

More importantly, regardless of the environment, we aim to distinguish ourselves by using volatility to our advantage rather than to our detriment. Instead of composing a portfolio designed to mimic the performance of some benchmark or index, we utilize a deeply-held contrarian philosophy oriented toward pushing back on a rising market by reducing exposure (thus allowing cash to increase) and conversely, leaning into a falling market and spending that cash to opportunistically buy inexpensive securities.

We hope that we have made it evident that we spend a disproportionate amount of our time evaluating and managing company-specific and macroeconomic risk. We believe that if we look to limit the downside of your portfolio, the upside will take care of itself.

- **Upside/Downside**

We invest your money in stocks that have what we believe to be advantageous upside/downside characteristics. Put another way, we seek to make a multiple of what we could potentially lose. In managing our portfolios, we accept that we will not always win and that “good” “bets” will sometimes be lost. What we seek to avoid is making bad bets. In addition to targeting asymmetric payoffs, we try to improve our odds further by conducting deep due diligence to gain a clear understanding of the underlying business and its industry, and then, wherever possible, applying some differentiated knowledge.

Equity Process

There is always a wide array of prospective investments from which to choose. We invest in an opportunistic manner, based on our view of the world and the businesses/situations that we understand. We look for what is out of favor. We look for bad news. We take into account what the landscape is today and how it might change over time, both organically and through exogenous events. We mostly hold our own counsel, speaking to relatively few “investment professionals” outside FPA. We prefer to spend less time on Wall Street and more time with people on Main Street – customers, competitors, company executives – because we believe the interaction improves our understanding of businesses and industries. Then we read, read, read. And then, we read some more.

Next, we decide which categories might offer the best opportunities for us to reach our established longer-range goal of market-beating returns with similar risk to the market. We then devote our time accordingly.

As we seek to gain comfort with a given investment, we determine what we need to know to prove - or disprove – the original thesis that drew our interest and triggered further research. We may read current and historic SEC filings and conference call transcripts, review pertinent periodicals, study the competition, and/or establish a model, among other things. We then work to gain a knowledge edge, an understanding of the business or industry that may not be universal. Some companies are followed too well for us to differentiate ourselves in this fashion but we certainly try. Such due diligence may take the form of conversations with ex-employees, vendors, industry consultants, etc.

Our bigger picture efforts have helped us identify areas of opportunity, and it has assisted us in avoiding landmines. Knowing the Titanic is unsinkable does not keep it afloat after it’s steered into an iceberg. We study the macro to avoid a similar fate.

The Fund finds opportunities in the following types of equities⁷ that generally have market values in excess of \$10 billion, a subset of equities used in the CV strategy:

- **Compounders** – The world’s great businesses. Unquestionable competitive strength. Solid balance sheets. Shareholder-centric management. We think of these as infinite duration bonds with rising coupons.

⁷ We invest in stocks that are generally greater than ~\$10 billion USD in market capitalization at the time of purchase. We now have the ability to convert our typical 13G to a 13D filing. We can now add activism as a periodic *defensive* tool should the need arise. We expect 13D filings to be rare, but there have been times in the past when it would have been advantageous, and we expect that will be the case, on occasion, in the future.

- **3:1s** – An investment in a business possibly of a lesser quality than that of a compounder, but still a good business and likely to have greater upside potential. We prefer to invest in these businesses when our assessment of the upside/downside (what we can make vs. what we can lose) has a ratio of 3:1 or better.
- **Shorter-Term Opportunities** – Identified catalyst(s) expected to have positive impact on the value of the underlying business and therefore its stock price. For example, operational turnarounds, balance sheet optimization, corporate action, etc.
- **Sum of the Parts** – The value of a company's disparate parts significantly exceeds its current stock price.

We recognize that the Fund's returns will be driven not just by what we own but also by what we do not own. The Fund's cash weighting will increase when we do not find enough appropriate investments. That cash is a residual of our investment process rather than a remnant of our macro-thinking. Cash helps us protect the downside and gives us the ability to take advantage of future opportunities.

Fixed Income Objective

The fixed income sleeve of the Fund will adhere to the principles of the FPA AFI strategy, which is designed to seek to deliver long-term excess real return with less volatility than the overall bond market. To that end, the strategy aims to generate (a) a positive total return on a rolling twelve-month basis and (b) a total return in excess of CPI + 100 basis points on a rolling five-year basis. This total return strategy seeks to achieve a combination of income and price appreciation with an emphasis on capital preservation.

Fixed Income Philosophy

We do not like to lose money.

The AFI strategy is not a relative value strategy. Success or failure will not be measured relative to the performance of an index or a peer group, since losing less money than an index is still a loss. Moreover, we will not buy a bond hoping that a decrease in the bond's spread or a decrease in interest rates will lead to price appreciation. Rather, our measure of value when investing in bonds will be whether a bond's expected future cash flows adequately compensate us for taking on credit risk and duration risk on an absolute total return basis.

Fixed income is an episodic asset class that moves between extremes, with periods of high yield and low risk and periods of low yield and high risk. The AFI strategy has a flexible mandate that allows it to take advantage of the high-yield/low-risk environments while preserving capital during low-yield/high-risk environments. During the low-yield/high-risk environments, we will not reach for yield. Rather, in such periods, we will employ a disciplined investment process that focuses on capital preservation to seek to preserve investors' buying power on a real basis for high-yield/low-risk periods.

To accomplish these goals, 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.
- **Flexible Mandate:** We do not bind ourselves to any one benchmark or index. Moreover, we do not have limitations in the types and duration of fixed income assets we may buy. In the absence of attractive investment opportunities, we hold cash. This flexibility is key to our ability to preserve capital and achieve our long-term objectives.
- **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 we adhere to a strict investment discipline.
- **Alignment of Interest:** We invest alongside our investors as partners in our process. As managers, we have significant amounts of our own capital invested in our strategy.
- **Strict Risk/Reward Parameters:** Risk of permanent loss is a critical element in our thinking, and so each investment must compensate for its unique risks while offering a margin of safety.

- **Independent Decision Making:** We do not follow the crowd. We are independent in our decision-making and are often viewed as contrarian in our strategy and execution.

Fixed Income Process

Our process requires discipline, patience, intellectual rigor and a long-term view. We seek to invest in individual securities that adequately compensate us for the potential risk of permanent capital loss and that meet the objectives described above. We build our portfolio by starting with 100% cash, then add individual investments that meet our risk/reward criteria. As a result, cash is the residual of our investment process. Our investment flexibility allows us to invest only where we see value.

A bond (or any other type of fixed income investment) is a claim backed by an asset such as a business, real estate, etc. Not unlike an equity investment, the value of a bond depends on the value of the underlying asset. Our research process is focused on valuing assets and then understanding the value of our claim on those assets.

Bonds have an asymmetric return profile, since they do not fully participate in changes in the underlying asset's value. A bond may only partially participate in increases in the underlying asset value, with a bond's potential value capped at par. On the other hand, a bond may fully participate in decreases in asset value, with the potential for the bond to be worth zero. Due to the asymmetry in a bond's future value, we invest in bonds by preparing for the worst and hoping for the best. Since bonds have limited upside potential, our research process focuses on identifying the myriad of ways in which a bond could lose value. This process applies when ascertaining both credit risk and duration risk.

Credit risk is the risk of permanent loss of capital. Our investment process focuses on understanding whether the borrower has the willingness and ability to pay us back the money we are owed. When assessing the creditworthiness of borrowers, we research the value of the borrower's assets and the borrower's ability to generate cash flow, including anything that might impact asset value or the ability to generate cash flow such as secular trends; customer, competitor and supplier dynamics; and the regulatory environment. We also research the borrower's capital structure to understand how our claim on the borrower's asset value and cash flow can be reduced or impeded.

Duration risk is the risk of near-term price movements caused by changes in yield as a result of changes in Treasury rates or credit spreads. Consistent with our goal of low-volatility returns, we seek to buy bonds at prices that provide insulation from near-term movements in yields.

In applying our investment process to fixed income, we divide the bond market into two segments:

- **High-Quality** - (Securities rated AA- and above). Price movement in high-quality bonds is closely linked to macroeconomic factors such as the level of interest rates and inflation, as well as economic cycles and monetary and fiscal policy. Nevertheless, though duration is a primary driver of returns (both near term and long term), we do not ignore credit risk. Instead, we seek to understand bond-specific and sector-specific credit risk. Our investment process seeks to identify high-quality bonds that meet our absolute return criteria of compensating us for the risk of permanent capital loss while also providing limited exposure to near-term price movements caused by macroeconomic factors.
- **Credit-Sensitive** - (Securities rated A+ and below). Price movement in credit-sensitive bonds is primarily linked to the credit quality of the issuer and the issuer's willingness and ability to meet its contractual interest and principal payments. As such, though we evaluate duration risk, we focus our research on understanding credit risk.

Finally, we ask ourselves whether the price of the bond is attractive on an absolute return basis, relative to the risk of permanent loss of capital, relative to duration risk and relative to inflation. We will only invest when we can buy at an attractive price.

Fixed Income Portfolio Construction

We will target an allocation of 75% of the fixed income portfolio to high-quality assets and 25% in credit-sensitive assets. However, the actual allocation of the fixed income portfolio to high-quality assets may range from 67% to 100% of the fixed income portfolio, and the actual allocation to credit-sensitive assets may range from 0% to 33% of the fixed income portfolio. The actual allocation will depend on available investment opportunities and the timing of changes to the Fund's allocation between equity and fixed income. Specifically, because of our absolute return, long-term oriented approach to investing, we will only invest in credit-sensitive assets to the extent that we feel we are compensated for the risk of permanent capital loss and near-term price volatility. As such, in the absence of attractive credit-sensitive investment opportunities, we will allocate more of the portfolio to high-quality assets or hold more cash.

Separately, fixed income markets, particularly markets for credit-sensitive assets, have varying degrees of liquidity. Increases in the Fund's allocation to fixed income are thus most easily accomplished on a short-term basis by increasing the fixed income portfolio's allocation to high-quality assets. For example, starting with a 40% allocation of the Fund's assets to fixed income and assuming that 75% of the fixed income portfolio is invested in high-quality assets, if the Fund's allocation to fixed income were to increase to 50% of the Fund's assets, then this increase in the fixed income allocation would be most efficiently accomplished by investing in additional high-quality assets rather than credit-sensitive assets. Consequently, the fixed income portfolio's allocation to high-quality assets would increase from 75% of the fixed income portfolio to 80%, and the allocation to credit-sensitive assets would decrease from 25% of the fixed income portfolio to 20%. Similarly, decreases in the Fund's allocation to fixed income are most easily accomplished on a short-term basis by decreasing the fixed income portfolio's allocation to high-quality assets. Using the example above, if the Fund's allocation to fixed income were to decrease from 40% of the Fund's assets to 30%, then this decrease in the fixed income allocation would be most efficiently accomplished by selling high-quality assets rather than credit assets. As a result, the fixed income portfolio's allocation to high quality assets would decrease from 75% of the fixed income portfolio to 67%, and the allocation to credit assets would increase from 25% of the fixed income portfolio to 33%.

The fixed income portfolio's duration, sector allocation and yield are the cumulative result of the individual, bond-specific investment decisions made consistent with the process described above.

Unlike an open-ended fund, which needs to maintain liquidity for investor redemptions, we may take advantage of the lack of daily in/outflows due to the Fund's closed-end nature. So instead of holding cash and cash equivalents, we may instead opportunistically own more "illiquid" assets (as defined by the SEC) and more assets that have greater near-term price volatility (including, but not limited to, interest-only securities).

Fixed Income Portfolio Review

We monitor each investment in the portfolio to ensure that its fundamental performance is consistent with our investment thesis. In addition, as interest rates and spreads change, we review each holding to ensure that it continues to offer us adequate compensation for credit risk and duration risk. To the extent that an investment's fundamental performance is inconsistent with our expectations and/or an investment no longer offers us adequate returns for the credit risk or duration risk we are taking, we will seek to reduce or eliminate our exposure to that investment.

Fund Asset Allocation

The CV team will decide how much of the Fund will be invested in equities and fixed income securities, having made such asset allocation decisions for more than two decades. The amount invested in equities will be relatively similar to the equity exposure in the CV Strategy – a derivative of bottom-up equity investment decisions. For example, in a sharp market decline, the CV team may decide to take advantage of buying opportunities that may drive a different asset allocation, one more exposed to equities. The AFI team will have responsibility for investing the balance in fixed income securities.

Important Disclosures

On December 1, 2015, a new portfolio management team assumed management of the Fund and the Fund transitioned to a balanced strategy.

The views expressed herein and any forward-looking statements are as of the date of this publication and are those of the portfolio management team. Future events or results may vary significantly from those expressed and are subject to change at any time in response to changing circumstances and industry developments. This information and data has been prepared from sources believed reliable, but the accuracy and completeness of the information cannot be guaranteed and is not a complete summary or statement of all available data.

Investing in closed-end funds involves risk, including loss of principal. Closed-end fund shares may frequently trade at a discount or premium to their net asset value. In addition, there is no guarantee the Fund's investment objectives will be achieved. You should consider the Fund's investment objectives, risks, and charges and expenses carefully before you invest.

Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. It is important to remember that there are risks inherent in any investment and there is no assurance that any investment or asset class will provide positive performance over time.

Non-U.S. investing presents additional risks, such as the potential for adverse political, currency, economic, social or regulatory developments in a country, including lack of liquidity, excessive taxation, and differing legal and accounting standards. Non-U.S. securities, including American Depository Receipts (ADRs) and other depository receipts, are also subject to interest rate and currency exchange rate risks.

The return of principal in a fixed income investment is not guaranteed. The Fund's investments in fixed income securities 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.

When interest rates go up, the value of fixed income securities, such as bonds, typically go down and investors may lose principal value. Credit risk is the risk of loss of principle due to the issuer's failure to repay a loan. Generally, the lower the quality rating of a security, the greater the risk that the issuer will fail to pay interest fully and return principal in a timely manner. If an issuer defaults, the security may lose some or all its value.

Mortgage securities and collateralized mortgage obligations (CMOs) are subject to prepayment risk and the risk of default on the underlying mortgages or other assets; such derivatives may increase volatility. Convertible securities are generally not investment grade and are subject to greater credit risk than higher-rated investments. High yield securities can be volatile and subject to much higher instances of default. The Fund may experience increased costs, losses and delays in liquidating underlying securities should the seller of a repurchase agreement declare bankruptcy or default.

Value style investing presents the risk that the holdings or securities may never reach their full market value because the market fails to recognize what the portfolio management team considers the true business value or because the portfolio management team has misjudged those values. In addition, value style investing may fall out of favor and underperform growth or other styles of investing during given periods.

You can obtain additional information by visiting the website at www.sourcecapitalinc.com, by email at crm@fpafunds.com, toll free by calling 1-800-279-1241 (option 1), or by contacting the Fund in writing.