Precautionary Measures

FPA Absolute Fixed Income Strategy
(including FPA New Income, Inc.)

July 19, 2011

We currently find ourselves operating and managing our Absolute Fixed Income Strategy (including FPA New Income, Inc.) in an unprecedented environment. Our leaders in Washington are at a current impasse at raising the debt ceiling, we are facing a possible downgrade of U.S. Treasury debt, Greece has all but defaulted on its debt, downgrades across other European countries and more. We have no ability to control any of these outcomes, but what we can control is how we position your portfolio in light of these events.

We have spent the past twenty-eight years managing this strategy with the goal of producing positive absolute returns, using a mix of capital preservation, yield and capital appreciation to achieve such objectives. For the past few years the first of these three tools, capital preservation, has outweighed focus on the latter two.

In our Q1 2011 call, we discussed our view and proactive actions we have taken given a possible downgrade of U.S. Treasuries. The only real change since that conference call is that we felt it may come later than this summer. Over the past few weeks our precautionary measures have become larger and more meaningful.

As of today the portfolio has 30% in Treasury Notes. The longest maturity is October of 2012. A downgrade does not mean default, however the specter of the federal government delaying some payments could very well result in increased price volatility for Treasury securities. With maturities of October of 2012 and less we have severely dampened this price volatility.

With respect to agency debentures from such entities as FNMA, FHLMC, FFCB, and FHLB, with minor exceptions, we have maturities of 2012 or less. Those bonds with maturities beyond 2012 included a FHLB Step Up note callable in October of this year but with a maturity of 2016, a CPI Index floater from FNMA that matures in 2013 and another Step Up note also issued by FNMA, which is callable in September, but does not mature until 2013. Last week we reviewed the potential for downside price volatility across this part of the portfolio. With each stress test showing a negative outcome, all positions were liquidated. Surprisingly, the prices received in our view continued to reflect a perfect world for government-backed securities.

The portfolio has 41% invested in single-family mortgage securities of which almost all are guaranteed by FNMA, FHLMC or GNMA. In the event of a downgrade of federal government debt these securities will likely be downgraded as well. With an average life of 3.1 years there could be some price volatility. Each bond was purchased based on the quality of the underlying mortgage loans and the value of the home and not on a guarantee of payment by a quasi-government agency. If taken in total the loans represent a LTV of 65%, median credit score of 732 and a weighted average final maturity of 2024. As we have stated in the past, these securities were either issued in 2003 or earlier prior to the poor underwriting of 2005-2007 or represent issuance in late 2009 to 2011 when again underwriting standards where stringent. We feel that the high quality underlying loans should compensate for the potential ratings downgrade.

We have also invested 12% in GNMA Project Loan Securitizations. These projects are various forms of government assisted housing. We see it unlikely that the federal government will not fulfill these rental assistance payments as the recipients are in need of these funds. These loans are also the refinancing of an existing fully rented property so default due to high vacancies is less likely. It is possible that the federal government could choose to delay expanding the rental assistance program. This delay could have a negative impact on new projects as their ability to ramp up occupancy may be constrained. While almost half of these bonds have an average life of 1.3 years, this short duration should help dampen price volatility in the event a downgrade. The remainder are in GNMA Project Loan securities with average lives of 5.4 years. These securities might be the most vulnerable to negative price movements, but we continue to hold them as we are comfortable with the high quality of the underlying mortgage loans.

In the aggregate your portfolio has a duration of 1.19 years. The average credit quality of the portfolio is very high (currently AAA) with only 3.6% rated below investment grade. We believe the changes highlighted above have further reduced the portfolio's sensitivity to a possible downgrade of U.S. Treasury debt.

We see little opportunity cost as a result of our recent actions in this environment. The outcome of decisions made by our policy makers and its impact on the U.S. Treasury rating and our country's ability to service our debt costs is unclear. If they are resolved, we have significant liquidity to deploy capital into a clearer opportunity set, losing little in the form of yield in the interim. If actions are not met with satisfaction by the ratings agencies and those who buy our debt, the implications could be staggeringly bad.

You have entrusted us to invest your capital in a manner consistent within that set out in our Policy Statement (www.fpafunds.com). We have exercised discipline and patience in executing this strategy over many cycles, and the current environment may now test these trusted skills to their maximum.

We thank you for your continued trust in us and our strategy.

Respectfully,

Thomas H. Atteberry, CFA

P.S.

From a personal perspective in my 25 years of managing fixed income portfolios, I never thought that I would have to write shareholders and clients to explain the steps we have taken to protect their capital in the event that the United States of America had its debt rating cut due to fiscal mismanagement. The elected representatives of this country have been making poor financial decisions for many years. They have been warned of these poor decisions and the approaching day of reckoning; and yet have chosen ignorance over action. Now the problem is front and center. If they do not rectify the situation in the near term and a downgrade does occur, the blame will sit squarely on all members of Congress, the President, as well as all of us for not voting into office individuals that care about the long-term financial strength of this great country. Given that the next opportunity for us to elect new representatives is over a year away we, as citizens, should demand that the current elected officials affect such changes so as to ensure the long term financial stability of this country. Very simply put: Do not spend more than you receive!