

# LETTER TO SHAREHOLDERS

Dear Fellow Shareholders:

This Semi-Annual Report covers the six-month period ended March 31, 2001. Your Fund's net asset value (NAV) closed at \$10.97. Income dividends of \$0.19 and \$0.20 were paid on October 6, 2000, and December 28, 2000, to holders of record on September 29 and December 18, 2000, respectively. The January payment also included a \$0.08 capital gains distribution of which \$0.045 was long-term in nature.

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.

	<u>Average Annual Total Return</u>		
	<u>Periods Ended March 31, 2001</u>		
	<u>1 Year</u>	<u>5 Years</u>	<u>10 Years</u>

FPA New Income, Inc. (NAV) . . . . .	12.16%*	7.38%*	8.71%*
FPA New Income, Inc. (Net of Sales Charge) . . . . .	8.23%‡	6.61%‡	8.32%‡
Lipper Corporate Debt Fund "A" Rated Average . . . . .	10.77%	6.40%	7.70%
Lehman Brothers Government/ Credit Index . . . . .	12.41%	7.42%	8.06%

The Fund's total rate of return for the six months was 8.12%\* versus 6.88% and 7.71% for the Lipper Average and the Lehman Brothers Index, respectively. For the calendar year ended December 31, 2000, total returns were: FPA New Income, 9.32%\*; Lipper Average, 9.73%; and the Lehman Index, 11.85%.

## Commentary

Before discussing the current period's performance and outlook, beginning with this letter and each subsequent letter, we will add a new section of commentary that will highlight the thoughts of one of my associates that assists me in the management of your assets. Thomas Atteberry, who has worked with me for four years and has nineteen years of investment experience, will be the first contributor. I hope you will look forward to these additional insights as I do. It is our hope that you will become more acquainted, over time, with the other investment professionals who

work as a team toward a common goal of superior long-term investment performance.

Your Fund's performance continues to compare favorably to the Lipper Average and the Lehman Index over the various time periods indicated in the above table. Since 1984, your Fund has generally outperformed the bond market and other high-quality intermediate-term bond funds during periods of rising or stagnant interest rates while underperforming when interest rates are falling. This has not been the case for the three- and six-month periods ending March 31, 2001. Your Fund has dramatically outperformed the bond market and the Lipper Average during this timeframe. During the six months ended March 31, five and ten-year Treasury bond yields have fallen by 129 and 88 basis points, respectively (there are a 100 basis points in one percentage point). This led to returns of 6.88% and 7.71% for the Lipper Average and the Lehman Index, while your Fund returned 8.12%. The performance differential was even more significant for the three-month period ended March 31. Your Fund returned 5.68%, while the Lipper Average and the Lehman Index returned, 3.10% and 3.20%, respectively. We are gratified to be able to report this good news.

Your Fund's superior performance for this period was primarily a function of our large exposure to Treasury Inflation Protection Securities (TIPS), approximately 40% of the portfolio, and our selective holdings in high-yield corporate debt securities. Since December 31, the ten-year TIPS base yield has fallen 44 basis points versus 19 basis points for the ten-year Treasury nominal bond yield. Since the Federal Reserve began lowering the Fed funds rate on January 3, the ten-year TIPS yield has fallen significantly while the ten-year nominal Treasury bond yield has either remained unchanged or has risen. We believe the TIPS' superior performance was a result of their undervaluation versus nominal Treasury bonds. In addition, investors placed a greater value on the security's inflation call-option feature, since there appears to be a growing fear that the Federal Reserve's recent aggressive monetary easing may lead to a somewhat higher level of inflation longer term. High-

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

‡ Reflects deduction of the maximum sales charge of 3.50% of the offering price

yield bond exposure helped the Fund's performance, as the Fund benefited from sizeable price recovery gains in Conseco debt. As we explained in our September shareholder letter, we added to our Conseco holdings after a difficult performance period. We are now being rewarded for this decision. Your Fund also benefited from the sale or maturity of other high-yield or convertible bonds at substantial price premiums, despite the difficult high-yield bond market. High-yield bond selection does count.

Your Fund is currently defensively positioned, as reflected by its short modified duration of 2.99 years at March 31 versus 4.25 years at September 30 last year. This is our shortest duration since the fall of 1998. To reiterate, modified duration is a measure of how sensitive a portfolio is to changes in interest rates. The larger the duration number, the more sensitive the portfolio is to interest-rate changes. The Lehman Index's modified duration is 5.57 years and, therefore, it should be more volatile than your Fund. We are becoming more defensive since we believe we are not being compensated sufficiently, through a higher yield, for the various risks we believe exist. During the past several months, we have sold many of our long duration bonds and replaced them with higher coupon mortgage-agency securities of shorter duration. We have also allowed short-term liquidity to build. This is completely the opposite of what many other bond managers are doing. Investor optimism is quite high, regarding the benefits of a slower economy and the Federal Reserve's interest-rate lowering policy. According to the Bank Credit Analyst's March data, the average bond portfolio duration is close to the highs of the past seven years while "bullish" sentiment recently went to a new high for the same period. Obviously, we have a considerably different opinion, as reflected by our short modified duration.

As a result of the portfolio changes, at March 31, government/agency securities totaled 66.4% of net assets. AAA- and AA-rated securities, excluding cash and equivalents, totaled 0.3%. Short-term liquidity totals 18.3%. Convertible and high-yield securities, included in the less-than-AA category, totaled 15.0%.

In our September shareholder letter, we attempted to forecast the economic outlook for 2001. In a word, we were wrong. We were too optimistic about economic growth. Obviously, we did not see the economy falling off a cliff in October since our shareholder letter was dated October 15. This has been one of the sharpest and most unexpected falloffs in economic activity. I can say that we are in good company with many other less than prescient forecasters. Having said that, our inaccurate forecast did not preclude us from outperforming the bond market. We achieved this feat through security selection rather than interest-rate forecasting. Since 1984, this has typically been the case for your Fund. We learned a long time ago that it is far more difficult to forecast macro economic events than micro economic situations.

Still, we will humbly attempt to forecast the period into 2002. We continue to believe that we are in a profit recession rather than an economic recession. Analysts in general have been far too optimistic about earnings growth for this year as well as next year. Only recently has the consensus expectation for S&P earnings growth for 2001 fallen to zero versus a view of 12-15% growth for 2001 held late last year. We consider this new forecast also optimistic. Our forecast of profit growth is more negative while our economic growth outlook is somewhat more optimistic. We still believe the U.S. economy is far more resilient than the consensus believes. The wild card is the consumer. If the consumer continues to spend, the economy should remain reasonably stable or begin to gradually improve. If consumer confidence falls materially further and this leads to a contraction in consumer spending, all bets are off. We believe the Fed has been lowering rates rapidly so as to support consumer confidence. We do have our anxieties since we are unable to quantify the potentially harmful side effects of a decline in consumer wealth from the collapse in stock prices. There is a raging debate as to whether the economic recovery will be "V"- or "U"-shaped. Those who are forecasting a "V"-shaped, i.e. rapid, recovery, are being heavily influenced by the Federal Reserve's earlier interest-rate cuts as well as

by possible future reductions. Furthermore, they see a tax cut adding to this positive trend. As we said, we are not as optimistic. We think the odds favor a more prolonged period of slower economic growth because of eroding corporate profit margins. Higher employment cost, medical expenses, rising depreciation expense and lower operating rates are likely contributors to these reduced profit margins, which should negatively impact corporate capital-spending intentions. This is particularly true for the technology sector and is significant since the primary driver of U.S. capital spending during this past economic cycle has been expenditures for technology equipment. We do not believe the economy will recover as quickly as it did after the Asia crisis in 1998.

Our cautious view on capital-spending intentions stems from the belief that these interest-rate reductions will have only a marginal impact on corporate capital-spending plans. We believe we are on the backside of what was a very long capital-spending cycle and, therefore, these lower rates will only modestly influence capital-spending intentions since the excess capacity that has developed will have to be reduced or grown into before a new up-cycle can emerge. The positive side of this negative argument is that a major portion of this past capital-spending cycle was centered in the far shorter life-expectancy areas of technology. Our best guess is that it may take two years to work off a large portion of the excesses of this past cycle.

Some might argue that, if we have such a cautious economic growth outlook, why are we not more optimistic concerning the high-quality segment of the bond market, especially longer term Treasury securities. We still believe that inflation expectations are too low and that there is a growing risk to the value of the dollar. We have a record current account deficit that makes the U.S. economy very dependent on the importation of foreign capital. Should this flow lessen, it could have a negative effect on the dollar's value. Should the dollar weaken versus the Euro, this could put upward pressure on our interest-rate levels. Tom Atteberry and I are currently investigating potential low-risk investments to counter a weak dollar that would partially protect the value of your Fund's

assets. Given these thoughts, your Fund is strategically positioned to be able to take advantage of several market sectors, should opportunities present themselves. Now I would like to introduce you to Tom Atteberry's investment thoughts.

### **Thomas Atteberry's Investment Commentary**

We always strive to take advantage of market dislocations and profit from other investors' overly optimistic or pessimistic behavior. During the last six months, the high-yield segment of the domestic bond market experienced poor performance as investors fled the area, despite historically attractive yield and valuation levels. In the prior two periods where this occurred, calendar year 1990 and the fall of 1998, investors, and your Fund, were well rewarded for increasing their exposure to this segment of the bond market. Currently, circumstances appear to be different enough to warrant a less aggressive approach in entering the high-yield or credit-sensitive segments of the bond market.

The fundamental financial characteristics of bonds within the high-yield bond market have changed over the past decade, resulting in considerably riskier credit profiles. Typically, these newer high-yield bonds are from companies that are less seasoned and more entrepreneurial in their business characteristics. The proceeds from debt issuance have been used to build infrastructure and fund growth versus the purchase of existing assets in an ongoing business. In the past, the debt structures were comprised of senior claims on a company's assets compared to subordinated claims today.

As a result of these changes, newer issues of high-yield debt have lower and less seasoned cash flows available to pay interest costs and repay the debt along with fewer, if any, assets to support the bond's value in the event of a liquidation. An example of the impact of lower asset protection is that, at the height of the 1990 recession, the average principal loss on a high-yield bond default was 68% while in 2000 it was 76%.

There has been a dramatic shift in the composition of the high-yield market within the past three years.

The telecommunication sector's share has increased from 10% in June 1997 to approximately 23% in June 2000, according to Bear Stearns & Co., Inc. Companies focusing on newer communication technologies were raising sizeable amounts of debt capital to fund the new infrastructure building that was required to attract customers. These types of companies, along with several others, financed their operations with large amounts of debt, when they should have used more equity. Therefore, a far greater percentage of high-yield bonds look more like the equity position in a corporation's capital structure.

It is this migration of high-yield bonds toward equity-like characteristics that concerns us. Over the intermediate term, corporate profit margins are likely to be squeezed by rising costs, a difficult pricing environment and slower economic growth. This should lead to a drop in debt coverage ratios; therefore, at current yield levels, the market does not appear to be pricing in some of these potential risks. We believe that we will need to be even more discriminating in our selection and investment in high-yield securities.

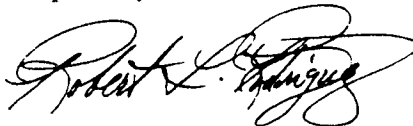
A potential alternative to the straight high-yield market is the "busted" convertible-bond sector. These are securities where the bond prices have fallen, because of a declining share price, to a level similar in yield to a high-yield bond. They can have a similar credit position to that of a high-yield bond within a company's capital structure while having the added benefit of participating in the underlying stock's price appreciation. We also find that some of these convertible securities have yields competitive with high-yield bonds while having a shorter maturity.

Because of our cautious view towards corporate profitability growth, we expect the less-than-AA portion of the Fund, primarily high-yield and "busted" convertible bonds, to remain below the maximum allocation of 25% for the near term. We are maintaining our financial flexibility so as to take advantage of any dislocations that might occur within the high-yield/"busted" convertible market. Potential investments will be companies that hold a significant market share within their industry and have the

financial strength to survive and prosper in a more difficult profit environment. We see potential opportunities within the industrial, technology and consumer non-durable segments of the high-yield "busted" convertible-bond market. We plan to be opportunistic but cautious in the deployment of your capital.

With those closing comments, we thank you for your continued investment and support.

Respectfully submitted,



Robert L. Rodriguez, CFA  
President & Chief Investment Officer

May 4, 2001