LETTER TO SHAREHOLDERS

Dear Fellow Shareholders:

This Annual Report covers the fiscal year ended September 30, 2007. Your Fund's net asset value (NAV) per share closed at $11.03. During the fiscal year, your Fund paid four income dividends totaling $0.53. 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, 2007					
	1 Year	5 Years	10 Years	15 Years	20 Years	FPA Inception 7/1/1984
New Income (NAV)	5.36%*	4.66%*	5.60%*	6.49%*	7.96%*	9.15%*
New Income (Sales Charge)	1.68%**	3.92%**	5.23%**	6.23%**	7.77%**	8.98%**
Lipper A-Rated Average	4.04%	4.13%	5.22%	5.91%	7.51%	NA
Lehman Govt/ Credit	5.08%	4.16%	6.03%	6.33%	7.71%	8.71%

The Fund's total rate of return for the fiscal year was 5.36%* versus 4.04% and 5.08% 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., 2.79%*; Lipper Average, 1.36%; and the Lehman Brothers Index, 2.51%. Finally, on a calendar year-to-date basis, the total returns were: FPA New Income, Inc., 4.21%*; the Lipper Average 2.74%; and the Lehman Brothers Index, 4.00%.

Comment on Morningstar's Lowering of Your Fund's Stewardship Grade

We feel compelled to comment on Morningstar's action to downgrade your Fund's stewardship grade. Morningstar recently changed its stewardship grading methodology and lowered your Fund's stewardship grade from "A" to "B." I want to assure you that we have done nothing to change how we manage the Fund or the principles that guide us. The protection and growth of your assets remain paramount in our thinking, as we have consistently stated. We strongly disagree with Morningstar's change and have communicated our displeasure with this action. I will briefly discuss why this was done and why we are of a different opinion. You may read our full response to Morningstar on our website at www.fpafunds.com. According to them, the two primary issues that led to this change are how they view our lack of performance-based compensation for fund managers and the absence of an independent chairman of the board of directors. In the first case, Morningstar wants to see that fund managers have a portion of their compensation subject to a relative market performance adjustment. They believe this helps to better align the interests of the manager with those of the shareholder. Morningstar's model is based on the manager being an employee of the management company, but does not adequately consider our company structure, where the managers of your Fund are owners of FPA. We believe that managers' ownership of FPA creates a strong, long-term incentive for stewardship and aligns the long-term interests of the managers with those of Fund shareholders. The second issue, independent chairmanship, has been addressed by your Fund's independent board members and subsequent to the issuance of Morningstar's grades they elected an independent chairman. The board has maintained its autonomy with more than 75% of its members independent outside directors, who bring impartial and objective skills to the oversight of your Fund. In all, FPA's management system has led to unprecedented stability over the last 30 years, which is longer than Morningstar has existed. Along with the board, we will

* 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

continue to maintain our emphasis on strong stewardship and governance over the Fund, as we have since we took over its management almost 25 years ago.

Commentary

Your Fund outperformed both the Lipper "A" rated Bond Fund Average and the Lehman Brothers Government/Credit index for the six-month, fiscal year and calendar year-to-date periods ended September 30, 2007. We achieved this positive relative performance while taking considerably less credit risk and maturity risk. These comments also apply to the five-year measurement period as well. For the past five years, we have also maintained a portfolio average maturity and duration that have been materially less than those of the Lehman Index. We believe we have attained a very high risk-adjusted total return. The results of this strategy are reflected by your Fund's very low volatility relative to that of the Lehman Index as well as by its attractive relative total return.

Your Fund's duration, a measure of portfolio volatility, was 1.4 years as of September 30, 2007, which is up from 0.98 years at the beginning of this fiscal year. Between March and August of this fiscal year, we began to extend the average maturity and duration of your Fund. By June 30, the Fund's duration had risen to 1.68 years. By comparison, the Lehman Index's duration is 5.2 years. What this means is that your Fund's current duration would indicate that the portfolio's potential volatility would be approximately 73% less than the index's volatility. During the last five years, your Fund's average duration has ranged from barely 2 years to 0.53 years, which occurred on September 30, 2005. We have been unwilling to invest in longer-term bonds since we have been of the opinion that their potential return has been inadequate for the amount of volatility risk that must be accepted. On June 16, 2003, we wrote "Buyer's Strike," available on our website, which explains why we would not be a buyer of longer-term bonds. We considered longer-term Treasury bonds (typically ten-year maturities or more), with yields in the 3% range, to be nothing more than speculative securities since, in our opinion, they provided no investment value. They did not or would not provide a sufficient degree of protection from the potential risks of higher levels of future inflation or from the ever-increasing federal government's fiscal mismanagement. Since then, we now include the 4% range, because of the recently expanded entitlement liabilities created by the new prescription-drug benefits program. This new program was added without the federal government first reforming any of its existing and expanding entitlement programs. Furthermore, these new benefits were added while the country is currently engaged in fighting a war. In some ways, this reminds us of what took place in the 1960s when Medicare was enacted at the same time we were engaged in another war. These long-term IOUs will eventually come back to exert a high price on a future generation of investors and citizens. We do not believe these low levels of yields provide adequate compensation for these risks.

You should realize that there will be periods when your bond Fund's total return will lag that of the other bond funds or the indexes since we are unwilling to accept the risks that these other managers seem willing to accept. As an example, this calendar year has been a tale of two different bond markets. From March 7 through June 12, the Merrill Lynch U.S. Corporate & Government Master Index's total return was a negative 2.18% while your Fund achieved a positive 0.64% return, a positive 282-basis-point performance differential. This took place because interest rates rose, as reflected in the rise from 4.49% to 5.30% by the ten-year Treasury bond's yield. Between June 12 and November 2, the Merrill Index achieved a 6.16% total return, as the ten-year Treasury bond yield fell from 5.30% to 4.32%. By comparison, your Fund produced a 3.34% total return, a negative 282-basis-point performance differential. Over this measurement period, your Fund's total return was 4.01% versus the 3.84% for the Merrill Index. The Fund achieved this return with less volatility and credit risk. The Fund's shorter duration protected its value from the negative effects of rising interest rates, while its shorter duration hindered its performance as interest

rates fell. During this period, longer-term bond yields rose to a level where they were barely attractive to us, if at all. We were willing to extend maturities out to the equivalent of three years with some purchases that had maturities as long as five years. Beyond this maturity level, the yield and risk were unacceptable to us.

For the past two years, we have been aggressively culling out securities that had credit, structure or sector risk. In particular, we eliminated a class of security, Alternative-A, that has recently come into question and is now considered one of the riskier sectors of the mortgage market. We suspected that there might be credit issues developing in this sector and therefore, we sold all of our holdings more than two years ago. With the recent disclosures of aggressive and unsound underwriting standards that took place in this sector, our decision has proven to be correct. At the time of their elimination, we took on the philosophy or strategy that we would no longer be like Baskin-Robbins with 31 flavors of debt investment. We wanted to become a new fixed-income ice cream store with only one flavor, vanilla. We were of the opinion that we were on the verge of a period of credit excess and that the growing variety and complexity of new types of debt securities would create problems in the fixed-income market. Only those securities that were more vanilla in flavor would be able to trade or even be evaluated and priced. We believe our conservative credit posture is finally being vindicated by the growing list of credit issues and financial service company asset impairment problems and charges.

On November 4, Citigroup Inc. announced a charge of as much as $11 billion to its earnings because securities, supported by subprime loans, were downgraded by the rating agencies. On a conference call, the chief financial officer indicated that for many of these securities it was difficult, if not impossible, to get market price evaluations and, therefore, they used pricing models that were negatively affected by the credit-rating agency downgrades. In their September 30, 2007 10-Q, they reported they had $134.8 billion of Level 3, mark to model assets, which compares to stockholders' equity of $127.1 billion. These are the most difficult and questionable securities to evaluate. We mention this example because of Citigroup's importance to the financial services industry. Their problems reflect the growing asset quality and pricing issues facing many financial institutions. In contrast to these reported problems, your Fund accounts for 80% of its holdings at mark to market prices with another 20% evaluated by a third-party pricing service. We have zero investments in the mark to model category — more on this later in this letter. Because of this, your Fund can be evaluated far more easily and accurately.

Your Fund has not and will not stretch for yield. It is at its highest weighted average credit quality ever, with AAA or higher rated securities representing nearly 91% of the Fund, with an additional 8% invested in AA securities. A record low 0.9% is invested in high-yield securities. Within these totals, we have included the underlying credit grades of the commercial paper securities that we own. Money-market and short-term U.S. Treasury securities represent 19%. Government/Agency securities total 71% and are also included in the 91% total. We do not own any subprime-related securities, collateralized debt obligations (CDOs), or any of the other alphabet soup names of securities that have been created with complex derivative structures. Beyond Treasury and Agency securities, we own mortgage-backed securities and some collateralized mortgage obligation bonds that are easily understandable. During these past two years, we have actively and aggressively reduced the number of qualifying companies on our commercial paper approved buy list. As this list has grown shorter, we have increased our exposure to Treasury bills. We have not utilized any of the newly created commercial paper alternatives, such as structured investment vehicles (SIVs), that are now growing in disrepute. Our focus has been on preserving and protecting the capital you have entrusted to us.

In the March 2007 Shareholder Letter, we had an extensive discussion entitled, "Special Commentary." We discussed the growing risks in

several areas of the capital markets and went on to detail them. On June 28, I gave a speech before the Chartered Financial Analyst Society of Chicago entitled, "Absence of Fear," which you may read on our website, www.fpafunds.com. This is a more detailed discussion of what was covered in the Shareholder Letter. Since then, many of the potential risks identified have now become more widely understood. The collapse in loan originations and pricing in the subprime and Alt-A loan sectors along with questioning of security pricing and credit-rating models has been covered widely in the press. On October 12, the front page of the *Wall Street Journal* led with the story, "U.S. Investors Face an Age of Murky Pricing." A discussion of the difficulties and pitfalls of pricing highly complex securities is covered quite well. A brief discussion details the three different methodologies used to price securities: marking to market; marking to matrix; and marking to model. As Warren Buffett said, "They call it 'marking to market,' but it's really marking to myth." I refer to "marking to model" as "Imaginary Accounting." You imagine a price and then you account for it at that price. Many of these securities values are predicated on valuation models that were created by management. This is like having the fox guard the hen house. It is all legal but it does not give us great confidence in the viability or soundness in the balance sheets of many financial service companies. Many of these securities have become so complex that it is nearly impossible to accurately value them. It is all guess work.

I highlight these issues because, for several years, U.S. economic growth has been driven by high credit growth and the development of the structured finance industry. According to David Rosenberg, chief North American economist at Merrill Lynch, the ratio of total household debt to total disposable income has risen to 136% from 100% in 2000. During this six-year span, the consumer added as much debt as was added in the previous 40 years combined. The vast majority of this debt growth has been created outside of the banking system. Through the second quarter of this year, non-bank credit creation was $3.12 trillion while bank credit creation was $578 billion, according to MacroMavens. Between 2000 and 2006, it is estimated that total mortgage securitizations outstanding rose from $5.1 trillion to $10.4 trillion. Collateralized debt obligations — these take mortgage securitizations and pool them into another synthetic security — rose from approximately $99 billion to $562 billion for this same period. These numbers do not include collateralized lease obligations, structured investment vehicles, now the subject of intense concern, or the many other types of private credit transactions that have been creatively developed. Most of these securities do not come under the regulation of the banking system. The securitizations that are under the most stress are those that are dependent upon questionable borrowers, subprime for example, or have loans that have been underwritten with highly lax credit standards. Most of the structured finance issues revolve around housing-related securities, but we are of the opinion that questionable underwriting processes spread to all areas of the credit market.

On September 18, the Federal Reserve lowered the Fed Funds rate by ½ percent to 4.75%. The stock market took this as an all-clear sign that everything is going to be all right. Many "experts" are saying that the worst of the credit crisis is over and that 2008 will be just fine. We disagree! The ABX Indexes, indexes based on several asset-backed securitizations backed by subprime credit loans of different periods of issuance, have recently been hitting new lows compared to those that took place at the height of the August credit crisis. It took years for the excesses in the credit system to develop. To think a few weeks of market decline and a ½ point cut in the Fed Fund's rate will solve our large and varied credit issues seems to us to be a bit unrealistic. This credit crisis, unlike earlier ones which were a function of Fed policy actions that led to higher interest rates and a lessening in credit availability, had its genesis in unsound underwriting and aggressive credit creation that was accommodated by the credit-rating agencies' use of faulty models. The basic problem is that borrowers took on more debt than they could handle and the rating agencies had faulty

models that allowed large-scale debt sales to buyers who had little understanding of what the risks were of the particular security they were buying. All that counted was that there was an appropriate credit grade that allowed the buyer to purchase a structured finance security at a yield substantially higher than what could have been attained with a similarly rated corporate bond. These ratings have been shown to be quite faulty, with Moody's, Standard & Poor's and Fitch trying to get ahead of the situation by announcing a multitude of credit downgrades. Several of these downgrades entail securities rated as high as AAA that have now been reduced to as low as BB-. The pricing reaction to these downgrades could be as much as an 80% decline in value. In a word, incredible! They all have said that they have modified their models in light of new information. As the old saying goes, "Fool me once, shame on you. Fool me twice, shame on me." Many buyers worldwide were sold securities that were not what they thought they were. There was a scramble for yield, in a low interest-rate world, that allowed this mess to develop. To think that these buyers will return rapidly is, in our opinion, quite optimistic. It will take a revamping of the structured finance industry and a restructuring of the credit-rating agencies to re-establish confidence in the entire process. This will take time and, therefore, structured finance credit creation should shrink in size for the foreseeable future.

Should we be correct in this assessment, a smaller potential structured finance market will lead to a large number of layoffs from those companies that specialize in this area. Unless a multitude of financial institutions are willing to grow their balance sheets and increase their leverage ratios, particularly banks, it would seem that we are in for a rough spell, regarding credit availability and growth, and this should have negative implications for economic growth. A contraction in structured finance originations will likely prolong the housing slump by further depressing home construction, turnover and prices, resulting in a further erosion of consumer confidence and spending. A cleansing of the credit system should and will have to take place. At this time, we have seen no material cleansing of toxic investment securities within the capital market. If any structured loans have traded, they have been of the higher-quality credit ratings. We believe most holders have not been able to or willing to take the appropriate price discounts to move these troubled securities off their books. These comments apply to other areas of the credit market such as high-yield and leverage buyout loans. We do not believe these credit market issues will likely be resolved within the next twelve to eighteen months. Additional pain and fear must occur before this process can begin.

Outlook

In light of the above comments, we believe the odds of a 2008 recession have increased to at least 50% or more. Given the growing credit contraction, oil prices that are nearly $95 per barrel and the dollar setting new all-time lows versus a basket of currencies, future Fed policy actions may prove rather ineffective in dealing with these challenges. The Fed followed up its September 18 lowering of the Fed Funds rate by lowering it again by 25 basis points on October 31. The financial markets' reaction was far more muted this time than the first lowering, when equity markets rallied strongly and bond yields fell. We are of the opinion that the Fed will lower the Fed Funds rate into the 3.75% to 4% range next year, or lower, as housing, capital markets and consumer issues negatively affect economic and corporate earnings growth; however, the Fed will have to be measured in its response otherwise, Chairman Bernanke may receive the moniker "Greenspan Lite," in essence, lowering interest rates to a level that potentially leads to another type of asset bubble. There has been a very negative reaction to these two Fed Funds rate reductions in the currency market, as reflected by the dollar's 4.2% decline versus the value of a basket of currencies. A sharp decline in the dollar's value has both positive and negative potential outcomes; however, we believe a sharp decline in the dollar poses destabilizing risks that are not being adequately reflected in the financial markets.

We view consensus corporate earnings growth expectations as being too high and believe that they will have to be lowered. Only recently have various types of financial services companies begun to recognize their problem loans and investments, with charges and provisions for future losses. Many of these stocks initially reacted favorably to these actions and especially after the first Fed Funds rate lowering. The belief was that these companies were getting their problems behind them. Again, we believe the consensus is being too optimistic. Generally, managements are always initially optimistic, until they have to face the grim reality of the situation, and this process should extend well into 2008. Since then, financial service stocks have given up most of their gains or they are setting new lows. We believe this is only the initial phase of a more protracted and difficult credit environment. We expect credit spreads to widen next year for several bond sectors. Should the perception grow that recession is increasingly likely next year, high-yield bond spreads should widen considerably further. They would have to more than double their current level before we would become seriously interested in the sector.

Given this negative view for economic growth and the growing credit crisis, shouldn't we be increasing the portfolio's average duration and maturity, in the event that yield levels fall more? Treasury bond yields have recently fallen dramatically, with yields below 4% for maturities of five years or less while the ten-year Treasury yields 4.32%. We see little, if any, value in any of these maturities and, therefore, we will not be deploying capital into any middle or longer-term maturities. We will wait for a more attractive and rewarding yield level. With those closing comments, Tom Atteberry will convey his thoughts to you.

Thomas H. Atteberry Commentary

The third quarter of 2007 was the age of discovery; however, unlike the more glorious one described in history books, this age dealt with who and what entities owned the poorly underwritten mortgage loans of the last several years, and how much money they borrowed to acquire this poor-quality asset. Just prior to the beginning of the quarter, it was two hedge funds at Bear Stearns Asset Management; in the middle of the quarter it was a regional bank in Germany's Irish subsidiary; and at the end of the quarter it was a previously little known off-balance-sheet vehicle called a SIV or Structured Investment Vehicle. So it went from a risk-taking investor (a hedge fund) to a risk-averse investor (a money-market fund that buys asset-backed commercial paper issued by a SIV). In more general terms, broad cross sections of investors have exposure to this questionable asset. One significant question raised during this financial age of discovery is, what is the price of these mortgage assets? This "price discovery" is still underway. To date, the results have not been pleasant, with the potential buyer of the bonds offering a much lower value than the seller feels their cherished asset is worth. This has resulted in very little trading of many of the riskier mortgage-backed and mortgage-related bonds during the quarter.

From a fundamental perspective, it is our view that this action by the Fed will not have a major positive impact on the housing and mortgage markets. The effects of much tighter underwriting standards have started to be felt, as evidenced by the drop in subprime issuance from approximately $175 billion to $75 billion in the second half of the year. Over the next 15 months approximately $50 billion in adjustable subprime mortgages will reset each month. This reset event will result in the monthly payment for these mortgages increasing by upwards of 20%. It is our view that such a reset has the potential to increase the delinquency and default rates for the underlying mortgage pools. This could result in more houses coming on the market for sale during a period of greatly diminished demand for new or existing houses. The bottom line is that we think this event will lead, at best, to flat housing prices but more likely declining house values between now and the end of 2008.

We have spent extensive time evaluating the mortgage-backed securities segment of the fixed-

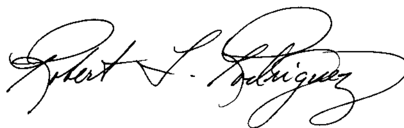
income bond market and have concluded that a 10-15% decline in home prices can have a significant negative impact on the value of all but the most senior tranche of a CMO. The subordinated tranches of these CMOs may experience substantial reduction in the amount of principal that is returned to the investor. This is a lesson we learned very well during the early portion of this decade when we owned subordinated tranches of manufactured-housing loan securitizations. It is that experience and gained knowledge that has kept us out of the subprime portion of the mortgage market today. There are significant similarities in the underwriting standards and loan quality between both subprime mortgages and manufactured-housing loans.

Much has been commented on how subprime mortgage holders should have their loans modified in order to reduce or eliminate the negative impact that will result from their loans resetting once the fixed-rate period concludes. A recent survey revealed that of those loans originated in 2006 that were no- or low-documentation in nature, 60% of the borrowers may have misrepresented their income by a factor of 50%. Even with a modification of the loan terms, a misstatement of income of this magnitude will make the mortgage difficult to perform over a long period of time. Knowing this information also makes it difficult for the loan servicer, lender, or government entity to institute blanket programs designed to modify these loans.

The expansion of the subprime and housing problem, the age of "price discovery," the contraction in available mortgage lending money, and the significant amount of questionable or fraudulent loan documentation are just a few of the myriad problems facing the housing industry. It is our opinion that all the bad news and its impact on the market has not yet occurred. The biggest factor is how this will impact housing prices. If prices continue to fall, it will make refinancing and modifications difficult to execute. From an investor's perspective, clarity and confidence need to return to the market. For example, investors in money-market funds may not know that their fund invested in a SIV. In addition, the fund managers may not have any idea about the underlying holdings of the SIV it invested in, only that a rating agency rated it AAA. From a confidence perspective, investors appear to be suspect of the complexity of investment vehicles. They have fled those investments, as evidenced by lack of bids, for the comfort of the shorter-term Treasury market, which was demonstrated by the 84-basis-point rally in the two-year Treasury note over the past quarter.

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

Respectfully submitted,



Robert L. Rodriguez, CFA
President and Chief Investment Officer

Thomas H. Atteberry
Vice President and Portfolio Manager

November 5, 2007

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.