LETTER TO SHAREHOLDERS

Dear Fellow Shareholders:

This Annual Report covers the fiscal year ended September 30, 2006. Your Fund's net asset value (NAV) per share closed at $10.99. During the fiscal year, your Fund distributed four income dividends totaling $0.54. There were no capital gains distributions.

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.

	Periods Ended September 30, 2006				
	1 Year	5 Years	10 Years	15 Years	20 Years
FPA New Income, Inc. (NAV)	4.59%*	4.35%*	6.01%*	7.05%*	7.97%*
FPA New Income, Inc. (Net of Sales Charge)	0.93%**	3.61%**	5.64%**	6.80%**	7.77%**
Lipper A-Rated Bond Fund Average	3.03%	4.56%	5.81%	6.59%	7.37%
Lehman Brothers Government/Credit Index	3.33%	4.96%	6.47%	6.86%	7.42%

The Fund's total rate of return for the fiscal year was 4.59%* versus 3.03% and 3.33% 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., 2.88%*; Lipper Average, 3.33%; and the Lehman Brothers Index, 3.76%. Finally, on a calendar year-to-date basis, the total returns were: FPA New Income, Inc., 3.64%*; the Lipper Average, 2.61%; and the Lehman Brothers Index, 2.71%.

First Pacific Advisors, LLC

Before discussing your Fund's performance, we are happy to report that First Pacific Advisors has successfully completed our transaction with Old Mutual (US) Holdings. We are now a Limited Liability Company owned entirely by eight internal members of FPA. This is the first time in the fifty-year history of this organization that the members who manage your Fund are the sole owners of the firm. We believe this solidifies the organization so that we may continue to operate it with a long-term perspective that is in the best interests of our clients, mutual-fund shareholders, employees and members. We thank Old Mutual plc for helping to make this an absolutely smooth transition and wish them well in their future endeavors.

Commentary

Your Fund's relative performance has materially improved for the calendar and fiscal-year periods ended September 30. The reasons will be discussed shortly. Over the last five years, your Fund has slightly underperformed both the Lipper and Lehman Indexes. Over this longer-term period, both the competitive funds and the Lehman Index have averaged materially longer portfolio durations and average maturities than your Fund and, thus, considerably more volatility risk was accepted for little incremental return. We maintained a materially shorter portfolio duration since we were of the opinion that longer-term high-quality bonds provided little, if any, investment value.

As we have explained in previous Shareholder Letters, when longer-term interest rates are in the 3% to 4% range, it does not take much of an interest-rate rise to cause a negative return. If we take the inverse of these two interest-rate levels, it would be similar to having a 25 to 33 P/E ratio on a stock. In other words, the potential for higher volatility is accompanied by a lower effective yield. We do not consider it wise to accept an elevated level of volatility for a lower effective yield. It is not a good return versus risk trade-off. We prefer to wait for periods where we are being compensated with higher yields and lower volatility risk.

As an example of this, between January 17 and June 28, 2006, the ten-year Treasury bond yield rose from 4.33% to 5.25%. This produced a holding period loss of 4.73%. For this same period, the Merrill Lynch U.S. Corporate & Government Master Index total return was a **negative** 2.25%. Your Fund, by comparison, achieved a **positive** 1.57% total return.

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

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

During this period, yields on the three-month Treasury bill through the thirty-year Treasury bond rose between 68 and 98 basis points (there are 100 basis points in a percentage point). Despite a general rise in the level of yields, your Fund's shorter duration and average maturity protected it from experiencing a potential portfolio loss.

During the past five years, the average yield on the ten-year Treasury bond has been approximately 4.50%, with an average adjusted duration of 7.7 years. What this means is that, for each one percentage point change, the bond's price will move 7.7%. The Merrill Lynch U.S. Corporate & Government Master Index (it has similar characteristics to the Lehman Index), has had an average effective duration of 5.1 years, so that for each one percentage point change, the Index shifts approximately 5.1%. In contrast, over this same time frame, your Fund's duration has ranged between 2.24 years and 0.53 years, with an average of 1.37 years. This means that your Fund has achieved approximately 88% of the return of the Index while having a portfolio duration that is only 26% of the Index's duration. In our opinion, achieving 88% of the return, after expenses, with approximately a quarter of the volatility risk is not a bad return versus risk trade-off. On a pre-expense basis, your Fund's portfolio approximated the return of the Merrill Index. This has been a trademark of your Fund over the last twenty-two years that I have led its management. When we believe we are being adequately compensated to accept both duration and credit-quality risk, we will do so; until then, we will patiently wait for better investment opportunities.

Though we have been very defensive, as exhibited by the record low 0.53 year portfolio duration at the beginning of this Fund's fiscal year, we have become decidedly more active, with your Fund's average duration nearly doubling to 0.98 years, at fiscal year end. As shorter-term yields rose, we began increasing the Fund's duration by adding securities with maturities between two and three years. We sold our floating-rate and step-up agency securities and replaced them with bullet agency securities. Furthermore, we have redirected our purchases from debt securities issued by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), since neither one has been able to publish financials since they ran into problems with elements of their statements, to the Federal Farm Credit Bank, the Federal Home Loan Bank and other instrumentalities of the federal government. In total, nearly 40% of the portfolio has been shifted since the beginning of this year.

We anticipate continuing this process, as yields in the two- to three-year sector rise. Since early July, yields have fallen between the maturities of two years and thirty years, as investors anticipate a reduction in the Fed Funds rate by the Federal Reserve. In our opinion, much of this yield rally has been excessive and premature. Since the end of September, questions regarding this view have begun to emerge and, thus, yields are again rising. In response, we have gradually added more two-year maturity agency securities. We anticipate continuing this process through the end of the year. At the end of September, your Fund held 17% in short-term money-market instruments and had another 26% invested in Treasury Inflation Protected Securities that mature in January 2007. We anticipate drawing down this combined 43% and redirecting a sizeable portion into two- to three-year maturity securities, when yields are above the 5% level. We feel that, at this yield level, we are being compensated for potential inflation risk but without having to accept much in the way of volatility risk. Yields have to be considerably higher before we will be willing to extend our maturities beyond three years.

As for credit risk, we have been unwilling to accept much. Our exposure to the high-yield sector remains at a very low 4.45% of the portfolio. We anticipate this level being lower by a minimum of 1% by the end of December. Should a potential takeover occur in one of our other holdings, our high-yield exposure could fall another 1%, bringing the Fund's exposure close to its all-time low of 2%. Obviously, we do not believe we are being adequately compensated to accept credit risk. Yield spreads on both investment-grade and high-yield corporate bonds are extremely narrow, implying little fear of an economic slowdown. However, these narrow yield spreads may also reflect the high level of activity in the credit default swap

(CDS) market. With default insurance being priced very cheaply, this appears to be driving the narrowing in yield spreads. In our opinion, the CDS market has not been adequately stress tested to determine how it will behave under adverse circumstances. It is many times larger than what took place in 1998 when a derivative fund nearly brought the international market to its knees. Furthermore, in 1987, we had an earlier form of derivative called Portfolio Insurance that failed on that fateful day of October 19, 1987, when the stock market collapsed. We do not know how to assess this risk; therefore, we will not participate in this market. We believe there are serious counter-party risk issues that have not been fully determined.

Given the changes to the Fund's portfolio, as of September 30, 2006, your Fund continues to maintain a very high credit-quality profile: 67% of net assets invested in Government/Agency securities, 10% in AAA/AA-rated securities, and 17% in short-term money-market instruments. High-yield accounts for just under 5%.

Outlook

At the start of this year, we expected the economy to begin slowing in the second quarter and continue this trend into the second half of the year. Along with this slower economic growth scenario, we thought that earnings growth expectations were likely to fall to the 5-6% level by the end of the year. We have been correct regarding slower GDP growth, but reported earnings growth has been better than our expectation. This is particularly true for the financial services sector. We still think we will eventually be correct, but the timing has been delayed somewhat.

The investment consensus has shifted to a belief that the Fed has finally finished raising interest rates, and in conjunction with the recent decline in energy prices, the major stock-market averages have been setting new highs. We do not believe this trend is likely to be sustained since it is predicated on the belief that the economy will not be too strong or too weak. Should the recent decline in energy prices lead to improved consumer confidence and spending, this could force the Fed's hand to keep the Fed Funds rate unchanged or possibly even raise it. If the economy proves to be less resilient, we would expect earnings growth expectations to be reduced and credit risk to become a growing concern.

We are quite concerned about the consumer's status. With each passing week, we get more data that says there are problems building. This is especially true with regard to the housing sector. The consumer has used their home as a form of piggy bank to sustain consumption through mortgage-equity withdrawals. This was possible when home prices were rising at double-digit rates. Since the beginning of this year, we have witnessed the sharpest decline in the median existing home price since 1981. Recent data indicates that prices have declined nearly 2% on a year-over-year basis. New home prices are also now declining. If these trends continue through the end of this year, we may see the first annual decline in home prices since the Depression. We are witnessing record levels of new and existing homes for sale by wide margins with inventory-to-sales ratios spiking. At the same time, household real-estate assets as a percentage of net worth is approximately 38%, a record level. Household real-estate assets at 154% of GDP are up approximately fifty percentage points since 1997. This too is a record level by a wide margin. In the event of a sharper decline in household real-estate prices, economic growth would likely slow considerably. We believe this scenario is a rising probability. This is all happening at a time when the Household Debt Service Ratio has been hitting new all-time highs. If there is any slowdown in employment growth in combination with a worsening housing situation, next year could be very challenging for the economy.

While this has been developing, the corporate sector has continued to strengthen its balance sheet. As a result of this positive trend, banks have had fewer corporate customers to lend to, though this has not stopped them from lending. Since 1997, real estate loans, as a percentage of total loans, have grown to a record level of nearly 55%. With the excesses in lending practices, it seems reasonable that this could be a potential problem area, if we experience a serious household real-estate downturn. On September 29, 2006, five bank regulators released their new rules, to take effect immediately, which restrict nontraditional loans. These include interest-only and other creative

loan options. This change may also help to constrain economic activity by reducing the availability of loans for home ownership. Real-estate activity has been a key driver of employment in this economic recovery.

Given this cautious outlook, why should we not be more optimistic regarding the potential for a decline in interest rates? There is a distinct possibility that long-term rates could decline further and that the Fed may start reducing the Fed Funds rate next year. It would not surprise us to see the Fed Funds rate a 100 basis points lower by this time next year. However, again, we reiterate that yields in the 4% range do not compensate us sufficiently for the longer-term risks that we perceive. One of these risks is the risk of energy price inflation. We urge you to visit our website at www.fpafunds.com and read the discussion on energy that appears in the September 30, 2006, FPA Capital Fund Shareholder Letter. It provides a detailed discussion on why we believe that energy prices are likely to be higher over the next ten-years and that, if we are correct, this could have negative implications for inflation and economic growth. We also believe that the challenges in the Federal budget will become far more serious beginning in 2010, the beginning of the retirement of the "baby boom" generation. By 2016-17, the Social Security "surplus" evaporates and the Federal government will either have to start cutting benefits or raising taxes to maintain their existing expenditure level. Either way, this is probably not positive. In our opinion, we should not lend long-term money, i.e. the purchasing of longer-term Treasury bonds, to a borrower who is intent upon an increased leveraging of his balance sheet. Finally, from a theoretical view, we do not believe that we are being adequately compensated with a high enough real yield. The real yield is the estimated bond yield after taking into account inflation. Currently, it is estimated to be approximately 2.5%. In our opinion, the Consumer Price Index that is used to determine this real yield is severely flawed and, in our opinion, understates inflation by at least one percentage point; thus, we do not believe there is a sufficient margin of safety for us to risk deploying your capital into longer term bonds. We know that we are at odds with the general consensus on this point, but this is not the first time that we have been placed in this position. Now Tom Atteberry will convey his thoughts to you.

Thomas H. Atteberry Commentary

As Bob commented above, the portfolio's current allocation to the high-yield portion of the bond market is at a very low level. What comprises this portion of the portfolio? We have two holdings, Avnet and BEA Systems, which make up approximately 1% of the Fund and mature this year on November 15 and December 15, respectively. After these events our holdings will represent about 3.5% and consist of five names.

The largest high-yield holding is Qwest Communications, a floating-rate note that matures February 15, 2009. The company provides telephone and data communications for the mountain states region of the United States. Over the past four years the company has reduced its outstanding debt by 38%, which resulted in a dramatic decline in the company's leverage ratios. The company has also increased its debt rating from a low of Caa1 in September 2002 to B2 in September 2006, with the current rating under review for a potential upgrade. In conjunction with the reduction in debt and improved cash flow, the company is contemplating reinstating a common stock dividend. At this point we are very pleased with the financial performance of this holding.

The portfolio has two holdings in the automobile industry, Metaldyne and Standard Motor Products, which make up about 1.5% of the Fund. While the automobile industry has been a very challenging sector for over a year, these two holdings represent a couple of our best-performing investments over the past year, producing returns in excess of 10%.

Metaldyne announced on September 1 that it had entered into a merger agreement with Asahi Tech, a Japanese-based metal components manufacturer for automobiles and construction machinery. Their interest in Metaldyne stems from its broad customer base and well-respected powdered metal forging technology. It is this type of corporate action that confirmed our belief that Metaldyne had a business model and products that could prosper in the auto-parts segment. We are hopeful that the merger will be consummated and potentially close by the end of the year.

Standard Motor Products is a completely different company. It manufactures engine control modules and heating/air-conditioning components for the automobile after market. Over the past several years the company has successfully purchased a computer module business from Dana Corp. and transferred various component production to Mexico and China. This cost reduction and broadening of product line should benefit the company going forward. By being in the after-market parts business, the company is not impacted by the current problems with Ford, GM and Chrysler. The drivers of growth are the aging of the outstanding car fleet and severe weather. As an example, with a hot summer the demand for air-conditioning compressors increases.

Not every one of our automotive sector holdings worked out. During the summer we liquidated our remaining position in Collins & Aikman at a significant loss. This company entered into Chapter 11 bankruptcy in May 2005. Our original view was that the company could have reorganized in a fashion where we, as a senior note holder, might have received a new bond and a portion of the reorganized equity. As this year progressed, it became apparent that we would not get a new debt security and that the equity we would receive would be worth much less than contemplated. Company sales projections seemed okay but the profitability of their contracts did not materialize. We discovered that when they signed the contracts with the OEMs, they assumed an oil price that was approximately half of what oil sells for today. Oil is a prime ingredient in the interior plastic components Collins & Aikman produces. This increased oil cost effectively wiped out all the profit in the contracts.

The final two holdings are small in allocation, representing about 0.5% of the portfolio. The first is a preferred stock, Pennsylvania REIT. This company owns regional malls in the mid-Atlantic region, usually in smaller towns, and we have found it to be a steady performer. The other holding is International Wire Group. This bond is the result of Chapter 11 reorganization in late 2004. The company struggled with an insulated-wire division that had a difficult time producing a positive cash flow. During 2006 the company divested that business and now produces only bare copper wire for a wide variety of customers. The proceeds from the sale of the insulated-wire business were used to expand the bare-wire business into some specialty niche markets with very limited competition. The bare-wire business is a moderate-growth steady-margin business that produces free cash flow. We have been very pleased with the company's ability to reposition itself into a much better financial position.

At this time we are excited about the holdings that remain in the high-yield sector. Each company has improved its financial position and they have strengthened their individual market positions. For these reasons we expect to continue to remain invested in these securities for the long term.

With those closing comments, we thank you for your continued investment support and happy that we are able to convey to you the Fund's positive investment performance.

Respectfully submitted,

Robert L. Rodriguez, CFA
President and Chief Investment Officer

Thomas H. Atteberry
Vice President and Portfolio Manager

October 15, 2006

The discussion of Fund investments represents the views of the Fund's managers at the time of this report and are subject to change without notice. References to individual securities are for informational purposes only and should not be construed as recommendations to purchase or sell individual securities.