The FPA Absolute Fixed Income Strategy (including FPA New Income, Inc.)

Investment Policy Statement

Introduction

The FPA Absolute Fixed Income Strategy (including FPA New Income, Inc.) is one of the longest standing fixed income strategies in the USA. We have a defined investment philosophy and process and have executed against it since 1984. At various times during this period, both aggressiveness and caution have been demonstrated in the selection of longer term and credit sensitive investments. Only when we felt that we were being more than adequately compensated for the potential risk of loss did we become aggressive.

Since 2003, our investment strategy has been one of caution since we believed that risk of loss was too great and thus, we focused on capital preservation first, income generation second and capital appreciation last. To demonstrate the strength of our conviction, we penned Buyer's Strike in 2003 and then followed it up with Buyer's Strike Revisited in 2008. We were rewarded by this approach in 2007 and 2008 and criticized for it in 2009 and 2010, but we stand by these commentaries, available on our website at www.fpafunds.com.

We strongly believe that the declining interest rate environment of nearly the past three decades is coming to an end. In light of this, we think it is necessary to succinctly restate our investment philosophy and process, in what we are calling our Policy Statement, so that it is well documented as to what drives us in the management of your portfolio. We are confident that our investment philosophy and process is sound and well suited for the challenging interest rate and credit environment that we believe lies ahead.

Investment Objective and Strategy

The objective of The FPA Absolute Fixed Income Strategy (including FPA New Income, Inc.) is current income and long-term total return. Capital preservation is also a consideration. Since its inception in 1984, the Fund has pursued a positive absolute return through a combination of income and capital appreciation. To achieve this goal, we employ a total return strategy using investments in fixed income securities that focus on income, appreciation and capital preservation. Market opportunity will dictate emphasis across these three areas.

We are proud to have been able to achieve this goal in that since the inception of this strategy, we have earned a positive absolute return in each calendar year, with considerably less portfolio volatility than various measures of investment performance. We hope and expect to continue this positive trend.

Detailed below is the philosophy and process employed to affect this strategy.

Philosophy

We do not like to lose money!

In order to do this we adhere to the following principles:

- Absolute Return: We are absolute return investors and each investment must meet our strict fundamental research and macroeconomic criteria, not just offer opportunity relative to other alternatives.
- Long-term Focus: Our investment time horizon is usually three to five years. We expect to hold our investments to maturity unless fundamental valuation parameters change. We are not speculators and adhere to a strict investment discipline.

- Alignment of Interest: We invest alongside you as partners in our process. As managers we have significant amounts of our own capital invested in this strategy.
- Strict Risk/Reward Parameters: We like to invest when there is a target rich environment. Risk of loss is a critical element in our thinking and thus, each investment must compensate for its unique risks, combined with a margin of safety.
- Independent Decision Making: We do not follow the crowd. As we are independent in our decision making, we are often viewed as contrarian in our strategy and execution.
- Flexible Mandate: We do not bind ourselves to any one benchmark or index. We believe this flexibility provides a competitive advantage over those who do not have this capability. This has been a critical element in achieving our goal.

Process

Our process requires discipline, patience, intellectual rigor, and a longer term view. We seek to invest in the bond market, in general, and individual securities, in particular, that we feel adequately compensate us for the potential risk of loss. Our investment flexibility allows us to invest only where we see value.

First, we research credit risk by dividing the bond market into two broad segments:

- High Quality - (Securities rated A- and above; Macro/Interest Rate Driven). Price movement is closely linked to the general level of interest rates, macro-economic views focused on fiscal and monetary policy, inflation, and economic cycles. These macro-economic factors dictate our themes and thus, security specific opportunities. Our analytical process seeks to identify the comparative attractiveness of the various high quality sectors. Though these credits have similar valuation drivers, i.e., yield levels, yield spreads and macroeconomic factors, there are sector specific considerations that require a deeper analytical understanding. From this we base our allocation decisions between sectors and securities in the high quality segment
- Credit Sensitive - (Securities rated BBB+ and below; Credit Driven). Price movement is primarily linked to the credit quality of the issuer and the issuer's ability to meet its contractual interest and principal payments. We focus on company and industry specific information. Our research work begins with the attractiveness of the segment based on our view of yields and risk in the high yield market. We then run quantitative screens and make qualitative judgments to develop a target list upon which an in depth individual company analysis and valuation appraisal are researched.

Second, we ask the question, "Are the current level of bond yields attractive?"

- On an absolute yield basis
- Relative to inflation
- Against macroeconomic uncertainty
- Do they compensate for government fiscal and monetary policy risks?

Portfolio Construction

Our strategy guidelines require a minimum of 75% of net assets to be invested in High Quality securities. The mix is derived from our Process.

Allocations to the Credit Sensitive segment are a function of our assessment of the area's investment attractiveness, with considerable attention now being paid to the new risks, changing legal status and policies that have been introduced by the federal government because of the recent credit crisis. In an environment where opportunities are plentiful, we expect to have a full weighting (25%) to securities in the segment. When we have concerns about the attractiveness of securities in this area, our allocation will be (and often has been) far less.

The portfolio's duration, sector allocation and yield are the results of this cumulative decision making process.

Portfolio Review

This takes place through a constant re-assessment of the securities we hold against our investment themes and strategies. Through this process, the nature and portfolio mix (quality) changes.

- On a continual basis we will review each security as it relates to its unique characteristics. This re-evaluation starts by analyzing daily, weekly and monthly price movements to identify any changes in magnitude or direction against that period's normal activity. Any outliers will be investigated.
- We analyze portfolio securities and stress the potential return outcomes against varying interest rate changes, always mindful that permanent loss of principal is to be avoided.
- As interest rates change, we review how those changes impact portfolio performance and whether individual securities are performing as expected.
- We analyze the prepayment or repayment assumptions of our mortgage and other securitized holdings against data we receive on a monthly basis.

This dynamic process and constant review allows us to maintain holdings that we believe meet or exceed our expectations and eliminate those that do not.

Conclusion

We have communicated our philosophy in many different arenas including: shareholder letters, special website commentaries, interviews and speeches. We believe our web commentary, "Buyer's Strike Revisited", from June of 2008, encapsulates our goal and philosophy by simply stating:

"Caution and preservation of capital have been the two guiding principles these past five years. In our shareholder letters and website commentaries, we highlighted several bond market risks where, in our opinion, we believed there was inadequate risk compensation. We did not stretch for yield, in a low-yield environment, by investing in complicated securities, where their investment merits were predicated upon the quality rating of a bond rating agency. We were suspicious and skeptical of bond ratings covering new mortgage security structures or that utilized lower-quality underlying collateral. In many cases, we sacrificed yield because we did not understand the complexities of these securities. In retrospect, we believe most buyers of these securities did not understand the risks they were taking. The combination of rising interest rates and the collapse of bond ratings for high-grade securities, because of their complex derivative structures, led to these very low comparative returns."

"We will not provide long-term capital to borrowers with unsound and unwise business management practices at unattractive real yields. We require a higher level of compensation, i.e. more yield, for these potential risks. This strategy requires patience and discipline - two qualities we have demonstrated these past five years, as well as since we began managing FPA New Income in 1984."

It is through a dedicated adherence to our investment philosophy and process that we expect to achieve our goal of positive absolute investment returns for a calendar year period, along with a superior risk adjusted return, i.e., less volatility, relative to various measures of investment performance.

We have often used the phrase "WINNING BY NOT LOSING" because it succinctly summarizes our philosophy, and if there is one takeaway that our shareholders should obtain from this Policy Statement, it would be our strict adherence to this mantra.

Disclosures

You should consider the Fund's investment objectives, risks, and charges and expenses carefully before you invest. The Prospectus details the Fund's objective and policies, sales charges, and other matters of interest to the prospective investor. Please read this Prospectus carefully before investing. The Prospectus may be obtained by visiting the website at www.fpafunds.com, by email at crm@fpafunds.com, toll-free by calling 1-800-982-4372 or by contacting the Fund in writing.

Fund Risks

Investments in mutual funds carry risks and investors may lose principal value. Capital markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. The Fund can purchase foreign securities, which are subject to interest rate, currency exchange rate, economic and political risks. The securities of smaller, less well-known companies can be more volatile than those of larger companies.

The return of principal in a bond fund is not guaranteed. Bond funds have the same issuer, interest rate, inflation and credit risks that are associated with underlying bonds owned by the fund. Lower rated bonds, convertible securities and other types of debt obligations involve greater risks than higher rated bonds. Mortgage securities and collateralized mortgage obligations (CMOs) are subject to prepayment risk and the risk of default on the underlying mortgages or other assets; derivatives may increase volatility. High yield securities can be volatile and subject to much higher instances of default.

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