FPA Capital Fund

Fourth Quarter 2014 Commentary

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, 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.

Average Annual Total Returns
As of December 31, 2014

Fund/Index	MTD	YTD	1 Year	3 Years**	5 Years**	10 Years**	15 Years**	20 Years**	Since 7/11/84**
FPA Capital	-0.15 %	-1.31 %	-1.31 %	9.97 %	10.76 %	7.42 %	9.88 %	12.47 %	14.42 %
Russell 2500	1.36 %	7.07 %	7.07 %	19.97 %	16.36 %	8.72 %	8.59 %	11.21 %	11.92 %

** Annualized.
Inception for FPA Management was July 11, 1984.
A redemption fee of 2.00% will be imposed on redemptions within 90 days. Expense ratio calculated as of the date of the most recent prospectus is 0.83%.

Past performance is no guarantee of future results and current performance may be higher or lower than the performance shown. 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. Current month-end performance data may be obtained by calling toll-free, 1-800-982-4372.

To view portfolio holdings from the most recent quarter end, please refer to the end of this document or at www.fpafunds.com.

Portfolio composition will change due to ongoing management of the fund. References to individual securities are for informational purposes only and should not be construed as recommendations by the Funds, Advisor or Distributor.

The views expressed and any forward-looking statements are as of the date of the publication and are those of the portfolio managers and/or the Advisor. 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. The accuracy and completeness of the information cannot be guaranteed and is not a complete summary or statement of all available data.

The Russell 2500 Index consist of the 2,500 smallest companies in the Russell 3000 total capitalization universe offers investors access to the small to mid-cap segment of the U.S. equity universe, commonly referred to as "smid" cap. The Russell 2500 Value Index measures the performance of those Russell 2500 companies with lower price-to-book-ratios and lower forecasted growth values.

Indices are unmanaged and investors cannot invest directly in an index. These indices do not reflect any commissions or fees which would be incurred by an investor purchasing the stocks they represent. The performance of the Fund and of the Averages is computed on a total return basis which includes reinvestment of all distributions. S&P 500 Index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. The index focuses on the large-cap segment of the market, with over 80% coverage of U.S. equities, but is also considered a proxy for the total market.

Fund Risks

Investments in mutual funds carry risks and investors may lose principal value. Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. The Fund may purchase foreign securities, including American Depository Receipts (ADRs) and other depository receipts, which are subject to interest rate, currency exchange rate, economic and political risks; this may be enhanced when investing in emerging markets. Small and mid cap stocks involve greater risks and they can fluctuate in price more than larger company stocks. Groups of stocks, such as value and growth, go in and out of favor which may cause certain funds to underperform other equity funds.

The FPA Funds are distributed by UMB Distribution Services, LLC, 235 W Galena Avenue, Milwaukee, WI 53212.

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Introduction

What a difference one quarter can make. Until October, the Russell 2000, a good proxy for small-cap stocks, had generated a negative return year-to-date but its fourth-quarter return of nearly 10% quickly changed that result. At the same time, the nine-month return for the Russell 2500, a reasonable benchmark for small mid-cap stocks, was essentially flat through September. However, the index's strong fourth quarter return resulted in the Russell 2500 producing an approximate 7% return for the year. Thus, the mini correction of small-mid-cap stocks during the middle of the year ended just as quickly as these indices, along with the S&P 500, reached all-time highs during the strong fourth quarter performance.

The Fund's outperformance through the first nine months of the year was reversed in the last quarter as the rapid decline in oil prices negatively impacted the energy investments. While the sudden and precipitous fall in oil prices during the last few months of the year was greater than we would have expected, given that oil demand is still growing, albeit at a lower rate than what we expected at the beginning of the year, this is not the first time we have experienced such a decline in the commodity. We will discuss the energy markets in greater detail in the Portfolio Commentary section, but investors need to remember that small changes in either supply or demand compared to expectations can result in much greater swings in the price of the underlying commodity.

While it is frustrating to see the negative impact that the portfolio's energy companies had on the overall portfolio, we remain resolute in executing our strategy of buying stocks when their values are depressed and reducing or eliminating stocks when they are richly priced. Moreover, the increased volatility allowed us to add to positions that had been substantially reduced over the past two years.

Market Commentary

2014 experienced some noteworthy reversals. First, as mentioned above, oil prices plunged roughly 50% in the second half of the year after having traded between roughly $80 a barrel and approximately $105 for West Texas Intermediate (WTI) since September, 2011. Second, while the dollar continued to strengthen against the yen in 2014, it markedly strengthened against the Euro having weakened in 2013. This dollar strength has not been seen since 2006 when the U.S. economy was being fueled by the enormous credit expansion and the widely-reported housing boom.

We believe these seemly independent factors are related to each other because oil prices are denominated in dollars for all global customers. For example, as the dollar strengthens against the yen, oil prices will increase in Japanese terms as they need to exchange more yen for dollars to purchase the commodity. In a well-functioning market, the price of oil will decline to offset the strengthening value of the dollar. If oil prices do not adjust downwards, Japanese demand for oil may recede due to the higher price. All else being equal, lower demand from Japanese and other global customers who are experiencing currency weakness versus the dollar should result in lower oil prices. Thus, it behooves Saudi Aramco and other oil exporters to lower the price of oil during periods of dollar strength in order to maintain global unit demand, and not risk losing market share to alternative energy sources.

We are not presumptuous enough to claim to be global macro-economic experts, but these significant reversals and the speed at which the dollar has strengthened and oil prices have declined portends more volatility in the future. While the initial reaction to lower oil prices and a stronger dollar may be greeted warmly by some, a closer inspection reveals that there are offsets to that analysis.

True, according to AAA, lower crude prices may mean American drivers could save upwards of $75 billion in gasoline outlays in 2015, but there also will be costs to the economy from lower oil prices. For example, according the Oil & Gas Journal, U.S. energy companies spent roughly $338 billion in capital expenditures (Capex) in 2014, with approximately $250 billion of that being spent on exploration and production projects. Recently, several brokerage firms estimated that the U.S. energy industry will cut their 2015 exploration & production budgets by 30% because of lower crude prices. If this forecast is correct, the potential $75 billion in consumer savings would be offset by the possible $75 billion reduction in capex.

This impending $75 billion reduction will impact future shale oil production and could mean nearly 800 land-based drilling rigs, compared to a recent peak of roughly 1,600 land rigs, are abandoned this year along with their crews and other service related personnel. There will be secondary effects as well. In early January, U.S. Steel announced that it will likely close at least one of its tubular steel plants that manufactures drill pipe and that over 600 workers will be laid off. These laid off steel workers, along with the thousands of highly-paid energy workers that likely will be laid off, could put a crimp in the housing recovery – particularly in Texas and Oklahoma where housing demand has been among the strongest in the country.

As we know, oil is pervasive throughout the global economy. Its rapid decline will likely have negative consequences for seemingly unrelated industries. For instance, base metals such as iron ore and copper are and will be negatively impacted by lower oil prices. The reason why is that energy is a sizeable component of the total cost to bring these metals to the market. The lower-cost producers will try to squeeze out the high-cost producers by passing on the savings from lower energy costs to their customers, and profits and employment in those industries, therefore, will be challenged. In addition to copper price declines of nearly 30% over the past few months and roughly 50% from the high set a couple of years ago, nickel and iron ore also are off roughly 50% from their prior peak levels.

These enormous commodity price and currency exchange rate swings could eventually alter current monetary policy at the Federal Reserve (Fed) and European Central Bank (ECB). The conventional wisdom is that Fed is about to tighten monetary policy and will soon raise rates and the ECB is about to embark on its own version of Quantitative Easing (QE). Henceforth, currency traders, macro hedge funds, and speculators behave accordingly. That is they buy dollars, sell Euros, and sell oil. These trades push the dollar higher, the Euro and oil prices lower, reinforcing the traders' confidence to continue with the strategy. However, these trends cannot continue forever without material consequences.

In summary, we believe the U.S. economy will benefit from lower oil prices, but not quite as much as some might expect. This is because the U.S. energy industry is larger today than the last downturn in 2008-2009 and, thus, more oil & gas projects and workers will be negatively impacted. We also have our doubts about the stronger dollar being a positive for investors. While consumers should see stable or lower import pricing for many goods due to dollar strength, foreign currency translation of overseas profits will likely weigh on corporate earnings over the next few quarters.

Expectations that lower crude prices will stimulate consumer spending may also be premature. For example, the recent Commerce Department's release of December retail sales shows store sales actually declined in December and November's sales were revised lower from the initial release's report. Gasoline prices at the pump reached multi-year lows in late 2014, yet consumers chose to hold on to those "savings" and not to go on a spending spree.

Finally, the dollar's rapid ascent versus the euro, yen, and other foreign currencies over the past year is becoming worrisome for investors. This is because U.S. GAAP accounting practices require foreign earnings to be translated into dollars at the end of the reporting period. A weaker functional currency vis-a-vis the dollar translates to lower earnings for shareholders. Moreover, rapid changes and high volatility in currencies make it a challenge for businesses to estimate what the return on capital will be for foreign direct investments. This slows the wheels of commerce and inevitably global economic growth.

Portfolio Commentary

Contributors	QTD Portfolio Contribution
Apollo Group Inc.	1.5%
InterDigital	1.4%
Western Digital	0.7%
Devry	0.4%
Aaron's	0.4%

Detractors	QTD Portfolio Contribution
Rosetta Resources	-2.6%
Atwood Oceanics	-1.6%
SM Energy	-1.4%
Ensco	-1.0%
Trinity Industries	-0.6%

The Fund underperformed the benchmark YTD and in fourth quarter 2014. Nearly all of the underperformance was due to the portfolio's energy investments. Energy stocks accounted for approximately 22% of weighting and roughly a combined 11% underperformance for the year (about 7% for the quarter). Over the past few years, we trimmed nearly every energy stock or eliminated several outright from the portfolio when oil prices were trading above $80 a barrel. For example, we cut the number of Rosetta Resources shares by roughly 77% from the end of 2009 to the end of 2013. However, it is clear that we did not anticipate the free-fall in oil prices that has transpired over the last four-to-five months. Our thesis on the energy stocks in the portfolio has been predicated on oil prices trading at $80-$85 a barrel, which is what many oil experts believe is the global marginal cost of production (MCP).

We did not underwrite our energy investments with a $100/barrel price, or higher, into our analysis. We carefully reviewed many energy reports and talked with energy executives and experts about what is the long-term sustainable price of oil. The answer we generally received is that oil prices, like any other commodity, should converge toward the industry's marginal cost of production. This MCP concept is a fundamental rule of basic economics. Short-term price swings above and below the marginal cost of production are not infrequent and should be expected. However, large deviations above or below the MCP, similar to the recent decline, are much rarer. Nonetheless, history shows that whatever the factors were that drove the big swings in oil prices above or below the marginal cost of production they eventually abated and oil prices converged back toward the MCP.

This historical pattern and economic logic facilitated our analysis and partly explains why we eliminated or reduced certain of our energy investments in 2013 and the first two-thirds of 2014, when oil prices were above of the industry's MCP. On the other hand, once oil prices declined below the marginal cost of production, we added to the portfolio's energy investments that we believe will prosper should oil prices rebound and move back toward its central tendency of the industry's marginal cost of production. For example, we purchased more Atwood Oceanic (ATW), Rosetta Resources (ROSE), Cimarex Energy (XEC), Ensco (ESV), Rowan Companies (RDC), and SM Energy (SM). We will highlight attributes of two of these holdings.

Atwood Oceanics is an offshore drilling contractor. They have been an industry leader in utilization rates, profit margins, and returns on capital for years, and they have been profitable 19 of the last 20 years. Our thesis for purchasing the stock was that the company had almost completely renewed its fleet over the last few years and signed those rigs to contracts that gave it one of the biggest backlogs in the industry. We are currently modeling in our Base Case that 98/77/36% of the total revenue we expect them to generate in FY2015/16/17 is already under contract. We believed the culture and business practices behind the company's peer-leading efficiencies would allow them to convert that backlog into substantial profits and initiate a meaningful dividend, which they recently implemented ($1/share per year).

The stock's negative performance in the fourth quarter is due to a combination of macro and company-specific factors. Macro: Spot prices for Brent Oil fell by nearly 40% during the quarter, as discussed above, and the Philadelphia Oil Service Sector index had a total return of (20.38%). Company-specific: Atwood delayed the delivery of their two uncontracted newbuild drillships by 6 months because they lost out on a customer tender that would have put them to work at decent rates of ~$400k/day. However, even if drillship dayrates fall further to $350k/day the company should still earn $3/share by FY2017 when most of their backlog will have burned off. At the Dec-31 price of $28.37 the stock is trading at less than 10x that figure (and yielding 3.52%), but in the intervening two years the company should earn ~$12 per share, or greater than 40% of the current market cap. The company-specific elements of our thesis are still intact.

Let us now discuss Rosetta Resources. ROSE is an exploration & production company that generates approximately 90% of its production from the Eagle Ford Shale basin in southwest Texas and the remaining production from the Permian basin in west Texas. The Fund has owned various amounts of ROSE over the past eight years, with its peak share count occurring on or around the financial crisis when oil prices were similar to the current level. The Fund's share count troughed at the end of 2013 at approximately 77% less than the peak share count and when oil prices were around the $100 level.

Given the subsequent plunge in oil prices and ROSE's share price, the Fund increased its exposure by over 60% in the past two quarters. This is the hallmark of our investment strategy. That is, assuming our investment thesis remains intact, we buy stocks when prices are depressed and reduce or eliminate stocks when they are rich.

ROSE's revenues from oil represented roughly 58% of their most recently reported quarter's sales, with natural gas liquids (NGLs) and natural gas producing approximately 23% and 19%, respectively, of the remaining revenues. The decline in ROSE during the quarter can be attributed to the rapid decline in oil prices. The company not only performed well over the past year, earning among the highest operating profit margins for small-mid-cap publicly-traded E&P companies, but also we expect the company to increase its production in 2015, despite a substantial decline in its Capex this year. However, given the large decline in oil prices, we expect profits will be down materially this year, but unhedged pre-tax cash flow is estimated to be over $7 a share, given the current depressed spot oil price. It is also worth noting that we believe ROSE has approximately $350 million of hedge profits on its books, again given the current spot commodity prices.

Looking beyond the poor performance of the energy stocks in the quarter and consistent with our investment strategy, we trimmed back two companies, Apollo Education (APOL) and InterDigital (IDCC). InterDigital creates and designs different wireless technologies and then licenses those patents to hardware manufacturers. Apollo provides on-line educational services and grants Bachelor and post-graduate degrees through its For-profit schools.

APOL operates the online school called the University of Phoenix (UoP) as well as several international schools. UoP generates approximately 85% of Apollo's revenue but 100% of its operating earnings. The international schools account for roughly 15% of revenues and are currently losing money but we believe they are quickly moving toward break-even and eventually profitability.

The core operation for Apollo is UoP, which is the largest independent online university in the US. UoP was the first For-profit company to offer online degrees over thirty years ago. The University of Phoenix is a well-known brand, but one that is in the process of being upgraded.

The company has invested a tremendous amount of capital into developing superior software programs not only to educate students, but also to provide a more timely feedback loop to professors who are teaching classes. As UoP rolls out this new software to all of its students, one should expect some disruptions to the business. Thus far, just 3% of the students have incurred a negative experience and dropped out of school. Nevertheless, student satisfaction and superior service for UoP's cohort of students should help the company differentiate its platform versus either other For-profit or traditional Not-for-profit universities.

APOL is also aggressively courting businesses not just to place their graduates in a well-paying job, but to partner with them and tailor certificate programs that provide students with skills specific to an individual company or industry. Many CEOs will tell you that there is not a jobs problem in America but a skills problem. That is, many traditional, Not-for-profit universities in America are not educating students and imbuing them with skills for the 21st century global labor marketplace. APOL is now working with hundreds of companies to deliver graduates, whether they are fully credentialed students or students with a narrower certificate degree, to businesses that are looking to hire qualified people.

These initiatives will take time to fully implement and for shareholders to see tangible benefits. In the meantime, APOL management has cut expenses like marketing and recruiting to reflect the lower enrollment numbers to maintain profits and free cash flow at the company. Given where APOL was trading, we trimmed back the positioned about 25% during the quarter.

Moving on to IDCC, there has been tremendous growth in wireless communications and the growth is expected to continue. Many years ago, Nokia and Ericsson were the major players in the industry. Today, their phones are nowhere to be found and Apple and Samsung dominate. It is hard to predict future market share of any individual company but it is also hard to disagree with the growth of wireless communication. InterDigital is a company that will allow us to participate in this growth without taking sides on which smart phone, tablet, or e-reader companies will hold the largest market share in the future. The company has been around since the early 70s. It is not a patent troll but, rather, a group of 175 engineers that work on new inventions every day. To date, they have obtained or applied for approximately 20,000 patents. They work with Standard Development Organizations to incorporate their technology into the standards.

We had an opportunity to invest in this company because of the prolific litigation that takes place in this industry. IDCC had a number of lawsuits pending against some of the largest players in the industry such as Nokia, LG, ZTE, and Samsung because these companies were not paying royalties to InterDigital. While the company has had some recent legal setbacks with the International Trade Commission, IDCC generally has ultimately prevailed in prior cases with the Federal Circuit Court and we expect this to occur in the current cases.

Recently, in June 2014, the largest unlicensed company (Samsung) signed a 10-year deal with InterDigital. In Q4'14, the market started paying attention to InterDigital's success with Samsung and its resulting cash flow generation abilities. Recall that IDCC was our worst performing investment in 2013. We increased our position 15% that year and by more than 8% in 2014 as the stock further weakened. Given where IDCC traded during the recent quarter, we trimmed roughly 15% of our position.

As volatility has increased, the portfolio's cash level has declined. However, small-mid-cap stocks are still expensive as supported by the high price-to-earnings (P/E) ratios of both the Russell 2000 and 2500, 33x and 26.4x, respectively. In contrast, your portfolio's P/E is close to 13x. Nevertheless, we have invested in a number of new stocks over the past few years and we expect any additional volatility will only increase the opportunity set for our deep-value, long-term investment strategy.

It is not uncommon for our Fund's performance to stray away from that of our index – Russell 2500. Let's look at two recent periods where our performance compared unfavorably for a multi-year period and then that what happened when one looked at the following two years, after completion of the full market cycle. The first example is more reminiscent of what seems to be happening today as 2000 was the end of a bull market whereas 2008 was the end of a bear market.

1997 to 2002:

	FPA Capital	Russell 2500	Under/Over
1997-2000	29.77%	61.59%	-31.82%
2001-2002	32.80%	-16.79%	49.59%
1997-2002	72.33%	34.46%	37.87%

2006 to 2010:

	FPA Capital	Russell 2500	Under/Over
2006-2008	-31.52%	-25.56%	-5.96%
2009-2010	91.06%	70.28%	20.78%
2006-2010	30.84%	26.76%	4.08%

In closing, we remain confident about our strategy's future. Our pipeline of potential investments remains robust, as evidenced by the two new stocks that went into the portfolio during the fourth quarter. One of those, Babcock & Wilcox, is an industrial company that recently announced it will split into two companies to further unlock shareholder value. The other new stock is an auto supplier with a wide range of global customers.

We also eliminated two energy stocks (Baker-Hughes and Helmerich & Payne) early in the quarter, and both of these of investments had been substantially reduced before the big break in oil prices. We also eliminated Signet Jewelers (SIG), an investment the strategy initiated over seven years ago. However, SIG's valuation grew to over twenty times earnings and became too rich for us to continue justifying holding the position.

We thank you for your continued trust and confidence in our strategy.

Respectfully submitted,

Dennis Bryan
Chief Executive Officer and Portfolio Manager

Arik Ahitov
Managing Director and Portfolio Manager

January 26, 2015

FPA investors first

FPA Capital Fund, Inc.

Portfolio Holdings

12/31/14

CUSIP	TICKER	SHARES / PRINCIPAL	SECURITY	MKT PRICE ($)		MKT VALUE ($)	% OF NET ASSET VALUE
002535300	AAN	851,096	AARON'S INC	30.57	$	26,018,004.72	2.17%
001084102	AGCO	524,600	AGCO CORPORATION	45.20		23,711,920.00	1.98%
037604105	APOL	1,670,200	APOLLO GROUP INC.- CLASS A	34.11		56,970,522.00	4.75%
04269Q100	ARRS	2,269,163	ARRIS GROUP	30.19		68,506,030.97	5.72%
042735100	ARW	968,400	ARROW ELECTRONICS	57.89		56,060,676.00	4.68%
050095108	ATW	1,646,400	ATWOOD OCEANICS	28.37		46,708,368.00	3.90%
053807103	AVT	1,391,300	AVNET	43.02		59,853,726.00	4.99%
05615F102	BWC	711,400	BABCOCK & WILCOX CO.	30.30		21,555,420.00	1.80%
15135B101	CNC	160,300	CENTENE CORPORATION	103.85		16,647,155.00	1.39%
171798101	XEC	282,000	CIMAREX ENERGY	106.00		29,892,000.00	2.49%
229669106	CUB	272,700	CUBIC CORPORATION	52.64		14,354,928.00	1.20%
251893103	DV	1,147,408	DEVRY, INC.	47.47		54,467,457.76	4.54%
29358Q109	ESV	1,402,800	ENSCO PLC	29.95		42,013,860.00	3.50%
314211103	FII	366,043	FEDERATED INVESTORS INC- CLASS B	32.93		12,053,795.99	1.01%
344849104	FL	344,900	FOOT LOCKER	56.18		19,376,482.00	1.62%
45867G101	IDCC	1,149,200	INTERDIGITAL, INC.	52.90		60,792,680.00	5.07%
688239201	OSK	532,600	OSHKOSH TRUCK CORPORATION	48.65		25,910,990.00	2.16%
			OTHER			7,069,848.00	0.59%
759509102	RS	186,608	RELIANCE STEEL & ALUMINIUM	61.27		11,433,472.16	0.95%
777779307	ROSE	2,168,200	ROSETTA RESOURCES	22.31		48,372,542.00	4.04%
779382100	RDC	2,678,900	ROWAN COMPANIES	23.32		62,471,948.00	5.21%
78454L100	SM	806,700	SM ENERGY COMPANY	38.58		31,122,486.00	2.60%
88830M102	TWI	904,855	TITAN INTERNATIONAL	10.63		9,618,608.65	0.80%
896522109	TRN	427,500	TRINITY INDUSTRIES	28.01		11,974,275.00	1.00%
922417100	VECO	241,700	VEECO	34.88		8,430,496.00	0.70%
958102105	WDC	573,500	WESTERN DIGITAL	110.70		63,486,450.00	5.30%
			TOTAL EQUITIES:		**$**	**888,874,142.25**	**74.16%**
912796DF3		85,000,000	US TREASURY BILL 01/08/2015	100.00		84,999,753.50	7.09%
912796EV7		85,000,000	US TREASURY BILL 02/19/2015	100.00		84,997,458.50	7.09%
			TOTAL US GOVT AND AGENCIES:		**$**	**169,997,212.00**	**14.18%**
			CASH & EQUIVALENTS (NET OF LIABILITIES):		**$**	**139,797,907.51**	**11.66%**
			TOTAL NET ASSETS:		**$**	**1,198,669,261.76**	**100.00%**
			NO. OF EQUITY POSITIONS			**25**	

Portfolio Holding Submission Disclosure

Except for certain publicly available information incorporated herein, the information contained in these materials is our confidential and proprietary information and is being submitted to you for your confidential use with the express understanding that, without our prior written permission, you will not release these materials or discuss the information contained herein or make reproductions of or use these materials for any purpose other than evaluating a potential advisory relationship with First Pacific Advisors.

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