Tom: I thought I'd start out with this picture. To sort of set the stage and maybe lighten things up a little bit. How many of you in the room have ever been on a safari in Africa? Okay, so there's a few of you, and you probably might be able to… already figured out part of the significance of this particular picture. For those of you who haven't, I would highly recommend you do it. It's fascinating, for one. You'll learn an awful lot about the animal kingdom. And the people over there, from my experience when I went, they're very friendly, very friendly…. Shouldn't have any problems at all unless you do certain things.

And the first thing that they teach you when you're out, as these gentlemen are—by the way, they had an actual road. We didn't have a road; we just followed where the elephants went—is that the animal to the left, the lion—that by the way is a fairly adult lion—cannot... recognizes and realizes that it, does not harm it, doesn't chase it, doesn't do anything. So it's ambivalent to that black object, which is a truck. As long as you sit in the truck or, as the two gentlemen are, just put your head above the top of the truck, it can't tell the difference. However, if you stand up, as that one gentleman has done, it now recognizes you're a human. To it, you are either prey or a predator. And since the lion that is there being an adult

male, that's his territory, just so you might want to know. He will attack you either way—either because he's hungry or you threaten the territory.

So I put this in here because, in our view to many respects, some fixed income portfolio managers have become the gentleman who has stood up. They're looking off over here going, wow, isn't this beautiful? I've done a really great job. Life has been good for me for five years. They have no clue what's behind them. That's why I put that picture in there. Obviously for you who didn't, you sort got that… ones who've been on a safari went, oh.

So as that as a backdrop, that's sort of how I'm going to speak for the next 40 minutes about the markets—more about where we might be going, less about where we've been, although where we've been has a very nice place. So as we start to move forward, I'm going to spend a little time, just a few minutes on sort of how we manage. If sort of helps to go through the presentation if you understand the context of where we're coming from. Bear with me a little bit. We're going to talk a little bit about history—I very much appreciated what Peter spoke about; thought it was very important—and then where the world might go and what you might be able to find to invest in as we get there.

So from our view, we think you can get an absolute return and you can get a real return if you take a few things into consideration and you have an uncompromising risk management strategy and you never vary from it. You spend a lot of time on portfolio construction and a tremendous amount of time on individual security selection. Peter was very good. I liked… I loved the guy's talk and all the things about geopoliticals and macro things. But we spend a lot less time on that. We're value investors at end of the day, so we also want to be adequately compensated for the risks that we take.

Something else to keep in mind with us and myself… it sounded great when he said Mercantile Bank. I appreciate that very much. It was Mercantile Bank in Joplin Missouri—much smaller town than the one that's in St. Louis. But while I was there and while I was at Fifth Third, I used to manage equities. I used to be an equity analyst. This in fact is the first time I've not done equities in my life. But the other people on our Fixed Income Team all have equity backgrounds. So we're equity people who've now chosen to invest in the fixed income market.

We have two objectives that we go by. We want an absolute return in 12 months, and we want CPI plus 100 over a five-year period. We do that… so we do just look at securities that will accomplish that objective.

So that's how we're looking at the world. Put this chart in the bottom just to give you a sense… it's always we're bond people, okay? We do math. So at the bottom here, just to give a sense of, okay, you've got a portfolio with a two-year duration and about 250 yield. I can take roughly 125 basis point increase in interest rates, and I get a zero return, just as back of the envelope.

I'm looking for a margin of safety[1] to rising rates. I don't know when they're going to happen. I'm very comfortable they are going to happen. And I couldn't figure out what goes on in Washington and policies if my life depended on it. It's very difficult. So I need to get a margin of safety to the fact I can't figure out what that's going to be. You can see the indices have a much different look to them.

So we'll run an exercise… we do this with Treasuries. I did this with Treasuries just to give a sense. We'll just given an exercise… well, what happens if in 12 months I have 100 basis point increase in interest rates on something that I own? What's my total return? So I f I bought the two-year at a 32 basis point yield, a year from now that's a 132 yield. I lost 63

[1] A principle of investing in which an investor only purchases securities when the market price is significantly below its intrinsic value. In other words, when market price is significantly below your estimation of the intrinsic value, the difference is the margin of safety. This difference allows an investment to be made with minimal downside risk.

basis points. To us that's telling you: you're not getting paid for the event of rising rates to happen.

Don't really try to figure out how much. I know they've happened. About 40% of the 100 basis point rise in rates in a 12-month period since 19 roughly 50 have happened in the last 30 years during a period of falling interest rates in general. So I know it's going to occur. I can get a sense generally how it might occur if I just look at the yield curve. Can you just tell me what it's trying to tell me? What are investors trying to communicate to me if I listen? So if I have a flat yield curve like I did in 1990 where I have 2s, 10s, and 30s all at 8%, investor doesn't fear inflation, isn't demanding a higher return, tie up their money for a longer period of time, next move in interest rates is down? I have no idea when, but I know that's the next major move down.

The number there by the way is the duration we had in the portfolio, just so you know what that piece is. I put this in here mainly just to show you the yield curve and directions that move.

I look at today. I have a very steep yield curve. It tells me investors do fear inflation. They are demanding a higher return to tie up their money for a longer period of time. And the next move in rates is up. I have no clue when. I don't know when. I do know that the Federal Reserve Bank is

doing its darnedest to try to change that. They're trying to control that situation. But if I take them out of the equation, I realize where they're going to tend to go.

I also find I have an interesting sense of humor. I don't… think any fixed income presentation is incomplete without a Bloomberg slide, okay? Love those guys. I never liked the black background, but I'll deal with it.

This is a look at one-year Treasuries versus ten-year Treasuries… constant maturity Treasury from 1954 forward. Now that's because if I go to the Fed Reserve site, that's the date… I can get back that far for that set, not the fact that I was born basically a year before this and this covers interest rates during my life. That's the top panel on the left. The bottom one's the spread between the two. Blue line's the median. Upper right-hand corner gives you the data. Right now it's about 261 basis points; the median level is 83. You're pretty much more than one standard deviation away, which is what the bottom right is telling you: you're all the way over at one edge.

If you sort of dig into that graph, you realize that, during the rising interest rate periods from sort of the 60s and 70s up into 1982, the spread tended to be a lot narrower. During the falling interest rate periods from 1982 forward, hmm, tended to be a lot… tended to be above the median.

If you dig into it close enough, you realize, wow, every time short rates to up, long rates sort of go up also—not as much, but they go up. And you look at the bottom right-hand side and go, wow, short rates are pretty much nothing, and I've got long rates that have started to move up.

So looking at that, started to go back in history and try to get a sense in history much longer back than 50 years of what people expect to get from fixed income. So this is an exercise… And before I go deeply into this, I'm going to take you to the very bottom where the print is very small, especially because I looked at your copy of the slides and there's two per page. And there's a book listed down there called *The History of Interest Rates* by Sidney Homer. My advice is to find a copy of it and read it. It's not the most riveting thing you're going to read in your life. It's actually not that boring… very telling. We actually made a presentation one time where we told the client what we thought the Babylonian Fed Fund's rate was about 2000 years ago because it's in Sidney Homer's *History of Interest Rates*.

But one of the interesting things you learn in that book is rarely in history did anybody lend money to somebody else to buy a house for less than 5%. And history goes back 2,000… basically 3,000 years. Hmm, 3.5%, 30-year fixed rate mortgage, okay, all right. The other thing you

learn is don't lend money to governments. Well, why? Well, it talks about lending money to dukes and princes and such, people that you know… and this guy with that castle. They only borrowed money to go to war. So if they won the war, you got paid back; if they lost, you didn't. So they said: bad investment; you tend to charge those people more.

So that's one book. The other one is *The Ascent of Money* by Niall Ferguson. You'll figure out why the systems works the way it does today. It goes through and explains how did we come to this finance system and this lending system that we have today. It's a little… it's not quite as dry. Reads about 300-and-something pages. He's a professor mostly of history at Harvard, Scottish by descent. He's written may books, but I always… I found that one quite telling.

So the chart that's in here, there's a couple things that popped out at me. I love this. The fact is several times in history real rates have been very negative. They're always periods that occurred soon or doing a major war. Oh, that's interesting to know how we get to that number. And then we have the data in here… what I found most telling is, if I look from 1800 forward, real return on a long-term bond—something longer than ten years—about 435, 431 basis points. Since 1913, about 240. So what do

people expect to get as a return above inflation for lending money for greater than ten years?

This is the actual data and the graph. The green at the bottom is that spread. And you… Sure enough, you look at it: wow, look at that; 1860 big negative real return. Hmm, 1914 to 1920, another one. Oh, look at that: 1940 to 1950 another one. I had one anomaly: ’74 and ’79, not a major war, but we tripled the price of oil a couple of times and we did some fighting in the Middle East. And there I am where I am today. And you look at this in real returns today on long assets… very, very low by historic standards. The blue line above is this… is inflation. Fortunately it’s a little calmer than it was in the 1800s, but it still has some movement to it—not quite as violent as it used to be.

So from that we’ll just look forward… what about nominal rates? And you see some very cyclical patterns. The shortest one’s 20 years, 1900 to 1920, a 20-year rise in rates. You have a decline in rates that lasted 58 years, sort of the mid to late 1800s. And then if I look forward, I’ve got a 30-year up and a 30-year down. But the one thing I noticed is, if I go from 1790 forward… The first time I did this, someone said, well, that’s a typo. What do you mean 1790? Don’t you mean 1970? I said, no,

I mean 1790. People expect to get something just shy of 6% to lend money to somebody else for more than ten years.

And the data's very, very good. The British were able to finance their colonization and trade with 3% perpetuals, 3% British consols. They used to be around for a long period of time. I think they're… I think they've retired them, but I'm not 100% sure. If they haven't, eh, for historic reasons, go buy one. We financed the railroads in this country from about 1840 to 1900 with borrowed money from Europe—lots of it. Records are pretty good. So that rates… Once you get past about 1919, it's all U.S. Treasuries.

So the data's actually very good, and it becomes very telling when you start to look at it. You get this long slide down in rates from 1790—you had some glitches—until you get to 1940. I circled 1940 to 1950. How did I get there? Because that's where I am today. Oh, how'd I get to that one? Too much leverage, deflation, depression, and—I can't come up with a "D" for it—war. And that's how I got to that level. That's what I needed to do to get to where I had a long-term Treasury bond with a 2% yield until this latest round that we've had. And if you look at that recorded history… go, wow, that's not for a very long period of time either.

So what might we learn about that period of time that could help us today? And so I went through this and looked at this. You can go on the Richmond Fed's website and get this whole report where there's a discussion and report about the Fed Accord of 1951 and why it was important. And I do advise you to go read it; it's only about 40 pages. It's not too hard to read. It's very informative. So what was going on? Well, April of 1942, the Federal Reserve Bank set interest rates in this country. The three-month bill would be three-eighths; the ten-year Treasury would be 2.5. And they would buy as many of them as they needed to buy until they got that rate. And that lasted through World War II. They fixed prices.

After World War II, inflation became a very big problem in this country. In 1947 in sort of June-over-June year, it was over 17%. In 1948 it was 9.5. The Fed was not real interested in that. They were trying to control inflation because that was their primary objective at the time. Their goal and mandate was to control inflation. So they wanted to discontinue fixing interest rates. They wanted to be independent of the Treasury Department. And what ensues is a fairly nasty political fight for the independence of the Federal Reserve Bank of the United States.

Here's party number one: President Truman, Secretary John Snyder. They believe that banks and not market forces set supply and

demand and interest rates. Well, that's an interesting concept for a capitalist country. So they had this to say one time to the Fed. They wanted to make it perfectly clear to the New York bankers that the peg is stabilized. The board hopes…. will not allow the bottom to drop out from under our securities. Hmm, borrowing lots of money. If that happens, that's exactly what Stalin wants. Oh, good, let's throw the war part in there just to get everybody all patriotic and spool up. Our securities—is that talking about the U.S. securities or Harry Truman's borrowing that needed to go on because we were heavily levered at that time?

The Federal Reserve had a slightly different view. This is an exchange between John Wright Patman, a populist Congressman from Texarkana, Texas, and Marriner Eccles, which the Fed Building's now named after, who was a Fed Governor at the time. As a small aside, I went to school with John Wright Patman's great-grandson. He thought differently than this. But I'll just leave it at that. So Patman asked a very interesting question: do you think there is some obligation of the Federal Reserve system to protect the public against interest rate risk? Eccles: I think there's a greater obligation for the American public to protect… to protect the American public against the deterioration of the dollar inflation. Seems like a reasonable…

So then you get this one: who is the master, the Federal Reserve or the Treasury? You know the Treasury came first. What's that got… so? This is about the independence piece. Eccles thinks: how do you reconcile a position of saying that you want interest rates low, you want the Federal Reserve to stand behind the peg, and at the same time you want it to stop inflation? Can reconcile those three. You're going to have to come to some meeting of the minds.

And this last one is what I really liked: will the Federal Reserve system support the Treasury… Secretary of the Treasury in his efforts to retain a 2.5% rate, or will it refuse? You are sabotaging the Treasury. I think it ought to be stopped. Oh, I found Eccles very nice in his answer. He was pretty polite and nice. Either the Federal Reserve should be recognized as having some independent status, or it should be considered simply an agency, a bureau of the Treasury. I think I know where he was going with this.

The next page I summarize a lot of this. This is the accord. This is a piece of the accord that showed up in the Fed minutes when they were finished. And they sort of came to a meeting of the minds that debt management and monetary policies would be pursued further to their common purposes, that there would be successful financing of the

government, and at the same time minimize monetization of the public debt. And this is what started the Fed on its independent course.

There's a side note in here when you read that. Harry Truman sent over someone who worked… as an Assistant Secretary of the Treasury afterwards to be the Fed Governor because he figured he'd put his man in place. It was William McChesney Martin. Only problem is Martin was good Fed man, and he went right along with what this was. And he said, no, the Fed's going to be independent. I'm not going to support the Treasury in its efforts to raise money.

But I go through this because this is what was going on in that little period of time when we were at 2%. And now we find ourselves with the Fed wanting to sort of—we can have a discussion, but one of those things might be—help the federal government fund itself in a cheap fashion.

So the next series of slides, I'm going to go through quickly. But this is just, okay, what was inflation like when these guys were talking? Left-hand side's 1946 and 1947. Those were some pretty nasty spikes. And inflation has now gotten a lot more as we go through time… gotten a lot more stable. But it's median's 3%, and I'm at 1.5% today. If I look at Treasuries, a one-year Treasury, it's at 13 basis points basically, and it should be about 5% if I go back over the last 50-some-odd years. And if I

look at the three-year, I get the same thing, although I noticed the three-year Treasury's moving up a little bit. It should be about 5.40, 5.39 to be exact. A five-year, about 5.5 is where it should be. And a ten-year should be about 5.75. It's right now what… this says 2.74. We got a bull market going on today. I think we're at 2.65.

But all those longer ones you're starting to see them tail up well beyond the median level. So we sat down and go, well, what if we sort of got a median level bond market in the future? And before I do that, the couple of next slides just sort of look at spreads. This is long-term BAA corporates. I can't get high yield to go back that far, but I could get BAA and figured, okay, it's a good representation of high credit risk. And if I go back from 1925 forward, eh, it's about the median level today that it's always been. So probably if I look at that, if rates rise, spread's not going to help me a lot unless it's going to go well below its median.

Mortgages haven't existed for as long in a public state, so this only goes back to '71. And this is sort of a look at a 30-year mortgage rate on a median level—the spread versus the Treasury. I used like a ten-year Treasury with this. Eh, it's about the average. This I find interesting. The Federal Reserve Bank's bought $1 trillion worth of these, and the spread

still looks like the median long-term level. Nice work. Spent a lot of money, though.

So you look at these, and you realize spread's probably not going to help us. So what if I take the market back to a median level at some time in the future? And that's what the next two pages go through. This first one looks at these and goes, well, what if it takes me three years? What if it takes me five year? Well, if it takes me three years to get back to a median level, so I take the 10-year from, at the time I did this, 288, and I take it to 573, my annualized return over the next three year is minus 2.68. If I have five years to get there, I'm going to make a whopping annual return of 43 basis points on the ten year.

If you look at the bottom and look at the aggregate index, it's not very much better either. In fact, even over the next five year, if I got back to a median level of yields, all those returns are going to be less than inflation unless I get inflation to drop significantly from here. So there doesn't seem too much upside.

So I looked at it the opposite way. Let's do an exercise. Let's say we'll just use the aggregate index at the bottom. Said, okay, I want to get a 4% annualized return over the next three years on the Barclays Ag Index. Well, in order to do that, that index is probably going to have to go

to a 1.22 yield. Go back to the long-term picture I showed you before. Oh, I have to go lower than I've ever been before—possible, but not probable. If it takes me five years and I want to get 4%, I got to get the thing to get a minus-1.51.

The point of this exercise is: there doesn't appear to be much upside from here. At best it's just going to stay where it is, but it's probably going to tend to move up the other direction because history tells me I haven't been at these levels for very long, and to get there I had to do a lot of things that were not very pretty and happy.

Now the similarity is: yes, I'm in an over-levered economy. Yes, I might have deflation. Yes, that's not good, but if I'm in the bond market, it kind of looks like the 30s. No, I don't have a world war going on, and I seem to have somewhat of a more independent Fed.

So we go through this exercise and say, okay, I probably can't play in sort of the major areas if I'm going to be successful. What can I do? What can I own? How do I deploy capital in this type of environment that I find myself in? Economically we sort of look at this… de-levering, probably have slow growth. You heard talk about demographics. We've looked at those, too, and agree with it… okay, probably going to tend to grow slower. Economy's getting older.

I hope by the way that gentleman continues to work. I'm 60. In five years I am retiring, and I'm expecting him to take care of me. Is he in the room… Peter in the room? Did I scare him completely off? Just so you know… I'm that guy in 2017, '18 that's going to kind of go, I'm out of here.

So I look at those… we looked at those and said, what can we do if the economy's going to grow slower because of its leverage and de-levering, grow slower because of its demographics, and the uncertainties I have with various policies? So what could we buy? And this is what we sat down at the end of 2008 and started to paint the picture of what would we want to own. We wanted to have bonds that were secured by an asset that was critical to an individual or a company. We needed to be able to value the asset. We needed to be able to get our hands on the asset if the person didn't pay us. We needed to have that entity, that individual, or that company have equity and skin in the game so they would want to keep the asset. They needed capital at risk. I'm not going to lend my money to someone, and they don't have capital at risk. And then the last one is, because of the problems with interest rates and where we were, you needed to be five years and less.

And that's what we started to look at. What goes through here is a series of things that we found. We agnostic to what they were; they just

needed to fit in this environment. So the first thing we look at… this is about 6% of our portfolio. This is a pool of loans that I'm kind… when I say significantly delinquent and defaulted first lien loans. These people aren't 30 days past due; they're 30 months. They're not waking up tomorrow and paying you unless you do something. The loan size is a little less than $400,000; the house value today is about $250,000. I got a current loan to value of 154%, and I got a credit score of 565. These are not prime people, but they've got to live somewhere. House is critical; not going to live on a street corner.

So what did we do? Well, when we purchased these and put them in a securitization, we paid about $0.35 to the dollar for the outstanding loan balance and about $0.43 on the dollar for the current appraisal on the house. I got lots of room to maneuver with and sit down and go through the next path. And that path is either we're going to modify the loan to a level at which these people can afford to pay and move forward. Or you're going to default. Okay, we're going to foreclose on the house. We're going to sell the house to somebody else. They may turn around and rent it back to you, but we're going to do that. Those are the two paths. Does not take long; it takes you a couple of years.

Interesting thing is at $252,000, that house will support about a $200,000 loan. The cost of the loan I have is $136,000. I could take a lot of principal value off that house… off that loan and make it work for that individual. I've already figured out that it's not going work for them. When figure out this… that the financial transaction, it's not working. Now let's try to find one that does.

At $0.43 on the dollar on the house, it's pretty simple to sell and get your money back. It doesn't take a lot to fix it up and get it to go. At the end, I have a bond that's going to be around for about a year-and-a-half, and it's about a 3.5% yield. This is an aggregate of everything we bought. We've been at this for a little over a year. Well, probably I shouldn't say… two years at this point.

So this was one idea. Oh, by the way, it has nothing to do with the economy. I don't care what Fed does in interest rates. This is an event-driven situation that has to be dealt with. And the banks have made enough of these bad loans, the supplies still pretty good to go find them.

The next one I have to… this is the detailed part. The next one that we looked at is government-assisted housing. Slow economy, I'm going to need more of it—apartments, assisted living facilities, nursing homes… places where the renter is getting some or all their rent paid by a

government entity. Ginnie Mae has a program of which they will guarantee the loans on these projects. The loans are 30-to-40-year fixed rate amortization. Two-year lock-out, year three prepayment penalty is 8%. Then decline is 7, 6, 5, 4, 3, 2, 1. Very good demand for it in a weak economy. We particularly looked at the IO tranche, interest-only. All I'm going to get is stream of income.

As I like to usually say, we have now found the practical use of what we learned in college: what is the present value of your future stream of income. We all remember that when we took that finance class and go, why do I need to need to know this? This is why. They just didn't tell you at the time—IO.

The other interesting thing about the interest-only security is: what's its risk? It's default and prepayment, refinance. Those are the two risks I have. So I know through history I can figure out the default on multifamily projects that are in Ginnie Mae project loans. I will just factor that in my prepayment speed… increase it for my return. So how do I deal with refinance risk? These securities, if in year three they refinance that loan, pay the eight points of penalty, the IO holder gets it because he gets compensated for his loss of the income.

So I look at that investment and go, there a need, it's critical, I've protected myself against my risk. The next page on the very right-hand side looks at the analysis if I had interest rates rise by 100 basis points on a Ginnie Mae project IO loan. This is about 10% of our portfolio. To go through it quickly, you basically have something with about a five-year average life, little over 4% yield. If I make it a 5% yield a year from now, my total return's 53 basis points. I can stomach rising rates. I can deal with that fact and this, and I have a critical… oh, by the way, I have an asset that I know is critical.

The next one is… this is a little complex, but the nice thing is you'll see later on we put pictures of things in here to make fixed income more interesting. This is a look at a securitization we did. It was a 2007 deal. These are all the properties. The three ones at the top are important. Three JW… two JW Marriotts and a Ritz Carlton. Two are in Orlando; one is in Phoenix. These are five-year interest-only loans, LIBOR plus. They were done in 2007. They now have to be refinanced. He's got about two one-year extensions he could deal with on this. Thought I'd show you the pictures just to make it a little more less than boring.

This is the JW Marriott Desert Resort in Phoenix, Arizona—nice golf course right next to the hotel. Oh, I get to Orlando—nice gold course

right next to the hotel. Three's a pattern here—nice lake and golf course next to the hotel. These are large resort properties—destination resorts people will go to. If this person can't manage it well, somebody else can.

So we looked at this and said, all right, we own this D tranche. And we said, we're going to look at those hotels, and then we're going to look at the rest of them. And we're going to come up with a loan to value, and we're going to base it on two things. What's the current net operating income by sort of an unstressed cap rate… be the last 12 months? What's the worst net operating income these properties had, and what's the worst cap rate you could put on them, which is 12%, by the way? What's the value there?

And if you look at the far right-hand corner, that only looks at those resort properties. And realized that based on their appraisal, the loan to value was 27%. Base on our downside case, our loan to value was still $0.86 on the dollar. So if these people don't pay us and we have to take those three properties back, if we can sell them at $0.86 on the dollar, we're going to get our money back.

But we know there's an event coming… doesn't have anything to do with interest rates. They have to refinance these loans. And the next page looks at what are events… how we laid them out. We paid about

93.5 for this bond in October of last year—about a year ago exactly. So if it lasted till October of ’14, we were going to get a 4.7% return. If they extended the loan as far as they could, it got to December of ’15, we got 3.4%. If they extended it as far as they could, then they went bankrupt and it took me a year to sell the properties, I was going to earn 2.80. Because of the liquidity in the marketplace for CMBS, they refinanced this in April of this year. We made 15%.[2]

So we looked at this and said, wow, we’re going to earn somewhere between 2.8 and 4.7? That looks like a good investment only valuing those three properties and not looking at the others. We got fortunate. They took us out early. We made 15. I’m very happy. Limited downside; lots of upside that we had in something that’s not economically driven. We also had others, by the way. We did the Royal Hawaiian in Waikiki, and we did the Sheraton Kaanapali—all exactly like this.

You’ll find interesting humor. Anytime you do airplane financing, you have to put the picture of the airplane in. Okay, the only interesting thing here is: that is the plane we financed. Every time I come to a hub—New York, Detroit, L.A.—I’m walking… if I walk through a Delta terminal, I’m looking for that tail number. I want to see my plane. We financed this

[2] Realized annualized return as of April 2013. Total holding period return from October 2012-April 2013 is 6.9%.

aircraft for Delta. It's one aircraft. It was a $23-million roughly securitization. It's a 7.6% yield. We did this in the summer of last year on a 4.2-year average life.

It's a 747 400. Yes, I know it's not the most efficient aircraft in the world. But Delta's dedicated to this. They use them for one sole purpose. The fly people from the United States to Tokyo, Japan. They then fly the people from Tokyo, Japan to somewhere in Asia. And they get to do that, and no other domestic airline I know in the U.S. gets to do it. And that's fascinating to me.

I don't know who the man was that was running Northwest Orient Airlines at the end of World War II, but when General McArthur is signing on the *Missouri* the surrender papers, probably page 400-and-whatever is a clause. And it says, Northwest Orient Airlines will reconstruct a commercial aviation business for Japan. In exchange for that, they will get a hub in Tokyo because if you left Boston, Massachusetts and you decided to go to Frankfurt, Germany and you got the United plane here and you flew to Heathrow Airport and you got off the plane in Heathrow, you get Lufthansa and go to Frankfurt. United Airlines is not going to make much money on the Heathrow to Frankfurt. If you want to go to Beijing from Detroit, Michigan—some people do, by the way, just in case

you want to know—you will fly that plane. You will get off that plane in Tokyo, walk down three or four gates, get on another plane that looks just like that one with Delta on it, and you'll fly to Beijing. And Delta gets to collect 100% of that whole fare.

The bottom part that convinced us to make this was they turned around and they said, that plane, it's lie-flat beds, new coach seats, really cool electronics. Multimillion dollars, going to take them several years to get that money back. They're dedicated to that airplane for that sole purpose. So if any of you want to go to Beijing, we would appreciate if you would fly to Detroit, get on this plane, fly to Tokyo, and get to Beijing. We thank you for it.

This is a look at the bottom that… you can read to the bottom. We then sat down and we did a depreciation curve on this plane. We talked to people about what they're worth today, what they might be in the future, looked at the depreciation curve. We came to the conclusion they're worth about 3 million bucks at the end of their life. That's worth $3 million. We put a depreciation curve, looked at our amortization schedule against this, and came up with this, and realized we've got at worst a 70 LTV in this plane. We said, okay. If Delta doesn't pay on it, we have the right to take the plane back, lease it to somebody else. We could sell the plane if we

want. We could do whatever we want with the plane because we have it. If Delta goes bankrupt, it has to pay on this note unless it no longer wants to use the plane. But we've ascertained that they probably do; they put a lot of money into it.

And then the last one—yeah, I got time, I'll do the last one; I'm going to skip through real quick—is an interesting look at something that's critical. This is Nielsen, A.C. Nielsen. They rate television shows. They have a legal monopoly. You got to like somebody that's got a legal monopoly. If you're CBS and you want to get a rating how many people are watching your show, you have to call this guy up. So for CBS, Nielsen's critical. He has it. You look at sort of the sales, EBITDA? Stable growing business. Of course it's a stable growing business. I have more cable channels; I have more people watching TV trying to figure out how many people are watching what. We started out in March owning the bank debt for this company. This is the cap structure on the next page. The blue at the top is the bank debt. We own that. We said, short maturity, stable company, stable yield. This is attractive for us.

Lo and behold, we get into April and May and June. Oops. Somebody gets into trouble. I get a phone call at two o'clock… or 11 o'clock my time on a Friday—two o'clock for you guys on the East Coast.

Hey, would you be interested in 30 million 11-5/8 of February 14 from A.C. Nielsen? Hmm, might. Wow, you're calling me at this hour, hmm. Got a liquidity problem? I can solve the problem for you. We bought that 30 million. That bond's less than one year to maturity at 2% yield. They tendered for it a month ago. We got a 2% yield for that.

That was the first thing we made. Then we noticed a sell-off in the 7.75 of '18. So this 7.75 senior unsecured note due 2018 is off 2.5 points in about three weeks. Goes from 1.11 to basically…1.115 to 1.09. We paid a little over 109 to buy this. It's callable in two years… in a year roughly. We get a 3.53 yield. If they don't call us, we get a 5.74 yield at maturity. We think rates could rise over time. I would like to have a bond that would help insulate me against that problem. This bond, because it's callable, is.

Oh, by the way, they can probably refinance this thing. That's a pretty high coupon for them because the next page——is a look at the 4.5s of 2020, which went from 1.04 to 0.98. Ooh, that was painful. Its yield to call is 5.89. The problem is it yield to maturity is 4.86, but it's got a 4.5 coupon on it. Chances are pretty good they'll be able to refinance me and call me out. I look at this yield to call schedule and go, I don't like the fact that I get a lot of return up front and the longer I own this bond, the less

my return is. I don't want to own a bond that I get less return if I think interest rates are rising. That doesn't seem to work out real well for the way we manage money.

So these are ideas. This is about 1% position with what it ended up in. The airline was about 30 basis points. The combining of all the hotels at one time was about 4% of the portfolio; it's now only 2% because they keep refinancing us out. That's fine; I'm happy. I'll go invest in something else. And if… the one thing you'll notice from this: these tend to be very specific companies. They tend to be very specific assets. They tend not to look like an index. They tend to be smaller. We're having to run around… we're having to spend a lot of time running around finding things away from the index in order for us to find value with them.

Wonderful gentlemen here. Someone said we're neighbors. On a good day, he's an hour from me. I am in L.A. His world is a lot different. He can't do the things that I can. I don't want to do the things that he does. The reason I go through that is he and I can coexist very well because we sort of look at the world differently and try to find to find different things.

So this is how we would tackle what we sort of said was the new frontier. On that point, I've got about 15 minutes. I'm open to any question

you may want to ask about anything. And I see a couple of cards have shown up, but feel free to ask me any questions. I thank you very much for your time. I was flattered that someone would call up… We made 6 billion. I'm flattered that someone would call us up and go, hey, would you come speak to this conference? We manage $6 billion. So thank you very much. Hopefully this was somewhat entertaining, helpful to you. It is a little different way of looking at bonds. And I'll open it up to any questions.

Moderator Thanks. Thanks very much. I can't help but think about that picture of the Delta airplane and have, instead of Delta scratched out, First Pacific Advisor painted on the side of it. If you ever take delivery of it, I think it'd be quite a good look. I think…

Tom: You like that idea? Would you like to be on it with us because we'll all be going to Tokyo?

Moderator: It'd be great, yeah… and points further. Speaking of Tokyo and Japan, someone wanted to challenge your rate… sort of just the median view on rates and the U.S. rate experience. And they bring up the Japanese comparison view. The Japanese have been in 20 years of deflation and de-leveraging and interest rates GGB's yield less than 65 basis points. So why… how do you dissuade someone in the audience that the United

States isn't Japan and that perhaps the next 20 years… and that we couldn't be at this level of interest rates for 20 years and there's no real catalyst in the near term to get back to those median levels that you presented so clearly?

Tom: Okay, so when you look at Japan, you start to look at what would be the… what are the differences of why we're not necessarily going down that path. And think back to the Japanese when they got into this trouble, what, roughly 1990, something in that range, and what they chose to do. And the first thing they chose not to do was to write off the debt that they had that was not getting paid. There was a period of time that if you just made one interest payment to the bank, you were classified as… for the year, you were current. So they had dead assets sitting on a banking system, which meant they had a dead banking system. It can't lend money out because it knows the loans it has are bad. And that was the first thing the Japanese sort of had to deal with, and they didn't deal with.

You look at the U.S., I'm buying pools of defaulted loans that haven't paid for three years from Wells Fargo, Bank of America, Citicorp, J.P. Morgan. Am I missing anybody? That pretty much covers who I buy those things from. And I'm disposing of the loan. They are disposing of it. They're selling it to me at $0.35 on the dollar. I'm turning around now

doing something with it. So the banking system in the U.S. has the ability to purge itself of bad loans and reconstitute it.

Look at what we did capitalization-wise and how the banking system in the U.S. has been recapitalized so quickly. And look at the Europeans and look at the Japanese. We quickly said, you need to put equity in these businesses. You need to write off debt. We're much better at doing that than the others.

We have a chairman who is hell-bent on making sure we don't go into deflation. He's going to inflate this thing hell or high water. He's trying to figure out how to do it. The Japanese really for a long time didn't want to do that. If you look at Japanese from the standpoint of consensus builders, lots of committees and stuff, they tend to move sort of corporate- and political-wise much slower than we do.

And so we look at those differences and go, I don't think that's a high probability outcome. If it is the outcome, you're correct. Owning long duration U.S. assets of high quality will probably do you fairly well. Owning equities probably won't do quite as well for you because the Japanese equity market by and large hasn't done real well for the last 20 years. And if you think about U.S. companies, let's see, deflation, falling prices, falling sales, what's that going to do to margins? They're going to decline.

But the main one is we're much better at reconstituting ourselves after we destroy capital than the Japanese were.

Moderator: A question on the Fed, which you might expound on a little bit: the Fed talks about quantitative easing in the context of cost/benefits and risks. And benefits have historically and continue to outweigh the cost and risks. The cost and risk that is normally associated with someone like Jeremy Stein is that of asset price inflation. And so how do you feel about asset price… how do you feel about measures of inflation not incorporating asset prices? And should they incorporate asset prices? And should the Fed be concerned about asset prices as a measure of inflation?

Tom: Well, okay, to the asset prices, that's what they want to do. They want to drive asset prices up… is what they're trying to do. So let's look at how well they've done… and they've done a pretty decent job with houses and they've done a pretty decent job with the stock market, and they've done a pretty good job of high yield assets, of which are only owned by a small segment of the population. Most of the population hasn't benefitted from the increase in the asset prices.

The other reason of asset prices… if I could make asset prices rise like a house, I can take the negative equity and sort of get rid of it. It's one way I can do it. I could also pay down the debt or write it off. It's sort of the

two ways I'm going to get there. So they've been very much interested in getting asset prices up because they thought those who had those assets would turn around and spend more money.

So I take a little umbrage with, okay, the cost/benefits… the benefits are outweighing the costs. And we were looking and going, no, it looks like the costs of this are getting to be rather painful because look at the middle class. Has the middle class of this country benefited from house prices up, high yield prices up, and stock prices up? Anybody want to venture a guess, yea or no? Who thinks they have, yes? Who thinks, no, middle class has not benefited with QE? Right. Median incomes in this country are down. Unemployment rate is still high. Great, the wealthy have more money.

I saw… I was talking with a partner of mine, Bob Rodriguez. Some of you may have read or heard of him. He has usually entertaining things talking… he made a comment about assets. There was Formula One car that Mercedes built in the early 50s. Anybody want to venture what it sold for a couple of weeks ago? About 52 million bucks. There's only one of them, by the way, and it has a dent in the front—$52 million. Now with that $52 million sale, did we employ more people? Are we building more Mercedes Formula One cars that we're all driving around on the streets?

No. But someone has gotten very wealthy, and one wealthy guy sold it to another wealthy guy. The only person who's benefited is the mechanic for the thing. He's now got a new employer because someone has to maintain the thing.

Asset prices are up. That's great, but it's not a… Think of what you could do with $52 million in this economy if I started up a business. How many people would I hire? What would I pay them? What could I make? A lot more than the fact that there's this really cool 1952 Mercedes F1 car that some guy pay 52 million bucks for.

By the way, it was eclipsed. Someone bought a Ferrari here a week or so ago and paid even more. It's a really cool car, but I'm not thinking you're getting that thing out in the streets in Boston in February. It may see the road once.

Moderator: One last question, bring it back down to the security level: back to your sort of original framework for what you will buy and what you won't buy or what you like to buy, there's been a lot of money that has flowed into bank loan funds this year. Contact $50 or $60 billion have been sort of stunning in a grander context of outflows across broader fixed income. How does the bank loan market… you talked about the Nielsen experience, but how

does the bank loan market generally fit into your portfolio construction or your views?

Tom: So when we looked at that matrix of things that we wanted to be interested in, back loans played a role because we knew we could get at the top of the capital structure when we dealt with a high yield corporation of some sort, or someone maybe was a BB rated. And we said, okay, that would be one way we could get there. And we became interested in that from that purpose.

We liked the fact that by and large bank loans are shorter maturities—3s, 5s, and 7s. We're not interested in the 7s, but we could find the 3s and 5s. So we realized we could do that. We know there was a cost and a tradeoff for that, which is they could be refinanced; they could be called. Basically they just recast the coupon, see if you want to stick around awhile longer. And that's somewhat of a negative to us.

The other negatives that we started to notice popping up was, as new deals would come out, the covenants would sort of go away because that's where the flow of money has come into. So supply being greater than demand, you watch covenants erode on you. You're still dealing with a high yield company. This is someone who's borrowed a lot of money to

run their business I a slow-growing economy. I like covenants; I don't like ones without them because I know things can go wrong.

The other thing when we looked at them… I know people will look at them as floating rate. Oh, look, it's floating rate; isn't this great? Rates rise, I'm going to be done… right. The Federal Reserve is pegged Fed funds rate till they claim in the middle of 2015. If they're true, then that means they got a year-and-a-half of that thing being basically fixed. Why would I pay an option premium for a floater of which the guy… the central bank is peg the rate for a period of time? So we look at them as fixed rate.

Now I guess if it was a ten-year maturity, okay, I'm sure there might be some value to that. But we didn't… looked at them as fixed rate and didn't look at them as necessarily a home that, okay, floating rate would help protect us.

We started out with that investment in this portfolio. It's… about 2% is in bank debt. But when the market sold off in May and June, we said no. Because it kept running money into there, we went to where they were taking the money out of. I don't see it playing as big a role as we originally thought going forward. It's going to be more specific.

The last thing is, when you look at the two that we own, outside of Nielsen, we're very project-oriented. I got a methanol plant in Beaumont,

Texas, a great place for one. I have two power plants… gas turbine power plants in Texas. I'm missing one. There's another one I'm missing off the top of my head. But anyway they tend to be more project-oriented and less big corporate-oriented. Again back to that thing: I want to find a single critical asset that I can lend on, get a value on, get my hands on if I need it. And so we would look at it again going forward still in that context.

Moderator: Thanks, Tom. Please join me in thanking Tom for his presentation.

Tom: Thank you.

[END TRANSCRIPT]

DISCLOSURE

These slides are intended as supplemental material to the CFA Institute audio presentation that is posted on our website fpafunds.com.

We do want to make sure you understand that the views expressed on this transcript and in the accompanying audio presentation are as of today, October 17th, 2013 and are subject to change based on market and other conditions. These views may differ from other portfolio managers and analysts of the firm as a whole, and are not intended to be a forecast of future events, a guarantee of future results or investment advice. Any mention of individual securities or sectors should not be construed as a recommendation to purchase or sell such securities, and any information provided is not a sufficient basis upon which to make an investment decision. The information provided does not constitute, and should not be construed as, an offer or solicitation with respect to any securities, products or services discussed.

Past performance is not a guarantee of future results. This data represents past performance and investors should understand that investment returns and principal values fluctuate, so that when you redeem your investment it may be worth more or less than its original cost. Performance has been calculated on a total return basis, which combines principal and dividend income changes for the periods shown. Principal changes are based on the difference between the beginning and closing net asset values for the period and assume reinvestment

of all dividends and distributions paid. All applicable expenses such as advisory fees have been included in calculating performance. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the security examples discussed. Current month-end performance data may be obtained by calling toll-free, 1-800-982-4372.

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.

Current holdings can be viewed by visiting the website at http://fpafunds.com/docs/funf-holdings/new-income-13-09.pdf?sfvrsn=6.

Statistics have been obtained from sources believed to be reliable, but the accuracy and completeness cannot be guaranteed.

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.

It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the security examples discussed. Any statistics have been obtained from sources believed to be reliable, but the accuracy and completeness cannot be guaranteed.

The FPA Funds are distributed by UMB Distribution Services, LLC

GLOSSARY OF TERMS

Absolute Return: The return that an asset achieves over a certain period of time. This measure looks at the appreciation or depreciation (expressed as a percentage) that an asset - usually a stock or a mutual fund - achieves over a given period of time. Absolute return differs from relative return because it is concerned with the return of a particular asset and does not compare it to any other measure or benchmark.

Adjusted Duration: see effective duration

Barclays Corporate IG Index: is the Corporate component of the U.S. Credit index which includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

Barclays U.S. Corporate High Yield Index: covers the universe of fixed rate, non-investment grade debt.

Barclays US Aggregate Bond Index: covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. .

Bps (Basis Points): a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument.

Call Date: The date on which a bond can be redeemed before maturity. If the issuer feels there is a benefit to refinancing the issue, the bond may be redeemed on the call date at par or at a small premium to par.

Call Price: The price at which a bond or a preferred stock can be redeemed by the issuer. This price is set at the time the security is issued. Also referred to as "redemption price".

Call Yield: The yield of a bond or note if you were to buy and hold the security until the call date. This yield is valid only if the security is called prior to maturity. The calculation of yield to call is based on the coupon rate, the length of time to the call date and the market price.

CMBS (Commercial Mortgage Backed Security): a mortgage-backed security backed by commercial mortgages rather than residential mortgages.

CMO (Collateralized Mortgage Obligation): a mortgage-backed, investment-grade bond that separates mortgage pools into different maturity classes.

CPI (Consumer Price Index): A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

CPJ: Bloomberg's prepayment rate notation which is exactly like CPR, except that it also incorporates Project Loan Default model for involuntary prepayments.

CPR (Constant Prepayment Rate): is equal to the proportion of the principal of a pool of loans that is assumed to be paid off prematurely in each period. The calculation of this estimate is based on a number of factors such as historical prepayment rates for previous loans that are similar to ones in the pool and on future economic outlooks.

Effective Duration: the duration calculation for bonds with embedded options. Effective duration takes into account that expected cash flows will fluctuate as interest rates change.

EURIBOR (Euro Interbank Offer Rate): The rates offered to prime banks on euro interbank term deposits. The EURIBOR is based on average interest rates established by a panel of around 50 European banks (panel banks) that lend and borrow from each other. Loan maturities vary from a week to a year and their rates are considered among the most important in the European money market.

GNMA: Government National Mortgage Association, or Ginnie Mae was established in the United States in 1968 to promote home ownership. As a wholly owned government corporation within the Department of Housing and Urban Development (HUD), Ginnie Mae's mission is to expand affordable housing in the United States by channeling global capital into the nation's housing finance markets.

LIBOR (London Interbank Offered Rate) An interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The LIBOR is fixed on a daily basis by the British Bankers' Association. The LIBOR is derived from a filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one full year.

LTV (Loan-to-Value) ratio: a financial term used by commercial lenders to express the ratio of a loan underwritten to a value of an asset purchased.

NSA (Not Seasonally Adjusted): data series not subject to the seasonal adjustment process. In other words, the effects of regular, or seasonal, patterns have not been removed from these series.

Real Return: The annual percentage return realized on an investment, which is adjusted for changes in prices due to inflation or other external effects. This method expresses the nominal rate of return in real terms, which keeps the purchasing power of a given level of capital constant over time.

REMIC (Real Estate Mortgage Investment Conduits): A complex pool of mortgage securities created for the purpose of acquiring collateral. This base is then divided into varying classes of securities backed by mortgages with different maturities and coupons.

Risk: The chance that an investment's actual return will be different than expected. Risk includes the possibility of losing some or all of the original investment.

Spread: The difference between the bid and the ask price of a security or asset.

StDev (Standard Deviation): is applied to the annual rate of return of an investment to measure the investment's volatility. Standard deviation is also known as historical volatility and is used by investors as a gauge for the amount of expected volatility.

S&P (Standard & Poor's): The world's leading index provider and the foremost source of independent credit ratings. Standard & Poor's has been providing financial market intelligence to decision-makers for more than 150 years.

Tranche: A piece, portion or slice of a deal or structured financing. This portion is one of several related securities that are offered at the same time but have different risks, rewards and/or maturities. "Tranche" is the French word for "slice".

Yield Curve (Crv): A line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates.

YOY (Year over Year)

Yield to Maturity (YTM): The rate of return anticipated on a bond if held until the end of its lifetime. YTM is considered a long-term bond yield expressed as an annual rate. The YTM calculation takes into account the bond's current market price, par value, coupon interest rate and time to maturity. It is also assumed that all coupon payments are reinvested at the same rate as the bond's current yield. YTM is a complex but accurate calculation of a bond's return that helps investors compare bonds with different maturities and coupons.

Yield to Worst (YTW): The lowest potential yield that can be received on a bond without the issuer actually defaulting. The yield to worst is calculated by making worst-case scenario assumptions on the issue by calculating the returns that would be received if provisions, including prepayment, call or sinking fund, are used by the issuer. This metric is used to evaluate the worst-case scenario for yield to help investors manage risks and ensure that specific income requirements will still be met even in the worst scenarios.