

# LETTER TO SHAREHOLDERS

Dear Fellow Shareholders:

This Annual Report covers the fiscal year ended September 30, 1997. Your Fund's net asset value (NAV) per share closed at \$11.24. During the fiscal year, income dividends totaling \$0.68 and a \$0.05 short-term capital gains distribution, were paid.

The following table shows the average annual total return for several different periods ended on that date for the Fund and several comparative indices. 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 September 30, 1997		
	1 Year	5 Years	10 Years
FPA New Income, Inc. (NAV) . . . . .	9.54%*	8.27%*	10.37%*
FPA New Income, Inc. (Net of Sales Charge) . . . .	4.61%‡	7.28%‡	9.86%‡
Lipper Corporate Debt A Rated Fund Average . . .	9.60%	6.70%	9.34%
Lehman Brothers Government/ Corporate Bond Index . . . .	9.60%	6.95%	9.42%

The Fund's total rate of return for the fiscal year, which reflects the change in NAV combined with the reinvestment of dividends and distributions paid, was 9.54%\* versus 9.60% for both the Lipper Average and Lehman Brothers Government/Corporate Bond Index, respectively. The second half fiscal year total returns were: FPA New Income, Inc., 6.08%\*; Lipper Average, 7.14%; and the Lehman Brothers Index, 7.27%. Finally, on a calendar year-to-date basis, the total returns were: FPA New Income, Inc., 6.67%\*; the Lipper Average, 6.28%; and the Lehman Brothers Index, 6.35%.

## Commentary

Your Fund has recently underperformed both the Lipper Average and the Lehman Index. Over the past year its performance has been average. This is frustrating for us as your Fund is typically among the top performers in its category. Why has this occurred? The short answer is that we have positioned your Fund more defensively than the average fund or the Lehman

Index. We have done so because we believe that we are not receiving sufficient compensation to take on either credit risk or maturity risk. The following commentary outlines why we are employing this strategy.

The yield curve is very flat today. This means that one does not gain much additional yield for the risk of investing in longer term bonds. Recently, the ten-year Treasury bond yield fell to 5.85%. At that level, it provided only 35 basis points (there are 100 basis points in one percentage point) more yield than we are currently earning on three-month commercial paper. Unless a strong argument can be made for significantly lower short-term rates, we cannot see longer term bond yields falling much lower.

For almost four years, we have argued that long-term Treasury bond yields were likely to remain most of the time within a range of 6.25% to 7.50%. During this past year, this range narrowed to 6.25% to 7.25%, with yields generally below 6.625%. Because of the low level of yields, we were unwilling to extend the portfolio's average maturity. When yields were higher than 7%, we did purchase longer term securities. The rewards from this strategy have been minimal, due to the short duration and infrequency of bond market declines and the rapid growth of your Fund. The Fund's rapid growth diluted the maturity extension strategy.

This defensive portfolio strategy has been a direct result of our belief that economic growth was likely to be faster than consensus expectations, as we discussed in our September 1996 Shareholder Letter. During the past year, real gross domestic product grew at a rate of approximately 4.0%, a level that was about 60% faster than the consensus forecast. In light of this, we would have expected bond yields to have been biased upwards, but this was generally not the case. We also anticipated that various measures of wage inflation would be accelerating by now. The national unemployment rate continues to hover around a twenty-five-year low. We do see pockets of wage pressures, but these have not yet significantly impacted the total wage inflation numbers. We still believe, however, that pressures are building in

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

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

this area. Our own direct contacts with companies indicate a growing level of labor pressures, which show up as either higher compensation demands or, more commonly, as a difficulty in finding and attracting qualified personnel. More industries indicate that these are growing challenges. For example, during the past twelve months, the labor pool grew by approximately 1.6 million, while annual job creation was at 2.7 million. This trend cannot continue indefinitely without higher wage demands developing on a much wider scale.

We feel we may have misjudged the environment in terms of comprehensive measures of inflation. Various indexes of inflation, such as the Consumer Price Index or the Producer Price Index, remain benign. There has been widespread speculation as to why this has been the case. Productivity improvement and foreign competition frequently have been cited as the principal reasons for the diminished levels of inflation. We believe both of these are rather soft explanations. There is very little question that there has been a reduced level of pricing power in broad areas of the economy. The test will come as we reach high levels of capacity utilization of resource inputs. The September Capacity Utilization Rate was at 84.4%; the highest level since January 1995, a period that followed Federal Reserve monetary tightening. Essentially, the inflation debate boils down to whether longer term it will be at the 2-2.5% or 3-3.5% level. We seek longer term yields high enough in order to win under either inflation scenario. This is a typical element of our investment philosophy of "winning by not losing."

During the last week of October, global financial markets were rocked by the events emanating from the Asia/Pacific region. Several stock markets collapsed. Currencies that were previously linked to the dollar have been now set free to fall to more realistic exchange values. This has resulted in an upward escalation in interest-rate levels in those countries. A growing number of analysts expect a slowing in global economic growth, as a result of these economic dislocations. It is expected that these countries will use their depreciated currency values to increase their exports; their cheaper exports may help to contain any inflation tendencies in the system. It is estimated that non-Japan Asia accounts for 23% of global gross domestic product. If China and India are excluded, the Asian weight drops to 7.3%. Though significant, it does not appear to be catastrophic. By way of comparison, Latin America accounts for 9% of world GDP. Unless this economic chaos spreads to other regions, we see only a limited impact on the world economy.

We do think this economic disruption will likely lead to a period of somewhat lower yield levels in the

near term. During periods of economic uncertainty, foreigners view the U.S. as a safe haven for their capital. U.S. bond yields can be temporarily depressed because of this flight capital. During a later stage, central banks of the troubled regions are likely to liquidate portions of their Treasury holdings so as to support their own domestic economies. This process can place upward pressure on the level of Treasury yields.

In light of the above, we are somewhat torn as to what the appropriate yield range will be going forward. We think the odds have increased that longer term Treasury yields will be contained in a new 6% to 7% trading range for possibly the next year to eighteen months. We think it will be difficult to sustain longer term yields below the 6% level because of the current level of short-term rates. We do not think Federal Reserve chairman Alan Greenspan will lower short-term rates, in response to the international situation in Asia. The Fed did not do so when Mexico had its problems a few years ago. With a strong economy experiencing low unemployment rates, we do not think Greenspan would risk re-igniting a potential demand-pull inflation with an easier monetary policy. Longer term rates may again be biased slightly upward. A potentially higher level of rates could occur as a result of renewed foreign economic growth, challenges from the recently enacted budgetary agreement, and the before-mentioned tight labor markets. Please note that virtually all of the major expenditure cuts in the budget agreement do not occur until the final two years—2001 and 2002. Major changes in entitlement spending are still required in order to achieve long-term budgetary integrity. Without them, we are in only a temporary period of budgetary calm.

Despite this long discussion of the macro-economic environment, we continue to focus on selecting individual securities one at a time. The largest addition to the Fund, approximately 10% of total assets, was a ten-year Treasury Inflation Index Bond. This bond has severely underperformed its ten-year nominal Treasury counterpart, since its introduction last February. During this period, the ten-year nominal yield bond declined about 50 basis points while the inflation index bond yield rose 35 basis points. As a result, we believe the inflation index bond's embedded call option on inflation has become very cheap and, thus, these securities should provide excellent principal protection, if fears of renewed inflation return. Furthermore, the combined yield and inflation accrual will also protect the portfolio from any decline in short-term interest rates. We also added to some of our existing less-than-investment-grade holdings. We are being very cautious in this area because yield spreads are the narrowest they have been since the

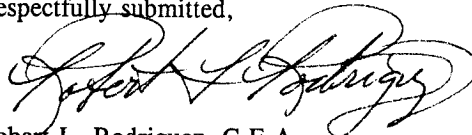
beginning of the decade. We did add one new high-yield holding, the senior debt of restaurant holding company Flagstar. The company is currently in bankruptcy, but will exit with a dramatically improved balance sheet and interest coverage ratios some time later this year. At the price paid for them, we will collect what should be an 11% cash yield and have the opportunity for capital appreciation.

The portfolio continues to maintain a high-quality asset mix. Government/Agency securities total 62% with 75% of these being agency mortgage-backed securities. An additional 4% is invested in AAA mortgage-backed securities. High-yield and convertible securities represent 6% and 5%, respectively. Short-term liquidity totals 21%. On September 30, the Fund's duration was 3.85 years versus 4.87 years at March 31. (The lower the duration number, the more defensive and less volatile

a portfolio is.) By comparison, the Lehman Index's duration is 5.2 years.

Before closing, I would like to introduce you to a new member of our management team, Tom Atteberry. He joined us earlier this year from Fifth Third Bank of Ohio, where he was the head of fixed income investment. He has over fourteen years of investment experience. We look forward to his future contributions. Finally, we wish to thank all of our shareholders for their support and investment in the Fund.

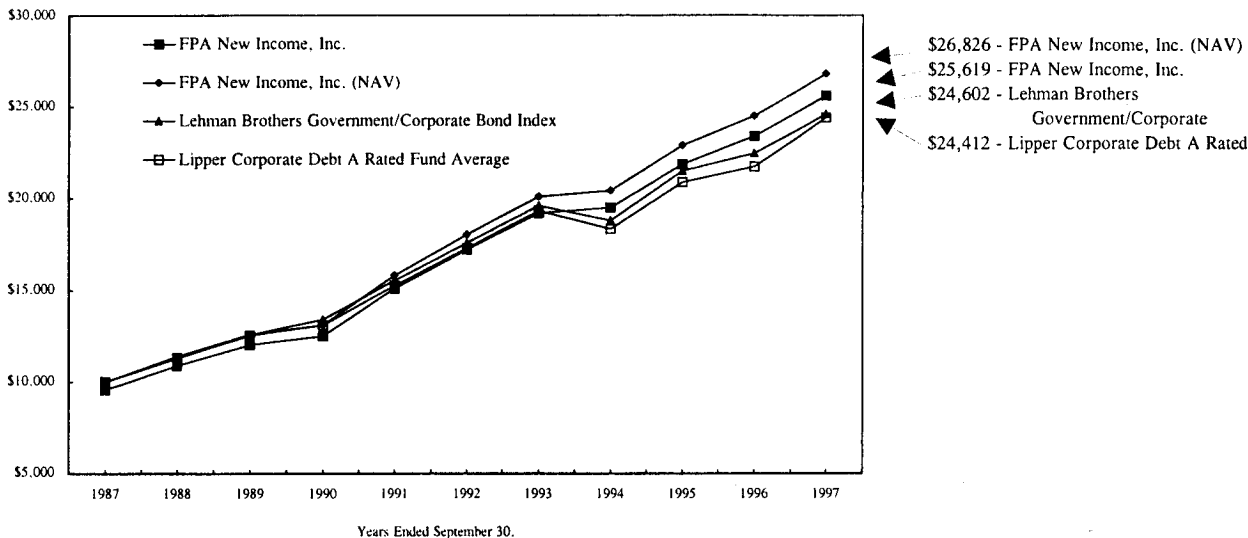
Respectfully submitted,



Robert L. Rodriguez, C.F.A.  
President & Chief Investment Officer, October 31, 1997

## HISTORICAL PERFORMANCE

*Change in Value of a \$10,000 Investment in FPA New Income, Inc. vs. Lehman Brothers Government/Corporate Bond Index and Lipper Corporate Debt A Rated Fund Average from October 1, 1987 to September 30, 1997*



Past performance is not indicative of future performance. The Lehman Brothers Government Corporate Bond Index is a broad-based unmanaged index of all government and corporate bonds that are investment grade with at least one year to maturity. The Lehman Brothers Government Corporate Bond Index does not reflect any commissions or fees which would be incurred by an investor purchasing the securities it represents. The Lipper Corporate Debt A Rated Fund Average provides an additional comparison of how your Fund performed in relation to other mutual funds with similar objectives. The Lipper data does not include sales charges. The performance shown for FPA New Income, Inc., with an ending value of \$25,619 reflects deduction of the current maximum sales charge of 4.5% of the offering price. In addition, since investors purchase shares of the Fund with varying sales charges depending primarily on volume purchased, the Fund's performance at net asset value (NAV) is also shown, as reflected by the ending value of \$26,826. The performance of the Fund and of the Averages is computed on a total return basis which includes reinvestment of all distributions.