

**Q3 2019 FPA New Income, Inc. (FPNIX)/  
FPA Flexible Fixed Income Fund (FPFIX) Webcast  
October 29, 2019**

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*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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(00:00:00)

Moderator: Hello and welcome to today's webcast. My name is Christina 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. Click the green Q&A icon

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

Kristina: [Please reference slide 2] Thank you. Good afternoon and thank you for joining us today. We would like to welcome you to FPA New Income and FPA Flexible Income Fund Third Quarter 2019 Webcast. My name is Kristina Surkova and I am the relationship manager for the Funds.

The audio, transcript and visual replay of today's webcast will be available on our website, FPA.com. In just a moment you will hear from portfolio managers, Tom Atteberry and Abhi Patwardhan and members of

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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 Portfolio Manager for FPA Flexible Fixed Income Fund since its inception in December 2018.

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

Now let's talk about what happened during the quarter. Treasury yields declined, reflecting expectations of a weaker economic environment and central bank easing.

As in past quarters, we continue to favor high-quality—those rated A and above—structured product securities while being cautious towards credit-sensitive securities—those are the ones rated BBB and below.

(00:02:54)

As part of today's agenda, Tom and Abhi will discuss the highlights for both funds, provide commentary on the markets, review performance

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and portfolio activity and then will open it up to question and answers.

Tom, over to you now.

Thomas: [Please reference slide 4] Thank you, Kristina. First of all, just really quickly the Fund highlights as far as our objectives. And we've shown these before so really what I want to just drop to is just a small update on Flexible Fixed Income Fund, which is in the end of the quarter had slightly over \$117 million in assets in it.

[Please reference slide 5] Looking at our general statistics, the New Income Fund had 2.63 yield to worst at the end of the quarter but similar to the end of the second quarter, an effective duration of 1.75. So the portfolio continues to have a yield that's higher than those of either the broad index, the Barclays Agg, or the 1-3 Year Agg and a significantly shorter duration in order to accomplish that yield to worst, giving us much better metrics as it comes to sensitivity in changes in interest rates.

Now that we have the Flexible Fixed Income fully invested as well, it's taking on that similar characteristic which means it has a yield [to worst] higher than its index, the Barclays Universal, and an effective duration that is significantly less as well.

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[Please reference slide 6] From a performance aspect, we've been generally pleased with overall performance over the last several years, year to date. Most of that's being driven by our ability to be able to reach one of our longer term objectives of late, which is CPI plus 100. In doing that we still [in our view] have a very competitive return as it looks at the Bloomberg Barclays 1-3 Year Agg Index as well. And this goes back, if you look back into history backwards through three, five and even back into the ten-year period of time.

[Please reference slide 7] These are the returns for Flexible Fixed Income. Quite frankly, we've been at this for nine months, don't find these particularly useful or germane, but it is interesting to note that we are producing a return year to date that's greater than CPI PLUS 200.

[Please reference slide 9] Moving on, I'll skip through sort of the detail of returns; you can look to that at your leisure. A couple of introductory comments as I start to go through the market commentary.

Why don't I start off with really a stepping back in time to an Investor Day presentation that Abhi and I made in May of 2016 where we made some comments about quantitative easing, zero or negative interest rates and demographics.

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[Please reference slide 10] This first slide is a look at the concept of negative rates as we explained it in 2016. It was designed to tax savings and hoping that would turn people into taking savings and spending it. To make the cost of borrowing negative so leverage would increase and that might stimulate consumption in the economy. Make the cost of government interest expenses decline so they could run their debt levels at a more efficient fashion. And it would make it punitive for banks to hold excess reserves, hoping that they would then lend those reserves out and the economy would increase.

The reaction you see at the bottom to using these tools in 2016, whether it was the price of gold increasing—because while gold yields zero it's better than a negative number—and the things about the household and people hoarding cash and such that we were talking about in 2016.

A couple of them are the same today, one of them being the price of gold and the other one at the bottom being savings percentage increases to offset the lack of earnings that individuals are getting from their savings.

[Please reference slide 11] We talked about helicopter money in

2016. The objective of that is just a direct stimulation of the economy to get inflation up by increasing consumption. It's a permanent injection of money into the system. It might be done by vouchers to households. It might be done with tax rebates to households, maybe just funded all this by the central bank. You don't borrow the money; you just print the money and hand it to individuals.

The one thing that wasn't mentioned and has since come to light is MMT or Modern Monetary Theory, the idea there being that your central bank will print the money, hand the money to your Treasury Department who will then turn around and use that for various fiscal policy programs, whether it's a social program such as Social Security or Medicare or the decision to replace bridges and build this and build that. That's something new that's come to light and we expect to see more of that going in the future as far as the debate.

The comments that were made by the individuals listed, still somewhat germane today as they were when in essence it's a little over three years ago.

So why are we seeing this? What are the reasons we're seeing causing this?

(00:07:58)

[Please reference slide 12] I pulled this on that same Investor Day in 2016. This is a look at Germany, it's a look at Japan and the US population. And the population is broken down in five-year increments and then the left side is female and the right side is male. The two periods are 1980 and then 2015. And in 1980 they all look similar kind of looking pyramids where you had more young people than you had old people. You go get down to 2015, though, and that has changed. And in the cases of Germany and Japan, you have a much larger segment of the population that's older versus that is younger. In the US it's fairly static, it looks a little different, it looks like a general stack.

[Please reference slide 13] Now this is 2015 data. We understand that we're now in 2019 so we added a couple of pages to update this information. And this first graph is looking at the total population over 65 years of age and it's the sum of the following that are listed. Basically the countries that are listed are always the developed world countries.

So in 1980 to 1985, that period of time that we've highlighted, there are roughly 185 million people who were 65 years of age or older. From the previous page we then highlighted 2010-2015 and that had now



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increased to 293 million—basically almost 294 million—an increase of just shy of 60%.

But if you move that forward, thinking about that being post the great recession, you realize that if you move forward from 2015 and you look out to what would be the period 2020-2025, it's going to increase again by about 9.5%. So you've had a pretty dramatic increase in the number of people who are over the age of 65.

[Please reference slide 14] If you happen to be in that category today, this graph would be something you would like and be happy with. This is a look at those same countries and the life expectancy after you reach age 65. The black line is the average of all the developed world. So thinking through and realizing if I look at 1950-1955, that would equate to 2015-2020 today for someone basically to be 65 years old. Well, when they were born, their life expectancy after they turned 65 was about 13½ years. Now it is 21½ years. Like I said, they're much happier. If you look at that black line, you'll notice that sort of in the period 2000-2010, the slope of the line increased rather dramatically. That's where that sort of the increase in that life expectancy went up.

[Please reference slide 15] So this graph, I found this interesting

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because what it does is it takes the previous two. It says, okay, give me the number of people who are 65 years of age and older and then multiply that by what's their life expectancy. So you take that number and you multiply it by 21.5 and you get the years of the elderly remaining. And what you see is not only are you seeing an increase in the number of 65 years and older, you're also seeing how long they're going to live increasing as well. And it becomes evident when you look across the page to about the period that says 1995-2000 and all of a sudden that line starts to have a lot more upward slope, the slope increases.

So we have a larger segment of the population living longer and the demands that is going to tend to have is one of, well, their life expectancy is up so their need for income is going to be for a greater period of time.

[Please reference slide 16] And lo and behold, looking at this graph on this page, this doesn't surprise you when you look at what is the world's gross national savings as a percent of gross domestic product and you see this spike down. 2008 you see the drop-off obviously. Some of that's associated with GDP declines. But in 2009, as an example, savings was about 23% of GDP. It's now just shy of 26%, so it's increasing. It's not surprising it's increasing because I've got those who want to save is

exponentially growing as well.

(00:12:32)

[Please reference slide 17] So how is this starting to impact the marketplace? The graph here looks at mutual funds and ETFs. The orange line is for equities, the blue line is for fixed income and, lo and behold, post the crisis of 2008 and '09, the amount of money going into fixed income increases rather dramatically but the amount of money going into equities does not. And equities have had a very nice run—very nice return—but they're not going up. In fact, the last several years they've actually turned down.

And we postulate from this that one of the reasons is you have an aging population that wants less equity exposure because they've reached 65 years of age and they don't feel comfortable taking that equity risk as much anymore.

[Please reference slide 18] Another area is on this graph as you start to see the change. There are lots of lines on the top, it's very colorful but let's just boil down what we're looking at here. This is all of developed world countries. It takes their sovereign debt yields and subtracts the local—whatever it is—CPI from them to come up with a real rate. And the

black line at the bottom is a look at, well, what's the percentage that had a real rate that was positive? And up until about 2009 it, most of the time, was 100%. Post 2009 it's been declining and now, currently, it's only 11%. So most of the developed world's high quality assets as defined by their sovereign debt now has a negative real yield. And that we think is partially, at least, being driven by this demographic change in pushing on a need for people to save more. Because if you're earning less on your savings, then you have to save more if you're trying to get to some targeted income number you think you need to live on a year-to-year basis.

So when we think about the demographics, we know it's not the only reason that you're seeing negative yield across Europe and into Japan where the demographics are more due to the aging, but we know it's a secular trend that's going on that is having an impact. It's something we've talked about on and off for several years about something for an investor to be aware of, something to try to factor in as they think about interest rates and why they're acting the way they are, but it's difficult to make a day-to-day decision from that. But suffice to just say you have an aging population which is trying to save more because it realizes it's going

to live longer.

[Please reference slide 19] Now to shift gears to something a little more from the very large demographic to what I liken to the plumbing of the financial markets or, as I told some people around the room, what we ended up happening was we had a problem in the repo market was that the Federal Reserve Bank needed to go on their computer, click on Home Advisors, click on Plumbing and click on some expert to come in and help them unclog the plumbing that had become clogged.

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And why did it become clogged? What were some of the reasons that were causing this problem?

Well, the first ones on the left, this is the Federal Reserve's balance sheet. It got to about \$4.5 trillion. They got to the beginning of 2018 and said, look, we're going to taper off QE, we're going to reinvest less of the proceeds that come in. And, lo and behold, they went from \$4.5 trillion to about \$3.7, \$3.8 trillion in assets, so a significant shrinking.

Now think about the shrinking. When you bought the assets, you put money into the system. When you let the assets roll off and don't reinvest your assets, you are taking money out of the system—putting it in

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one way, you take it out the other way. And on the right, you start to see how some of that pans out.

This is the reserve balances which peaked at about \$2.6 trillion. They're now back to the level they were in 2012, so the excess reserve levels that you're finding over on the banking system have shrunk as well.

[Please reference slide 20] So from that aspect, that was one of the reasons we think that daily liquidity was starting to get somewhat of a problem, there was just less money around. The other one, I'll start off with the bullet point that says these excess reserves are part of the banks' high-quality liquid assets for regulatory purposes. The result was it's an illusion of liquidity. And the reason it's an illusion of liquidity is post 2008, you've got new Basel III, you've got Dodd-Frank, you've got a series of other regulations that were designed to make the banks safe to where they weren't over-levered, they could put runs on them, they'd have living wills—all these sorts of things. They never required them to hold more high-quality liquid assets. Lo and behold, excess bank reserves are high quality liquid assets.

On the left you see a bar graph that shows you those high quality liquid assets, in Wells Fargo's case, about 40% of it is their excess

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reserves. It's a little more than 20% for JPMorgan, it's about 15-ish for the Bank of America, and Citigroup's probably 12% or 13%. These are the four largest banks with excess reserves. But these are not reserves that can go into the system. They're sort of stuck from a regulatory world.

(00:18:01)

The right-hand side is, what did the Fed have to do when the plumbing got clogged and they had to get on Home Advisor and click on Plumber and find someone to come help them fix it?

Well, on the 16<sup>th</sup>, the day before they had this problem, their amount of money injected into the repo market was zero. By the end of September it was \$200 billion. It tailed off a little bit and now it's back to \$205 billion. And I'm always struck by this, is the fact that they had this problem because there were tax settlements at the end of the quarter and some very large auctions that needed to be settled. Now these are events that we all know about, they're not anything big and surprising and shocking except for, maybe, to the Fed who wasn't doing their math quite so well and realized, oh, my gosh, there's a greater demand for money than there is actually supply of it. The end result is overnight repo went to 8%, 9%, 10% depending on who you were talking to at the time.

So after they went through the ‘we’re going to inject into the repo market’ which, by the way, still is oversubscribed which means there are more people wanting money than there is money available. Their next act was ‘we’ll buy \$60 billion of Treasury bills every month until some time in the middle of next year.’ Okay, nice and interesting.

(00:19:19)

But when you start to look at that you realize they may end up being 50% of that marketplace over the next six to nine months. That’s a significant amount. It may also be permanent; we don’t know yet. Now they claim it’s not QE but if you’re permanently injecting money into the system in order to affect a rate, it sounds kind of QE-ish to me, but that’s more of a debatable item. The side note of it is—and we’ll get to the details later—it may actually drive down the yield on Treasury bills.

So when we look at this, we were a little surprised by the lack of foresight from the Federal Reserve to get caught with this whole situation. In fact, the first time they announced that they were going to do the repo facility they had to back off for a second because they had some technical difficulties, couldn’t get it to work. And what really concerns us more is this is happening during a time when the economy is doing reasonably well.



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What happens in a downturn? What might the needs be? What could be the problems that might occur? And so this is one of those areas that concerns us.

[Please reference slide 21] Now on this one, Ludwig, doesn't work here although we did think one time about hiring a guy who could do this. Unfortunately for Ludwig, the inversion has unwound so he doesn't have to stand on his head on his desk every day. But we want to spend a couple of minutes on the Treasury yield curve and what's going on.

(00:20:51)

[Please reference slide 22] The first thing is to refresh people's memory. This is the difference in yield between the 10-year and the 3-month bill and it's been negative since, really, the beginning of May until—actually the beginning of October, it was still negative at the end of the third quarter. But you see that spike up on the right, and there are two reasons for that, with the main reason being that's about the time the Fed said, hey, I'll buy \$60 billion worth of Treasury bills every month. And, lo and behold, Treasury bills declined in yields. At that same time, people sort of thought, well, maybe the world's not coming to an end and the 10-year Treasury actually went up some as well and now we've un-

inverted the yield curve.

[Please reference slide 23] More specifically during the quarter here's what went on. The top line, the olive dotted line, is the yield curve at the end of June. The green line at the bottom is the yield curve at the end of September. I've circled the 2-3 year area. I've circled it for a reason, that's literally the area we've been focused on for the last several years. And it also happens to be the area that has the least movement during the quarter, which may go to a long way to explaining why the yield to maturity or yield to worst for the Fund during the second to the quarter pretty much stayed unchanged.

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So if I look at the short end, why is it declining? Well it declined because there were two Fed rate cuts. Well, why did the long end decline? Well, there was a demand for positive yield in sovereign assets because you couldn't get them in Europe, you couldn't get them in Japan. People were looking at the economy going, the economy's not growing faster, it's growing slower. And there were no concerns about inflation so it drove the long end down as well.

After the end of the quarter, the short end changed. Instead of

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having a Treasury bill that looked like a 1.80 yield, it's now 1.60. So this U-shape that you see—if you think about, look at it—of the yield curve, has gone away. And one of the prime reasons it went away was the Federal Reserve said they're going to buy \$60 billion worth of Treasury bills a month. Which leads me back to, as I think through this, it goes well if you're doing that, then you affected the rates, yes, you probably are doing QE.

[Please reference slide 24] Finally some words on credit. March of last year we wrote a piece called “Rare Bond Market Conditions Set Up Complacent Investors for Subpar Returns”, and you can go on the website and you can read it, it doesn't take long—mostly graphs, a little bit of verbs.

And we were talking about how flat yield curves and low credit spreads have really resulted, going forward, in sort of anemic or substandard returns in the fixed income market. So we're 18 months later and I looked to credit and said, hmm, interesting on how the behavior of credit has changed. The graph is looking at the Bloomberg Barclays High Yield Index and it's carved up by CCC, B and BB, so we just carved it up by credit. The left half is this 2018, the right half is 2019. And for most of

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2018, owning CCC rated made the most sense, it gave you the best return followed by B then followed by BB.

But after the fourth quarter of last year, that completely flips around. And owning, this year owning CCC has not done very well for you, it's a laggard. For a while the B Index did better and then you'll notice the BB Index caught up and it's slightly ahead as you get to where we're speaking today.

So there seems to be a change in investor behavior about how they perceive risk and such from a credit standpoint and maybe there are concerns that are making them pull back on that.

To give you a couple of numbers, if you think about the BB Index, during that period of time the yield to worst on that went down a little over 60 basis points and the spread actually narrowed a little over 20 basis points. If you look at the B component, a small decline in yield of a little over 10. But the spread actually went up 124 basis points. And then finally, for a CCC, both the yield and the spread increased over that complete period of time.

[Please reference slide 25] So taking that and looking at that and saying, okay, the peers investors are focusing more on the BB sector than

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they are on the CCC sector, a couple of other things we wanted to share, as I close this section out, the upper left-hand side is CCC high yield issuance. Now this annualizes 2019. And, lo and behold, it looks like it might be less than what was issued in 2018. Interestingly, if we annualize the PIK issuance, or Payment in Kind—those who will pay you interest by just paying you more bonds instead of cash interest—it's actually up this year, so it kind of works against that trend.

And then in the bottom second-lien issuance is down. And then dividend recapture, or the equity sponsor, borrows money to pay themselves a dividend, has declined as well.

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[Please reference slide 26] From an LBO perspective, the amount of LBOs from a dollar perspective, is down after three years of being up. And on the right-hand side the financing of that, whether it's leveraged loans or whether it's high yield bonds, is down as well.

And then, finally, in the lower left-hand corner, that's a bar graph that looks at covenant-lite issuance which has declined rather precipitously this year. That's good news. Bad news, when you look over on the right, still the highest preponderance of bonds out there are

covenant-lite.

So when we look at these elements it's, to us, giving us some indications that, yes, investors' thought process and behavior towards credit is changing. They are becoming more concerned about it. They're trying to at least—if you want to think about it on a relative basis—rather own a BB-rated bond than a CCC-rated bond.

[Please reference slide 27] With those comments at this point, I'm going to turn over to Abhi, who is going to spend a lot more time going into detail of what we bought and how we performed and how the portfolio's constructed.

(00:26:40)

Abhijeet: [Please reference slide 28] Thank you, Tom. From a high level, not much has changed for us in terms of how we are managing the portfolio. We've commented extensively about our approach in today's market during the past several webcasts and letters. Much of it still applies today and so please feel free to refer there for more details. But in the meantime here's the Cliff Notes version.

First, we're trying to push out the duration as much as we can in line with our duration test which seeks investments that we expect will

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produce a positive or breakeven total return over 12 months assuming that yields increase by 100 basis points.

The rationale for that approach is that it gives us an attractive upside versus downside with respect to interest rate exposure. If rates decline, there is some price upside in the portfolio. If rates rise, we expect the portfolio will preserve its value in the short term which allows us to recycle capital into higher yields. That, then, sets up the possibility of a higher, lower volatility, long-term return. Second, we think credit is expensive. As we mentioned before, we define credit as an investment rated BBB or lower. Thus, while we spend a lot of time researching credit ideas, not a lot is passing our absolute return hurdles

So with that background, let's dive into the funds. Let's start with New Income and performance.

(00:27:57)

At the bottom right, you can see that New Income's return before fees for the quarter was 93 basis points. The first and third largest contributors to performance during the quarter were equipment asset-backed securities, or ABS, and ABS backed by other loans.

Neither of those had notably large returns but they were large

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contributors to performance because they are a relatively large part of the portfolio. For both, most of their return came from coupon payments with some price appreciation due to lower yields.

The second largest contributor to performance was corporate bank debt and bonds, nearly all of which are credit investments for us which means they are rated BBB or lower. These were a large contributor due to a combination of coupon payments and fundamental-driven price performance.

There were no meaningful detractors from performance during the quarter. However, within our corporate holdings, our investment in PHI detracted from performance. Our quarterly letter should be on our website shortly. In that letter we share additional information and thoughts on that investment. If you have any questions after reading the letter, please do not hesitate to contact us.

[Please reference slide 29] The next slide shows the duration and yield on our high quality holdings versus the two-year Treasury. These are our investments rated single-A or higher. As shown in the green bars on the right, we've increased the duration on these holdings consistent with our efforts to increase the duration on the portfolio overall.



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[Please reference slide 30] Within credit, again, those are investments rated BBB or lower, you can see in this next chart that there has not been a material change in terms of yield and spread available in the credit market and we're using the High Yield Index as a proxy for that. Nevertheless, we were able to add about 60 basis points to our credit exposure by adding to existing investments and adding a couple of new bank debt investments.

The general nature of those new investments is that they are secured with significant collateral coverage and the pricing makes sense for us because they are in industries or situations where the rest of the market is experiencing some level of angst. In this case those investments were in retail.

[Please reference slides 31-32] The bottom left of the next table reflects the slight change in credit exposure. The high quality exposure is about 60 basis points lower than it was last quarter while the credit exposure is about 60 basis points higher. The net impact of our investment activity is that the yield and duration on the portfolio are unchanged, as shown on the bottom of the next slide. This is despite overall lower yields in the market.

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[Please reference slide 33] These pie charts show the portfolio broken down by investment idea which is how we think about the portfolio on a day to day basis. The “other” category includes any idea that is less than 4% of the portfolio.

Areas where we invested meaningful dollars include prime auto ABS which increased by about 5 percentage points and Treasuries which increased by about 2 percentage points. Equipment ABS, performing CMBS—which includes both agency and non-agency bonds—and credit card ABS, each increased by about a percentage point. All of these amounts are net of repayments and sales of bonds.

For reference, within CMBS, we’ve been buying highly rated bonds, mostly non-agency, that were originally too long for us to buy but with the passage of time they now fit our desired duration profile.

As to why we’ve bought what we did, as we discussed earlier, we have been trying to add duration to the portfolio.

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Within high-quality bonds, once we identify the duration that makes the most sense for us, we try to find the most attractive bonds that we can find and then buy those bonds subject to our credit and other work. The

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most attractive bonds at any given time will depend on market pricing and supply and demand. This part quarter, that process resulted in our buying prime auto ABS, Treasuries, equipment ABS, CMBS and credit card ABS among other things. As we've noted in the past, historically that process has yielded investments in agency mortgage pools, for example. In short, because we are not tied to an index, what we buy and whether we buy it will depend on market conditions and there's latitude around that. That's part of what makes this strategy unique.

[Please reference slide 34] The next slide shows the portfolio's expected 12-month total return before fees, assuming that yields increase by the amounts shown on the X-axis. For example, if the yield on all of the bonds in the portfolio were to increase by 100 basis points, the portfolio's expected 12-month total return before fees would be approximately 1.6%. The far right-hand side of the chart shows that yields could increase by more than 200 basis points across the entire portfolio and the portfolio should still have a positive total return before fees. That yield increase could come via a combination of rising risk-free rates and rising spreads.

(00:33:08:00)

[Please reference slide 37] Now moving on to Flexible Fixed

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Income. The bottom right of this slide shows that the total return for the quarter for Flexible Fixed Income was 90 basis points before fees, or 0.9%. The largest contributors to performance were agency mortgage pools, equipment ABS and ABS backed by auto loans. The return on these was driven by coupon payments and higher prices as a result of lower treasury yields and spreads. Here, again, none of the three had a particularly large return but they're all large parts of the portfolio so they became large contributors to performance.

There were no meaningful detractors from performance during the quarter, though our investment in PHI was a detractor from returns.

[Please reference slide 38] We added to our credit exposure during the quarter, as shown at the bottom of this next table. The credit exposure increased to 8.4% of the portfolio. That increase came by way of additions to existing positions, mostly in bank debt but a little bit in high yield bonds. We also added bank debt investments that fit the same description we outlined earlier for New Income: significant collateral coverage and the pricing makes sense for us because they are in industries or situations where the rest of the market is experiencing angst.

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In the case of Flexible Fixed Income, those investments were in retail and also in energy, namely a loan to PHI that was issued upon its emergence from bankruptcy. In total, as shown at the bottom of this slide, our investment activity led to a slight increase in the yield-to-worst of Flexible Fixed Income despite an overall lower yield environment.

[Please reference slide 40] Here we show Flexible Fixed Income broken down by investment idea. Notable changes include prime auto ABS which increased by about 4 percentage points and Treasuries which increased by over a percentage point. Similar to New Income, we attempted to push out the duration on Flexible Fixed Income and those investments were the ones that made sense this quarter.

We also deployed capital in agency mortgages, credit card ABS and CMBS, though some of those areas showed a net decline because the investments were offset by amortization and maturities.

Finally, the corporates exposure increased during the quarter in line with our credit comments from a few minutes earlier.

(00:35:38)

[Please reference slide 41] Moving on to Q&A, we can start with a question we received in advance. The question relates to seven-year auto

loans and the implications for auto loan bonds owned in the portfolio. Six-year loans have been the norm for a long time; seven-year loans are somewhat new. The premise behind the question is that lenders are lengthening car loans to lower the monthly payment and shoehorn customers into a more expensive car. In addition to questions about affordability, there is a danger that longer car loans can put the borrower under water over time as the loan balance fails to keep up with the depreciation on the car.

As it relates to auto loan securitizations, generally-speaking, securitizations do not include seven-year loans so our auto loan bonds do not include seven-year loans except for the following.

There is an issuer of prime quality loans that does include seven-year loans in its securitizations. However, that issuer has always included seven-year loans in its securitizations dating back to before the financial crisis. That's important because, generally-speaking, the risk in underwriting these sorts of bonds is a mismatch between history and the present. Specifically, if the past did not include seven-year loans but the future does include seven-year loans then if we use the past to guide the future that guidance will be wrong because it will not capture the impact of

seven-year loans.

(00:37:01)

Our approach to underwriting auto loan bonds, in general, is to assume the worst. We look for issuers that have been in business through recessions and bad markets and we look at what their loss experience has been during bad times. We then assume that the worst losses that have ever occurred are going to occur again in the future. We will only consider buying a bond if it survives that sort of loss scenario.

Since this issuer of seven-year loans has always included seven-year loans in its securitizations, their past loss history is a useful data point for future losses. We pored through a lot of historical data on this issuer's loan losses and assumed that future loan loss experience will mimic the experience of past recessions including the financial crisis. We make this assumption even when the economy is doing well.

For the most recent bond that we bought from this issuer, 0.01% of the collateral was comprised of seven-year loans. As a point of reference, though, if you draw the cutoff line at six and a half years and call that seven years, then about 5% of the loan collateral was comprised of seven-year loans. The bond we bought could sustain loan losses of

approximately 9% before the bond incurs a principal impairment which means you could write off all of the six and a half year and longer loans and the bond would be fine.

(00:38:20)

In total, approximately 1% of the portfolio is invested in bonds from this issuer. On average, those bonds could sustain losses that are three and a half times greater than the exposure to loans that are six and a half years or longer. Now that analysis assumes that those long loans are worth zero i.e. you don't collect any money from them. Historically, that has not been true.

So in summary, we understand the concern about seven-year loans but we are not concerned about them in our portfolio because of the protection that we have against loan losses and because our underwriting captures the impact of seven-year loans.

We have another question which reads: Could you please explain where most prime and subprime auto loans originate, like AutoNation or CarMax?

Interesting question, so where do most loans originate? So loans usually originate when someone shows up to a car dealer to buy a car.



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And so I'm sure many of the people on this webcast are familiar with that process. You show up to a car dealer, whether it's a Honda dealer to buy a brand new car, or even a used car from the Honda dealer, or AutoNation or CarMax or Johnny's Used Cars on the corner near your house. So you walk into that car dealer, you find a car that you like, you sit down with the sales guy—or you're trapped in the cubicle—and they ask you to disclose all your financial information. You see them typing away a bunch of stuff on a computer. What's happening on the screen that you can't see is that they are actually entering your information into a web portal which is then sending your financial information out to a number of loan lenders who have access to the portal. Within a matter of seconds all of those lenders are then responding back to that dealer and telling the dealer the terms on which they're willing to lend you money.

What is supposed to happen is that the person sitting in front of you is then supposed to quote you the best terms that they're seeing on the screen and, generally, that is what happens, although, of course, there's always a bad apple somewhere. So that's how loans originate.

Now whether a loan is prime or subprime really depends on the financials and credit history of the person who is trying to buy the car and

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submitting the loan application. And so based on the information that you submit, that will determine whether certain lenders respond or do not respond to your loan request and that will also determine the terms that are submitted by that loan lender.

Hopefully that answers the question.

(00:40:58)

Kristina: Thank you, Abhi. We received a number of questions in advance of this webcast and many of them dealt with the current positioning of the Fund and also where the team finds opportunities as well as the interest rate environment. These have been addressed during prepared remarks but if you need additional clarification, please submit your question right now or contact us after the webcast.

We also had several additional ones that were submitted in advance and then we'll move on to the live questions.

Number one is: What is the maximum amount of leveraged loans that the Flexible Fixed Income may hold?

Abhijeet: Sure. So as a technical matter, the credit capacity—again, that's investments that are rated BBB or lower—the credit capacity for Flexible Fixed Income is up to 75% of the portfolio. So technically-speaking, we

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could have 75% of the Flexible Fixed Income portfolio in leveraged loans. However, and this is a big however, as you could probably gather from everything we've been discussing, we tend to be kind of cheap as to how we spend money. In today's market, credit exposure out of 75 percentage points of total capacity we only have about 8 percentage points actually spent in credit which is another way of saying that the market would need to be particularly cheap in order for us to significantly ramp up the leverage loan exposure in Flexible Fixed Income. And, more to the point, the world would have to be extraordinarily cheap—think financial crisis types of pricing—to get the credit exposure and, namely the leveraged loan exposure anywhere in the 75% area.

Kristina: Thank you. The next one is: What is your greatest fear about the corporate bond/leveraged loan market? And I think we mostly covered that in the prepared remarks but if you have a different answer.

Tom: I think the only thing to add is Abhi and myself and Steve Romick, part of the contrarian team, wrote a piece at the beginning, it came out right at the end of last year, beginning this year, we talked about our concerns within the BBB portion of the corporate bond market or the investment grade and, necessarily, the high yield portion. And the

elements we laid out, the arguments we laid out in that piece, in our opinion, still are germane today and haven't changed so the detail of those concerns can be found there and it hasn't changed in nine months after we've written the piece.

Kristina: Thank you, Tom. Large passive and active fund allocations are influenced by indexing today more than ever before, and some view this as a route of impending contagion in the future market dislocation. For example, a large-scale downgrade of BBB-rated debt would cause investment-grade index bond funds to dump those issuers, regardless of fundamentals. Do the advisors consider such an indexing-driven event a real risk in the bond market? And if so, what steps are taken to protect the Fund from impairment of capital in such an event?

Abhijeet: Yes, so I think that that is a real concern and it's a real risk. And I think we've seen some flashes of that in the last couple of years where you get what's essentially baby out with the bath water type of selling activity because people are redeeming from fully invested index tracking funds or ETFs-specifically en masse and you just kind of have to hive off a huge chunk of those portfolios, regardless of whether the underlying investments are good or not.

I think, too, from our seat the way we protect the portfolio from that—at the risk of talking our own approach—is that you have to be absolute return oriented and you have to be cognizant of buying bonds and loans at prices that you think are compensating you for the risk of not getting paid back. And I think if you can do a good job of that you'll avoid owning those sorts of investments or even BBB investments you'll end up avoiding owning those sorts of investments when the market is really expensive. And, because of that, you will not have the mark-to-market exposure when people dump bonds in an expensive market.

And on the flip side of that you will end up having dry powder available to buy bonds and buy loans and take advantage of buying opportunities when there is panic redemption-based selling. And that, generally, is creating an opportunity to make investments at attractive prices.

Kristina: Thank you, Abhi. To what extent are negative interest rates the result of forced buying by financial institutions? How much of the negative interest rates that is actually held momentarily by non-regulated firms and households?

Thomas: So when we think about negative yielding bonds, and you will actually to

start to look in Europe—mostly Western Europe first—and Japan, there is a certain amount that comes about from the fact that the pension scheme, the bank, the savings schemes in those countries have regulatory requirements that say they must own high-quality assets, of which this stuff fits in. And so you do have some of that.

As far as how much of it, maybe it's just the household, the percentage number is difficult, or I have not found it yet, but it does exist because when you think about the negative-yielding bond, it's not that the bond has a negative coupon. It has a positive coupon. The lowest one you could get is you can buy the current German 10-year, it has a zero coupon. But the others have a positive coupon. The 100-year Austrian bond, it has a massively negative yield to it. I think, as a coupon, it's in the 2s, you know, although it trades for something close to 200, it has a negative yield to maturity but it has a positive coupon. And the reason for that is, if the bond actually had a negative coupon it would no longer have the rating that it has. Because right now, whoever issues the bond—the person that borrows—we can identify them, look at them, figure out their credit quality and say, okay, you're a AAA, a AA, a A, or whatever, because you've got to pay that interest.

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If the coupon was actually negative, then we'd have to go to the people that are lending this money and do a credit check on each and every one of them to figure out, well, do they have the ability to pay the person who borrowed it the negative coupon every year. So they all hold zero or positive coupons.

If I'm a retiree and think back to that graph where I showed you, say, Germany, big savings place, much older population, who thinks they're going to live for 20 years, 21 and a half years. They can look at the Austrian 100-year bond and go, I'm going to get 2 and a quarter percent or 2 whatever it is, 2 something. They're going to pay me that every year for the next 21 and a half years and then I'm going to die, but I'd get the income.

Their heirs, on the other hand, are going to end up with the loss. So you think about that behavior and you realize that, yes, there are probably households that are doing this because they're merely buying the stream of income and they figure they're going to buy the stream of income that's longer than their life expectancy. So they really are less concerned about the fact that the yield to maturity is actually negative.

It's a fairly strange and perverse behavior but not something that

when you think about it from a logical standpoint, it's someone trying to find income for retirement wouldn't undertake. Wish I could give you the answer as the percentage, but I look at it and figure it's going on.

Kristina: Thank you, Tom. Are we on board with the lower for longer interest rate thinking?

Thomas: You know, I've presented the demographic side of why you're seeing this demand for bonds and one of the reasons why it's probably ending up with the kind of low rates that we're seeing. And then you have the monetary policy out of the ECB with negative short rates and the one out of Japan with negative short rates and in the very low rates here in the US. And all those should sort of point to you, well, you could probably have low rates for a long period of time.

Having said all that, we don't spend much time coming up with the grand mackerel thesis, oh, the 10-year is going to be—and then fill in a rate range for the next ten years. We don't.

I only bring this stuff up and put it in front of people to go, you should think about these items as you look at investing. It doesn't say that we're necessarily telling you lower for longer but it is a set of information that tells you that's a possibility.



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I was recently at a conference last week, an interesting bookend of presentations. The person in the morning built the case for zero interest rates and negative interest rates in a recession. The person at the backend, they were almost at the end of the conference, had the exact opposite. Well, we've got more debt coming on. We've got to borrow more money therefore interest rates are going to go up. If we do MMT we're going to create a whole bunch of money and inflation is going to increase.

(00:50:44)

And I walked away from that and went, two very persuasive arguments. I cannot tell you which one is going to happen. I'm not sure if one or the other is going to happen. There might be something in the middle. But to go through all that to go, well, it's useful to know, it's helpful. Abhi's laid out where, okay, we have a stress test that we use that tells us am I going to get a positive return if. And we find that discipline goes a long way to telling us what's the interest rate risk we can take, instead of really trying to figure out all these others, is it going to be lower for longer because of demographics or something else. Or is someone in Germany going to continue to buy an Austrian 100-year bond with a negative yield because they just want the coupon.

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Kristina:               Why isn't the federal government issuing more debt with very long term bonds?

Thomas:               Great question. I really don't have an answer for it. I know that during the summer there was discussion again about issuing 50 and 100-year bonds, which would seem to make sense at the low level we have. If we've got deficits for a long period of time, why wouldn't we necessarily do that? And the primary dealer said—I'll get to the joke in a minute but really just pass it across—the primary dealer said that they couldn't come up with the real reason; there was a market for them. And so maybe it is one that there's only a defined market for the longer maturity and there's a much larger market for the shorter maturity securities so they continue to go down that past.

I have to share the joke with you. As Julian put up, not enough repo.

Kristina:               Someone has heard the other day that a US corporation has issued 20-year bonds in Europe with half a percentage yield. Are many US companies doing this? Shouldn't more companies be doing this?

Thomas:               If you look at the multinationals, you will see that they have issued bonds in euros with very low or almost zero coupons and at times, the

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actual secondary market they traded negative yields. It is something that goes on. But when you think about that multinational, okay, they've got a European operation that they need to fund. Well, they could fund it from the US, borrow money in the US and send it to Europe. Or they could just borrow the money in Europe and spend it in Europe.

If the person wants more detail I have some information about who the issuers are and some of those that I can share with you but it is something I don't know off the top of my head but, yes, you are seeing the US multinationals borrow in Europe for its European operation.

Abhijeet: Yes, and I'll just add one thing. I think it's a little bit simplistic to just look at the yields and say that companies should be doing more of that because if you're a US-based corporation, generally-speaking, you're trying to deliver US dollar to your shareholders and so really, you should be thinking about things on a currency-adjusted basis.

So where I'm going with that is, yes, a US multinational could borrow in euros with a half-a-percent coupon but they need to have euros available to actually repay that debt. So in some instances companies can hedge out that euro risk but once you account for the cost of the hedge and you translate everything back into US dollars, from what I've seen it

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looks like the cost of financing is actually not necessarily that competitive with what they could get if they just borrowed in US dollar terms outright from the beginning.

I think that these borrowings make the most sense for multinationals that are actually generating some amount of earnings in euros because then you have what's known as a natural hedge, you're actually already generating euros that you can use to repay that euro denominated debt.

Kristina: Thank you. This takes care of the questions that we had. Thank you, everyone, for listening to FPA New Income and FPA Flexible Fixed Income Third Quarter 2019 Webcast. We now turn this over to the system moderator for closing comments and disclosures.

Moderator: [Please reference slides 42-45] 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 on the Fund such as a complete portfolio of holdings, historical returns, and after-tax returns.

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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](http://FPA.com) for future webcast information, including replays. We will post the date and time of the prospective calls at towards the end of each current quarter and expect the calls to be 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](mailto:crm@fpa.com). We hope that our quarterly commentaries, webcasts and special commentaries will continue to keep you appropriately informed on the strategy.

We do want to make sure that you understand that the views expressed on this call are as of today and are subject to change based on market and other conditions. These views may differ from other portfolio managers and analysts of the firm as a whole and are not intended to be a forecast of future events, a guarantee of future results, or investment advice.

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

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