LETTER TO SHAREHOLDERS

Dear Fellow Shareholders:

This Semi-Annual Report covers the six-month period ended March 31, 2007. Your Fund's net asset value (NAV) closed at $11.00. Dividends of $0.15 and $0.11 were paid on October 5 and December 22, 2006, to holders of record on September 29 and December 15, 2006, respectively. There were no capital gains distributions.

The following table shows the average annual total return for several different periods ended on March 31, 2007 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, 2007				
	1 Year	5 Years	10 Years	15 years	20 Years
FPA New Income, Inc. (NAV)	5.46%*	4.02%*	5.94%*	6.83%*	7.78%*
FPA New Income (Net of Sales Charge)	1.77%**	3.28%**	5.56%**	6.57%**	7.59%**
Lipper A-Rated Bond Fund Average	6.07%	5.18%	5.85%	6.44%	7.16%
Lehman Brothers Government/Credit Index	6.38%	5.57%	6.51%	6.78%	7.32%

The Fund's total rate of return for the six months was 2.51%* versus 2.61% and 2.53% for the Lipper Average and the Lehman Brothers Index, respectively. For the calendar year ended December 31, 2006, total returns were: FPA New Income, Inc., 4.79%*; Lipper Average, 3.87%; and the Lehman Index, 3.78%.

Commentary

What a boring six months this has been for the bond market. There has been much talk about Federal Reserve policy changes that change direction almost weekly, if not daily. One day the talk is how strong the economy is and the next it is about the unfolding weakness. Had you gone to sleep on September 29, the ten-year and two-year Treasury bond yields were 4.63% and 4.69%, respectively; while on March 30, they were 4.65% and 4.58%. Therefore, there was not much change for this period. There has been a lot of churning between 4.5% and 5% for both of these maturities, but we essentially ended up where we started.

Because of this narrow band of yield changes, there was little opportunity to add much in the way of value from a shift in portfolio maturity. One would have had to trade these small variations quickly. This is not our style nor do we believe that it is what an investment manager should do. Trading quickly is just another form of speculation. Because of this environment, your Fund essentially performed in line with the Lipper Average and the Lehman Brothers Index.

While all this inactivity was taking place, we were actively adding securities so as to maintain your Fund's average duration. At March 30, it was 1.00 years versus the September 30 duration of 0.98 years. We have added additional mortgage securities with effective maturities between two and three years; however, these are being added at a rate that matches the maturing of similar term securities. With the Fed Funds rate currently at 5.25% and the two-year yield at 4.65%, we have waited for periods when the two-year yield rose closer to the Funds rate to add some duration; however, these opportunities have been infrequent. Unless we can add securities that yield greater than money markets, approximately where the Fed Funds rate is presently, we see little reason to give up yield while accepting more volatility risk. Unless we get a major lowering in the level of interest rates, we see other funds taking on considerably more volatility risk for little, if any, yield advantage. Furthermore, we are unwilling to accept virtually any credit risk since credit spreads are quite narrow. The yield increment that we would earn over like-maturity Treasury securities by purchasing low investment grade rated securities is insufficient, in our opinion, for the credit risk one must accept. We are in a period where "risk" does not seem to be of much concern to

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

** Reflects deduction of the maximum sales charge of 3.5% of the offering price.

either investment managers or investors in general. We will address this point later in the letter.

We are of the opinion that a higher level of credit quality should be maintained in the current economic and investment environment. In light of this, we have continued to reduce our exposure to high-yield (junk bonds) securities. As of March 31, they represented 1.67% of the portfolio versus 4.45% at September 30, 2006. One of our remaining high-yield securities, Metaldyne, has been a major winner, thus, we are reducing our holding. Tom Atteberry did an excellent job on this one and we are the better for it. When it is gone, the Fund will barely have 1% invested in high-yield securities. We see virtually no value in this sector, given the very narrow yield spreads that exist versus Treasury securities. Investor confidence is extremely high; therefore, many are willing to stretch for additional yield beyond that which is available in the Treasury or mortgage sectors.

Your Fund has not and will not stretch for yield. It is at its highest weighted average credit quality ever, with securities rated AAA or higher representing 83% of the Fund while AA securities account for another 15%. Within these numbers, we have included the underlying credit grades of the commercial paper securities that we own. Money market securities represent 36% of the Fund. Government/Agency securities total 56% and are included in the 83% total.

At the beginning of last year, we expressed a cautionary economic outlook, especially for the second half of the year. We believed that economic growth was likely to decelerate into the 2% range, accompanied by inflation pressures. This outlook proved to be reasonably accurate, but it did not get reflected within the bond market. We cautioned about the likelihood of a housing slowdown, with problems developing in the sub-prime housing finance segment. We thought that, should these events unfold, credit risk fear would start to re-enter the psyche of the bond market. This did not occur. We do not believe that we were wrong, only a little early. Recent economic data has confirmed that economic growth is continuing to decelerate along with a slowdown in corporate earnings growth. This is the scenario that we thought would unfold in the fourth quarter of 2006, but it looks like it is just now beginning to gain momentum on the downside. With preliminary first quarter real GDP growth of 1.3% and S&P 500 earnings growing at 5% or less, this is decidedly different trend than in the second half of 2006. We expect this trend to continue throughout this year.

Our main focus continues to be the protection of your capital since we do not believe that we are being adequately compensated to take much in the way of credit or interest rate risk. Until we believe the odds are in our favor, we will continue our defensive posture. We have maintained a defensive posture for more than four years. Because of this, your Fund's total return for the five-year period ended March 31, 2007 does not compare well. Over the four-year period ended March 31, 2007, your Fund compares very well with a 4.36% total return versus a 3.70% total return for the Lehman Brothers Index. We were a little early in getting defensive, but we still believe that this will serve you well in the long-run since we see little value in long-term Treasury securities with a 4% yield handle. We see no reason to change our fundamental position that we took when we wrote "Buyers-Strike" in June 2003.

Special Commentary

Nearly two years ago we began discussing the risks in the sub-prime area and then went on to mention an area referred to as Alt-A. We were of the opinion that the lack of underwriting standards would come back to haunt the sub-prime area. At the beginning of last year, we forecast that the sub-prime sector was likely to come under duress in the second half of 2006 and that this was likely to hurt the economy and the housing sector into 2007. As it developed, the process really did not get going until December and then picked up steam in February 2007. There have now been over 50 sub-prime organizations that have been taken over or have filed for bankruptcy since the end of November. The second largest, New Century Financial, has filed for bankruptcy, while the largest, HSBC Holdings Plc, has fired the senior management of its U.S. operations that included the sub-prime credit operation, the former Household International Inc.

Fear of a general contagion from the sub-prime fallout has worried the financial markets and especially

the housing sector. So far, the general belief is that it will be contained. Federal Reserve Chairman Bernanke said that the fall-out from "the sub-prime markets seems largely to be contained." We are not so sure. In 2005, we reviewed three mortgage-backed securities that we owned in FPA New Income. What caught our attention was that they were exhibiting an elevated rate of delinquency and foreclosures, while being barely nine months seasoned. This did not seem to make sense to us since these securities had high FICO scores (710-720). They were Alt-As and we did not understand what was going on, but we were unwilling to stay around to find out, so we sold them without any trouble. At the time, I had conversations with others who noticed these same trends. They were cautious in their outlook toward this sector as well. Now we are witnessing a growing concern regarding Alt-A securitizations. The April 3, 2007 *Wall Street Journal* reported that M&T Bank Corp. shares, in which Berkshire Hathaway Inc. is a big investor, declined 8.5%. The company announced that it was having trouble selling their Alt-A loans and thus, they would keep the loans, "a move that could knock about $7 million off its first-quarter earnings." In another article that same day, SouthStar Funding LLC, an Atlanta lender, announced that it would be closing down because the type of loans that it originates, Alt-A, are experiencing the same problems as sub-prime. Alt-A loans are loans that are supposed to be of a materially higher credit quality level than sub-prime and can have characteristics that are equal to prime mortgage loans.

As we researched this area, we ran across the First American Real Estate Solutions report, "Alt-A Credit—The Other Shoe Drops?" In it the data shows how far the underwriting quality has deteriorated since 2003. The report details how ARM loans have escalated from 1.7% to nearly 70% of total originations, with low documentation rising from 58% to nearly 80%. Furthermore, between 2002 and 2006, IO (interest only) loans rose from 7.7% to 35.6%, of total loans, while negative amortization loans grew from 0.4% to 42.2%, respectively. I could go on but the data obviously demonstrates the deterioration in underwriting standards.

Why are these two areas important? Sub-prime and Alt-A originations accounted for nearly 40% of total mortgage loans in 2006. The hunger for housing on the part of the individual, along with the hunger for profits by the originating organizations, created a perfect storm for excesses to develop. In our opinion, all of this is a direct result of the Federal Reserve's misguided interest-rate policy that led to the steepest yield curve ever. It helped to create a housing bubble of massive proportions that then encouraged buyers and lenders to speculate. The development of liar loans, i.e., low or no documentation loans were able to proliferate because everyone knew that home prices only went up. All of this would not have been possible without the development of the securitization market. The development of sub-prime ABS securities allowed many organizations to rapidly grow their origination base with the goal of selling these securities into the secondary market and, as such, sub-prime loans grew from slightly less than 5% of mortgage origination in 2001 to nearly 20% in 2006. With the easing of credit standards and the ability to sell these securities into the secondary market, an excess demand for housing was created.

I go through this long discussion since there is quite a bit of debate as to how big and how long the housing downturn might be. There are questions as to how much, if any, house price depreciation might occur. I have seen various studies try to estimate what the decline in home prices might be. These estimates generally range in the 10% to 20% area; however, Robert Shiller of Yale estimates that, if housing were to come back into alignment, after adjusting for inflation and the expansion in the average size of a home, the price adjustment would have to be approximately 45%. This may all sound a bit extreme since there has not been an annual decline in the national average price of a home in the post-WWII period.

My associates and I wondered, how might a house price decline affect the models that rating agencies use in determining the credit rating of a mortgage-backed ABS? On a conference call with Fitch on March 22, Fitch presented its assessment of the sub-prime ABS market. During the question-and-answer period, my associate, Tom Atteberry, asked the

question, "What are the key drivers in your credit rating model?" Fitch responded that it would be the FICO score along with the assumption that home price appreciation (HPA) of low- to mid-single digit would continue, as it has for the last fifty years. Tom then asked, "What would happen to your model if HPA were flat?" They responded that the model would start to break down. If HPA were a negative 1% or 2%, the model would completely breakdown. Thus, if forecasts of 10% to 20% declines in home prices were to occur over a ten-year period rather than one or two, the model that Fitch uses would breakdown and various securitizations with credit ratings of AA or even AAA would experience considerable difficulty. This aspect of risk is not factored into the market today.

The potential of a breakdown in the rating agency models has serious implications for various types of financial institutions and debt origination structures. It could potentially strike at the confidence in the rating agencies themselves. My associate, Julian Mann, has been studying the area of sub-prime and rating agency involvement. He recently showed me a very garden variety Libor sub-prime floating rate security. The Standard & Poor's pricing service valued this bond at par while on March 19, 2007, Moody's rated this bond A3. To affirm the accuracy of this bond's pricing valuation, Julian went to two brokerage firms that traffic in this type of security and requested what might their bid be, if we were to request a bid. One responded that it would likely be in the $7 area. This does not mean 70% of par but 7% of par, a differential of nearly 93% between what the Standard & Poor's pricing service indicated and what might occur in the actual market. The other firm declined to indicate a bid but did say that the 7% of par bid was probably the correct one. Julian is continuing to investigate this area to determine whether this is an isolated occurrence or whether this may be the tip of something even larger. It does raise a serious question in our minds.

Since the conference call with Fitch, there has been a heightened level of discussion by many of our elected representatives as well as from some of the federal agencies. On April 12, Congressman Barney Frank of Massachusetts suggested that mortgage bond investors should be held liable for deceptive lending practices. This was followed up on April 17 when FDIC Chairman, Sheila Bair, said that mortgage investors failed to do due diligence before buying all these mortgages and that "everybody needs to share the pain." Should any of these misguided comments create the environment to legislate this type of liability, I can assure you that less capital will become available for mortgage loans. This I can say with absolute certainty in the case of the Funds we manage at First Pacific Advisors.

One additional risk to the sub-prime and possibly the Alt-A and other credit ABS structures is that the credit pipeline has gotten very extended between the providers of capital and the borrowers of capital. With so many different entities between borrower and lender, and with each taking their fractional share of fees, the discipline of the credit underwriting process can become tenuous since the loan is being passed on to another entity. In this case, should the borrower get into trouble, the ability to manage or restructure the loan terms becomes more difficult as these loans are securitized. It is estimated that approximately 75% of all sub-prime loans have been securitized so that a modification of the loan terms may be restricted by the prospectus or legal agreements. With many of these loans held in CDOs (collateralized debt obligations) that are owned by distant third parties, an effective loan restructuring is difficult, if not nearly impossible. This is a decidedly different scenario than what happened in the last credit contraction of 1990-93. Back then, most loans were held in a portfolio by the originating organization and, therefore, a loan restructuring could be done more easily. It will be interesting to see how these new structures operate and how they might affect the economy in a credit contraction. For the past two years, we have been weeding out any questionable loan-structured securities in the portfolio.

Should the economy experience a reduction in job growth or the beginning of a rise in the unemployment rate, this could accelerate the negative price adjustment in housing and further cause a weakening in consumer disposable income and spending. Any weakening in employment would also

occur at a time when between $1.1 and $2.2 trillion in mortgages will be subject to rate resets this year, according to The Bank Credit Analyst. We feel the risks of this negative scenario are rising, but this risk is not being factored into valuations in the stock market or into credit spreads in the bond market. Again, the word "risk" does not seem to be in the vocabulary of many investors.

Outlook

We expect that economic growth will be quite slow this year, as the unfolding housing market challenges affect consumer and business psychology. The key will be whether employment and wage growth continue or whether we will see a rising unemployment rate. We are of the opinion that employment growth is in the process of slowing and that it will become more difficult, as the year progresses. In light of this, we see the odds rising that the Fed will begin to lower the Fed Funds rate, with our best guess being that this process will likely start around September and that the Fed will be initially quite measured because of its inflation focus. Given the price action of commodities last year, we expect to see rising CPI inflation in the second half of this year; thus, the Fed faces the prospect of slowing economic growth accompanied by rising CPI inflation.

Should the housing issue worsen, we could then see the Fed becoming more proactive to stem the tide of a credit or housing crisis. In that case, the Fed Funds rate could fall considerably more. We would expect the debate to then shift to one of what will the yield-curve look like. If the Fed Funds rate is lowered 75 to 100 basis points, where will longer term Treasury bond yields be? The simple response would likely be one that they will fall too, with the debate being whether yields will decline into the low 4% or 3% range. This is a complex issue since our yield levels are likely to be influenced by what develops overseas. With more than half the Treasury bonds owned by foreigners, they would likely compare those yields to what they could earn in their own country bonds. This is especially true for Euro denominated securities.

We are concerned that, if our longer term Treasury yields fall to or below those in Europe, we could see the partial unraveling of the yen-carry trade. This is a strategy where speculators borrow in yen, because of the low interest cost, and then invest the proceeds in Treasury-denominated securities. Depending upon the amount of financial leverage utilized in this type of strategy, a movement back into the yen or a shift from dollar-denominated securities into Euro-denominated securities could likely negatively affect Treasury bond values.

Given these concerns, housing credit issues and international financing risks, we do not believe that longer term Treasury yields, in the 3% or 4% range, compensate us sufficiently to risk your capital. Should Treasury bond yields fall, despite our point of view, this would likely have serious ramifications for the high-yield bond market as well as for the securitization market. We will patiently wait for better investment opportunities. Now Tom Atteberry will convey his thoughts.

Thomas H. Atteberry Commentary

What are the areas in which we have committed capital when the yield on Treasuries approaches 5%? Specifically, we have concentrated on two ideas within the mortgage sector. In each case the portfolio allocation over time may approach 10%. This is not unlike the 30 year amortization Agency mortgage pools with 6.5% coupons purchased a year ago.

The first idea, which is about 50% complete, is to invest in 6% coupon 10 year amortization Agency mortgage pools. The characteristics of these mortgages make the investment very attractive. The loan size is approximately $150,000, the purpose of almost all the loans was to refinance an existing mortgage, and the loan-to-value ratio is about 50%. This means the homeowner has $150,000 of equity in a home valued at $300,000. This high level of equity combined with the refinance purpose leads us to believe that the homeowner is intent on owning the home free and clear. It is this assumption that gives us comfort that the possibility of the homeowner refinancing again is limited, somewhat reducing the prepayment risk of these loans. This should enable the portfolio to earn the 6% coupon interest for a longer period of time. To date, the yield to maturity of these pools at the time of purchase has been between 5.27% and 5.52%.

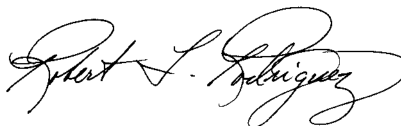
The next idea is a little more complex but still a low risk investment in our view. During late 2005 and into 2006 homeowners expanded their use of mortgages with more intricate features in order to afford the home purchases. One such conservative option was an Agency underwritten 7/1 adjustable rate mortgage. An Agency underwritten loan will have full documentation and require a cash down payment. The 7/1 feature is one where the interest rate on the loan is fixed for seven years and then converts to a one year adjustable rate loan for its remaining life. These loans also tend to be interest only payments for the first seven to ten years of the loan. Given the 30 year term of these loans, not receiving principal payments in the early life of the loan has a minimal impact on the average life of the loan.

The characteristics can lead an investor to expect that these types of loans also have a more limited refinance potential. This is further supported by tightened lending standards in wake of the sub-prime mortgage problems. The loan-to-value of these loans tends to be between 80% and 85%. The interest only feature and slightly lower interest rate associated with the 7 year fixed term tends to reduce the monthly payment to an affordable level for the borrower. The credit score of these borrowers, or FICO Score, is in the 690 to 710 range which is at the low end of the prime range. Earlier in Bob's commentary he talked about the potential for home price depreciation. If this does occur, or at best if home prices just stay flat, it will further limit the ability of these loans to be refinanced. The range of yield to maturity for these purchases has been between 5.40% to 5.58%.

Finally, we may return to the 30 year amortization Agency mortgage pools with 6.5% coupons that we purchased last year. They provided a return for the Fund that outpaced both the benchmark and the mortgage sector of the market in general. The idea would be to return this portion of the portfolio to about a 10% allocation. The capital to make all the investments discussed above would come from the current money market allocation in the portfolio.

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

Respectfully submitted,



Robert L. Rodriguez, CFA
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April 29, 2007

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FORWARD LOOKING STATEMENT DISCLOSURE

As mutual fund managers, one of our responsibilities is to communicate with shareholders in an open and direct manner. Insofar as some of our opinions and comments in our letters to shareholders are based on current management expectations, they are considered "forward-looking statements" which may or may not be accurate over the long term. While we believe we have a reasonable basis for our comments and we have confidence in our opinions, actual results may differ materially from those we anticipate. You can identify forward-looking statements by words such as "believe," "expect," "may," "anticipate," and other similar expressions when discussing prospects for particular portfolio holdings and/or the markets, generally. We cannot, however, assure future results and disclaim any obligation to update or alter any forward-looking statements, whether as a result of new information, future events, or otherwise. Further, information provided in this report should not be construed as a recommendation to purchase or sell any particular security.