

Mark: ... I'd now like to introduce Tom Atteberry and Abhi Patwardhan, the portfolio managers of our FPA New Income Fund. Thank you.

Tom: We're in the right place. Anyway, thank you Mark, and I greatly appreciate anybody who would come back from lunch after that more interesting conversation we had to talk about fixed income for an hour and so. Not exactly sometimes the most riveting thing that we will discuss. I have a team with us today, although two of them, Naz Pajoom and Julian Mann may duck out for a period of time. They need to go price the fund this afternoon. But they will be back for cocktails and for dinner this evening, and then the two credit people, Prakash Gopinath and Joe Choi are also with us. So at the end, when we get to sort of a Q&A, feel free to ask any of the credit questions. They're here to answer them.

Abhi and I are going to spend the day talking about a couple of things. Sort of the capital markets as it relates to fixed income, how the portfolio's positioned and why. And we'll also spend some time speaking about sort of how we've positioned, why we've put the portfolios, and how we look at things, and how we decide what we're going to invest in and what we're not going to invest in.

To start off, I'm going to assume that maybe not everybody is a shareholder of the FPA New Income Fund. That's fine. So we've got our

investment objective. We're looking for current income. We're looking for capital appreciation, and yes, capital preservation is a consideration in what we do. We have two objectives we're trying to reach. One, we are seeking to get an absolute positive return in a 12-month period. The second thing we're trying to do is to get CPI plus 100 basis points over a five-year rolling period. So those are the two things we do, and what that leads us to is, we're indifferent to a benchmark. We are merely looking for securities that will help us accomplish those two objectives.

There are some general guidelines. The portfolio, 75 percent at a minimum are going to be high quality. Our credit component could be up to 25 percent. We don't use options, we don't use futures, we don't short, we don't use leverage. We're old-fashioned sort of bond people. We buy bonds. We pay cash for them. And it is also a bottoms-up approach as well. The cash component of this portfolio is nothing more than the output of-- it's the residual after we come up with all our investment ideas. We are very bottom-up people looking at individual securities.

This is a look at the portfolio. Lots of good numbers. We're fixed income people, so we love to put this stuff up. I direct your attention to the bottom, as this is the portfolio itself. Right now it's got an average maturity of a little less than two years, a yield to worst of a little over 3 percent, and a duration of 1.3 years. So it's a fairly conservative today, conservatively-

priced sort of positioned portfolio.

Securitization is almost 80 percent of the portfolio's assets, whether asset-backed, CMBS, mortgage-backed, doesn't make any difference. It's about 80 percent. The biggest piece of our asset-backed security holdings, the biggest component are sub-prime auto loans. We're comfortable with some of them, we're uncomfortable with others of them. We also have loans backed by equipment, whether it's farm equipment, computer equipment, other sorts of manufacturing equipment, construction equipment. The mortgage holdings at the bottom has gotten to be smaller over time. The biggest piece in there is non-performing. Non-performing mortgage loans. These are people that haven't paid you anywhere from 36 months to 60 months, seriously non-performing. And then the other one we've talked quite a bit about is the CMBS stripped. It's actually an interest-only security backed by Ginnie Mae project loans, or basically government-assisted housing. Our corporate holdings are fairly small at only about a little over 7 percent, and they've been declining, oh, probably over the last year or so. We have one municipal bond, and then we have cash and equivalents and some treasuries.

This is a look at a 10-year period of time, the five worst declines for the Barclays Aggregate Index. And then you're got these other pieces, the aggregate index being sort of the green bar, the non-traditional bond

funds, which is where Morningstar puts us, is the teal. Red is the Barclays one-to-three year. We've pretty consistently, during these big draw-downs, had the lowest number. Only here did the one-to-three year Barclays index actually draw down less than we did. By and large, this is what we try to do, is protect capital on the down side. This is the objective we have. If we can protect the capital on the down side, we don't have to worry about spending a lot of time trying to take big time risks trying to make up for losses that we had.

Something else that you'll find out, for you that don't know me well. I sometimes joke about, but we sort of chuckle about, we are fixed-income people, so we do statistics in math. We're not concept people. We're not linguists. We're math people. So this is a look at, how does our fund correlate with other major bond fund categories? Intermediate-term bond funds, long-term world, high-yield bond funds and emerging markets. We took two periods of time, prior to 2008 and after 2008. And in our category, non-traditional bond funds, we correlated better with them prior to 2008. Not that .25's a very big number. We're now down to a .1.

The point of all this is that we do not correlate with the others very well. We think we add value because we don't act the way they do. When they're going up, we may not be going up. When they're going down, we're not going down. So we realize that we play a role. And to play that

role, we need not to act like these. This bottom piece is a look at an intermediate-term bond fund. And oh, by the way, they correlate pretty closely to the rest of those. That was the point of here.

And then finally, on this sort of intro to the portfolio itself, this top graph, the green line is the yield to worst. It's been somewhere between two and three percent since the beginning of 2009. The duration has been somewhere between a half a year to two years.

And then a metric that we talk about a lot-- you can use this with any bond fund, to give you just a sense of how sensitive are you to the changes in level of interest rates, is if you take the yield to worst, if you can find that. Lots of them will publish that, but that's sort of one of those yields that, if everything goes right, that's sort of the best that's going to happen for you. And you divide the duration into it. That will give you an instantaneous look at how much interest rate risk can you take before your return gets to zero. Remember, duration is telling you the percentage change in the price of the bond for 100 basis point change in yield. And we've been able to maintain something generally, except for over here in the beginning, right after the financial crisis, it was quite high, sort of something-- it's been two on the high side, and one on the low side.

So, that is a quick background of what we are and what we're doing. I thought I'd spend a minute, macroeconomic commentary sounds

really great, but basically it's the strange, brave new world that we now find ourselves living in. To those of you I had a conversation with last night about negative interest rates, you understand what that strange, brave new world is. If you haven't, get us aside and we'll talk to you about it. It's something that'll sort of put you on your ear for a second. I thought this was pretty good to explain the world in which we find ourselves in.

If I look down here at economic reality, I have sub-optimum growth. Steve showed you some slides this morning and talked about sub-op and really low-GDP growth. But what he didn't necessarily put in, at the same time, I have some very unusual monetary policies being undertaken by central banks. Unusual might be a kind word. Let's just say things we haven't ever tried before. So on that, I now have a series of assets that have gotten quite high in price during a slow-growth economy using unusual central policy sort of tools. I find the expression on his face appropriate, if you're trying to invest in stocks or bonds.

So when are some of these unusual policies? Well, for the US, it's ZIRP. As I said in my commentary, this is like something out of the Ministry of Silly Walks from Monty Python. ZIRP, zero interest rate policy. That's what the US has been running. NIRP is what Japan and Europe has been running, a negative interest rate policy. And both of those groups have been doing QE, or quantitative easing.

Well, what's a negative interest rate policy? What are you trying to do when you do that? You are putting a tax on savings. You are taxing a saver for the purpose of trying to get them to spend the money that they've saved to avoid the tax. You're making borrowing costs negative, so that leverage increases to stimulate consumption. Okay. You're not stimulating consumption, you're moving consumption. By borrowing money, you are just taking consumption in the future, and you're just pulling it forward 'till today. You're not increasing it. You're just moving the time in which you're going to get it. Could be that you want to lower the cost of interest expenses to the government so they can manage their debt better. We'll show you some details of that, and then make it punitive for banks to hold excess reserves. All these items are things that are looking at forcing someone to lend money, is what you're trying to do.

The bottom is sort of the market reaction. Well, this year, when the Japanese decided to go to negative interest rates, year to date gold's up 17 percent. Gold is a zero-yielding asset, but if everything else is negative, it looks good. Cash is a zero-yielding asset. Japanese are hoarding 10,000-yen notes. Why do we know that the Japanese are hoarding 10,000-yen notes? Because there was a spike in the sale of safes to put in their homes, because you've got to put the stuff somewhere, right? But you can see, I didn't have a place to put the graph, but it just goes straight

up. Hoarding cash. Do we know the hoarding is of cash? Some companies are hoarding cash. German reinsurance company called Munich Re has \$10 billion of cash. It's not in a bank account. It's in a vault. They also have gold in that vault, but they won't tell you how much it is. Change in behavior. And then savings is increasing. Why is savings increasing? Because what you're earning on your savings is less. You're trying to reach a target, so you've got to turn around and save more.

As an example, the typical German household saves about 17 percent of its disposable income. They're not big stock buyers. Their money is in banks and insurance companies. They buy life insurance policies and annuities, those sorts of things, and savings accounts. The German 10-year bond in the last five years has gone from four percent yield to 15 basis points. That's impacting the behavior of a saver in Germany. New one-- not really new, we're just going to try this idea. Helicopter money. The original idea was that the central bank would distribute cash directly to a household or an individual. Don't worry about borrowing the stuff. Print it. That's exactly what it's designed to do. You want to stimulate inflation by literally going out to the household and handing them money and say, "Here, go spend it." Might work. It's permanent injection of money. You can't get it back once you've done it. It's like having, you know, let's go borrow some money and build

something. This is really, turn up the printing press, let's just print the stuff. Ask the Germans about how that worked out before World War II. You talk about get a voucher. Easiest way is just to give everybody a tax rebate. We'll print it, have the IRS send it to you.

These two down here I need to read to make sure you get them, because it's kind of small, and you might not be able to read in the back. But I found these two to be very interesting as far as quotes about behavior and fixed income. The first one comes from Colin Lundgren. He's the head of fixed income for Columbia Threadneedle. "In a yield-starved world where a significant percentage of global government debt is yielding zero or something less, investors are reaching for yield by either extending the maturities or buying credit or some combination of the two." This next one from Kathy Jones, she's in charge of fixed income strategy over at Charles Schwab. "There is clearly a lot of demand for anything that gets something with a positive yield." Okay. "If you're a buy and hold investor, you might as well, every chance you get, buy it." I look at these two comments and realize these are non-fundamental comments for why you would buy a bond.

Now, as some of you might have noticed, I have gray hair. Some of you also might have noticed I look a little older. If you haven't, good. I want to know you better. Anyway, I appreciate that. So I remember the

'70s. Gosh, I don't know if I should say that. I remember the '70s. We had double-digit inflation, for those of you that don't remember those sorts of things, where inflation was 10 to 15 percent. And the mantra was, you might as well buy whatever it is today, because the price is just going up tomorrow. And these two quotes remind me of that kind of behavior. Buy the bond today before the price goes up and the yield either goes to zero or gets negative.

I'm not going to look at everything on here, but this is kind of from Swiss Re, another reinsurance company. Does a lot of research that they publish. This is a look at the financial repression, what's been the impact. So for the US, government gross debt's up 9.6-- that's a T, for those in the back row-- trillion. That's 41 percent of GDP. Not that dissimilar when I get over here to Japan or UK. Increase in central bank balance sheets. Ours is up 3.6 trillion in about five years. Change in the 10-year interest rates. We're down about 1.8 percentage points. Like I said, it says here for Germany 3.7, basically went from four to 15 basis points. This I find interesting. If we did not have a zero interest rate policy, if we were not undertaking financial repression according to Swiss Re, we'd have a different set of interest rates. But because we have, the household sector has forgiven interest of \$950 billion they're not getting. Where did it go? Well, it went to the borrower. It didn't go to the lender. And the insurance

world has given up 440 billion.

Another little interesting thing is the present value of the liability stream for a defined pension plan is up 30 percent. That's 50, that's 40, that's 45, that's 15, and it doesn't count for China, because they don't have any. So that says N/A. Good news? \$14 trillion has been added to the stock market value of households. Well, that's great. You're going to have to probably sell those assets to live off of.

Why is this not working? Why is all this money we've tried to print, all this ZIRP, NIRP, why is it not working? We're coming to the conclusion is, you're in conflict. The objectives of the central bank are in conflict with the objectives of the population. Why is the objective of the population different? These are graphs that look at-- the green are males. That's females are red. Each bar represents five years of age. Germany, Japan, US, 1980. All sort of look like a pyramid. Ours is more pyramid-looking than these two. You have more young people than you have old people. That didn't come out right. You have more young people than you have old people. I'll go with it. 35 years later. We're just flat. Look at these pyramids. They're all inverted. Germany, Japan, have far fewer young people who are working and can put into a Social Security system and can support the older people who are up here. In 35 years, this is the change.

This is a look at, for 100 people in China, who are the age of 15 to 64, how many 65 year olds and plus there are. For every 100 of people who are 15 to 64 and working, there are 13 who've retired. And it's increasing. Not too bad. Check this one out. This is that same one for France, Germany, Italy, Japan. For 100 people, put 100 people in a room who are age 15 to 64 years old, in Japan, you're also going to have 43 people who are over the age of 65 in that room. These are unsustainable. This is one of the reasons in Europe you hear a lot about immigration and migration of people. How do they deal with these numbers? How do you pay for the entitlement programs of the retirees when you've got so few people who are working? Not because they don't want to work, just don't have many of them.

So how does it start to manifest? Why do we think this is really going on, and what supports our argument? This is a look at debt as a percentage of GDP. Blue line is total, total non-financial debt as a percentage of GDP. This is the private sector, this is government. This happens to be for Europe. Interestingly, since 2008, private sector, hmm. Flat to declining. Makes sense. Population's getting older. They want to borrow less, save more. Government debt, though, has been going up at a greater rate. Their economies continue to lever even more. Japan, same thing, it's just more acute.

China's a little hard to tell, because I can't figure out what's the difference between private non-financial debt and government debt. But they appear to have gone on a debt binge in order to figure out how to grow. They're borrowing consumption from the future into the present. And then the US. Hmm. Consumer, you know, businesses, everybody else. Debt's declining. Government debt's gone up by the same amount, and ours is kind of flat. We're not quite as ugly as everybody else. But you have highly levered economies. You have to service this debt somehow. Servicing of debt takes money away for other productive uses.

This is probably the one-- Steve had a chart this morning, it was in a similar vein. This is a look at the 20 developed economies, the median growth of debt, nominal GDP. You are borrowing money faster than you are growing. You are becoming more and more levered. You're on an unsustainable path. At some point, you've got to figure out how to roll this debt over. You've got to service this debt. But because we're in developed economies, which we have a much older population than we have young folks, it's very hard to do. Because that old person wants to save. They don't want to borrow. But you're punishing that person who's trying to save, not letting them earn as much, so they save more.

Another place this one shows up is looking at pension plans, how well they're funded. This is a graph, it's the 100 largest sort of pension--

not public plans, but private plans. This is the funding status. Assets minus liabilities. So the present value of your liabilities, what percentage of that is covered by the assets you have in the plan? And it sort of started over here in 2011, about 90 percent, and starting lo and behold in 2013, it's been dropping. It's down to 80. Their assumption is, because you have to do a present value of the future stream of liabilities, so you have to put some assumptions. It's sort of a corporate bond rate of some sort. It's sort of asset matches liability, they've been using 4.06 percent. Their assumption is they're going to earn 7.3. If that continues for the next two years for them, this is the blue line. Not a whole lot increased, within the next two years, the people in here just get old.

When you head down the path of zero and negative interest rates to try to stimulate economic activity, it doesn't work real well. So we go from 4.06 to 3.56 to 2.96. But since things aren't doing very well, we only earn 3.3. The funding status goes to 65. Not to be complete pessimists all the time, everything is awesome. It all works. This is perfect. The discount rate increases because inflation increases, economic activity increases, and you go from 4 to 4.5 to 5 percent. Your return on your assets is 11.3 because everything's great and wonderful, and in two years you're funded 100 cents to the dollar. You pick which one of those you think might happen.

Now, the not so good part, the last two I'm going to talk about here. This comes from the Congressional Budget Office. This is a combination of the Social Security trust funds. So there's two. There's disability, and there's old age and survivors. We all think of old age and survivors, but it's the Social Security system. It's got two. And what this graph is telling you, it's the ratio of the balance in those two funds at the beginning of the year, divided by the outlays, the benefits you're going to pay out, and your administrative costs. So up until 2008, it was growing. Your assets were growing faster than the liabilities you were paying out. Since then, it's been on a downward trajectory. Somewhere between here and here, which is 11 years from now and 18 years from now, you're going to get to zero. Why is zero important? Does anybody know why? You don't have to answer, but I bet most people don't. Because the way the law is written, once this gets to zero, you have to adjust the benefits you pay to equal the amount of money you're taking in. Oops. In fiscal year 2022 that will be October 1st, 2021 those of you doing math at home, that's about five and a quarter years from now. You are going to have to cut the disability insurance benefits you pay out by 21 percent, because of the law you can't run a negative number. And that's as much as coming in. The good news is we will last until 2031, probably, before the main system goes under. When that happens, those benefits get to be cut by 31 percent. As

you can see again, I'm still an older person. I may not be real happy when that happens. Because that's the benefit I'm going to receive. It's going to be 31 percent less.

This is an unsustainable path. The lucky person who gets elected president, who gets elected to Congress, gets the inevitable job of dealing with it, because this will happen and show up in the news about the time. The other thing that's causing this problem is, is there any real money in the Social Security system? Yes or no? No. What's in there? What are those IOUs based off of? Treasuries. Every time we go through a zero interest rate policy and we continue to drive Treasury rates down, guess what happens? The earnings in that thing goes down. They're causing the same problems for themselves that that pension plan is causing.

Now, this is sort of the macro part. I'm going to stop here, I'm going to turn it over to Abhi. He's going to talk much more about it. Okay, you've got this sort of environment. How do you find things to invest in? What is of interest to you? How do we, you know, sort of analyze these, and what has been the impact in the capital markets of some of this activity that's been going on?

Abhi: Thanks, Tom. We found this picture a few years ago, and sadly, many times now have found it to be a great metaphor for what's happening in fixed income and in bonds. So, on the right hand side, you've got these

individuals in this truck who are hunting, they're on safari, they're out looking off in the distance, completely unaware of the danger behind them. And clearly, the metaphor is that those individuals are like fixed income investors, gleefully buying bonds, completely unaware of the dangers around them. Things like overpriced credit, the risk of interest rates, weak fundamentals. And the problem is that bonds are no longer the safe place, or the ballast in the portfolio that they used to be.

So our job at FPA is to protect you guys, make sure that you're aware of the risks, and try to protect you from the risks. And the way that we do that is we pursue an absolute return-oriented long-term type of fixed income strategy, which is also trying to minimize short-term price volatility and preserve capital. And the way we accomplish that is that everything we do is focused on buying bonds at prices that compensate us for risk, whether it's interest rate risk, or duration-related risk. So really, when you think about it, we are trying to be what fixed income has traditionally been, which is the ballast in portfolio, the source of stable return. And when I say that, you will note that there's two big differences between the way we do things and what you'll find that the typical core fixed income manager does.

The first is that you'll never hear us say things in relative value terms. We'll never say things like, "Oh, this bond is really interesting, or it's

really cheap because it's 50 basis points cheaper than the index." And the reason we never say that is because losses are absolute. If you make a bond investment, and the investment doesn't work out, the amount of money that you lose isn't determined by what an index is doing. And so because of that, we always focus on absolute expected returns whenever we make our investment decisions. And, you know, to be candid with you, we've always just found it to be silly whenever a bond manager goes through a rough market, and they say, "Well, we did better than the index, but we lost money." Losing money is losing money. Loss is loss.

The second big difference between us and the typical core fixed income manager is that you won't hear us make proclamations like, "We think that the 10-year is going to a one and half percent yield, so we're long the 10-year." And the reason that we don't do that is because we view that as speculation. That's not value investing. And we are a value oriented fixed income manager. As value investors, it's just tough for us to get comfortable with that sort of investing approach. That's like an equity manager who buys stocks based on a multiple expansion thesis. The notion of buying a bond on the hope that someone's willing to pay a higher price for the bond later just don't really resonate with us. It's a lot more intuitive, and certainly a lot less risky to buy bonds at prices where you feel like it's compensating for the risk.

So to help you better understand our approach to investing, what we're going to do is we're going to first go through our investment process. And then we'll apply that investment process to the high quality part of the bond market, and then the high-yield part of the market. And in doing so, we hope to demonstrate three things.

The first is that the bond market is expensive, which many of you may already know, but we hope to put that into stark detail here. Two, the bond market has really turned into this speculative game that's really tough to win. Three, we don't believe in speculation, we believe in value. And so we hope to show that an absolute value approach to fixed income investing offers a much more attractive alternative to what you can find in a core relative values strategy. By the way, the Hulk is supposed to be us looking out for you guys. It was the second thing that popped into my mind when I was trying to come up with something intimidating. I actually have a four-year-old daughter and I've seen Frozen 20 times now. And the first thing that popped into my mind was a Disney princess, but it didn't really seem to fit the bill here.

So this is our process. Tom referenced this, I made a reference to this as well. We don't benchmark against an index. Well, what does that mean? That means that we don't have to do top-down type of allocations, so we never have to own X percent in mortgages, or Y percent in high-

yield. The implication of that is that we're free to roam about the bond universe, looking for bonds that meet our absolute return criteria. So it doesn't matter if it's called a mortgage-backed security, or an asset-backed, or bank debt. We'll look at anything, as long as it meets what we're looking for in terms of risk-reward.

Tom also referenced this before, it's a bottom-up portfolio. So what that means is that really, this whole investment process boils down to the second and third boxes that you see on this page here. That's the bond selection process. The second box relates to interest rate-related risk or duration risk, and the third box relates to credit risk. So why don't we spend some time on those two? If you understand those two, you'll understand 95 percent of what we do.

The first thing that we consider whenever we buy any bond is, we try to understand what the interest rate risk or the duration-related risk on the bond is. And that really gets to the potential for short-term price volatility. The way we do that is, we ask ourselves the following question. If we were to buy a bond, and 12 months from now, yields are 100 basis points higher, would that bond have a positive total return? What we've shown here is just an example of that approach in practice. So the blue bars at the top represent the Treasury yield curve as of March 31st, 2016. And the gray bars represent the result of that hypothetical duration

calculation that I just posed. For example, on the 10-year Treasury, which is, oops, sorry, which is that one right there. For example, if you bought the 10-year Treasury on March 31st at a 1.77 yield, you own it for 12 months, and over that 12-month period, the yield increases to 2.77 percent. Over that 12-month period, you would have a return of negative six percent. And that's an example of the math we apply to every single bond that we look at. So if we can find a bond that will have a positive total return using that math, it's something that we'll consider adding to the portfolio, and then we go to stage two of the investment process, which is a credit risk.

If we look at a bond and it has a negative return under that scenario, then at a minimum, we need to wait for a better price. That duration process goes a long way towards explaining the duration of the fund, and we've shown the duration of the fund over time in these boxes on this chart here. In essence, as you can tell by what I just described, we're basically just taking what the market is giving us. On this chart, we've shown the Barclays Aggregate Bond Index, but what we've shown in this blue-shaded area is the hypothetical total return you would get if you apply this duration process that I've just described. So, for example, if you look on the left-hand side, in the late '80s, early '90s, which was clearly a much higher rate environment, if you were to buy the Barclays

Aggregate Bond Index at that point in time, own it for 12 months, experience 100 basis point increase in yield, you would still expect to have roughly a positive three to four percent total return. And in that sort of environment, our fund had a duration of about four years. Scanning across to the right side, you can see that every time the shaded area's positive, meaning you could own something that looked like the market and expect to have a positive return in a rising rate environment, our fund has a longer duration. And whenever the blue-shaded area is negative, meaning you can't own enough yield to compensate for rising rates, then we tend to have a shorter duration. Certainly, the recent history over the past few years with the rates at historically low levels, you just can't buy enough yield in your portfolio to compensate you for the risk of rising rates. And so consequently, we have a short duration.

Now, you've heard me say multiple times that we look at 100 basis points every time we run this analysis. Why do we run 100 basis points? And the answer is because 100 basis points actually happens quite frequently, or at least it used to before we entered this price-controlled environment that Tom alluded to.

On this page, you can see we've shown the two year Treasury and the 10 year Treasury. And for each of those two bonds, we've shown the year-over-year change in yields. And then we've added a yellow

highlighted area in the middle. That yellow highlighted area represents 100 basis point yield movements. If the line zig-zags outside the yellow area, then the yield has moved by 100 basis points. And what you'll notice, if you look prior to the financial crisis, so prior to 2009 or so, you'll see that the line left the yellow area pretty frequently, perhaps every few years. Meaning that yields went up by 100 basis points basically every few years.

But now things are different. We've entered this price-controlled environment where the Federal Reserve is basically controlling bond prices through its quantitative easing program. So, as a result, you can see here with the two year Treasury, it's basically been stuck near zero in terms of yield movements for the past five or six years. On the ten year, it's less clear. You can see that the yield movements have generally been more muted over the past several years. But it's also a symptom of the monetary policy environment that we find ourselves in.

The problem here is that when you're operating in a price controlled environment, you never know when the controls are going to be lifted. And we had a great example of that in 2013 when the taper tantrum happened. 2013 was a year when Ben Bernanke made a comment suggesting that the Fed might start to scale back its quantitative easing. And on that mere suggestion, bond yields spiked by over 100 basis

points, and investors ended up suffering that year. So this is the very reason why we don't like to speculate on the direction of rates. Over the past several years, investors have been clamoring for a return in fixed income, and in doing so, they've turned fixed income from a safe, low volatility store of capital type of strategy into something that looks more like a rate betting, or interest rate speculation type of strategy. And so we think that investors really should be asking themselves whether the returns that their fixed income managers are getting them really justify the risks that they're taking on in terms of short-term price volatility and the potential for permanent capital loss.

Because of our approach to duration, we've created a portfolio that we think offers much better protection in a rising rate environment, and we've tried to outline that here. So what we've shown in this table is as of March 31st, 2016, we've shown FPA New Income versus the Barclays One to Three Year Index, and the Barclays Overall Aggregate Index. And for each one we've shown the duration, the yield to worst, and in the third column, the yield to worst to duration, which as Tom mentioned is a rough barometer for how much protection you have against rising rates or rising spreads. So if your ratio's greater than one, then generally speaking, you should have enough yield there to protect you from rates rising by 100 basis points, and in general a higher number's better. Then in the last

column, we've shown a very simplistic stress test, which attempts to estimate what your total return would be over 12 months if rates were to rise by 100 basis points, and you can see the formula down here at the bottom.

So for FPA New Income in a 100 basis point rising interest rate environment, we would expect that the fund might have a return of about 2.4 percent. If you own an ETF or a fund that mimics the one to three year index, you might expect to lose a little bit of money, maybe 27 basis points. And if you own an ETF or fund that mimics the overall bond aggregate index, then you would expect to lose about three percent. So clearly, our fund, we think, offers much better protection against rising rates. But there's a more subtle point that's being shown here, and that's one about opportunity costs.

The yield to worst is the best estimate that you have of what the long-term return on any particular bond fund or strategy is going to have over a number of years, assuming that rates aren't changed, and assuming that there's no permanent capital loss. So in a flat rate environment, given that FPA New Income has a yield of 3.2 percent versus 2.2 percent for the Aggregate Bond index, in a flat rate environment, we should have a better return than what the overall bond index gets you. And as I just demonstrated, in a rising rate environment,

we clearly expect to have a much better return than what a bond index or something that looks like a bond index would get you.

So really the only scenario where a long duration type of strategy will get you a better return than what our fund offers is if you have declining rates. So you really need to ask yourself that question of, if that were to happen, what are you really getting? In a declining rate environment, something that looks like the aggregate index is going to earn you maybe a mid to single digit type return. And FPA New Income will get you maybe a low single digit return. So what are you really getting by having a long duration strategy today? We would argue you're not getting that much.

So that covers the duration risk or interest rate part of our investment process, so now we'll move on to the credit element of the investment process. Fundamentally, if you own bonds to maturity, bonds have an asymmetric return profile. What that means is if you own a bond, the best that you're ever going to do is that you're going to get par on your investment. Alternatively, if things don't work out well for you as a bond investor, you're exposed to 100 percent of the losses, and we tried to illustrate that here. On the X axis of this chart, we've shown the value of the business or the asset that's securing the bond you might own. And on the Y axis we've shown the value of the bond. And then in this dark blue

line in the middle of the chart, we show the relationship between the underlying asset value and the value of the bond. So imagine for a moment that you own a bond with a face value of \$100. Let's pretend that the asset securing this bond is worth \$140. As a bond investor, you're only going to get \$100 at maturity. That's just the nature of what a bond is. However, let's assume for a moment that the asset is only worth \$40. Well, as a bond investor, then you're only going to get \$40, because there's only \$40 of value to go around. It's because of this asymmetry in the return profile, and because we don't get to participate in the upside that we spend the vast majority of our time trying to understand how much a business or asset could be worth in a downside scenario. We really want to understand this bluish-green area, which is the margin of safety. It's the amount of cushion that we have between the value of the asset and how much our bond is entitled to. And it is this focus on fundamental value which often leads us to avoid certain parts of the market because we just view them as expensive, meaning that we feel like we're not getting compensated for credit risk.

So that covers the investment process. Now let's move on to the high quality and the high-yield bond market in comparison to FPA New Income. We'll start with the high quality market. This is a chart of the Barclays Aggregate Bond Index, which is a proxy for the overall high

quality bond market. We've shown the yield to worst of the index in green and the duration in dark blue. And if you just focus on the right hand side, what you'll see is that we're at historically low levels in yield, and historically high levels in duration. This chart though, I think better captures the risk in the market. We've collapsed the yield to worst and the duration into that one metric of the ratio of yield to worst to duration. It's really, you can think about it as like a live sharp ratio. It's telling you how much return you're getting per unit of risk on a live basis. And what you can see when you look at this metric is that in comparison to history, and this chart goes back to 1991, and this is the same index that we're showing, we're at historically low levels. So if you own something that looks like the aggregate bond index today, you're getting paid one of the lowest levels of return per unit of duration risk than you've been paid over the past 25 years, which to us a clear sign that the market is expensive. Also, keep in mind, it's not just pure risk-free interest rate related movements. It's also credit risks, which manifests itself in the form of spread movements.

So to help you understand why the aggregate bond index looks so bad, let's look at what's exactly in index. And I won't read through all the numbers here, but just quickly you can see that if you look at the major sectors in the Aggregate Bond index, you can see that 37 percent of it is

in Treasuries. Eight percent of it is in government-related bonds. 25 percent is in corporates that have a yield of three percent and a duration of seven, which is particularly scary. And then 31 percent is in securitized products. So let's just hit on a few of these quickly. This chart shows the Treasury component in the index, and the same type of chart that you've seen before. So we've got the yield in red here and the duration in green, and the blue-shaded area is again that same 12-month hypothetical total return calculation that we just looked at a few moments ago. Again, just focusing on the right hand side, you can see that we are in uncharted territory here. Yields are at historically low levels. Duration is historically bad, and the potential total return profile in a rising rate environment is just about the worst it's ever been. So again, people should be asking themselves a question, why would it make sense to own long-duration Treasuries today?

And the answer is, only if you think someone's going to pay you a higher price for it later. It's just speculation. It's not true investing. And it's because of that, we just don't think that investors are really getting paid enough to take on the bet that Treasury bond prices are going to keep going up. Because if you end up guessing wrong, that loss profile of, I don't know, maybe potentially negative four or five percent is pretty painful.

Moving on to the investment-grade corporate bond market, quickly what we've shown here is leverage levels at the top for investment-grade corporate borrowers, and coverage ratios at the bottom. And the brief takeaway is that leverage levels are going up. They are certainly higher than they were prior to the financial crisis, and are approaching levels last seen during the telecom bubble. Coverage ratios are also going down, which is pretty astounding considering that investment-grade corporates can now borrow at historically low rates of financing, so that's a point of huge concern.

Similar chart that we just saw for the Treasuries. Now we're looking at investment-grade corporates. Similar story. Yields are really low. Duration's really high. Potential total return in a rising rate environment is historically awful.

This is again a similar chart. We're looking at the securitized investment-grade bond market. Keep in mind that the securitized investment-grade bond market is mostly agency securities. So we're basically looking at the agency mortgage market here. The reason the duration shown in green is jumping around is that, as I'm sure many of you are aware, duration on mortgages tends to move with the interest rate environment. So when interest rates go down, refinancing and prepayments tend to pick up, and so then you've got mortgage duration

shortening. And that explains-- and the opposite happens when you have a rising rate environment. So that explains a lot of the movements in duration.

What's important to note here is what happens when you have a rising rate environment, which is shown right here. And that's again, 2013 during the taper tantrum. So when rates rose in 2013, you'll note that the duration almost doubled from around three to six. So when you couple that sort of duration jump with a historically low yield environment, that sets up what could potentially be a really bad return profile going forward.

Now, in comparison to all that ugliness that we just went through, we think that the high quality of holdings in FPA New Income offer a much more attractive alternative to what you can get in the high quality bond market in general. So we've already talked about the aggregate bond index and its sector composition, which we showed a few slides ago, and now we're looking at the FPA New Income Fund high quality holdings. And if you just look quickly on the left hand side, you can see that most of our holdings are in a securitized product. Overall, our high quality holdings have a yield of about 2.1 percent and a duration of 1.4, which gets us a yield to duration ratio of about one and a half. And for the aggregate bond index in comparison, you're getting a yield of about 2.2 percent and a duration of five and a half years, resulting in a ratio of 0.4. So again, it

gets to this notion of, what are you really getting for taking on all this extra duration related risk? We don't think that much.

Now, moving on to the high yield market, which we find troubling for two reasons. One, the fundamentals are heading in the wrong direction. This chart shows year over year changes in EBITDA growth for high yield borrowers. In yellow, we've shown the borrowers excluding energy companies, and blue includes energy companies. Even if you leave out the energy companies, just looking at the yellow bars, you can see the EBITDA growth on a year over year basis recently has been down to maybe flat, if you're being generous. And that fundamental performance carries over to leverage metrics. On the left hand side we're showing leverage, and on the right hand side we're showing coverage. Leverage determines whether you're going to get paid back par on your bond. Coverage determines whether you're getting paid your interest payments. As you might expect, given the poor EBITDA performance of high yield borrowers, leverage is moving up, and coverage ratios are moving down.

So, this really points to why we focus so much on downside protection when we're evaluating bonds. It's because of this poor performance, you can't generally count on high yield borrowers growing their way out of their leverage situation, so you need to make sure you get paid for that risk.

And then the second most worrisome thing about the high yield market is it's just really expensive. Now, a lot of people will counter that comment by saying, oh, well, the yield on the index is higher than it has been in the past several years. But we think that's a misleading statistic, and here's why. We've shown since 2012, in the dark blue line, the yield on the overall index, the dark green line is the yield on the CCC component, and the lighter green line is the yield on the BB and single B component, which is basically what you have left. So yes, the dark blue line will tell you that the overall high yield index is trading at a seven and a half percent yield today, which is fine, high relative to the past four years. But if you strip out the CCC bonds, which are trading at really high yields relative to where they've been recently, what you have left is a BB and single B index which is only trading at a 6.15 percent yield. Which, A, is not that cheap relative to history, and B, we would argue, not that cheap based on the weak fundamentals and the weak structural protections that high yield bondholders have.

But this, I think, is a more telling chart. This chart shows through 1994, which is as much history as we were able to get, the price to earnings ratio of the high yield bond index. And I'll make a couple comments here. One, we're only showing double B and single B bonds. And the reason we're doing that is, this is the purest view you can get on

the opportunity set in high yield. What we've done is we've taken out the CCC bonds, which are trading at enormous yields, and we've taken out the energy bonds, which are also trading at enormous yields. So really, if you don't want to have any more CCC exposure, or you don't want to have energy exposure, what are your options? Those are your options. And the reason we've shown it on a P/E basis is because when you look at it on a P/E basis, then it aids comparability across other asset classes. So for a high yield bond, the P/E ratio is essentially just the inverse of a yield to worst. It's the price you pay for a dollar of yield.

It's pretty clear to see here, looking at the right hand side, that the high yield bond market is more expensive than it's ever been. We've also taken the liberty of adding a horizontal line connecting it to the pre-crisis levels, which I think most people would agree was a period of particular frothiness. Bond prices are higher than they were prior to the crisis, which should really give investors some cause for concern, and think about what might happen next.

As an investor, you don't have to limit yourself to high yield bonds. You can look at structured products. You can look at anything in the bond market, which is what we do. We have a flexible mandate that allows us to explore the bond market and try to find bonds that we think offer us appropriate returns for the risk. So we've built this credit portfolio which we

think has a much more attractive return profile than what you would get if you owned the high yield market, or something that looks like the high yield market.

This table compares the high yield index in the second column to our credit sensitive holdings in the third column. And what you'll notice is that both of them have similar yields of about 8.2, 8.3 percent. But the duration on the high yield index is about 4.2 years, and the duration on our credit-sensitive holdings is about 1.4 years. So in terms of that measurement, and the yield to duration ratio, and again, a higher ratio is better, the index is offering you about a ratio of two. Our ratio is almost six. And the way we've achieved that is by having only about a third of our credit-sensitive holdings in actual high yield bonds or high yield bank debt, and about two-thirds of our holdings in a variety of structured product instruments and one or two municipal bonds.

Having said all that, when you put it together, what you have is, we think, again, a more attractive portfolio than what you might get if you tried to pursue a more index-oriented strategy. So we mentioned at the outset that we have to have at least 75 percent of our holdings in high quality bonds, and we can have up to 25 percent of our holdings in credit-sensitive bonds. One way to replicate that is to do a 75-25 percent blend of something that looks like the aggregate, and something that looks like

the high yield index. And we compare the sharp ratio of New Income to that 75 percent-25 percent blend. Whether you look at the one year, three year, or 10 year history, it's pretty clear to see that our sharp ratio is much more compelling than what you might find on some sort of blended-type product.

In the interest of time, we'll skip over the next few slides. But in case anyone wants to ask about it in the Q&A, we have some material here regarding the three largest homogenous exposures in the portfolio. Those would be our auto ABS holdings, our stripped performing CMBS, which represents Ginnie Mae project loan interest only bonds, and then our non-performing mortgage-backed securities. In total, the three of those represent about 40 percent of the portfolio.

So, when you put all that together, I think we've gone through a lot of risks here, you would think that there would be a lot of concern in the bond market about what's been happening in terms of fundamentals and overpriced credit. And yet given the performance that you've seen in bond markets this year, you would think that everything is awesome. Everything in fixed income has done really well. Treasuries, structured product, high yield, it's been a tremendously returning market. And how is that happening? Well, it's because of anomalies like the Japanese government bond returning five percent because it's gone from a slightly

positive yield to a negative yield. And we're left wondering how long that can keep going on.

So to try to put that in perspective, let's play a game of name that chart. Can anyone tell me what this chart represents? Good. NASDAQ. This is indeed a chart of the price to earnings ratio of the NASDAQ leading up to and through the height of the tech bubble in the mid-'90s. So if you'll recall back then, again, it was a time of clamor. There was a tremendous fear of missing out as people saw their friends making a lot of money on the likes of Razorfish and DrKoop.com. This particular speculative trip ended with the NASDAQ falling about 50 percent in 2000, when people simply decided that they weren't willing to pay increasingly higher prices for businesses that don't make money.

Now, can anyone recognize this chart? This one's a little bit harder. Close. It is the price to earnings ratio of the Barclays Aggregate Bond Index, so yes, it's a lot of Treasury in there. So again, recall, the price to earnings ratio of a bond is the inverse of the yield to worst. It's the price you pay for a dollar of yield. And as you can see, this trajectory is eerily similar to what we saw on the NASDAQ during the tech bubble. We're certainly not chartists, so we're just presenting this as a point of concern, and just a way for people to think about the direction that the market's heading in. But for the past several years, bond investors have been

paying increasingly higher prices for bonds due in no small part to central bank manipulation.

As bond investors, we are in our own tech bubble moment right now. And we suspect that it's going to be painful when this speculation reverses course. And in fact, we already had a preview, again in 2013 during the taper tantrum, when the price of this index fell by seven percent on the suggestion that rates might rise. So just like during the tech bubble, I know it feels like you're missing out, and you see a lot of other people making a lot of money by rate trading and trading duration. Hopefully we've just demonstrated the irrationality of this approach, and hopefully we've also demonstrated that patience, flexibility and a focus on value will ultimately deliver a better return profile going forward. And now I'll turn it back to Tom.

Tom: Thank you. I'm going to close up with a couple of comments here, and then we're going to go to Q&A. We're almost through this, and I see that most people have stayed awake. I appreciate that. So, effective June 1st, we had a couple of fund announcements. We put them out on the 31st, that I wanted to share with you. There were two of them. The first one is, I alluded to earlier 75 percent of the assets in the portfolio always are going to be of high quality. And this would be that high quality bucket. And in March, further back, it was always AA and higher. And the reason for

putting things in here was, we looked at what price movement was. And price movement here in these bonds is all driven by shape of the yield curve, monetary policy, fiscal policy, macroeconomic factors, what's the level of inflation, absolute yields. Big macro stuff. Drives them all in a very homogenous fashion. Then over here is credit. Sometimes difficult to implement, and very easy to figure out. This is, do they have a willingness and ability to pay you back? That's really only the question you're trying to answer.

Well, in 2010, we started doing an awful lot of work and deep work into the structured product market. And one of the things that we discovered, and we've got the details here, but time, I'm not going to necessarily go through it, is we found that A rated securities fit this bill with characteristics. The prices of them moved because of macroeconomic factors, not credit factors. And so we made a decision that we changed the high quality bucket. Instead of AA-, it's A-. Now, having said that, we don't have any in the portfolio today. We don't have a list of things to buy tomorrow. This is for something in the future that Abhi talked about when he said, okay, this market looks really overvalued when it sells off what might work for us. So it's something in the future. It's not something for today. We don't expect to see a change of any significance today.

And then the last one is, I'll just leave that up here. Someone else

can go through all of them. Last one is, we've talked to you today about, Abhi laid out our good case about how things were overvalued in the bond market. I explained a lot about financial repression, and NIRP and ZIRP and QE and all these sorts of things, and what it's doing to us is everything that we look at, the yields continue to get lower and lower. Not a surprise to most people. Now you're faced with the quote that I showed you earlier. You either stick with the discipline that you have that got you here, the discipline that Abhi laid out, or you shift that discipline, and go, you know what? I'll reach a little bit for yield. Ah, it's okay. They're not going to do anything today. Janet Yellen's not raising rates tomorrow. But you know what? Eh, the economy's okay. I can take a little more credit risk. It's okay. And you start to compromise your principles. You start to compromise your discipline. And we are not someone who wants to compromise those two items. But we also realize for our investors, because that's who we work for, our investors, which are you sitting out there, and him, and people on the team, the rest of my partners. We're all in this together, and decided that if you're going to keep this the same, you need to do something. So, effective June 1st, we've capped the expenses in this fund at 49 basis points. Basically, it's 15 percent less than it was before. And we will do that and review it on an annual basis. People will ask us, "Well, when might you change that?" I said, "Well,

probably one of the things you might want to look at is, once we get through-- if we ever do get through financial repression and ZIRP and NIRP, we probably would revisit it. But until such times, that's where we're going to be." The other thing I will say for it, it does not stop us investing in the strategy as it relates to people. Abhi and I have three people, candidates for a credit position we have open. We're going to hire that person. Just because we reduce the fee doesn't mean that that stops. We need to continue to invest in the product. We just realize we're in an environment where we need to do that. It's the best thing to do for our investors. So with that, I will stop, and we are open to any questions that you may have for us. Yes, I'm going to make you wait until that shows up.

Q1: Thanks, guys. Talk to us about cash in the portfolio, how that plays as a byproduct of finding opportunities. Is there limits on the amounts of cash, and could that get very high if you're really trying to preserve capital? Talk to us about that?

Tom: Okay, cash is the residual of the number of investment ideas that we have. If you think about us in the past, there was lots of things I've not been able to do. I could've left it in Treasury bills back in some of the periods of the '90s and such, and even in the 2000s, I could've gotten three, four, five percent out of it. I don't get that obviously today. But that doesn't mean you don't still treat it as it's the residual of your investment

ideas. It is also one of the ways you can sort of dampen your duration down. The portfolio's been running of late somewhere in the 10 percent range. It's basically Treasuries that mature in less than a year, is what makes it up. During history, I can get in here, if I dug around far enough there's a slide in here that has it. But in history, that has been as high as-- I might get this wrong, Bob, but I want to say upwards 30 percent of the portfolio. There isn't a cap on how much cash we could have. We've been as high as 30. We've probably been as low as five. But the prospectus and the guidelines don't have any specific cap to it at all. But it is, think of it always as it's the residual of the number of ideas we have, because we are bottom-up in what we're looking for. All the way back in-- I can-- oh, I'm sorry. I could see him easier than I could see you. You've got-- okay, go ahead.

Q2: Can you talk about the securitized investments that you hold in terms of-- you said that's the majority of your investments, is that correct? Who are the issuers of them, and what do they have to put up to, I mean, do they have to put up Treasuries, meaning collateral, or how does that work in that business?

Tom: Want to go ahead?

Abhi: Sure, let me just flip back for a second. So the securitized investments are the majority of our high quality holdings. Let's see if we can go back here.

[technical discussion]

Abhi: Anyway, so securitized investments are the majority of our high quality holdings. In terms of the overall portfolio, I think we have roughly high 70s, low 80 percent of the overall portfolio in securitized product. So this is an example of a fairly typical asset-backed securitization, and this actually represents our auto loan ABS, which is about 19 percent of the overall portfolio. The way these things work is that in terms of protection, this particular bond follows what's known as a sequential payment structure. So as the underlying car loans make their principal payments, that money gets distributed first to that A1 tranche on top until it's paid off, and then it goes to the A2 tranche, and then the A3, and so on and so forth. Any losses that occur in the underlying loans get absorbed by first the over-collateralization. So, over-collateralization is the difference between the total loan balance and the amount of the bonds that you've issued. In this particular instance, there is about \$1.2-1.3 billion of total loans with \$1.1 billion worth of bonds issued against those loans. So if you have losses, that over-collateralization gets eaten up first. And then it starts hitting those bottom tranches, E, D, C, et cetera. What we've done, just given that yields are really low, given that you're really not getting paid all that much on an absolute basis to take on that much risk, we just assume out of the box that the losses on the loans are going to be really, really high.

In general, that means that we're assuming losses that are at financial crisis-type levels or higher. And because of that loss assumption, if you look across, in aggregate, what our holdings are in the auto ABS space, our bonds, on average, can withstand something greater than three times the level of losses that we've seeing during the financial crisis before they take any sort of hit to principal. That speaks specifically to our auto ABS bonds, but generically, that's the approach that we take when we evaluate any sort of securitized product type investment.

Q2: But when they but these together, they have to—somebody has to service for you?

Abhi: Yes.

Q2: Can the servicer service bonds if their loans had some losses?

Abhi: Yes, so that's right. So that's actually a key point of emphasis for us. So whenever we make an investment in a securitized product-type investment, we spend a lot of times meeting with the issuer themselves. So specifically, for example, and it's a great example to use, in the auto lending space, there are maybe 10 to 15 outfits out there that issue auto loans. We're really only willing to invest with a handful of them, because the other guys that we met with we just don't think are really prudent in managing their actual business. And it goes to the concern that you highlighted, which is that if the losses end up being greater than what the

issuer is assuming, then that jeopardizes whether or not that business is going to continue to exist and actually be around to service our loans and service our bonds. So we only want to invest with firms that we think are going to be there through the duration of time to service our bonds and pay us off. Ultimately, if the underlying company were to go away, what happens is that the servicing gets transferred to another firm. Often times in the auto lending space, it ends up being Wells Fargo. Our bonds should probably be fine. But it's just not worth the agita of going through the servicing transfer, so that's why we spend so much time with the issuers themselves.

Tom: There was a question-- oh, okay. Oh, I've got a waving hand back here. Yes sir, I think?

Q3: Yeah. Given the macro landscape you outlined, and the absolutely low level of interest rates, I'm just wondering what a more severe stress testing looks like at 200 basis points or something larger.

Tom: We-- is it in here?

Abhi: It's in there.

Tom: Hold on. We actually have it in the back. Elliott?

Abhi: There you go.

Tom: Okay. So what we've done here, to outline what this is, is we took the portfolio, and we said, we're going to stress test this portfolio to a series of

interest rate movements. Whether it's spread-related or interest rate doesn't make any difference. We're going to let it age for a year. So, things mature, they would get paid back. Any cash that we get in just sits, doesn't do anything, doesn't get re-invested at some really great whiz-bang rate to help us out, and it's on a gross basis. The system doesn't know what to do on a fee basis. So to your point about, okay, we have looked here at this sort of 100 basis points-- this was done at the end of March for the portfolio. This was 100, and a little over two percent would be your return. All the way over here, and I'm not asking you to say, okay, you can read this from the back row, this is 200 basis points over here. And you still are looking at something at about one and a half percent before fees. So to answer your questions, yes. We do look at things other than the 100, other scenarios.

Now, we're just showing you the portfolio. Behind this is every security. We know what every security does in each one of these scenarios, and we will sit down and look, well, wait a minute. I have a series of securities that aren't working up here as rates rise. Why is that? You investigate why, you may end up selling. It's one of the ways we come up with a sell discipline on things. They no longer can withstand increases in rates. They did when we bought them, but now they can't for some reason. So it's also a way that you go through and analyze your

portfolio, and go okay, is it acting the way we think it should act? If some security isn't, then we need to do something about it. Go ahead, sir.

Q4: All right, question on the auto asset-backed securities. As losses increase, how much extension do you get in kind of the interest rate sensitivity, as those lower-rated tranches are depleted faster than anticipated?

Tom: Right, okay.

Abhi: Sure. So it's kind of a weird thing to think about, but generally speaking, when losses accelerate, that's happening because someone's defaulted on their car loans. When someone defaults on their car loans, the car gets repossessed and sold. So the odd thing that happens is that as losses pick up, the bonds actually shorten in duration, because the cash flow's just coming back to the structure sooner.

Tom: One of the elements of it is, as these get smaller, they have to try to protect these at the top to still be AAA. You start diverting more and more cash flow to pay these off and not those. That's one of the risks that you have as losses increase, and these lower tranches start to experience losses. It starts to accelerate, because you're redirecting cash flow to the top.

Q4: Do you own the AAA tranches, right?

Tom: This particular one, yes. Actually, you're right. The one I own is the highlighted one that's here, yes.

Q4: So what's the average life?

Tom: Yes. Interestingly with this one, if I remember right, Abhi, this one is older, and these don't exist anymore. They paid off. This is the one getting paid now. This was at the time of issuance. I think this is what, a couple years old?

Abhi: Yeah.

Tom: So these have tended to go away. That one's now only getting paid. But to answer your question, yes. It would tend to shorten as well.

Q5: Tom, how much do you have in IOs, and is that done as a hedge, do you anticipate a good, positive return from that?

Tom: So we have two types of IOs. Elliott, would you go to page, I think it's page two? The portfolio itself. When it gets there-- give me something to work with. Page two.

So there are two sets of IOs, but they have different characteristics to them. The first one is a CMBS Stripped. And you can do this in a short period of time. We discussed whether you can explain these in a short period of time to people. So an interest only security is just what it says. You only receive interest. You never get any principal payment. If you want to figure out the value in an interest only security, you go to your statistics or math book, and it's nothing more, what is, you know, the present value of a future stream of income? We all took that in college,

didn't we? We all remember that. This is when you finally get to apply it.

So the CMBS are a little different. The underlying loans actually have prepayment penalties in them. So if they get refinanced early, usually after two years-- you can't refinance them for two years, but say in year three you refinance them, you can refinance them, but you might pay an eight point penalty. And so with these, in the CMBS place, the IO holder receives that. So because of that, they act like any other bond. They have a positive duration, let me see if I get the right one, right here. Because you're going to get all this income, so they go up, you know, yields rise, price goes down, vice versa, with the CMBS IO that we have. You'll see a smaller one, it's a little less than one percent that says mortgage back stripped, single-family mortgages. They don't act that way, because none of us have mortgages with prepayment penalties. We can pretty much refinance them any time we wish. So because of that, interest rates decline, people refinance their homes. The stream of income gets shorter. Its present value is less, and then vice versa.

Well, for that reason, interest rates decline, value of bond goes down as a negative duration tool. Big number, minus four. When we look at it, we've at time used these as a way to protect ourselves against rising rates. Because if interest rates rise, the stream of income becomes longer, the present value of it is greater. Well, that doesn't work very well

today for several reasons, much as the valuation doesn't make nearly as much sense anymore. So to your-- how much would we use of this single family mortgage one down in here? Julian, how many years since we've bought one? That might give you an indication. So what we have is, it's just running off. We've been much more active in this one because of its characteristics than we have in single family. Does that sort of help flesh that out a little bit for you? Okay. Somewhere over here.

Q6: Yes, I think you just kind of touched on my question a little bit. But on the security level, how are you factoring in extension risk, and I guess, when you use these single mortgages in the past, and protect you against some of that. But you use conventional pre-payment models, or do you factor in some of your own analysis into that?

Abhi: So, it's the same general duration approach, so we stress it under a minimum 100 basis point rising yield scenarios. As you alluded to on mortgages, when you have changes in interest rates, that changes the duration. So, generally speaking, what we do on a typical mortgage security, we will assume the rates are rising. But we apply that higher yield to a longer duration bond. Typically, as a rule of thumb, people will say that in a rising rate environment, you would expect that mortgages prepay at a prepayment speed of six CPR, and that's just industry convention. So what we'll do is we'll assume that the bond is prepaying at six CPR, even

though in today's environment, maybe it's paying at 15 or 20. But when we do our duration stress test, we'll assume it's paying at six CPR and apply that higher yield to the six CPR scenario. And if we can still buy the bond at a price that will give us a positive return assuming that six CPR scenario, then it's something we would consider.

Tom: Okay, so we have time for one more question, but after that, Abhi and I and the rest of the team will be out in the hallway, more than happy to answer any further questions you have during the break. But I do have time for one more question. This gentleman here in the third or fourth row?

Q7: I don't believe I saw it in the portfolio, but what are your views on student loan ABS?

Abhi: How much time you got?

Tom: We've looked at them. First off, the quick answer is, there's one tiny one in there. It doesn't even show up, but Abhi's looked at them, and I'll let him explain what he found when he looked.

Abhi: 30 second answer is, there is a ton of legislative risk around student loans, so it's unclear whether they're going to preserve their protection that they have through consumer bankruptcy processes. The one loan that we own is government guaranteed on the principal balance, which is why we own it. It's one of these, it's an old, busted auction rate security

that was issued in, I think, 2007. In general, it's tough to get really comfortable with the student loan space, because the bonds tend to be really long. Because they've got this government wrapper on them, they tend to trade at very, very, very expensive prices. So it's not a space that we pay a lot of attention to.

Tom: So, okay. Well, thank you for your attention this afternoon. We do appreciate it.

Tom: And we will be outside to answer any other questions you have.

Mark: Thanks, Tom. Thanks, Abhi.