

Buyer's Strike Revisited - June 16, 2008

June 16, 2008 marked the five-year anniversary of when we drew our line in the sand by penning "Buyer's Strike." Our stance at that time was that "we are on a buyer's strike in regard to the high-quality segment of the bond market." We argued, "we consider high-quality bond yields below 4% as having little or no investment merit and, therefore, we will not deploy your capital into them." We believed that high-quality bonds, with maturities of greater than two-years, had too much price risk.

Since June of 2003, our buyer's strike has been questioned many times by clients, shareholders and others, so we thought it was appropriate to look back at what has transpired in the bond market since we took that position. During this period, the ten-year Treasury note's yield rose from 3.14% to as high as 5.25%, and then fell back to 4.27% on June 16, 2008. In between, it did get as low as 3.31% on March 17, 2008. Given this volatility, has our position been validated? How have the performance results of FPA New Income compared with the bond market in general, as reflected by the Merrill Lynch Government/Corporate Index and the Lehman Brothers Government/Credit Index, and with FPA New Income's peers, as measured by the Lipper A-Rated Bond Fund Average? The results are:

Annualized Total Return June 16, 2003 to June 16, 2008

FPA New Income, Inc. (NAV)	4.25%*
3-Month Treasury Bill	3.14%
Lehman Brothers Government/Credit Index	3.02%
Merrill Lynch Government/Corporate Index	3.04%
Lipper A-Rated Bond Fund Average	2.47%

Neither the measures for bond market performance nor that for high-quality bond mutual fund performance compare favorably to the average return achieved by the three-month Treasury bill. Considering the longer average durations and greater credit risk of the bond market indexes and bond mutual funds, Treasury bills were a far better risk-adjusted return investment.

During the past five years, FPA New Income's average duration was just over one year - far less than a two-year Treasury note's duration - while those of the Merrill and Lehman indexes averaged more than five years. In other words, FPA New Income's duration was less than 1/5th of the comparative indexes, or less than 1/5th as sensitive to changes in interest rates, while its total return was approximately 40% higher. The funds in the Lipper Average generally have a duration that approximates their comparative indexes and as such, their durations would be considerably longer than FPA New Income's. Thus, FPA New Income achieved a substantially higher total return with considerably less duration volatility risk, while its average portfolio credit quality was among the highest levels in its history, above a AA level.

Caution and preservation of capital have been the two guiding principles these past five years. In our shareholder letters and website commentaries, we highlighted several bond market risks where, in our opinion, we believed there was inadequate risk compensation. We did not stretch for yield, in a low-yield environment, by investing in complicated securities, where their investment merits were predicated upon the quality rating of a bond rating agency. We were suspicious and skeptical of bond ratings covering new mortgage security structures or that utilized lower-quality underlying collateral. In many cases, we sacrificed yield because we did not understand the complexities of these securities. In retrospect, we believe most buyers of these securities did not understand the risks they were taking. The combination of rising interest rates and the collapse of bond ratings for high-grade securities, because of their complex derivative structures, led to these very low comparative returns.

So we were right. Where do we stand today? We continue our buyer's strike and have raised our target hurdle yield from 4% to 5% before we will consider deploying capital into longer term Treasury/high-quality bonds. This increase in yield level reflects the new risks that have developed since our 2003 commentary. Our basic philosophy is one that does not reward a borrower with a lower interest rate when that borrower has degraded their balance sheet. The U.S. Federal government has done exactly that. On December 8, 2003, the Medicare

Prescription Drug, Improvement, and Modernization Act became law. In one fell swoop, a new liability was created with a present value that was larger in size than the entire debt of the United States. We believed this was irresponsible since the existing entitlement funding issues facing the Federal government had not been dealt with yet. We were not the only ones with this opinion. The former U.S. Comptroller General David M. Walker has called this act "...probably the most fiscally irresponsible piece of legislation since the 1960s... because we promise way more than we can afford to keep." Of greater significance, according to the U.S. General Accounting Office, the Federal government's fiscal liability exposures totaled approximately \$53 trillion as of September 30, 2007, up more than \$2 trillion from September 30, 2006, and an increase of more than \$32 trillion from about \$20 trillion as of September 30, 2000. The Federal government's balance sheet continues to erode with its liabilities increasing at a non-sustainable growth rate of 14.9%.

The current credit crisis has further encouraged fiscal irresponsibility by both Congress and the Federal Reserve. Congress is considering additional mortgage bailout legislation, in addition to what has already been enacted. The economic benefits of the tax rebates are debatable. All of these increase the size of the demands upon the Federal government's balance sheet. The recent Federal Reserve actions, especially those taken as a result of the Bear Stearns meltdown, are the most significant policies enacted since the Great Depression. The Federal Reserve's new policy of accepting potentially risky mortgage assets as collateral for borrowing its Treasury securities from entities it does not have regulatory authority over, nor monitors, have these same potentially negative balance sheet risks.

Additional fiscal funding demands may develop over the next five years, as the negative consequences of the current credit crisis continue to unfold and lead to a slowing in real economic growth. Unsound fiscal policies may be implemented in order to try and reignite economic growth. Stronger economic growth will be viewed as one of the solutions to the onrushing entitlement funding crisis. This year, the oldest members of the baby-boom generation are eligible for Social Security and Medicare Hospital Insurance outlays will exceed cash income. In 2011, the oldest members of the baby-boom generation are eligible for Medicare and, in 2017, annual Social Security benefits will exceed cash income for the program; thus, there will be no more Social Security Surplus to fund other governmental spending programs. These next five to ten years should be quite interesting from a fiscal policy funding point of view.

In light of the above, we will remain on strike and continue our investment policy of caution and capital preservation. Per our March 30, 2008 website commentary "Crossing the Rubicon," the collective judgment of the partners of First Pacific Advisors, LLC, is that the U.S. government's fiscal irresponsibility has significantly raised longer-term inflation risks. We will not provide long-term capital to borrowers with unsound and unwise business management practices at unattractive real yields. We require a higher level of compensation, i.e. more yield, for these potential risks. This strategy requires patience and discipline - two qualities we have demonstrated these past five years, as well as since we began managing FPA New Income in 1984.

Sincerely,

Robert L. Rodriguez
Chief Executive Officer

Thomas H. Atteberry
Partner

* The total return of FPA New Income, Inc. was calculated at net asset value and does not reflect the sales charge which, if reflected, would reduce the performance shown. The table below shows the performance of the Fund at net asset value and after deduction of the maximum sales charge. Past performance is not necessarily indicative of future returns.

FPA New Income, Inc.	Average Annual Total Return Years Ended June 16, 2008		
	1 Year	5 Years	10 Years
At Net Asset Value	5.43%	4.25%	5.44%
With Maximum 3.5% Sales Charge	1.74%	3.51%	5.06%