

LETTER TO SHAREHOLDERS

Dear Fellow Shareholders:

This Semi-Annual Report covers the six-month period ended March 31, 1998. Your Fund's net asset value (NAV) closed at \$11.27. Income dividends of \$0.17 were paid on October 7, 1997, and January 7, 1998, to holders of record on September 30 and December 31, 1997, respectively. The January payment also included a \$0.02 long-term capital gains distribution.

The following table shows the average annual total return for several different periods ended on that date for the Fund and comparative indices of securities prices. The data quoted represents past performance, and an investment in the Fund may fluctuate so that an investor's shares when redeemed may be worth more or less than their original cost.

| | Average Annual Total Return | | |
|---|------------------------------|---------|----------|
| | Periods Ended March 31, 1998 | | |
| | 1 Year | 5 Years | 10 Years |
| FPA New Income, Inc. (NAV) | 9.85%* | 7.74%* | 9.54%* |
| FPA New Income, Inc. (Net of Sales Charge) | 4.91%‡ | 6.75%‡ | 9.04%‡ |
| Lipper Corporate Debt Fund "A" Rated Average | 11.63% | 6.65% | 8.76% |
| Lehman Brothers Government/ Corporate Bond Index | 12.39% | 6.96% | 8.93% |

The Fund's total rate of return for the six months was 3.55%* versus 4.12% and 4.78% for the Lipper Average and the Lehman Index, respectively. For the calendar year ended December 31, 1997, total returns were: FPA New Income, Inc., 8.31%*; Lipper Average, 9.17%; and the Lehman Index, 9.76%.

Commentary

Your Fund underperformed the Lehman Index and the Lipper Average over the past six and twelve months, as shown above. The largest magnitude of underperformance covers the year ended March 31, 1998. This can be explained by the fact that bond yields fell for most of this period. As we discussed in our September 30, 1997 shareholder letter, we have been shifting the portfolio to a more defensive posture, which results in the portfolio participating to a lesser degree in a rally when rates decline. We describe below why we believe our strategy is the appropriate one.

During the past year, the yield curve shifted down in an almost parallel fashion between the three- and thirty-year segments. Approximately 70% of this shift occurred between March and September of 1997. During the year, we explained why we believed the economy was likely to grow faster than consensus expectations. This outcome did occur; however, we missed the mark on inflation levels that were considerably less than what we were anticipating. In addition, the Asian crisis began and consensus expectations again moved towards a much slower economic outlook. The crisis convinced bond managers that the Federal Reserve would not need to tighten monetary policy and that they might have to ease rates to keep the "Asian problem" from spreading. We argued that the Asian problem would be contained with a much smaller impact than that expected at the time. Since then, the economy's growth rate has been far in excess of consensus expectations. I guess you can say that we were right, but still wrong.

In the past six months, interest rates have had difficulty extending their decline. We tried to convey this feeling in our last shareholder letter, when we lowered our anticipated longer term Treasury yield range to the 6% to 7% level. For a brief period, long-term Treasury yields fell to 5.65% but could not stay there very long. Since then, they have been contained in a very narrow range of 5.75% to 5.95%. With shorter term yields at 5.5%, an investor does not derive much additional yield through maturity extension. This is one of the flattest yield curves we have seen in a long time. Typically, flat yield curves are inherently unstable. Usually, they are a precursor to either an inverted yield curve (short rates are higher than long-term rates) or a much steeper yield curve (short rates fall much faster than longer term rates).

We have a difficult time seeing the Federal Reserve lowering short-term rates in the near future and thus, a steep yield curve, by way of lower short-term rates, does not seem likely. The economy is already growing far faster than most economic forecasts. If it were not for the Asian difficulty, we believe the Fed would have already moved shorter term rates somewhat higher. Fed policy has been very

* Does not reflect deduction of the sales charge which, if reflected, would reduce the performance shown

‡ Reflects deduction of the maximum sales charge of 4.50% of the offering price

stable over the past nine months, and the next six to nine months should be very telling. If Asia does not slow U.S. economic growth materially, the Fed may be forced to raise short-term rates in order to moderate economic growth. All signs point to continuing growth. Unemployment rates are hovering at twenty-five-year lows while consumer confidence levels set new highs. We also see signs of inflation beginning to return. Wage rates are growing in excess of 4%, while health-care inflation is starting to show renewed strength. Rate increases from health maintenance organizations are now running between 5% and 10% for the coming year. Unless corporations get significant productivity improvements, these costs will either have to be passed on or be absorbed. In the eighth year of an economic recovery, it does not seem likely that we will get major productivity improvements, especially with a very low unemployment rate. If this sounds familiar to you, we made these same arguments a year ago. Our problem was that we were too early. It now seems more likely that these pressures should start to destabilize the bond market.

We believe that it is more prudent to protect your capital while awaiting better investment opportunities. Not only is one not being paid sufficiently to take on maturity risk, credit spreads are also very tight. With a strong economy, lenders are willing to take on greater credit risk for lower yields. This typically occurs late in an economic cycle. We again are being very patient in order to invest at a more opportune time.

Finally, we still believe that we are in a period of temporary fiscal budgetary calm. One cannot pick up the newspaper without reading about the budget surplus. We have been surprised by the magnitude of recovery, but we still question its durability. The Federal government is having a difficult time estimating its revenue. The surging stock market has created surprisingly large capital gains tax receipts. We should not take them as sustainable—they should be viewed more as a positive windfall. Until the Federal government gets a handle on how it will deal with its growing entitlement liabilities, these windfall revenues should be used to get a jump-start on them. What is done in this area over the next one to three years will help determine how U.S. interest rates shift.

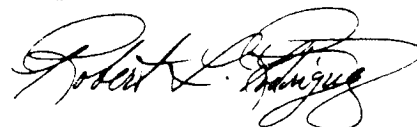
Our defensive portfolio posturing has shown very tangible benefits when interest rates have risen only a small amount. During these brief periods, your Fund has gained considerable relative performance versus the bond market and other high-quality bond funds. This

indicates to us that the average bond fund is either very close to or in excess of its duration benchmark. In the case of your Fund, its portfolio duration at March 31, 1998 was 2.85 years versus 3.85 years at September 30 and 4.87 years last March 31. (The lower the duration number, the more defensive and less volatile a portfolio is.) By comparison, the Lehman Index's duration is approximately 5.2 years. Since September, the portfolio's duration has dropped dramatically because of the Fund's rapid growth as well as the changing characteristics of some of the securities held. Our large exposure to mortgage securities makes it likely that many will prepay at a faster rate due to the decline in interest rates. This does not come as a surprise since many of the securities were purchased with the idea that if interest rates got to these lower levels, we would experience higher prepayment rates. We view this as a built-in hedge against a portfolio manager getting more optimistic after an interest-rate decline. To help protect the portfolio from duration extension risk should interest rates rise, we increased our holdings of interest only, "I.O.," securities from 1.7% at September 30 to 5.5% at March 31. These are securities whose value generally increases when interest rates rise. They are part of the derivatives portion of the portfolio that totals 12.8% of assets.

We continue to increase our exposure to Treasury Inflation Index Bonds. They now represent almost 20% of the portfolio versus 10% at September 30. Our reasons for holding these were discussed in our September shareholder letter. After these additions, the portfolio continues to maintain its high-quality asset mix. Government/Agency securities total 65% with 64% of these being in agency mortgage-backed securities. An additional 2% is invested in AAA mortgage-backed securities. High-yield and convertible securities represent 7% and 5%, respectively. Short-term liquidity totals 16%.

In closing, we wish to thank all of our shareholders for their support and investment in the Fund.

Respectfully submitted,



Robert L. Rodriguez, C.F.A.
President & Chief Investment Officer

April 21, 1998