the lesser of for securities that have multiple ratings. And then finally, our guideline limitations, they apply to 100% of the portfolio.

This approach was established by Bob Rodriguez, the first leader, when First Pacific Advisors purchased the mutual fund from Transamerica Corporation in July of 1984. Bob's a very unique portfolio manager, and he's managed both an equity fund and a fixed income fund, and he is the only individual to receive Morningstar's Manager of the Year in the equity category and in the fixed income category.[14]

[14] Source: https://newsroom.morningstar.com/newsroom/news-archive/press-release-details/2022/Morningstar-Hall-of-Fame-Fund-Manager-of-the-Year-Winners/default.aspx.

Bob hired me in March of 1997 as the first dedicated fixed income analyst for the strategy. My primary experience, I was a fixed income analyst and portfolio manager, however I also had some experience as an equity analyst and portfolio manager. The result was we had a fixed income fund being managed by individuals with equity portfolio experience, and I have long felt that this assists in understanding risk, specifically downside risk.

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The first ten years of my tenure, Bob and I went about building and refining the infrastructure of the strategy so as to present a consistent, disciplined and measurable story about this unique fixed income approach. We installed the first specific portfolio management system for [FPA] fixed income that gave us analytics and attribution and improved our risk management. We created a more quantitative explanation of our risk management and investment strategy. And finally, the stress test that we've talked about for years was introduced on all the high-quality bonds.

As the transition from Bob to myself grew near, there was sort of a formulation of the next leadership and it took shape. This decision was to move to a more team-based management approach to the strategy, and it was driven by two philosophical tenets that drove the construction of that team.

The first relates to an event that occurred very early in my career as an investment professional. In August of 1987, I became the chief investment officer in a trust department for a mercantile bank in Joplin, Missouri. Two months into that position, and the stock market crash of October 19th occurred, with the Dow Jones Industrial Average declining 20% in one day, something that had never occurred in its history, nor has it occurred since.

I was summoned by the chairman of the board of the bank to a board meeting, in order to articulate the bank's position to clients and the public on this event. The quote machine had frozen up about 15 minutes into the trading session, so I had no idea what prices were. I had talked with multiple people on Wall Street who had decades of experience, and they could offer no insight either as they'd never seen this before. So the only known information was that our clients' equity holdings had not reported any adverse activity to their fundamentals.

So I proceeded to tell the board we should hold the equity positions and once there was better price discovery, we should add to those holdings. The chairman of the board stopped me at that point, said thank you, wheeled around to the board and said, "That is our position in conversations with our clients and the media," and then summarily dismissed me. He figured I was busy and needed to get back to my office.

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I later discovered that, regardless of the market outcome, because I'd given a definitive answer to his question, the chairman of the board would defend my position. He realized that the recommendation was based on limited information, in a very difficult environment. And I took that lesson in how the tenet of constructing this team came about, and that was to hire experienced analysts, allow them the freedom to make decisions and as the leader, always defend those decisions.

The second tenet revolved around hiring individuals that complement your own weaknesses and focus on your strengths. This came from long conversations with Steve Romick at the firm. The result is a team that is stronger than its individuals. The corollary was to focus on your own strengths and deliver them in the best manner possible to the clients. So Abhi and myself went about systematically assembling this diverse team of investment professionals. It was completed in 2019.

We relentlessly strive to find clients who have a likeminded absolute return philosophy toward the management of fixed income assets. We combine that with a transparency of process and communication. Our objective is to have an enduring client base for the strategy that potentially results in less turnover, which in the end is less disruptive to our clients, some of whom have been with us for 10 years, some as much as 20 years.

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We are interested in what is best for our clients—current clients—and we state that in our mission statement. We focus on our investing efforts rather than gathering assets. We will not expand our business unless we are comfortable that our clients' interests will not be harmed. We will restrict assets or close our products, as we have done in the past, if we believe that is what will benefit our existing clients.

So, discipline and a repeatable investment process are driving the elements of this team's investment efforts, and that's based on two overriding principles. If you do not have a well-defined set of goals and objectives, how do you know what road to take and when you've reached your destination? And the second one is: practice makes permanent.

This relentless focus on investment objectives allows a small team to efficiently find only those ideas that accomplish those objectives. Having the proper analytical tools makes the process efficient. This allows the team to eliminate all those securities that will not meet our objectives, quickly, and deeply investigate the few securities that will help us reach our investment objectives. Internal collaboration and debate keeps the team aligned to the investment objectives. Our small size is designed to maximize that collaboration. And finally, compensate everyone based on all aspects of the strategy, including profitability, stability of assets under management, client service, in addition to total return performance. Treat each member like they're an owner of the business. The foundation and structures are in place for them to successfully navigate any difficult market environment in a similar fashion to the two previous generations.

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So at this point, I'll make a few closing comments. It's been a pleasure getting to know our investors, and I thank them for their confidence, trust and thoughtful conversations. Having likeminded investors is important to any investment strategy's success, and we feel fortunate that we have these types of investors over the years.

I've found this somewhat difficult and uncomfortable to talk about my accomplishments over the past 25 years at First Pacific Advisors. As I look back at what I learned from Bob Rodriguez and the others at FPA and how I then applied those lessons to building out a fixed income investment team, I take great satisfaction from the way this occurred, specifically that what Bob created continues today in each member of the fixed income team as they contribute to its success.

The team takes great pride in managing this unique philosophic approach to fixed income portfolio management created by Bob, refined by myself, and then contributed to by each member of the team. It is that pride and dedication to the process that should be of comfort to our clients, realizing that this next generation of investment professionals will continue to improve the strategy and deliver in a manner that is consistent with the past.

And with those concluding comments, I'll turn it back to Kristina for any questions.

Kristina: [Please reference slide 45] Thank you, Tom, and thank you to those of you who have submitted your questions in advance. We addressed some of them in the prepared remarks and then will cover the remaining of them before moving on to the live Q&A.

Abhi, first question: How much capacity do you have now that you reopened FPA New Income?

Abhijeet: I'm glad we got this question. So given where the market is today, I think we have capacity to manage several billion more in assets. That's the short answer.

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The longer answer is that ultimately, it will depend. Our capacity is a function of the opportunity set. When the market's really expensive, fewer assets make sense if we want to get attractive returns because there just aren't enough bonds that meet our criteria. And that's where we were a couple of years ago when we soft-closed New Income. When the market's really cheap, we can manage a lot of money well because there are a lot of bonds that meet our criteria. So that means our capacity will change depending on the environment. There's no fixed capacity number that will always be true. However, I think we demonstrated two years ago, when we proactively closed the Fund without anyone asking us to, that we will do what's best for our investors. We'd like to be known for our performance and returns, not our assets under management. So trying to manage more money without regard to our ability to put it to good use doesn't really support our aspirations.

That's a long answer but hopefully we've proven with our actions in the last couple of years that we will manage capacity appropriately. And it's also worth noting that if we have to limit capacity again in the future, like the last time, we'll try to do that before we hit our capacity limit so that our existing investors can continue to allocate to the Fund without interruption.

Kristina: Thank you, Abhi. Next is: How is the increase in defaults on auto loans impacted the auto asset-backed securities that the Fund owns?

Abhijeet: Sure. So in terms of getting repaid on these bonds, there has been no impact and we do not expect any impact. Defaults could increase a lot from where they are today and [the Funds'] bonds shouldn't be impacted.

Defaults have been relatively low over the past couple of years, and some would say abnormally low. In fact, we've heard the increase in defaults characterized as a return to normal. When we buy our bonds, we assume losses that are much, much greater than what has been happening recently. The reason we [seek to] only own highly rated bonds is because the lower-rated bonds don't survive our loss assumptions.

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Now having said that, while we don't expect a permanent impact on our bonds even if defaults increase a lot, the market could start to get nervous about defaults and that could lead to some mark-to-market movement in our bonds. Will that happen? I don't know. It could. Keep in mind that our auto ABS has an average duration of 1.5 years, and they're rated AAA down to single A. So [we believe] that tends to put some constraints on the price movement.

Kristina: Thank you, Abhi. Are you seeing signs of distress or recession in the asset-backed securities market?

Abhijeet: So in some asset classes we're seeing an increase in delinquencies and defaults, which the prior question alluded to. So that points to some recession concerns. I don't think that we've seen anything major yet. We wouldn't be surprised though if we see things get worse. If that happens, we think [the Funds'] bonds will be fine because, again, we're stressing to scenarios that are much worse than what's been happening recently, and we're generally looking back to past recessionary environments to stress-test our bonds.

Having said that, I'm not so sure about everything else that's out there in the market because it's a broad, broad market with so many different types of assets and tiers of risk. We've tried to avoid owning bonds that require a strong economy in order for the bonds to do well.

Kristina: Have credit spreads gotten attractive enough for Flexible Fixed Income to start dipping into things like BBB-rated and lower bonds? If not, what spreads would make you acquire in that area?

Abhijeet: So thanks for this question. I'll add to our earlier comments that we made during the presentation by saying that it's hard to define a spread and say it's a good time to buy, and then feel comfortable with that. For all the reasons we discussed earlier, the spread is only part of the equation. It could be the case that it's a good time to buy when spread hit a certain level, but I don't think we know that until we dig in and understand the risk. We also need to know where risk-free rates are so that we can see the absolute yield, since it's absolute yield—not spread—that compensates us for not getting paid back 100 cents on the dollar.

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I think maybe this question might be referring to some commentary that we've seen out there that says something along the lines of when spreads hit a level of X, it's a good time to buy because the subsequent returns have historically been attractive.

I personally view that as more of a trade than a long-term investment. And the reason I struggle with that is because a lot of those analyses are predicated on what's happened over the past 20 or 30 years. But when in the past 20 or 30 or even 40 years have we had this combination of inflation, an aggressively tightening Fed, huge increases in yield, and a starting point of historically high valuations? I think the answer is never. So I don't know how relevant the past few decades are because it's not clear that the Fed and the market reaction functions will be the same as it was in the past.

So is there a trade you do if spreads get to a certain level? Maybe. I'm not really sure. It feels like a risky way to make money to us. We're focused on making long-term investments so we go back to the fundamentals and bond-by-bond analysis. But as we noted before, the market is definitely cheaper and we're definitely looking. We've been adding credit to FPFIX, or Flexible Fixed Income, and will continue to do so when we see attractive prices.

Kristina: Thank you, Abhi. Where can we find safety in bonds?

Abhijeet: So it's hard to answer that question without knowing the objective. If you don't want exposure to the risk of rising interest rates, I would say buy shorter-maturity bonds or go short as cash, depending on how you concerned you are about rising rates. But there's an opportunity cost to doing that. You never know when yields will decline, like they have in the last year or two, and you've missed an opportunity to lock in an attractive yield. I'm clearly talking our book, but I think our approach is appealing because we're buying bonds at prices that have some protection against rising rates in the near term but lock in better yields for the long term.[15]

Kristina: Thank you, Abhi. How much of the Funds are floating rate—and I believe that was covered in the prepared remarks—and are you increasing or decreasing that weight?

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Abhijeet: Yes, that's right. So we showed the floating rate exposure during the presentation. There's no predetermined plan on how we'll manage that exposure. We're willing to sell some of our shorter-maturity floaters that we don't expect to be around long enough to benefit from rising rates. On the other hand, we could find bank loan investments or some other

[15] Portfolio composition will change due to ongoing management of the Funds. Any mention of individual securities or sectors is for informational purposes only and should not be construed as a recommendation to purchase or sell such securities, 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 any security or sector examples discussed.

floating rate investment that looks attractive. Where that balances out in terms of the exposure, we're not sure; it's to be determined.

Kristina: Thank you. Are you buying munis in either strategy?

Abhijeet: Not really. We bought a utility cost recovery bond recently that I think is technically a muni bond, even though we don't view it as such, and I don't think it's a muni bond in the sense that the questioner is asking. It's not a government obligation.

Kristina: Thank you. For FPA New Income, did NPL RMBS move into Other category due to lower weight or disappear completely? And if it's in the Other category, could you share the allocation level?

Abhijeet: Yes, so it has not disappeared completely. It did move into the Other category because of the lower weight. So, by definition, it's something less than 4% of the portfolio. I don't recall the exact number off the top of my head but we can follow up.

Kristina: We'll do so. There are no other questions at this time. We thank those of you who submitted questions and listened to the webcast. We thank you for listening to FPA New Income and Flexible Fixed Income Second Quarter 2022 Webcast. We now turn it over to the system moderator for closing comments and disclosures.

Moderator: [Please references slides 46-51] 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 weeks at FPA.com. We urge you to visit the website for additional information for the funds, such as complete portfolio holdings, historical returns, and after-tax returns.

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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 keep you appropriately informed on the strategies discussed today.

We do want to make sure you understand that the views expressed on this call are as of today, and are subject to change without any 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.

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You should consider the Fund's investment objectives, risks, charges, and expenses carefully before you invest. The prospectus details the Fund's investment objective and policies, risks, charges, and 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.

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

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