Q2 2020 FPA New Income, Inc. (FPNIX) and FPA Flexible Fixed Income Fund (FPFIX) Webcast
July 29, 2020

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This transcript must be preceded or accompanied by a prospectus for the Funds. The prospectus for FPNIX dated January 31, 2020 can be accessed at: https://fpa.com/request-funds-literature. The prospectus for FPFIX dated April 30, 2020 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 Heidi, and I will be your event specialist today. All lines have been placed on mute to prevent any background noise, and 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. Click the green Q&A icon on the lower left-hand corner of your screen, type your question in the open area, and click Ask to submit.

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

(00:01:01)

Kristina: [Please reference slide 1] Thank you, Heidi. 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 2020 Webcast. My name is Kristina Surkova, and I am relationship manager for both funds. The audio, transcript, and visual replay of today's webcast will be made available on our website, FPA.com.

In just a moment, you will hear from portfolio managers Tom Atteberry and Abhi Patwardhan and members of the Fixed Income investment team. Tom Atteberry is a partner at FPA, and joined the firm in 1997. Tom has been a portfolio manager of FPA New Income since 2004, and a portfolio manager FPA Flexible Fixed Income since its inception in December 2018.

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

[Please reference slide 2] Now, let's talk about what happened during the quarter. Treasury yield curve fully reflects the Federal Reserve quantitative easing program. The dramatically lower Treasury rates and high-quality credit spread decline results in our focus being in bonds that mature within one to two years. The decline in credit spreads, combined with economic expectations, limits opportunities in this portion of the bond market.

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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 will open it up to question and answers. But first we wanted to discuss the recent announcement of the soft closing of FPA New Income. I will turn it over to Ryan Leggio, partner at FPA, to cover this portion. Ryan, over to you.

(00:03:28)

Ryan: [Please reference slide 3] Thanks Kristina, and hello everyone. We all hope everyone is safe and healthy during these times. As Kristina mentioned, I am going to briefly be covering the announcement that we made on July 13 that FPA New Income would be closing to new investors. We're doing that, in case you did not see our press release or email blast to everyone.

So as I mentioned, FPA New Income is going to be closing to new investors, as well as related separate accounts. And that's effective the close of business on July 31. In industry nomenclature, this is known as a soft close because current shareholders will not be affected. The goal of soft closing is to moderate inflows while not impacting the ability of current shareholders to invest in the Fund. FPA New Income will continue to accept investments from existing shareholders and we are treating shareholders as not only individual investors who might be trading on their own on an online brokerage platform, but as the financial advisor who may be helping numerous individuals, as well as institutional consultants and their affiliates.

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I want to provide a few examples to make it clear what we mean that this should not affect existing shareholders, and that existing shareholders will continue to be able to invest in the Fund. So for example, if you are a financial advisor or an institutional investment consultant who have investors in the Fund, let's say, as of today, and you obtain a new client at a later point; let's say, in a month, but you are an investor in the Fund as of the close date—we will do our best in working with the platforms and custodians that you work with to allow you to continue to invest in the Fund, even if you obtain new clients because you are an investor as of the date of closing.

Contrast that with a financial advisor who comes to us two months from now who has never had an investment in New Income, who doesn't have any clients invested in New Income; they would be precluded from investing. Hopefully that makes it clear what we mean; again, the goal is to not impact any of our current shareholders.

Now, importantly, if you are an existing shareholder, and you encounter any trading issues, or have any questions, we encourage you to contact your FPA relationship representative, and if you don't know who that is, feel free to email us at crm@FPA.com. We have a dedicated resource at FPA that works directly with platforms and custodians that can help write exception letters, for example, if you're an investment consultant that works primarily with one platform, but you have a new client that works with a new platform; we will work with you and that platform, so that platform knows that you qualify under our soft closing.

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[Please reference slide 4] Why are we soft closing? Well, we believe that soft closing the Fund is in the best interest of shareholders due to a change of the current investment opportunity set; the overall size of the strategy that the Fund, in addition to related separate accounts; and modest but consistent asset growth. In just a moment, Tom Atteberry is going to spend some time detailing how the investment opportunity set has changed over the last few quarters.

In addition, because of elevated cash, on July 13, we also announced that as of the beginning of July, because of elevated cash in the Fund due, primarily, to the current investment environment and to mitigate the effects of cash on shareholders, FPA voluntarily implemented a temporary expense waiver. Abhi is going to spend time, during his section on the Fund's current allocation, on where cash sits.

Last, to be clear, while this does impact FPA New Income, it does not impact FPA Flexible Fixed Income, and it will remain open, given its broader opportunity set. Again, Abhi is going to be touching on that as the two funds have diverged as of late in terms of the securities they have been able to invest in.

Finally, we believe these actions demonstrate our commitment to capacity discipline here at FPA in putting investors first. And we want to acknowledge that we would not be able to soft close the Fund and the strategy without a group of fellow long-term, like-minded investors. And so thank you from all of us at FPA for your continued trust in us. With that, I will turn it over to Tom.

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Thomas: [Please reference slide 5] Thanks, Ryan. I appreciate it. Thank you everyone for joining us today. So what we will start out with is a look of a couple of graphs that we see on the page here that we use in our presentation material to prospective clients that illustrates the stress test that we always undertake for high-quality bonds. And that stress test is, quite simply, if you bought the bond today at a yield, and the yield is 100 basis points higher a year from now, or one percentage point, and you sold it, what was your total return?

And so we have June of 2019 on the left; we have June of 2020 on the right. Looking at the two, quickly on the 2019 on the left-hand side, the one-year Treasury bill had a 1.94 percent yield; so if you bought it, that's what you were going to earn over a year. As it matured, you got paid. The two-year Treasury had yield of 1.75 percent. A year later, they had a 2.75 percent yield; your total return would be 38 basis points. And then if you had the three-year Treasury; it had a 1.71 percent yield at the end of June of 2019. If a year later, it had a 2.71 percent yield, or 100 basis points higher, your return would have been minus 47 basis points.

So at that particular period of time, our ability to go in the Treasury space at roughly 2.5 years and have something pass the stress test; for Treasuries, it occurred. And our focus then was really looking at high-quality bonds. It tended to be sort of a 2.5 percent to 3.25 percent year kind of average life to maturity to them. They tended to pass this sort of stress test, and we were fine.

Now let's move ahead to the 30th of June of this year. The one-year Treasury yield is 16 basis points. So if you bought it, and owned it for a year, that's what you would earn. The two-year Treasury only yields 15 basis points. So if a year later it had a 1.15 percent yield, on a 100 basis point increase, you were losing 0.84 percent. And then the three-year, lo and behold, your loss all of a sudden becomes one of minus 1.76 percent.

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So this dramatic change in Treasury rates has moved into the point where owning Treasuries beyond 13 months no longer works for us because it won't pass the stress test. So that's the first area.

The second area is when you look at the rest of the high-quality space, you find that wow, a year ago, you could get things around close to three years. Well now, you're able to look at things that are only in the one to two year area. So that set of opportunities has shrunk down some as well.

When you look through the quantitative easing programs undertaken, and we'll show some details later, it's unlimited in nature and the result of that is the mortgage holdings that we had, the agency mortgage pools that we had, and we've talked about it in the past, they no longer make sense either. The duration is too long, and the yield is too short. As an example, at the end of the year, that was about eight percent of the portfolio; now it's about 20 basis points.

So the result of this is the ability to find bonds that, on a high-quality side, pass the stress test has shrunk. And so for that reason, it drives us to go, "Okay, what is best for our shareholders." And that means if the opportunity set has shrunk, then we should probably try to control as well the inflow of money into the strategy. Abhi is going to go into much more detail about what can still work for us and what may not be working for us in his presentation later on.

Keep in mind going forward, that what you are looking at is—when the opportunity set changes, if it was to get broader for whatever reason, that would be a trigger that might have us, okay, opportunity set is larger, we would then really go back and reconsider opening the strategy up again.

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[Please reference slide 6] So moving forward, we want to look for a second to refresh everybody, the highlights of the two strategies. [Please reference slide 7] So we have got them laid out, we have shown you this before, but let me walk through it quickly. For the FPA New Income fund, it has a goal on the short term on the absolute return on the 12-month period, something we have accomplished for now going on for roughly 35 years. Flexible Fixed Income, that absolute return objective is 36 months.

But on a long-term basis, we're trying to CPI plus 100 for New Income; Flexible Fixed Income we are trying to get CPI plus 200.

The big difference comes down, when you look at credit quality, for everything rated less than A-, the maximum we can have in New Income is 25 percent. The maximum we could have in Flexible Fixed Income is 75 percent. With the high-quality where it is today, in a lower-yield environment and shorter duration, it's offering less of a buffer to us to counteract the volatility that is inherent in owning BBB and less rated securities. So it's sort of another area that okay constrains some of our abilities to find a broad set of things in the BBB and below space, because of this objective of getting that positive return on a 12-month period, and how much volatility and credit can one take.

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[Please reference slide 8] So looking at the details on the two strategies that we show every quarter, the yield to worst of the FPA New Income fund at the end of the quarter was 2.06 percent, and had an effective duration of 1.14 years. So its yield to worst divided by duration how much interest rate sensitivity can it take before it reaches a zero return 1.81, or 181 basis points. Compare that with looking at either the Barclays Agg, or the Barclays 1-3 year Agg, and what you see is we are capturing, versus the Agg, 165 percent of the yield from a broad index, while taking 81 percent less interest rate risk to get there.

Going down looking at the Flexible Fixed Income, you see a 2.64 percent yield, a 1.38 duration; a similar yield to duration ratio. And it's similar, we're capturing, in this case, about 145 percent of the appropriate index's yields, while taking about 77 percent less risk from an interest rate perspective.

Thinking back over the last few quarters, you're starting to see yield and duration separate between the two strategies. And that's an outgrowth of the fact that once you had to sell off any credit that occurred at the end of the first quarter, we didn't have much credit exposure in Flexible Fixed Income, but it gave us an opportunity to expand it. Because we have a longer absolute return horizon of 36 months, not 12, Flexible Fixed Income can own some different high-quality securities than New Income can. So you're starting to see the differentiation occur that if we thought back a year ago, was much less prevalent.

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[Please reference slide 9] Quick comments on return and looking at them: for the quarter you see a snap back—Abhi is going to go into details about that—for New Income, we were up 2.66 percent for the quarter. Very well, it did much better than CPI plus 100. It did well versus the Barclays Aggregate 1-3 year index. Year to date, we are beating that [goal] of CPI plus 100, but we are not the index. However, if you look at the three, five, and ten-year periods versus that short index,[1] we've got a much better return. Going forward, keep in mind, it's going to be difficult to get CPI plus 100. I will go into some detail as to why, but just suffice it to say you have a Federal Reserve policy that wants negative real rates, and that will make it challenging.

[Please reference slide 10] We've been there before, going back into 2013/2014/2015 along in there, and over those rolling five-year periods, we got CPI plus something; we just didn't get CPI plus 100.

[Please reference slide 11] Moving on to Flexible Fixed Income, in its returns—let me first say, look, we've been at this for 18 months with this portfolio; so this is still early on in looking at return comparisons versus an index. But things are starting to develop. Again, quarter to date, very attractive returns [on a relative basis], much better than CPI plus 200, and not that far off from the Bloomberg Barclays Universal Index.

Year to date, again, we're much better than CPI plus 200. We are lagging, looking at that index. Same for the one-year period of time, or its inception. The reason for that is really just duration-driven versus the index. The index has a much longer duration than we do, so we don't

[1] The short index refers to the Bloomberg Barclays U.S. Aggregate 1-3 Year Bond Index.

Comparison to indices are for illustrative purposes only. FPNIX and FPFIX do not include outperformance of any index or benchmark in its investment objectives. **Past performance is no guarantee, nor is it indicative, of future results.**

benefit at all from the fact that that index has owned a 10 year and a 30 year Treasury, and we do not. But when we think about it, it's after that has occurred, and looking forward, afterwards being the after the end of the first quarter, and going forward, we go—okay, we are starting to produce very competitive returns against that index.[2] We have done very well compared to the contemporaries that we're with in the unconstrained category, where we have a very attractive return versus that universe of managers [year-to-date through June 30], mostly driven by the fact that we have avoided the credit problems during the first quarter.[3]

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[Please reference slide 12] Let me move to the market commentary. [Please reference slide 13] I think that the title sums it up. How is the economy going to recover from the recession? Anyone's guess. It could be a V. It could be a Z. It could be a U. It might be a swoosh from Nike. It could be a W. It might be an L. No idea. Very

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[3] Source: Morningstar. FPFIX is in Morningstar's *Nontraditional Bond Category*. As of June 30, 2020, FPFIX underperformed its category in the 2Q by -2.26%, but performed better than its category by 4.28% on a YTD basis (FPFIX YTD performance was 1.87%). **Past performance is no guarantee, nor is it indicative, of future results. Please see end of this transcript or the end of the webcast for important disclosures and definitions regarding Morningstar categories.**

uncertain. But one that appears to be the least likely outcome would be if we went to a V-shaped recovery.

Looking at all these, you go, “You pick the one you think is going to happen. We can build you a case that can explain each one.” Because we have heard the case that can explain each one. The point is, very uncertain environment. And that uncertainty is going to continue as long as we are fighting COVID-19, trying to figure out appropriate ways for treatment, how do we control its spread, and our abilities as a society to come with a vaccine that may help things out. So those uncertainties are out there; we don’t pretend to know when they might end. But I thought this is a great way of pictorially looking at things and going, “Hmmm. Lots of opportunities for things that could happen; we just don’t know which one.”

[Please reference slide 14] So this is a step back. We discussed this during the first quarter commentary we released. What we have here is a blue line that represents, this is the G7—this is the large, developed economies of the world, and their debt to GDP, that’s on the right-hand scale. And those bars represent bailouts that have occurred in various periods of time. We start in 1970, and we end up today. And you look at those blue bars, and most of them up until 2008, you have to squint pretty hard to find them. You have one in 1989 during the savings and loan crisis.

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But after that, you know it's wild. The bars come more often and then they become a little larger, and then you get to 2020, and you're basically 2x or better. So what you have going on is every time there is a recession, the reaction from policy is bigger than the last time by multiples, and it involves more encouragement of debt to try to get yourself out of the recession. Interestingly, each expansion after those bars has been growing at a slower and slower rate. So you have more debt coming on, but you're getting less benefit from it, and slower growth.

It would be interesting to see that we have the debt to GDP jumps up a lot in 2008, and then you look at that dotted line, it jumps up again. And this is only through the first set. This has all sorts of fiscal policies that have not been put in place, or been discussed, are not in that bar. So there is more to come with that.

[Please reference slide 15] So who is on the borrowing spree? This graph is looking at three cohorts: the orange line is the federal government; the blue line is nonfinancial businesses of all sorts; and the red line are households. You look at this, you look at post-2008, you've got two players. You've got corporate America, and you've got the federal government on a debt borrowing spree. Those are the two. This, by the way, only goes to the first quarter of this year, and really doesn't include the acceleration that's happened in the second quarter, which I'm going to detail for you here in just a second.

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[Please reference slide 16] So let's start out thinking about the federal government side and its impact. What's going on there? And so the graph we are looking at is gross public debt as a percentage of GDP. We go back to 1930. And that got to just shy of 120 percent during World War II, when we basically put all production, everything you could think of, to fighting a world war, and you borrowed as much money as you needed to fund that.

The graph you look at only goes to 2019; this is annual numbers that come out. We're already at 100, and the current set of policies and programs that have been put in place have $3 trillion attached to them. So we add the $3 trillion, we look at this, it would not surprise us to see this debt to GDP go beyond World War II, which would be the first time in US history we have done it during a peace time.

[Please reference slide 17] So how does that deficit look to GDP? I've always liked graphs that go back long in history. This is 1791, not a typo. It is 1791 through today. And this looks at all the surpluses and the deficits of the US government as a percentage of GDP. We're about ready to print 25 percent. The only time we printed more was World War II when it was 30 percent. And at 25 percent, you're 2.5 times what you had in

2008. So there is a tremendous deficit that is being thrust upon us, bigger than we have seen before, because we have got this massive borrowing coming from the federal government.

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[Please reference slide 18] So who is the buyer of this? And this is a look at the balance sheet of the Federal Reserve Bank of the United States of America. SOMA is their long term portfolio of things that they own; that salmon color represents Treasuries, and pretty much spiked up from the end of March through today. They are on course, right now, to at least, according to today, buy $80 billion a month for as far as the eye can see until they change their mind, of either Treasuries or mortgages.

Mortgages are the green part of this, and if you think about what they're buying in mortgages, back to one of the reasons we no longer own mortgages in the portfolio in the pool form, is that at the rate they are purchasing, by the end of this year, they will own about 30 percent to 35 percent of the agency mortgages that are outstanding in this country. It is going to make it very difficult in order to find out find out proper pricing when you've got one player who is not economic that is going to own that much.

[Please reference slide 19] So they have been buying all these Treasuries, where have they been concentrating their efforts? And this graph looks at that percentage of public debt that the Fed owns. That's the left-hand side. The right-hand side is just to look at the Treasury yield curve beginning of February, middle of June. Do you notice? They really haven't changed their ownership of Treasury bills from 5 February to June, June 3, when last I pulled this up, that was the last thing that was reported. What they have expanded is their one to three year holdings. They are now roughly 27, 28 percent of outstanding one to three year Treasuries, the Fed owns. The three to five year? They own a little over 20 percent; they have expanded it some. But look at the five to ten; they went from owning about 10 percent of what is outstanding to about 25 percent.

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The result is when you look on the right, that yield curve from one month to five years is pretty flat. It only starts to move some in the seven and then the ten-year. Thinking about the ten-year, and what they have been doing—since they started this, the ten-year has had an average yield of 67 basis points. The lowest it got was 57, and the highest it got was 89. It is basically no longer moving. It is steady because of the buying that they have going on.

[Please reference slide 20] Shifting gears to the corporate side—again, this is data that only comes to the end of the year, so we're just starting to get pictures about what's going to be going on. This is a look at two things: the green line is corporate nonfinancial debt as a percentage of GDP. It is the highest it has ever been, pushing 50 percent; it's actually

49. The blue line is the dollar amount outstanding; and post-2008, it's gone up rather dramatically, and just of late it has even gone up faster. It is now roughly over $10 trillion. This is the biggest that debt from corporations has been to GDP in history. This graph goes back to 1953.

[Please reference slide 21] So digging down into post what has happened in the last quarter, this is a look at investment-grade corporate bond issuance, gross issuance. The left-hand side is the issuance number; the right-hand side is what is monthly. The lines are 2019, and then 2018 and 2017. The blue bars [on the right chart] represent the average of the last four years. And in January and February, issuance this year looked like issuance it did in 2017, 2018, 2019. It wasn't any different.

Lo and behold, starting in March, it has ramped up big. It is huge. You can see it, it is the grey bars on the right, that are two, 2.5 times the average of the last four years. They are on a pace, which is a little red dot at the end of the forecast [in the left chart], it tells you that the last four years, this will be the largest issuance of investment-grade debt we have seen.

[Please reference slide 22] Shifting gears quickly, just to look at two things. The upper left-hand graph is just to look at the high-yield market. The lower right is looking at levered loans. Looking at the high-yield market, this is quarterly information, so the gross issuance in the last quarter was $61.5 billion. The last time we got close to that was September of 2013. So you've got huge issuance here.

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Interestingly, levered loans, while the issuances increase from $4 billion, to $10 billion, to $29 billion, it's still at a very, very low level. The activity that is going on in that less than investment grade space is definitely showing up in high yield bonds, and not the loans space.

[Please reference slide 23] So looking at this graph is a look in high yield, and looking through it in the aspect of what was the percentage of high yield that was issued in, whether it was BB or B categories, January and February, and then March through June. And then red bar, on the right, what's the difference between those two is the percentage issuance.

Starting from the beginning of the year, and into the second quarter, if you were BB rated, BB+ or BB-, that issuance has increased, March/June versus January/February. For everything less than that, it has decreased. Well, why are we seeing that? Because the BB space has got a backstop: the Federal Reserve has told you, "Hey, we will provide backstop financing for this group of people if we need be."

[Please reference slide 24] So why would they do that? Why would that want to do a backstop financing? And this is one of the reasons. This is a look at the Bank of America High Yield Master Index, and the percentage of that index that is populated by fallen angels: companies with BBB ratings that now have BB ratings. And you look back in time in 2003, that was Worldcom that jumped you up the first time, and then you had 2005 to 2008, you had GM, you had Ford. And it all sort of tails off, you get a little bump in 2015/16 from the energy space. And then lo and behold of late, you've got Kraft, you've got Macy's, you've got Ford again—they are a twofer in this one—and others, and now about 16.5 percent of that index is made up of fallen angels. That is one of the reasons why the Fed goes, "We need to provide a backstop for the BB rated credits, if they need to borrow from us, in order to stay alive."

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[Please reference slide 25] What's one of the outgrowths that you see of this kind of behavior, in this kind of policy? So this a look at what are defined as zombie companies. Well, what's a zombie company? The criteria in here, you had to have ten years of listed financial history, and your interest coverage ratio was less than one for three years in a row. And up until 2005, it is a tiny number. It is somewhere between zero and two percent. Post-2008, it went from about four percent; it is now [about] 20 percent.

So one of the results of having a monetary policy and a Fed policy of encouraging leverage to get yourself out of a recession and lowering rates in order to encourage that rating, you end up with firms that are called zombies. Which is, they can't earn enough money to even cover their interest costs.

What's the downside of that? Why is that important? Well, that means those companies don't have a great ability to do capital innovation and do capital spending. They tend to be companies that will run discounted prices just to generate cash flow. It's hard for them to hire people. They tend to lay people off. They tend to close things down. They are in a mode of where ability to grow is dramatically constrained. So they become a drag on the economy going forward.

[Please reference slide 26] Well, how else do we see this show up? And this graph I found interesting. Abhi actually showed this one to me a couple of weeks ago. The lines represent the real rate for either a ten-year Treasury or a ten-year German government bond, or Bund. The bars represent default rate for B. And as those lines decline, this goes from 1981 to 2019, as real rates in Treasuries or government securities decline, so does default.

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Well, what's the other thing that's going on? The default's declining, but the zombies are increasing. There's a movie there somewhere. There's a movie there somewhere. Anyway, so we find ourselves now in a policy that is probably going to encourage the zombies, that is going to make the growth more difficult going forward, because the zombie firms are just not able to innovate nearly as well.

[Please reference slide 27] So let's look quickly at defaults here. The lines on the left, on the upper left-hand side, that's the default rate on a trailing 12-month basis for levered loans and for high yields. They have both accelerated this last quarter or so. Shock of shocks, the economy went into recession, you kind of would expect that. And the recoveries, whether it's the high yield bond recovery, which is the black bar on the bottom right, or the grey bars, which is levered loans, have declined.

And that would make sense as well; we have talked about it; Abhi has talked about it many times, where we talked about covenant lite, increases in leverage, difficulties in growing all those items that will relate to the end of the day, you've got more leverage, less growth, chances are your recoveries are lower. Abhi will speak more to valuations in more detail a bit later on, but suffice it to say, we are early in this process and we don't see a reason why this shouldn't continue as a problem going forward.

[Please reference slide 28] So I'm going to close with this. This is my who's buying all this issuance that's happening in the corporate world. There are two lines that are sitting on this. The blue line is a look at mutual funds, fixed income that are not money markets, the non-money market ones, and ETFs. The orange line is equity ETFs and mutual funds.

Equities, they have been having money coming out of both ETFs and mutual funds for quite some time; there has been a huge push, as you see from this acceleration of things that have gone into the bond side. It peaked in the first quarter this year. You see a drop-off because of liquidity problems; people all rushed to the door when the pandemic hit. And then after that, it spiked and turns around and goes right back up.

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Well, what are the reasons that it's going back up? Well, data that we have looked at in more detail and such leads us to believe that one of the strong things that is happening in there is the new investment strategy, the flows that are coming in here, are based off of "buy what the Fed is supporting" investment management strategy versus buying what's being fundamentally driven is the thing to buy. So you see people just chasing figuring the Fed's got my back, I'm just going to go buy kind of mentality.

And with that, at this point, I'm just going to turn it over to Abhi. He's going to speak much more to the details that have been going on within the fixed income markets and how we have deployed capital and where we see some of those albeit limited opportunities that are going forward.

(00:36:15)

Abhijeet: [Please reference slide 29] Thanks, Tom. Let's start by catching everyone up on what's happening this year. Risk-free rates have declined a lot this year. That's due to a couple of things. The economy has experienced an unprecedented negative shock, and in response to that, the Federal Reserve launched unprecedented programs to support the economy, and the market, and lower borrowing costs.

This chart shows the Treasury yield curve as of the end of 2019, at the end of the first quarter, and the quarter that just ended in June. Most of the decline in Treasury yields happened in the first quarter. Since the end of the first quarter, rates have continued to decline, albeit by a very small amount, in the second quarter.

[Please reference slide 30] In March, as pandemic-related fears spread throughout the market, credit spreads blew out in investment grade and high yield bonds. This chart shows spreads on a variety of short maturity, AAA-rated asset-based securities. On the right, you can see the increase in spreads that far surpass anything that has happened since the financial crisis. Relative to the past ten years or so, this was a multi-standard deviation event.

Since March, spreads have declined to the point where for many parts of the market, spreads are at or near pre-COVID-19 levels. Quickly, as an example, prime auto ABS spreads started the year at 33 basis points, increased to 200 basis points, and were at 40 basis points at the end of June. Similarly, credit card spreads started the year at 26 basis points, got as high as 200 basis points, and were back down to 25 basis points at the end of June.

The two parts of the market which have lagged relatively are CMBS and CLOs. CMBS spreads were in the 90s at the end of June versus the 60s at the start of the year. And CLO spreads were at 165 at the end of June versus 120 basis points at the start of the year. And this will be relevant later in the presentation.

(00:38:10)

[Please reference slide 32] Let’s look at the high yield market. This slide shows the yield and spread of the BB component of the high yield index, excluding energy. We find this is a helpful measure of the high yield market because it excludes some of the more volatile, or more financially challenged companies.

Focusing on the right-hand side, and shown in the table at the bottom, you can see the spread and yield increase significantly, but have since rallied. Now, spreads are still quite a bit higher than they were at the start of the year, but yields are only about 120 basis points higher than they were at the start of the year.

As we have discussed in the past, more spread is helpful, but we tend to focus on yields. And today’s environment is a good reason why. There is a lot more uncertainty in the world today than there was six months ago, and everything is riding on whether an effective treatment and/or vaccine can be found and when it will be found. Yields on high yield bonds, today, suggest to us a lot of conviction that everything is going to turn out well, and turn out well soon.

But what if that doesn't happen? Which companies are going to have the liquidity to survive? Which companies are going to survive the new secular challenges? How will consumers respond?

If a vaccine takes a long time, or god forbid, never happens, we feel confident in saying that more companies are going to go bankrupt, and more consumers are going to default. The question is—which ones, and how many? If that happens, there could be losses on bonds, and the only thing that can offset those losses is yield, because yield measures dollars, and you need dollars to offset dollars of loss. If a company files for bankruptcy, it will be little consolation that you bought the bonds at a cheap spread.

(00:39:56)

It also seems that some of the price appreciation that we have seen in credit is due to Fed support, and the following the Fed mentality that Tom described a few minutes ago. The problem is that just because something trades like it won't default doesn't mean that it won't default. And if defaults do happen, will the Fed or the government step in to provide cash to avoid a liquidation of business? At this point, I guess anything is possible, but then you have to hope that you picked the companies that the government deems to be the winners, which means making a political bet.

Finally, we suspect that the Fed cares less about losing money than we all do, because they have unlimited capital, which means that if they buy debt and take the loss, they will say, "Oh well." The market, on the other hand, has finite capital, and we as investors have finite capital. So for the investing public, those losses are tangible and impactful.

Given all of that, when we look at yields for investments that have credit risk on a fundamental basis without a "follow the Fed" approach, we are hard-pressed to see a lot of value given the risk. As we will discuss later, that makes credit a tough fit for New Income's mandate. Specifically, with the dual goals of a positive return over 12 months and CPI plus 100 basis points over five years, it's tough for New Income today to take hits from what could be a volatile credit market as the virus situation unfolds.

Flexible Fixed Income, on the other hand, has a broader mandate, so there is more opportunity in credit for Flexible Fixed Income. But even in that fund, we're being selective in what we buy. We do not subscribe to the risk-on view that market is following.

(00:41:43)

[Please reference slide 34] The next chart shows the yield and spread on the aggregate bond index, which is a broad measure of the investment grade bond market. Focusing on the blue line, market yields [for the index] are at an all-time low.[4] In line with the earlier comments, this is happening at a time when there is greater uncertainty. [Please reference slide 35] This is also happening when duration [as represented by the index] is at an all time high, as shown by the green line in this chart. Combining the two together, the compensation for duration risk is at an all time low. We measure this by showing the ratio of yield to duration, which is a rough proxy for estimating future total return. When this ratio is low, bond returns are more sensitive to changes in yields. A lower ratio means a relatively worse return, all things being equal.

In summary, duration is very expensive. Because of low rates, and a not very steep yield curve, the opportunity cost, or the yield you give up for owning short-duration bonds, is to us, not significant. That, combined with high prices in credit markets relative to the risk, lead us to favor high-quality/short-duration bonds where we can have more conviction in the performance of the bond and expose our investors to less mark to market risk, especially given the uncertainty in the world, and related potential for future market volatility.

That's for New Income. That's somewhat true for Flexible Fixed Income, too, though as we will discuss, Flexible Fixed Income has been

[4] The inception date of the Bloomberg Barclays U.S. Aggregate Bond Index was January 31, 1976.

and can be more opportunistic about credit investments and certain high-quality investments, given its broader mandate.

(00:43:22)

[Please reference slide 37] Moving on to the portfolio, let's start with New Income, and New Income's performance. This table shows the contribution to return for the quarter by sector. The bottom right shows that New Income returned 2.74 percent before fees during the quarter. The largest contributor to performance during the second quarter was asset-backed securities backed by auto loans or leases. That is shown in the second row.

The second largest contributor to performance was asset-backed securities backed by equipment, and the third largest contributor to performance was the collateralized loan obligations. Those are in the third and fourth rows, respectively.

If you refer back to our commentary from the first quarter, after spreads had increased towards the end of March, we commented that we were confident in the fundamentals of the high-quality bonds in the portfolio and viewed the price declines in March as a mark to market issue, not a fundamental performance issue. We also said that we expected our high-quality bonds to move toward par over time as they shortened and amortized.

As we discussed earlier in today's presentation, spreads declined quite rapidly, so the prices of our bonds did appreciate as we expected, though probably faster than we expected. Fundamentally, the high-quality bonds in our portfolio generally performed in line with our expectations. The largest detractor from performance during the second quarter was Ginnie Mae project loan interest-only bonds, which appear here as CMBS stripped. The second largest detractor was agency mortgage collateralized mortgage obligations backed by relocation mortgages. Those are included in CMO agency on this page. In both cases, the impacts on portfolio performance was not significant.

At the sector level, there were no other material detractors from performance. But a couple of individual corporate holdings detracted from performance due to price declines related to COVID-19.

(00:45:20)

Quickly, we received a question in advance asking for an update on investments that are, quote, not money-good. As of today, a little under two percent of the New Income portfolio is investments that have been meaningfully impacted by COVID-19. Those are all within our credit holdings. That includes JC Penney, which we have referenced before. To be clear, these are not zeros. We think they are worth more than their current market value, which is why we still own them, but these are very dynamic situations, so that could change.

As of now, those changes are skewed towards better outcomes, but again, that could change.

[Please reference slide 38] I mentioned earlier that we think short duration makes sense in this market. Further to that point, as Tom described, we manage duration according to our duration test, where we try to buy bonds that we expect will produce a positive, or a break-even return over 12 monthsif we assume that yields increase by 100 basis points during that time period. That yield increase could come from higher risk-free rates and/or spreads.

By its nature, this test will lead us to buy longer duration bonds, as rates rise, and shorter duration bonds, as rates decline. You can see that here on this slide, which shows the two year Treasury yield in the red line, and the portfolios duration, in the green bars. Looking at the right-hand side, the duration has decreased as rates have declined, and that’s a function of us selling longer duration holdings that appreciated in price, and buying shorter duration bonds.

Despite lower spreads in high-quality bonds, as we showed earlier, we are still able to create a yield advantage over the two-year Treasury in our high-quality holdings, as shown by the blue bars on the right.

(00:47:08)

[Please reference slide 40] This table shows the portfolio broken down by ratings. The bottom of the table shows that 94 percent of the portfolio is in high-quality bonds rated A or higher, and cash and equivalents. Here, credit is defined as anything rated BBB or lower, and that exposure is down to approximately 5.6 percent of the portfolio. Notwithstanding our prior comment about credit being a tough fit for New Income's mandate in this environment, we still found a few credit investments in corporate bank debt and bonds, backed by nonperforming residential mortgages. However, those investments were more than offset by sales of existing holdings, resulting in a decline in the overall credit exposure.

[Please reference slide 41] This table has the portfolio broken down by sector. Of note, the bottom of this table shows that the yield has declined from around four percent to 2.06 percent. That's largely a function of the portfolio being priced at the end of the first quarter at historically high spreads, and now being priced at much lower spreads. The duration is shorter by about 0.2 years, owing to our shift towards shorter-duration bonds, as yields have declined.

[Please reference slide 42] The pie chart on this page shows the portfolio in terms of investment idea, which is how we think about it on a day to day basis. The chart on the left is the portfolio as of the end of the first quarter, and the portfolio on the right is as of the end of the second quarter. During the second quarter, as Tom mentioned, we sold much of our remaining agency mortgage pools, when the yields on those bonds declined to the point where they were no longer compensating for the duration risk. Those pools were among the longest-duration holdings in our portfolio. As Tom commented earlier, agency mortgage pools don't really work for us in today's market because they don't yield enough versus the duration.

As such, the proceeds from our agency mortgage pool sales, plus the proceeds from regular maturities in the portfolio, were invested in asset-backed securities of various sorts, CLOs, and commercial mortgage-backed securities. I mentioned earlier that these parts of the market have still not fully recovered on a spread basis, so they are more attractive.

(00:49:23)

Overall, to give people a sense of where we have been able to invest, we sold bonds that, on average, yielded around 70 basis points, and had a duration of around two years, and bought bonds that yielded around 1.7 percent with a duration of around 1.2 years. Inflows to the fund, plus proceeds from maturities and sales, net of investments, left cash and equivalents at 14 percent at the end of the quarter.

[Please reference slide 43][5] The next graph shows the hypothetical gross return for the Fund before fees, assuming various changes in yield. As an example, on the X-axis where it says 100, the blue bar says that the portfolio's hypothetical return over a year, if yields rise by 100 basis points, would be approximately 1.5 percent before fees. The green bar shows the same analysis as of a year ago, and the red bar shows the same analysis as of two years ago.

First, due to lower yields today, the left side shows that the portfolio has less upside in a declining yield environment than it did a year ago. Having said that, Treasury yields are at 15 basis points for short bonds, and spreads are low. So it is an open question as to how likely these declining yield scenarios are.

Since we just went through a historical spread-widening event, the far end of this chart, on the right, should help our investors get a sense of what the portfolio return could look like if spreads widen out again. The blue bar on the far right says that the portfolio would have a one-year return before fees of approximately 90 basis points, if yield rose by 200 basis points, which means that yields or spreads could increase by

[5] **For illustrative purposes only.** Please see the end of the webcast presentation for important disclosures.

something more than 200 basis points and the portfolio could still have a positive return before fees over 12 months.

(00:51:18)

[Please reference slide 45] And now let's discuss Flexible Fixed Income, starting with performance. [Please reference slide 46] The bottom right of this table shows that Flexible Fixed Income returned 3.4 percent before fees during the quarter. The largest contributor to performance during the quarter was asset-backed securities backed by auto loans and leases. The second largest contributor to performance was corporate high yield bonds and mortgage loans. The third largest contributor to performance was ABS backed by equipment. Here again, the driver of performance was the spread compression that occurred throughout fixed income markets, which drove up bond prices.

At the sector level, there were no meaningful detractors from performance, though a couple of the corporate holdings, individually, detracted from performance due to COVID-19 related price declines.

[Please reference slide 47] This table shows the Flexible Fixed Income portfolio broken down by credit rating. As a reminder, Flexible Fixed Income seeks a positive return over three years, and a return of CPI plus 200 basis points over five years. A key part of achieving the long-term [goal] is the ability to have up to 75 percent of the portfolio in credit, defined as investments rated BBB or lower.

The three-year horizon for the positive return allows us to take a longer-term view on investments, with less concern about short-term mark to market risk. That's why the opportunity set for Flexible Fixed Income differs from that of New Income, and why Flexible Fixed Income is able to do more in credit in particular.

As we showed earlier, the pandemic led to a fall in high-yield bond prices. That was true in leveraged loans, and lower-rated tranches in structured product too. That dislocation had very real underpinnings to it, with businesses decimated by the pandemic. All of that is to say that prices fell a lot, but not everything was attractively priced, given the new reality that we face. Nevertheless, we used that opportunity to add to Flexible Fixed Income's credit holdings, with the credit exposure increasing from about ten percent of the portfolio at end of 2019 to 15 percent of the portfolio at the end of June.

(00:53:27)

[Please reference slide 48] This table shows Flexible Fixed Income broken down by sector. As shown at the bottom, the yield decreased from 4.2 percent at the end of March, to 2.6 percent at the end of June, with the duration down slightly. This decline is due mostly to the decline in spreads during the quarter.

[Please reference slide 49] Here we show Flexible Fixed Income broken down by investment idea, and comparing Q1 with Q2. During Q2, about a fifth of the capital we deployed, or about seven percent of the June portfolio, was spent on credit investments, with those investments split about 60 percent in corporate high yield bonds, and bank debt, and 40 percent in structured product.

In past crises, it has often been the case that some of the most attractive investments are new bonds created during the crisis. And that is what we have seen time around as well. Consequently, about half of the capital we deployed in credit was in new issue bonds. But it's not all about credit. A lot of our conversations about Flexible Fixed Income end up centering around credit, but what is exciting to us is that really the mandate is to buy attractive bonds, regardless of the rating, and the flexible mandate allows us to do that. So in addition to the credit investments during the quarter, another 12 percent of this quarter's investments, or about 3.5 percent of the June portfolio, were in high-quality bonds that we bought at meaningful discounts, where there's optionality on an attractive total return depending on how quickly those investments pull to par.

And we'll stop there with the prepared remarks and move on to Q&A. [Please reference slide 52]

(00:55:04)

Kristina: Thank you, Abhi. And thank you to those of you who have submitted questions in advance. Some of them we covered in the course of prepared remarks, and now we'll take several of those. I'm going to group them by topic. Tom, those first two are for you.

Are we near a period of stagflation, and if so, how will you pivot the Fund allocation? And the second one is what are your views on the risk of inflation when the economy starts to recover from all the stimulus?

(00:55:42)

Thomas: So let me just wrap those into one talk about inflation, and what we start to read and hear about what could happen.

So right now, inflation isn't a problem because you still have a reasonable supply of goods and services, but you have a very much truncated demand for them for obvious reasons of the limits that are going on within the economy. So near-term, it's not something inflation-wise that you look at as a problem.

As you think about things longer, you go okay, what's going to happen at an intermediate to long term? We don't know when—I can't necessarily define that, but as we get a better handle on, better control of, and potentially dealing with the pandemic. And one of the things that starts to concern one is looking at the growth in money. It's usually defined as M2, but let's just make that real simple. Let's just [consider it as your] checking account, savings accounts, money market funds—money; cash in your pocket.

And that has shown growth in the past that looks a lot like six percent. Well right now, that number is 21 [%]. And that money is sitting there to help tide individuals, households, companies over during a liquidity problem associated with stay at home orders in an economy that was thrown into a violent recession.

Once you come out of that, okay, where does that money go? Is it still around? How is it deployed? And you can couple that, if you look at the Fed policy, where they talk about, "You know, maybe in the future we won't have a two percent target, but since we've been under a target, which by the way, they've had a really hard time ever reaching, we'll just let it go over for a while." Or we're going to leave these rates at extreme low levels for an extended period of time, in order to try to get the economy going, and then back to what I talked about before, various forms of leverage.

And you think out longer term, intermediate and longer term, and go, "Okay, there's a potential for an inflationary problem." I have no idea if it's going to occur. I do know that past quantitative easing programs and encouragement of leverage has tended to inflate certain things, the main ones being asset prices, so it wouldn't surprise us to see that. But when you start to think about inflation, you go, "Okay, near term, it probably isn't a problem; intermediate to longer term could be."

So how do you construct the portfolio? And one of the beauties, I think, of having a stress test the way we do and applying that discipline consistently—and as Abhi said, look, when interest rates decline, we have a shorter duration because we can take less risk and vice versa when they're rising it—is that if that pivot tends to occur, or when it occurs, because of our short duration, and because of the fact the portfolio has something that looks like four, five, six percent, sometimes three percent, that comes due every quarter, we are able to be in a pretty flexible, good flexible position to reposition the portfolio to what's the attractive asset to invest in, if in fact we find ourselves into a higher inflationary environment.

(00:59:21)

The stagflation environment will be something that is somewhat difficult to deal with if you're a highly levered corporation that happens to be a zombie. That's not an environment that does well for you. And that will be a challenge. But if you concentrated your efforts on looking at companies that have a willingness and an ability to pay you back, and you've analyzed the business, the value of the business, done all those fundamental pieces, and all that fundamental work, you can minimize some of those problems that could occur in a stagflation environment that can be difficult for a levered corporate balance sheet.

(00:59:57)

Kristina: Thank you, Tom. And the next couple of questions deal with ABS exposure, so those will be for Abhi.

How concerned are the managers of our structured finance within ABS it owns, given a weakening consumer but high unemployment and less unemployment benefits at the end of July?

And the second question is please expand on the Fund's position within auto and equipment asset-backed markets and discuss the impact of this position from a prolonged economic shutdown?

(01:00:34)

Abhijeet: Thanks, Kristina. So on the first question, to be honest, I would say that our ABS investments have probably performed better than we expected given everything that's going on in the world. It turns out that the unemployment benefits that were disbursed through the fiscal stimulus ended up being a boon to a lot of the ABS investments that we own, and a couple months ago we would have expected that the underlying loan performance—and that's an important distinction—that the underlying loan performance would have been worse than what's actually happened.

Because of all the unemployment benefits, delinquency rates and defaults on things like auto loans and mortgages, etc., have been a lot more benign than people would have expected. Having said all that, as you can potentially gather from my comments, whenever we made these investments to begin with, we went into them assuming that we were going to have really bad unemployment, really bad consumer strength, etc. And that was all before the economy went into this extremely bad recession.

So to the extent that there is not another round of stimulus that provides additional unemployment benefits, we feel just fine about the bonds that we have in our portfolio because we purposely bought them on the assumption that we were going to have a very bad unemployment environment. That's true for the bonds in our portfolio, that's not speaking of the ABS market, broadly.

(01:02:18)

As it relates to the auto bonds and equipment bonds as it relates to our portfolio, similar comments apply. If this recession gets worse, we originally underwrote all those investments to a bad recession, and assumed that we were going to have very large losses in the underlying collateral. The neat thing about structured product is that you can choose your level of protection, and over time, we have chosen bonds that we believe have a lot of protection such that we do not expect to have principle impairment, at least on the bonds that we own in our portfolio because there is so much cushion against very large losses.

(01:03:02)

Kristina: Thank you, Abhi. And one more question for you. Rates and duration are less attractive on an absolute basis. Has your view on fixed versus floating changed over the year? Are floating rate instruments becoming more attractive relative to short maturity, in relation to your CPI plus goals?

(01:03:27)

Abhijeet: So it's an interesting question. Our approach, or view, as it were, has not changed, in the sense that we have always tried to buy floaters to the extent that we could buy floaters, at prices and yields that were equivalent to or better than we could get in a fixed rate bond, based on what the market was assuming the future trajectory of rates was going to be.

Now, having said that, what is interesting about today's market is that because rates are so low, and also because so many floaters are out there do have floors on coupon, and we specifically do try to limit our investments to floaters that do have floors, you can essentially put a downside limit to what the return can be in the event of a declining rate environment because even if rates were to decline further from here, at some point the floor is going to be triggered, and there is not much further down that the yield on floaters can go.

So when you couple that with the fact that during the presentation we made the comment that the CLO market still not fully retracted to the spread levels that they were at prior to the COVID-19 pandemic infecting the financial markets, we have been investing the Fund's capital into floaters, specifically into CLO floaters, and we will continue to make that assessment as we see floaters versus fixed rate bonds on a case by case basis. But the fundamental approach hasn't changed, but the result of that approach has shifted a little bit, just given where rates are.

(01:05:18)

Kristina: Thank you. And one more question. With respect to things such as loan forgiveness and broad payments from the government being reduced or coming to an end, is there a way for you to factor this into the payment expectations in the ABS you hold?

(01:05:37)

Abhijeet: So I guess we could. As I mentioned before, we have always assumed that the losses that we would see in the underlying loans and collateral in our ABS are going to be very bad. To the extent that there is loan forgiveness or payments from the government being reduced—loan forgiveness I would put in the category of a bad outcome for the collateral that we're exposed to in general, but I would say that that's probably embedded into the loss assumptions that we made, at the time we made the investments, again, keeping in mind that we typically assume losses that are worse than the worst recessions that have occurred in the past 20 or 30 years.

With respect to broad payments from the government being reduced or coming to an end, as I said before, those payments have proven to be really an upside to us as it relates to our investments, because we had been expecting that losses were actually going to be worse than they have proven to be. So if the payments from the government cease or come in at a lower level in the future, I don't think that that's really going to have much of an impact on the investments that we have in our portfolio.

(01:07:05)

Kristina: Thank you. If we didn't answer your questions during these prepared remarks or the Q&A session, we will follow up with you individually. Thank you everyone for listening to FPA New Income and FPA Flexible Fixed Income Second Quarter 2020 Webcast. We now turn it over to the system moderator for closing comments and disclosures.

(01:07:30)

Moderator: Thank you for your participation in today's webcast. We invite you, your colleagues, and shareholders to listen to the playback of this recording and view the presentation slides that will be available on our website within a few days at FPA.com. We urge you to visit the website for additional information about the Fund 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.

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

[Please reference slides 53-58] **Past performance is no guarantee, nor is it indicative of future results.** Any mentions of individual securities or sectors should not be construed as a recommendation to purchase or sell securities, or invest in such sectors, and information provided is not a sufficient bias upon which to make an investment decision.

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

(01:10:32)

[END FILE]

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