investors first

Q4 2021 FPA New Income, Inc. (FPNIX) and Flexible Fixed Income (FPFIX) Webcast
February 2nd, 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, 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.

Moderator: [Please reference Slide 1] 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. Simply type your question in the Q&A widget located on the bottom left side of the console. Questions will be addressed at the end of the presentation if time allows. Should you need technical assistance, as a best practice we suggest you refresh your browser. If that does not resolve the issue, please submit your issue in the Q&A panel.

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 fourth quarter 2021 webcast. My name is Kristina Surkova, and I am relationship manager for the fund.

The audio, transcript, and video 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 the 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's been director of research for FPA New Income since April 2015, and portfolio manager for the fund since November 2015. He's served as portfolio manager for FPA Flexible Fixed Income Fund since its inception in December 2018.

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[Please reference slide 2] Now, let's talk about what happened during the quarter. Yields have risen in anticipation of monetary policy changes. Credit spreads remain generally unchanged. Rising rates caused short-term bonds to have their largest drawdown in over two decades. Both funds protected capital well during this drawdown. The market now expects the fed funds rate to be significantly higher by end of 2022. We believe the funds are positioned well to fulfill their short- and long-term mandates if this occurs.

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. Tom, turning it over to you.

Thomas: [Please reference slide 3] Thank you, Kristina, and thank you, everyone, for joining us this afternoon for our Q4 [2021] call. The first thing we want to look at it just give a quick summary of the objectives that we have for each strategy.

For the New Income Fund, we are trying to get—seeking a positive return on a 12-month period and then trying to get CPI plus 100 basis points over a 5-year period. And, while doing that, we have a very controlled risk strategy. We also do have some very succinct guidelines which says that at least 75% of the portfolio will be A minus-rated or greater.

For Flexible Fixed Income, it's a broader mandate. We have a 36-month positive absolute return [goal] and we're trying to get CPI plus 200 basis points over a 5-year period. And that portfolio could have a maximum 75% of its assets in securities rated less than A minus.

And the last thing I'll just—a comment, and then first one is, is to thank everyone who has participated in the Flexible Fixed Income Fund. We are greatly appreciative of the trust you've placed in us. And at the end of 2021, the Fund was at $667 million in assets.

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[Please reference slide 4] So let's get ahead—go ahead here and look at performance for both funds, and a few comments to be made here. Fourth quarter was a difficult quarter. We're going to go in details of why. [Please reference slide 5] The New Income Fund was down 20 basis points for the quarter, while the appropriate [comparative] index for it, which is the [Bloomberg U.S.] 1-3 Year Aggregate [Bond] index,[1] was down 56 basis points. The result of that index being down that much in one quarter was, is it's produced a total return for the year that was minus

[1] Referred to as the "1-3 Year Aggregate" throughout the transcript. Comparison to indices is for illustrative purposes only. The Fund does not include outperformance of any index in its investment objectives. Past performance is no guarantee, nor is it indicative, of future results.

49 basis points. For us [the FPNIX], we were still up for the year; we were up 82 basis points, which marks the 37th consecutive positive return we've had for, in a calendar year.[2]

The value that really shows up, the consistent value, that absolute positive return, shows up when you look at the multi-year periods versus the index, whether it's 3, 5, 10, 15 or even out further, that we have consistently been able to do better than that sort of appropriate [comparative] index for the Fund, which is the 1-3 Year Aggregate. As for the broad aggregate [Bloomberg U.S. Aggregate Bond Index],[3] it was sort of almost unchanged for the quarter at 1 basis points return but did produce a negative return for the year.

[Please reference slide 6] Moving forward to look at Flexible Fixed Income Fund and how it's done, for the quarter, we were up 19 basis points. The sort of appropriate [comparative] index you could use against is the Bloomberg Universal Index, which was down 3 basis points. And for the year, that index was down 1.1% while Flexible Fixed Income Fund was up 1.77% for the year. Shows to the discipline we have on protecting on the downside, producing a positive return while your sort of index produces a negative return. There is—across that, you look over the last

[2] Past performance is no guarantee, nor is it indicative, of future results.
[3] Referred to as the "broad aggregate" throughout the transcript.

three years and we've [FPFIX] not outperformed the index but we think on a risk-adjusted basis, we've done quite well.

(00:06:35)

[Please reference slide 7] Moving forward, I want to just spend a quick second here on a couple of things to highlight. The first one, if you look at the top, if you go down and you look at the 1-3 Year Agg had a negative return for the year. That’s the first negative return it has ever produced since it started back in what is, in essence, I think it goes back to—if I remember right, oh gosh—1994. The [broad] aggregate index itself was down 154 for the year. That’s the second time in the last eight years it’s had a negative return. The last negative return was 2013, well, over another period where we reached historic low levels of interest rates, and the thought processes of sort of changing fiscals and monetary policy and economic growth and such from market perspectives, in that, producing a negative return.

[Please reference slide 8] Moving forward, this is a look at that things, on the graphs, we’ve always wanted to show you the statistics, which is at the end of the quarter, our yield-to-worst in the New Income Fund was 1.42% and effective duration of 1.39 years, so that ratio is a little over 1. As it compared, and at the end of the third quarter, the yield-to-worst for the Fund was 1% and that effective duration was 1.32.

Looking at the [broad] aggregate index, that ratio of yield-to-duration is 0.26. It's not that much different than it was a quarter ago, which was sort of in a one-point—it was a 0.23. And then the 1-3 Year Agg has that ratio of yield-to-duration as 0.3—0.43, I'm sorry—which is an improvement over where it was in the third quarter. In the end of the third quarter, it was only roughly about 0.20. And that goes a long way to explaining why that 1-3 Year index had a negative return during the quarter. Its yield was so low versus its duration, very little change in interest rates were going to produce a negative return.

For Flexible Fixed Income Fund, we ended up the quarter at just shy of 2% yield and just shy of a 1-year effective duration, so we have a very attractive yield-to-duration metric. Yield is up, duration is up a little bit in that fund versus where it was at the end of September.[4]

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[Please reference slide 9] So this chart looks at [recent] drawdowns, and a couple of things to look at. We started the data for things post-June 30 of 2021. And what I want to focus on is the third column where you look at the Bloomberg 1-3 Year Agg index, the dates represent the peak that the index had in return, which was 8/3/2021, and its trough was 1/27/2022,

[4] In Q3 2021, FPFIX had a yield-to-worst (YTW) of 1.63%, an effective duration of 0.74 years, and a YTW/Duration of 2.20.

and that drawdown represents a minus 1.41% return. That's the largest we've seen in ten years. On a comparative basis, the New Income Fund was only down 34 basis points for that period.[5]

And then the far right-hand column looks at the [Bloomberg U.S.] Universal Index, which is that [comparable] index you sort of use to give you a rough idea how Flexible Fixed Income Fund is doing, and it peaked in its return on 14 June; it reached its trough, that index did, on the 26th of this January, for a minus 3.62% return. The Flexible Fixed Income Fund during that period of time was down a mere 5 basis points. So that speaks well to our protection on the downside when things get difficult. [Please reference slide 10] So with that, sort of some return comments and drawdowns and such, I want to move forward at this point and do a little talk about the market commentary.

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It was interesting, as Abhi and I sat down to write the letter,[6] I made a comment to him, I think this is the first time since I've been at FPA where the subject matter of each quarterly letter always focused on the

[5] Past performance is no guarantee, nor is it indicative, of future results.
[6] The FPA New Income and Flexible Fixed Income 4Q 2021 commentaries. The 4Q 2021 commentaries for FPA New Income and FPA Flexible Fixed Income Fund can be found in the Quarterly Commentary section for each fund on the fpa.com website, here and here, respectively.

same thing. And what it focused on is really this graph here, which is CPI, Consumer Price Index. [Please reference slide 11]

The blue line represents the year-over-year change; the green line represents the year over two years ago change. So when you look at that green line, it's the highest it's been in the last 30 years. If you look at the blue line, it's the highest it's been in the last 40 years. And this is really what's the driver of why we spent four quarters talking about inflation and such as this is front and center the biggest issue facing the bond market. [Please reference slide 12] But I think we need to dig a little bit deeper, and that's to go in and look at what are the drivers of this inflation. Why are we seeing what we have? And this graph looks at the five subcomponents with the largest contributors to year-over-year inflation for 2021.

And starting at the bottom, the dark blue bars, that's gasoline all types, so basically fuel, energy. And you look, that's pretty consist—you know, a pretty big contributor during 2021. It detracted from inflation in 2020. And if you look back to 2017, not a huge contributor but it is also something to keep in mind; it's volatile.

I'm going to lump the orange bars, which represent used cars—new cars—and the purple bars which represent used cars, and I'm going to lump them together because the two really are working in tandem. And that is, if there's a dearth of inventory—which there is, and we'll show in a minute—for new cars, people who want to purchase a car, they go, obviously they're going to go buy a used one. If you look at these two components prior to 2020, they're basically just nonexistent. They don't show up on there because they just aren't a contributor. On the used car front and how it's contributing, think about this in the fact that had you probably noticed if you watch much television, that both CarMax, which is a used car, national used car sort of dealership network, and Carvana have both been advertising that they will buy your used car. You know, they'll give you an on-the-spot appraisal of it and write you a check. That's because they're looking for inventory.

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And then the last one to look at in here is the green bars, which is shelter. That's both owner's equivalent rent[7] for a homeowner and what do you pay for rent if you're renting a house or renting an apartment. And it's grown over most of this year, doesn't look necessarily way out of line to history but it is on an upward trend.

[7] Owners' equivalent rent (OER) is the amount of rent that would have to be paid in order to substitute a currently owned house as a rental property. This value is also referred to as rental equivalent. In other words, OER figures the amount of monthly rent that would be equivalent to the monthly expenses of owning a property (e.g. mortgage, taxes, etc.).

But when you put those four together, that represents more than half of the inflation in total that occurred on a year-over-year basis in 2021. [Please reference slide 13] So let's take a minute and kind of look at a couple of these items in detail. The first one we want to look at is sort of the supply and demand dynamics that we're seeing in durable goods. The graph on the left looks at real consumption of durable goods—which is the blue line—and then there's a nondurable goods, which is the gray line, and then the more lighter blue line is services. And as we went in the pandemic, and we're all aware of, the demand for durable goods shoots up dramatically but you see that services, that demand is far below where it was prior to the pandemic. That demand for these durable goods has been tailing off as we went through 2021. This graph happens to come from Goldman Sachs and they've put a nice dotted line in to tell you where they think it's going to go going forward into 2022. Time will tell on that one.

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The two right graphs look at inventory. The first one, that middle graph on the right, as you go to the right, is new car inventories, and there it's about 30% of where they were in 2019. And so you think about that and go, well, that probably explains why used car prices have gone up so much. Looking at indications moving forward, the production for new cars in the first quarter looks like it's going to tend to increase. The shortages associated with chips and other materials is probably going to go away over time and it wouldn't be surprising to see that inventory level start to rebuild.[8]

The very far right-hand is just the retail inventory-to-sales ratio—again, something that's at a very low level. As sort of bottlenecks in the system start to work their way through, you would expect to see the inventory levels start to rise. The point of this being is that over time, demand, if it's declining a little bit, supply is increasing some, the two are going to tend to get back into equilibrium and that price pressure that you see from those elements probably will tend, it will be more transitory in nature and will tend to dissipate.

[Please reference slide 14] So moving forward, we'll look at what is the biggest component when you look at CPI, in many respects, and it's shelter. And this graph looks at the 12-month annualized change in the shelter component of CPI. It's a little over 4% right now, and that puts it up at the highs you've seen in the early to mid-2000s. Maybe doesn't look as draconian at this point but keep something in mind is this is a lagging measurement. Because rents, basically, for apartments are on a one-year

[8] Source: BBC News, January 25, 2022, "*Global chip shortage: US says firms' stocks have plunged*"; https://www.yahoo.com/video/global-chip-shortage-us-says-041508933.html.

rate, they don't sample everyone in this group every month. They sample a subset of it, so over time you'll have captured everybody because they realize that, okay, if you rented something today, for a year, it's probably not going to change. So it's a lagging indicator, and so what happens is, is it will take time for the rent increases and the owner's equivalent rent increases that have been showing up in 2021 to work their way all the way through the data. We talked a little bit about this in some prior calls. We said this becomes a more important component in the fourth quarter of this year into 2022. So it's one of those open issues on how it's going to be—is it transitory or persistent?

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[Please reference slide 15] And the next slide gives us an indication of some of the elements to keep our eyes on as it relates to how this shelter component is going to look going forward.

The left-hand graph looks at homeowner vacancy rates, which is the dark blue line off the left-hand scale, and the light blue line is rental vacancy rates—works off the right-hand scale. But just looking at the lines, you realize they're back to lows that you haven't seen since the late Seventies and early Eighties.

The middle graph, Case-Shiller National Home Price Index, you know, what the price of houses looks like over the past year. And lo and behold, as we all understand, they've gone up dramatically. They're at the highest level, on a year-over-year change, that we've seen going back into the mid-Seventies.

Now, owner's equivalent rent is not directly tied to price changes in houses. It's an indirect relationship. But it kind of gives you some indication of, when that owner's equivalent rent equation is calculated, how it might be faring.

And then on the far right-hand side, that's a look at the monthly change in apartment contract rent. Now, this is for studios, one-bedroom, two-bedroom, three-bedroom, and not just a vacant apartment that got rented but what were the renewals like for the existing rental contracts that were out there? And as has been indicated in the press, during most of 2021, it was quite high—quite high versus the past four or five years—but in December, actually slightly negative. And maybe this is pointing to the worst of that is behind us. We don't know for sure, but that sort of points to, well, maybe the inflation component for shelter is a little more transitory and less persistent than people think. At this point, you still don't have a conclusion and it's sort of that element of inflation that you want to keep a close eye on because it's going to take several months, if not quarters, for all that data to work its way through.

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[Please reference slide 16] But from this information of this movement we've seen in inflation and some of the reasons why, the next graph starts to go okay, how are different constituents reacting? And this is a look at the [Federal Open Market Committee] FOMC, which every quarter, they will survey all the members of the Open Market Committee and ask them what they think is going to happen for CPI, inflation, all those sorts of issues, and the Fed funds rate, which is what this picture looks at. And they do it each meeting, so the meeting dates here start in 2020, they go through 2021, and the question that's asked is where do think rates will be in 2022.

And really, up until September of last year, pretty much the Fed, the FOMC meeting, wasn't really looking for any changes. You got some moderate changes in September and then the December meeting, it perks up a lot. And when you add all those up and average them out, the implied inflation—or the funds rate that people were looking at—was maybe 75 basis points at the end of 2022.

[Please reference slide 17] So the next graph that we want to look at here, it says, well, how did the market—what's the market perceiving? And so what we've done here is we've looked at, starting in market expectations in June of 2021, the end of—so the end of each quarter, so June, September, December, and then the last, the end of last week—and said okay, where did the market think the Fed—how many Fed fund rate hikes were going to happen in, and then to each of the meeting rates across the axis, you know, at March of ‘22 which, as an example, in June of last year, the market didn’t think rates were going to rise at all, in March of this year. As of last Friday [January 28, 2022], everyone’s on board, we’re going to have one rate increase, it’s going to go to 50 basis points.

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Looking over to the set of bars that represent December of 2022, in June and September, the market thought okay, by the end of 2022, we’re going to have one rate hike, 25 basis points, which means the Fed funds rate is going to look a lot like 50 basis points. On December, the end of December, the market says nah, it’s going to be three. And that got them up to a rate that looked more like 1%. As of last Friday [Jan 28, 2022], oh no, three’s not right; it’s five. So now they're up to five, and they think five’s going to be the number. Well, five, if you take 25 basis point hikes and go okay, I’m going to do five of them. It’s, you know, 125 basis points, 1.25%, and you put on the 25 you are today, you get to some number that gets close to the effective rate, the top end of what the Fed funds rate might be, is 1.5%.

So in a mere six months, you went from 50 basis points expectation from the market to [approximately] 1.5%. So a significant change in a very short period of time.

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[Please reference slide 18] So how did that reflect itself into the Treasury yield curve, which is the next graph we want to look at? I'm not going to go through all of them. I'm just going to spend a minute on really two, if not maybe two and a half of these. So the dotted green line represents where the yield curve was on September 30, 2021. The line above it represents, well, where was the yield curve at the end of December of 2021 and just to give a reference point is the 2-year Treasury increase in that one-quarter period by about 50 basis points.

The solid green line represents, well, where was the yield curve last Friday [Jan 28, 2022]. And the 2-year went up another 43 basis points from there. So thinking through that, that means from September 30, 2021 through last Friday, the 2-year Treasury is up almost 100 basis points, a little over 90 basis points in that sort of, not barely four-month time period. This explains a lot of why you've seen the 1-3 Year Aggregate index produce a negative return for the quarter and struggle to have a positive return here year-to-date.

[Please reference slide 19] At this point, you've got a marketplace that vacillates between four and five rate increases in 2022. Okay. But how wide are those predictions? How often is all that correct? And the next graph leads us into something that sort of makes you pause for a second. So this is a look at, the blue line is the Fed funds rate just from 2001 where we just plot it, and all those dotted lines represent periods of time, the market's expectation of where the market thinks rates are going to go. And you look at sort of 2009 through 2016, the Fed funds rate didn't change but consistently, the marketplace goes no it's going to go up, no it's going to go up, no it's going to up. Not too accurate there. 2017 forward, Fed funds rate goes up, marketplace goes nah, it's not going up as much, not going to go up as much, not going to go up as much.

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So what you draw from this is the market doesn't seem to get this right very often. They seem to underestimate the number of raises that are going to occur and overestimate and miss the timing of when the change is going to occur. Now, we have no idea what that's going to mean going forward, but what it does tell us is that you need to have an open mind to the fact that the market, what it indicates today probably is not actually what's going to happen. Something else is probably going to occur and you need to invest a fixed income portfolio with enough flexibility to give yourself a) downside protection to, all right, they underestimate to b) some upside potential because they overestimate it. The point being is they're rarely correct.

[Please reference slide 20] So I want to close out at this point just a couple of things about rates in a historical perspective and a look at spreads. And so the first thing is we're going to look at the aggregate index. The graph on the left is a very long-term look from 2000 forward and yes, the blue line, dark blue line, for yield-to-worst is turned up in the last six to nine months. Okay, we're all aware of that. But when you look at the spread really hasn't changed and the implied real yield is still quite negative. In fact, if you look at these numbers and you go back, you're like, well, this isn't that much different to 2012.

The right-hand graph is just a look at the last, not—a little over a year, starts January 1, 2021. And yes, the yield-to-worst for the aggregate index is up. Quite frankly, the spread over that period of time is actually down.

[Please reference slide 21] And looking to the next graph, if we just sort of hone in a little closer and look at the 1-3 Year Aggregate index, you have a very similar pattern. Yes, yield is turned up on the left-hand side. Yes, spread looks like—and yes, real yields turned up a tad. But you look at it and realize, wow, it still is as low as it was back in 2012. It really hasn't changed that much. And the right-hand, interestingly enough, while yield has gone up, the spread on that index has actually declined a small amount. It's not huge. It looks huge on the graph but remember, it sort of went from 20 basis points to 14. So it's not a huge number but what it's telling you is spread hasn't widened.

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[Please reference slide 22] And then finally, what we always like to look at is a good down the middle of the fairway sort of look at credit or high yield, is the Bloomberg High Yield Index for BB and then we take out the energy component because it tends to be rather volatile because it's sort of commodity-driven. And looking on that left-hand of that graph, yes, you've gotten some yield to turn up and such, but you still, your yield, your spreads are at levels that look like you were back in 2012, and actually your implied real yield is still quite low and there's obviously no indication of sort of okay, what am I getting paid for for the event of default.

On the right-hand side, the spread has—it's the light blue line—the spread has turned itself up post the end of the year. You do see that movement up. And that has coincided with the movement up in yield. Having said that, I look back and the spread still looks like it did, look at sort of December and January of 2021.

The point is being, as you look at this, as we wrap all this together, the rate changes we've seen in Treasuries and in the high-quality side of the bond market has expanded the opportunity set for us over the past quarter. It sounds like, you know, the glass is half-full I think is how that goes. Well, the problem is the spread that you get either on high-quality or on credit really hasn't improved that much so valuation's not that great there either. It is, you know, just the yield is up but that compensation for credit risk really hasn't changed a discernible amount from where you were a year ago.

So from wrapping it up, I'm going to turn it over to Abhi, who's going to go into some more detail about what opportunities we did find and how we have positioned the portfolio for this change that's occurring in monetary policy and how it's impacted the fixed income markets and sort of, and maybe some other opportunities we might see going forward during this quarter.

(00:29:02)

Abhijeet: [Please reference slide 23-] Thanks, Tom. So we'll start with New Income, and we will begin with performance. This first slide shows the contributors to returns for the fourth quarter and calendar year 2021 for FPA New Income.

[Please reference slide 24] Starting with the fourth quarter, the bottom of the third column of numbers from the left shows that New Income returned minus 1 basis point before fees. The largest contributor to performance during the quarter were the corporate holdings shown at the bottom of the table.

The biggest component of return in the corporate holdings was income, which is the coupon payments that we received in addition to dividends that we received on the Fund's common stock holdings.[9] The common stock holdings also benefited from an increase in their market value.

The second-largest contributor to performance were the collateralized loan obligations or CLOs backed by corporate loans, which is shown in the fourth line from the top. The vast majority of these holdings were floating rate, so despite the increase in yields across the market that we discussed, these floating rate bonds didn't move much in price, which means that most of their return was due to their coupon payments.

The third-largest contributor to performance were the nonagency [commercial mortgage-backed securities] CMBS holdings. That's shown about halfway down the page. Over three-quarters of these holdings are

[9] Coupons (a debt instrument's interest payment) and dividends are not guaranteed.

floating rate, owing to our investment in commercial real estate-backed CLOs. These two were not significantly impacted by the rise in rates during the quarter, so their return was driven mostly by coupon payments. The remaining nonagency CMBS holdings are fixed rate, but the coupon payments on those bonds more than offset the decline in price that these bonds experienced due to rising market yields.

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The largest detractors from performance during the quarter were Treasury bonds, asset-backed securities or ABS backed by auto loans or leases, and ABS backed by equipment. For all three investments, the performance was driven by price declines caused by the increase in market yields.

The last column on this slide shows that New Income returned 1.3% before fees for the full year 2021.

The largest contributor to that return was the corporate holdings. Over the full year, the majority of the return on the corporate holdings came from price appreciation as risk assets generally appreciated in price over the year. But these investments also got some benefit from coupon payments and dividends on the common stock holdings.

The second-largest contributor to performance during the year were CLOs. Over the year, coupon payments represented the primary source of return since most of our bonds are floating rate, so the increase in the risk-free rates did not impact their price much.

The third-largest contributor to performance were nonagency CMBS, mostly due to coupon payments. Similar story to the fourth quarter—most of our holdings are floating rate so the increase in risk-free rates during the year did not impact their price that much. The rest of the holdings are fixed rate, and they did see lower prices due to rising risk-free rates, but the coupon payments on those bonds more than offset the price declines.

The largest detractor from performance last year were Treasury bonds due to the increasing Treasury yields leading to lower prices.

The second-largest detractor from performance were agency CMBS. The prepayment speeds on these bonds ended up being too fast relative to the premium on the bond, resulting in a total return loss over this time period.

The third-largest detractor from performance were asset-backed securities backed by auto loans or leases. These ABS bonds declined in price due to rising risk-free rates.[10]

(00:32:35)

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

[Please reference slide 25] The next slide shows the New Income portfolio broken down by investment idea. Each slice of the pie represents an investment idea that is at least 4% of the portfolio, with the orange Other slice representing the sum of all the individual investment ideas that are each less than 4% of the portfolio.

Before we discuss how we invested the portfolio this quarter, it might be helpful to revisit our investment process briefly. When we invest the portfolio, we don't make macroeconomic bets. We don't invest by making a bet on the timing and size of interest rate moves. We also don't make bets on which sectors of the bond market will appreciate relative to others. Frankly, it's just really hard to predict accurately and consistently what the world will look like over a given period of time, and then also predict how the market will react. So instead, we focus on investing using an absolute, not relative, return framework because we have found that that is the best form of risk management and the best way to generate consistent returns.

At a high level, we want to get paid on an absolute basis for the risk that we take. A key component of that approach is that we actively manage the duration of our investments by trying to buy the longest bonds that we can find that we expect will have roughly at least a breakeven return over a year if we assume that the bond yield will rise by approximately 100 basis points over that year. This is a way of measuring whether we are getting paid for duration risk and what this ends up doing is it pushes us to incrementally add duration when yields rise because we are getting paid more to take on duration risk, and then reduce duration when yields fall because we get paid less to take on duration risk. And intuitively, this makes sense. When yields rise, duration is cheaper, and we generally like to buy more of something when its price gets cheaper; and the converse is true as well. This approach has also—this approach also has a benefit of giving us a built-in cushion against unexpected increases in yield. We used this approach last year to try to avoid taking on too much duration risk when yields were historically low and duration risk in the bond was historically high. And that was a big contributor to New Income's positive return last year and New Income's finishing in the top 20% of the [Morningstar] Short-term Bond category for the year.[11]

(00:35:05)

Circling back to today's portfolio, with higher yields, we are trying to add duration to the portfolio. To that end, during the fourth quarter, we bought high-quality fixed rate bonds with an average life of approximately two years. We define high-quality bonds as bonds rated single A or higher.

[11] Please refer to the Important Disclosures – Morningstar Bond Categories section of this webcast's presentation for important information relating to Morningstar's Short-term Bond category.

Now, earlier in 2021, 2-year maturity bonds would have been too expensive for us to buy based on our 100-basis point test. But with higher yields in the fourth quarter of 2021, we bought high-quality ABS backed by subprime or prime auto loans or leases, ABS backed by insurance premium loans, and ABS backed by equipment. We also bought AAA-rated floating rate bonds in the form of CLOs backed by corporate loans and CLOs backed by commercial real estate.

Our investment activity during the quarter was funded using cash on hand and the proceeds from selling short-maturity bonds and Treasuries.

Our Treasury sales decreased the Treasury position during the fourth quarter from 28% of the portfolio as of September to 22% of the portfolio as of December. We own Treasuries with a blended duration of 2.7 years across holdings that mature between 2.7 and 2.9 years from December. The Treasury position is something that we've had in the portfolio for over a year now, as a duration placeholder or hedge against macroeconomic or market events that could lead to lower risk-free rates.

We went through this already so I won’t belabor the point, but the future path of the economy and rates is not set in stone. There is still macroeconomic uncertainty from a number of sources. We hope that things truly are getting better with respect to COVID-19, the economy improves, inflation gets under control, etc. but unfortunately, things can go wrong. And if that happens, we want something in the portfolio that will add some upside return potential to the overall portfolio in the event that yields decline. But, very importantly, we are focused on trying to achieve a positive calendar year return, which is one of our two stated [goals] in managing the Fund. I'm sorry, to be clear, the stated [goal] is to try to get to a positive return over a 12-month period.

(00:37:12)

So from a risk management standpoint, we decide the Treasury position and adjust its duration with that positive return [goal] in mind. It is through that process that the Treasury position declined during the quarter.

In the market for debt rated BBB or lower, which we refer to as credit, spreads remain low. Yields are higher due to higher risk-free rates, but that's a relative statement. On an absolute basis, we don't find yields too appealing. Consequently, we did not invest much in credit during the quarter. We made some investments in newly issued bonds backed by nonperforming residential mortgages and we also bought bank debt. [Please reference slide 26] As you can see on this next slide, after netting out credit investments that amortized or matured, our credit exposure increased from 6.9% of the portfolio at the end of the third quarter to 8.5% of the portfolio at the end of 2021.[12]

[Please reference slide 27] The bottom of this next slide shows that the yield-to-worst increased from 1% at September 2021 to a little over 1.4% at December 2021, and the duration increased slightly from 1.3 years to 1.4 years. Even with the Treasury holdings, which I'll note have a similar duration to what you might find in other short-duration funds or indices, the overall duration of the New Income Fund is still one of the shortest in the short-term bond category.

(00:38:36)

[Please reference slide 28] This next slide shows a simulation of New Income's return before fees over the next 12 months based on the changes in yield assumed on the x-axis. For example, the 100-basis point change in yield about two-thirds of the way along the x-axis assumes that the benchmark yield on every bond in the portfolio increases by 100 basis points over the next 12 months. That includes the reference rate on our floating rate bonds increasing by 100 basis points all the way out to the yield on our 2.7-year Treasuries increasing by 100 basis points. If that happened, this simulation shows that New Income would return

[12] During the audio presentation, the presenters stated incorrectly that the credit exposure for FPA New Income, Inc. increased from 8.1% (at the end of Q3 2021) to 8.3% (at the end of Q4 2021). The actual numbers are shown above.

approximately 90 basis points before fees. Now, this assumes that nothing changes in the portfolio over those 12 months and that the yield increase occurs gradually over 12 months.

We commented earlier that the market is currently pricing in approximately 120 basis points of increase in the Fed funds rate in 2022. If that were to happen and the rest of the yield curve also increased in yield by approximately 120 basis points, this chart suggests that the Fund would return approximately 75 basis points before fees. That's based on the 125-basis point scenario shown on this chart.

And finally, the positive returns on the far right-hand side suggest that the Fund should be able to withstand a greater than 200-basis point increase in benchmark yields across the yield curve and still produce a positive return before fees.

And one of the things that we think will be helpful here is that approximately 32% of the portfolio is held in floating rate bonds. These floating rate bonds not only shouldn't move much in price as benchmark yields rise, but also their coupons should increase, which should add to the return.

[Please reference slide 29] Lastly for New Income, on this next slide we show the percentage of the Fund's principal that we expect will turn into cash over the coming quarters as the Fund's holdings amortize and mature. This chart shows that 2% to 4% of the Fund's holdings should convert to cash each quarter which, all things being equal, should provide dry powder to invest into higher-yielding bonds to the extent that higher yields materialize.

(00:40:46)

[Please reference slide 33] Next, we'll cover Flexible Fixed Income, starting with performance. The bottom of the third column of numbers on this slide shows that Flexible Fixed Income returned 23 basis points before fees during the quarter.

The largest contributor to this performance was the corporate holdings, with much of the return due to income. In particular, dividends on common stock holdings were a meaningful contributor, in addition to an increase in the overall market value of those stocks.

The second-largest contributor to performance during the quarter were the CLOs, mostly due to coupon payments since most of our bonds are floating rate and did not move much in price as risk-free rates rose during the quarter.

The third-largest contributor to performance were asset-backed securities backed by loans to late-stage mostly software companies. For those bonds, the price decline with the rising rates over the quarter, that price decline was more than offset by coupon payments.

The three largest detractors from performance during the quarter were ABS backed by auto loans or leases, ABS backed by equipment, and ABS backed by insurance premium loans. In all three cases, the performance was driven by price declines caused by higher risk-free rates.

The bottom of the last column shows that the return for all of 2021 for Flexible Fixed Income was 2.26% before fees.

The largest contributor to that performance was the corporate holdings due to the combination of income from coupon payments and common stock dividends, and price appreciation over the year.

The second-largest contributor to performance last year was CLOs, where coupon payments were the primary source of return as again, the price on these mostly floating rate investments was not materially impacted by rising risk-free rates during the year.

(00:42:36)

The third-largest contributor to performance were asset-backed securities backed by equipment, which declined in price as risk-free rates rose, but that price decline was more than offset by coupon payments.

For the year, the only detractor from performance were agency commercial mortgage-backed securities. These bonds had a negative return mostly because the prepayment speeds on these bonds were too fast relative to the premium on the bond. That resulted in a total return loss over this time period.

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

[Please reference slide 34] On this next slide, we show the Flexible Fixed Income portfolio broken down by investment idea. These pie charts follow a similar format to the New Income pie charts we reviewed a few minutes ago.

As mentioned earlier, investing in credit or investments rated BBB or lower is a challenge given the valuations that we see. We made some investments in credit, primarily in newly issued bonds backed by nonperforming residential mortgages, ABS backed by communications infrastructure, bank debt, and ABS backed by loans to late-stage mostly software companies. As we will see in a minute, net of existing investments that were repaid, the Fund's credit exposure did not increase much.

Absent attractive investments in credit, we deployed capital into high-quality bonds rated single A or higher, or otherwise retained cash for use for when more attractive opportunities arise.

[Please reference slide 35] Similar to New Income, we took advantage of higher rates to push out the duration of the high-quality bonds we buy. This past quarter, we bought high-quality fixed rate bonds with an average life of 2 years, including ABS backed by subprime or prime auto loans or leases, ABS backed by equipment, ABS backed by insurance premium loans, and other ABS. In addition, we bought highly rated floating rate bonds, including CLOs backed by corporate loans and CLOs backed by commercial real estate loans.

(00:44:36)

This slide that we're currently looking at shows the Fund's credit exposure over time. As shown in the left two columns, the credit exposure increased a bit over the fourth quarter, ending the year at 24% of the portfolio, as shown in the last line in this table.

[Please reference slide 36] The bottom of the next slide shows that the Fund yield-to-worst increased to just under 2% and the duration increased slightly to 1 year.

[Please reference slide 37] Next, we have the same return simulation with the same assumptions that we looked at before, but here we're looking at Flexible Fixed Income. Using a 100-basis point change in benchmark yields, this simulation suggests that Flexible Fixed Income would return [approximately] 1.6% before fees over the next 12 months if the benchmark yield on every bond in the portfolio increased by 100 basis points over that 12-month period. Again, that assumes that everything from the benchmark on a floating rate bond increased by 100 basis points, to the yield on our longest fixed rate bond increasing by 100 basis points.

If the market's expectations for a 120 basis points of Fed funds increase over the year ends up being correct, this suggestion—this chart suggests that the Fund would return approximately 1.5% before fees in that scenario, based on the 125 basis points scenario shown on this chart. Here again, the floating rate bonds in the portfolio add to these rising yield scenarios. Approximately a third of the Flexible Fixed Income portfolio is held in floating rate bonds and because the price of these bonds should not be significantly impacted by rising benchmark yields, that their coupons increase as the benchmark yield increases, we expect that those bonds should positively contribute to the Fund's performance in a rising rate environment.

Now, for those comparing this chart to the same chart for New Income, please keep in mind that Flexible Fixed Income has more credit exposure and is more exposed to changes in credit spread than New Income. At a high level, these simulated returns for Flexible Fixed Income are higher than what we showed for New Income but please note that this chart does not capture the impact that a change in credit spreads might have.

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And we'll conclude this slide—we'll conclude with the next slide [Please reference slide 38] showing the portion of the Fund that we expect to convert to cash each quarter based on scheduled amortization and maturities. We expect to have 3% to 6% of the Fund available as cash each quarter, in addition to the cash and equivalents that we have today, which is helpful for taking advantage of higher yields to the extent that they materialize over time.

And then finally, two quick things before we get to Q&A. The first addresses our view on how best to beat inflation and get positive real returns, which is a topic that we've discussed in the past but it's worth discussing again.

Our view is that inflation is not something that can and should be beaten every day. Instead, we think inflation is something that is best beaten over time. To explain why we have that view, I refer back to the valuation charts that we discussed earlier, showing the negative real yields on the aggregate bond indices, and the extremely low positive real yields in high yield. If you want to beat inflation today, you either can't because real yields are negative, or you have to take on a lot of risk to do so, and that means buying high yield-rated debt at yields that don't compensate for the risk of credit losses. Now, there is of course a third option where you can invest at high valuations, close your eyes, and hope or speculate that someone will pay you more for those investments later. And if that were so, you could beat inflation by a total return. However, thus far, 2022 has proven that that's not a very reliable way to make money, let alone beat inflation.

What we have seen is that if we can preserve capital on a nominal basis in the short term, we are well-positioned to reinvest into higher yields as they arrive. And by doing that year-in and year-out, we think we can compound capital and beat inflation over long time periods. Historically, it has been true that for New Income, more often than not, and certainly more often than comparable indices or our peer group, we have been able to beat inflation over multi-year periods of time using that approach. Flexible Fixed Income does not have the same history yet but we are optimistic, given that we employ the same philosophy with that strategy, albeit with a different execution, as we outlined at the beginning of this presentation.

(00:49:06)

Then the second item we wanted to cover as a housekeeping note. When discussing the performance of both funds, we've mentioned the dividends on common stocks were a meaningful part of the corporate returns. As a reminder, these common stocks represent value that we received as part of restructurings that we went through in the past on corporate bond or loan investments. These common stock dividend payments are one avenue of achieving our recovery on these investments. However, the size and timing of these common stock dividend payments are not consistent, and the dividends may be nonrecurring. As these common stock dividends are passed along to New Income and Flexible Fixed Income shareholders, our investors may have seen that, on occasion, the monthly dividend received on their shares in these funds was larger than expected. Going forward, we may continue to occasionally see higher-than-expected dividends on the funds' shares, to the extent that we receive dividends on the common stock holdings. So please take that into account when you consider the run rate dividend on these funds, or look at metrics like the SEC Yield.[13]

So, to conclude, in summary, the Fed is on a path of tightening monetary policy, which is leading to higher yields in the market. We

[13] The SEC Yield calculation is an annualized measure of each fund's dividend and interest payments for the last 30 days, less fund expenses. Subsidized yield reflects fee waivers and/or expense reimbursements during the period. Without waivers and/or reimbursements, yields would be reduced. Unsubsidized yield does not adjust for any fee waivers and/or expense reimbursements in effect. The SEC Yield calculation shows investors what they would earn in yield over the course of a 12-month period if the relevant fund continued earning the same rate for the rest of the year.

believe that both funds are positioned for these higher yields, as evidenced by our performance last year and our performance year-to-date.

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

(00:50:30)

Kristina: [Please reference slide 40] 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 and will take the remaining ones right now, and then move into live Q&A.

Our first question: If you were nominated to run the Federal Reserve, how would you go about unwinding balance sheet and raising rates? Tom, do you want to take this one?

Thomas: Yes, thank you, Kristina, and I am flattered from the individual who sent this in that they would think that someone on our team might get nominated to be a Fed governor. Having said that, it's probably not going to happen, for one, so sort of what we think will occur and should occur is our personal opinion. What is important is what does the Federal Reserve do, and that's the important element. So that is sort of a context and background.

The Fed has a dual mandate. It is trying to get to stable prices, which is defining their way of saying stable inflation, and full employment.

And, as was outlined early in the market commentary section, inflation has become a problem, and they've made comments that talk about they think they're close to full employment. That's a debatable one but they seem to have gotten close to that. So they're now left with how will they use the various tools they have to get to a stable price environment, and while doing that, continuing to have full employment. That will be an interesting set of dynamics that they go through. I have no preconceived notions of how they're going to do it or what I might suggest. I just know that those are the two objectives they have, and so when focusing on how to invest in fixed income, realize okay, this is their objectives, they're going to go about trying to accomplish them using various tools and such in their toolbox to see if they can get themselves back to a stable price environment while maintaining full employment.

(00:52:49)

Kristina: Thank you, Tom. Abhi, the next one is for you. With all your asset-backed securities and knowledge of that market beyond the high-rated securities, are you seeing any signs of stress in the asset-backed market, or with the consumer? Also, are there any recession signals you gain from knowing that market?

Abhijeet: Thanks, Kristina. It's a good question and historically, yes, we have gotten some visibility into how the consumer's been performing, by seeing things like delinquency trends and default rates on consumer obligations, whether there are secured obligations or unsecured obligations.

As of late, and certainly for the past 12 months, we have not seen anything that would suggest that the consumer is weakening in a material way. But I say that with a caveat that a lot of consumers in the US have benefited from government largesse, so some of the data is not necessarily a good representation of what we should expect going forward when consumers no longer have the same sort of support from the fiscal authorities that they've had in the past.

But the short answer is yes, the data that we see on these ABS investments can be informative to what's happening in the overall economy.

Kristina: Thank you, Abhi. Also a question regarding the cash and equivalents exposure, and recent trends in that area.

Abhijeet: Sure. So the cash and equivalents in general is a residual of the investment process. So, to the extent that we cannot find investments that make sense for us in other strategy then we would generally retain cash and equivalents in the Fund. And that's essentially us weighing the opportunity cost of deploying cash today versus investing it in the future.

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Now, with that said, we always try to maintain enough liquidity to meet any potential redemptions that we might have out of either fund, and also we try to maintain enough liquidity so that we can quickly react to buying opportunities, because our view is that whenever it's a good time to buy, it's generally not a good time to sell.

So you may have seen in the past several quarters that the cash and equivalents have been relatively low. In the past, that cash and equivalents number, in the New Income Fund at least, has been anywhere from a little under 1% to as high as 10% to 15%. In the more recent history, it's been closer to that 1% number but offsetting that, we've had anywhere from 20% to 30% of the Fund in Treasuries, which we believe are extremely liquid and have thus far proven to be extremely liquid, so.

In the Flexible Fixed Income Fund, we pursue a bit of a different tack where we try to maintain a higher amount of actual cash and equivalents. So historically for the Flexible Fixed Income Fund, that cash and equivalents number has generally been in the 5% to 15% area.

Kristina: Thank you. Abhi, can you also discuss the NPL RMBS position in the New Income Fund, particularly in terms of credit exposure.

Abhijeet: Sure. So as we saw in the pie chart, the NPL RMBS investments are about 4% of the portfolio for the New Income portfolio. And what these investments represent are debt obligations that are secured by portfolios of nonperforming residential mortgages.

So the general idea here is that there are institutional buyers out there who go about buying portfolios of nonperforming residential mortgages and then attempt to get the borrowers to a state where those borrowers are able to make their payments consistently. Oftentimes that happens, and the buyer of these loans can then turn around and sell what was once a nonperforming loan as a newly reperforming loan and capture a gain on that sale.

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There is of course, unfortunately, an alternative path where, for whatever reason, the borrower's just unable to make payments consistently, and unfortunately those homes have to go through a foreclosure process and ultimately get sold, which is really the path that we underwrite. So whenever we look at these bonds, we always assume that the underlying loan portfolios, in their entirety, go through a lengthy foreclosure process and then the homes ultimately get sold.

And on that basis, these bonds that we buy, which are the first bonds to get paid from any proceeds that are realized from resolving these loans, the bonds that we buy are generally creating the underlying portfolio of homes at somewhere between 40 to 50 cents on the dollar of today's market values, which to us is important because we like to think about the margin of safety that we have in these investments.[14] And as everyone knows, home prices have been on a tear for the last couple of years probably. So when we evaluate these investments, we typically run what we think are pretty draconian stress tests where we assume prices—assume the home prices are anywhere from 10% to 30% lower than what they are today. And after doing that math, we want to have comfort that our bonds are going to get repaid. So, that hopefully gives you a sense of the nature of the bonds that we have within this investment idea.

And just for color, the duration on those bonds is generally around 1.5 years. They sit in our credit bucket because they are nonrated, even though they are pretty liquid, and we generally have been able to buy them in the past at yields somewhere between 2.5% to 3% depending on the time that we bought it.[15]

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Kristina: Thank you, Abhi. There are no other questions at this time. We want to thank those of you who have—we want to thank those of you who listened

[14] Margin of safety is when a security is purchased at a discount to the portfolio manager's estimate of its intrinsic value. Buying a security with a margin of safety is designed to seek to protect against permanent capital loss in the case of an unexpected event or analytical mistake. Determining a company's "true" worth or intrinsic value is highly subjective. There is no guarantee that the methods used to evaluate intrinsic value will be accurate or precise or that an investment made with a margin of safety will not decline in price.

[15] **Past performance is not a guarantee, nor is it indicative, of future results.** References to any particular security or sector should not be considered as a recommendation to purchase or sell such security or invest in such sector.

to the FPA New Income and FPA Flexible Fixed Income Fourth Quarter 2021 Webcast. We now turn it over to the system moderator for closing comments and disclosures.

Moderator: [Please reference slides 41-46] 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 webcast for additional information about the funds, such as complete portfolio holdings, historical returns, and after-tax returns.

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 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.

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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 may—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, charges, and expenses carefully before you invest. The prospectus details each 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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