

# LETTER TO SHAREHOLDERS

Dear Fellow Shareholders:

This Annual Report covers the fiscal year ended September 30, 1999. Your Fund's net asset value (NAV) per share closed at \$10.77. During the fiscal year, your Fund distributed income dividends totaling \$0.71. The December 29, 1998 payment also included a \$0.06 capital gains distribution of which \$0.05 was long-term in nature.

The following table shows the average annual total return for several different periods ended September 30 for the Fund and 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, 1999		
	1 Year	5 Years	10 Years
FPA New Income, Inc. (NAV) . . . . .	3.87%*	7.52%*	8.83%*
FPA New Income, Inc. (Net of Sales Charge) . . . .	(0.80)%‡	6.53%‡	8.33%‡
Lipper Corporate Debt A Rated Fund Average . . .	(2.19)%	7.01%	7.66%
Lehman Brothers Government/ Corporate Bond Index . . . .	(1.62)%	7.77%	8.08%

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 3.87%\* versus -2.19% and -1.62% for the Lipper "A" Rated Bond Fund Average and Lehman Brothers Government/Corporate Bond Index, respectively. For the second half of the fiscal year, the total returns were: FPA New Income, Inc., 2.34%\*; Lipper Average, -1.25%; and the Lehman Brothers Index, -0.57%. Finally, on a calendar year-to-date basis, the total returns were: FPA New Income, Inc., 3.67%\*; the Lipper Average, -2.18%; and the Lehman Brothers Index, -1.75%.

## Commentary

Your Fund's relative performance has improved significantly during this past fiscal year. A dramatic turnaround in performance occurred because we were unwilling to risk your capital last year at yield levels

that we believed did not compensate us for the risk involved. During the previous fiscal year, it was very frustrating for us to watch the better investment returns of other high-quality bond funds. Despite this frustration, our investment discipline would not allow us to play the game of chasing yields to lower and lower levels. As a result of the recent relative performance recovery, your Fund has outperformed the Lipper Average and the Lehman Brothers Index from the beginning of calendar 1998 through September 30, 1999, but with considerably less volatility.

We still believe that last fall many investors were speculating rather than investing when the long-term Treasury bond yield hit its low of 4.70%. According to the ISI (International Strategy & Investment) survey at that time, the average bond portfolio duration went to a record high relative to its respective benchmark duration. Optimism was rampant. With the current decline of the bond market, 1999 is rapidly becoming the second worst year of performance for bonds. This year very few high-quality bond funds are showing positive investment returns. Your Fund continues to be the only fund, either bond or stock, that has not had a down year in twenty-four years (excluding money market funds). Our basic philosophy of "winning by not losing" is paying off again.

Your Fund's positive performance is the direct result of having essentially a defensive portfolio configuration. We began the year with a 2.6-year modified duration versus the 5.2 years of the Lehman Index. The higher the duration number, the more sensitive your portfolio is to changes in interest rates. On average, we tend to have a shorter portfolio duration than our benchmark index until we believe we are being compensated by higher yield levels to extend maturities and, therefore, our duration. Two areas helped the portfolio's performance: Treasury Inflation Protection Securities (TIPS) and Interest Only (IO) securities. TIPS have been the best-performing conventional straight bonds this year. The gradual rise in inflation is making the TIPS' embedded call option on inflation more valuable. This rising call-option

\* 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

value helps to offset the negative effects of rising interest rates. These bonds continue to yield more than their nominal bond counterparts and, therefore, continue to be undervalued. We have deployed approximately 39% of your Fund's assets in these securities. Another positive contributor has been our IO holdings. An IO's value typically moves in the same direction as interest rates. In this case, as interest rates rose, IO prices increased while the average bond fell in price. Finally, our high-yield/convertible securities holdings were also positive contributors to investment performance. During the year, we eliminated our position in Lam Research convertible bonds. We originally purchased them with yields ranging from 10.5% to 15%. Lam Research's stock price rose dramatically in 1999 and this performance helped to drive up the price of the convertible bonds. We liquidated the position at yields between approximately 5% and 7%.

Your Fund's modified duration has been increased somewhat. As of September 30, it is 3.73 years versus 2.89 years as of March 31, 1999. As rates have increased, we have gradually begun to add some longer-term securities to the portfolio. For example, we increased our position in FNMA 7% Mortgage "Z" bonds at yield levels of 7.60% to 7.70%. These are very long duration instruments. We were attracted to them when mortgage yield spreads widened considerably and these higher yield levels began to compensate us for principal risk. We also added a new position, CKE Restaurants 4.25% 3/15/04, to our "busted" convertible bond holdings. These bonds were added at yields between 12% and 17%. The recent decline in the stock market appears to be causing weakness in the high-yield and convertible bond markets. Lower bond prices, higher yields, and wider yield spreads are occurring with greater frequency. We are maintaining some flexibility to increase our exposure to lower credit-rated securities should opportunities present themselves. After these changes, the portfolio retains its high-quality asset-mix orientation, with an average AA1 Moody's credit rating. As of September 30, Government/agency securities totaled 76% of net assets. AAA- and AA-rated securities, excluding cash and equivalents, totaled 1%, with the remaining 22% rated less than AA. Short-term liquidity totals 1%. Convertible and high-yield securities, included in the less than AA category, total 19%.

A recent survey of advisory sentiment by Market Vane is close to its lowest level in ten years.

Pessimism is growing, which is positive from a contrarian viewpoint. Thirty-year Treasury bond yields are currently 6.35%. Should they approach 6.50%, we will likely add duration to the portfolio. We want to do this in stages since we believe that there are still several challenges facing the bond market.

We believe that pressures will continue to build for at least another 25-basis-point increase in the Fed Funds rate, totaling 75 for this cycle. At a minimum, we believe the Fed has to take back last year's 75-basis-point decrease. We are seeing the emergence of economic recovery overseas, which should put further pressure on the Fed. We still do not see our economy slowing to any material degree. Inventory/sales ratios are at all-time low levels. So far, the anticipated inventory build-up because of Y2K concerns has not occurred. Unless it took place in September, we will most likely enter early next year with low inventories and high consumer confidence. This should bolster economic activity.

We expect consumer spending to remain robust since, according to the Conference Board's survey, the consumer views the availability of jobs as plentiful and easy to get. Initial unemployment claims and growth in the labor force are at the lowest levels in forty years. The sluggishness in labor force growth appears to be more a function of the lack of qualified workers. Should this negative trend continue, an acceleration in unit labor costs may begin to emerge. Unless productivity remains high, employment cost inflation may start to erode corporate profit margins if companies are not able to pass these increased costs forward. We see a potential impact of these trends on the Consumer Price Index. In our March Letter to Shareholders, we stated that the CPI is likely to exit this year above the 2% level. For the twelve months ended August, the CPI averaged 2.6%. We see the CPI continuing at this level or higher for at least the next six months. The extreme confidence that investors exhibited last year regarding the continuation of disinflation or even deflation is now beginning to reverse itself as discussion is growing about the possibility of rising inflation. We see this as an emerging positive trend. Fear always creates better opportunities for attractive purchases.

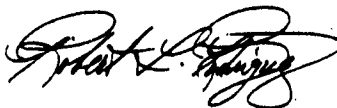
One last area that may keep the bond market volatile is the growing U.S. Current Account deficit. This measures trade flows as well as capital flows—all it goods, services and money. The deficit now is averaging 3.6% of GDP and appears to be heading for a record 4%. Unless it begins to reverse or stabilize,

it may start to negatively impact the value of the dollar. The significance to the bond market is that foreigners currently hold about 35% of the outstanding marketable Treasury debt, the highest percentage on record. If the value of the dollar erodes due to the Current Account deficit, foreigners may liquidate some of their Treasury holdings, thus driving prices down and yields up. Rarely does anyone know how to forecast these trends, but we would like to have a somewhat higher yield level to compensate us for this potential risk.

It is a pleasure to report substantially better and positive results, especially when most others are

experiencing losses. This has been our trademark over the years. We have typically excelled in declining markets. We thank you for your investment and continued support.

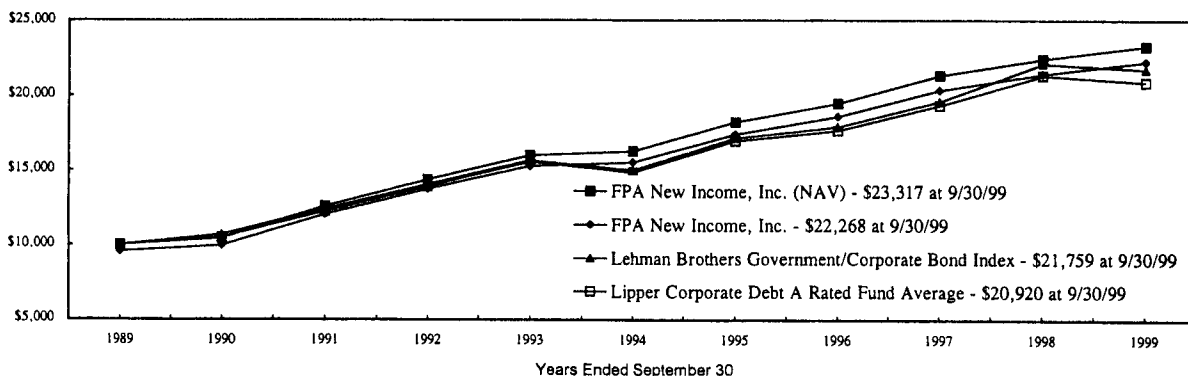
Respectfully submitted,



Robert L. Rodriguez, C.F.A.  
 President & Chief Investment Officer  
 October 28, 1999

## 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, 1989 to September 30, 1999*



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 \$22,268 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 \$23,317. The performance of the Fund and of the Averages is computed on a total return basis which includes reinvestment of all distributions.