FPA Capital Fund, Inc.
Fourth Quarter 2016 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 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 calling toll-free, 1-800-982-4372, or by contacting the Fund in writing.

Average Annual Total Returns
As of December 31, 2016

	QTR	YTD	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years	25 Years	Since 8/1/84*
FPA Capital Fund, Inc.	9.42%	22.86%	22.86%	0.15%	6.24%	5.42%	7.89%	8.99%	11.93%	13.47%
Russell 2500	6.12%	17.59%	17.59%	6.93%	14.54%	7.69%	9.17%	9.46%	10.73%	11.76%

Periods greater than one year are annualized. Performance is calculated on a total return basis which includes reinvestment of all distributions.

* Inception of FPA management was July 11, 1984. A benchmark comparison is not available based on the Fund's inception date therefore August 1, 1984 is presented.

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. The Fund's expense ratio as of its most recent prospectus is 0.77%. A redemption fee of 2% will be imposed on redemptions within 90 days. Current month-end performance data may be obtained at www.fpafunds.com or by calling toll-free, 1-800-982-4372.

Dennis Bryan and Arik Ahitov have been co-portfolio managers since November 2007 and February 2014, respectively, and manage the Fund in a manner that is substantially similar to the prior portfolio manager, Robert Rodriguez. Mr. Rodriguez ceased serving as the Fund's portfolio manager effective December 2010.

Please see important disclosures at the end of the commentary.

Introduction

The fourth quarter of 2016 continued the year's string of improbable events. In mid-2016, the United Kingdom (UK) voted to exit the European Union (EU). The UK's so-called Brexit was not expected by the capital markets due to nearly all voting polls showing that the "Remain" side was overwhelmingly favored to win. But the "Leave" victory was only a harbinger of things to come. Shortly after the Brexit vote, the Chicago Cubs won the World Series for the first time in exactly 108 years. Cubby fans will tell you that the championship was more improbable than Brexit. As a side note, the number of red stitches that sew the leather on a baseball is exactly 108. Folks, we cannot make this stuff up.

Shortly after the Cubs won the Fall Classic, Donald Trump improbably won the election to become the 45th president of the United States. Hillary Clinton was expected to win in a landslide, and the equity markets were expected to nosedive if we failed to elect the first female president of the USA. Well, the opposite happened. From Election Day to the end of the year, the U.S. equity market rose nearly 10%, with many stocks up over 15% in the last two months of the year.

Finally, the group that could neither shoot straight nor agree on anything other than to agree to disagree, otherwise known as OPEC (Organization of the Petroleum Exporting Countries), agreed in late November to curtail oil production to boost short-term prices. This group is notorious for cheating on their "agreed upon" production quotas and gaming the system before making any big decision. Hence, it is likely that the combined OPEC and non-OPEC production cut target of roughly 1.8 million barrels per day will be closer to half that level. Nonetheless, OPEC achieved an outcome that was seriously questioned and considered unrealistic.

Despite all of the improbable events listed above and the seven-plus-year bull market, U.S. stocks continued to march ever higher and reached all-time highs in the quarter. The fourth quarter's rise in interest rates and the year's sluggish earnings growth have not been enough to trigger a correction that could restore some sanity to equity valuations. For instance, the Russell 2500 started 2016 trading at nearly 27.7x earnings and ended the year trading at nearly 31x earnings. As the French journalist Jean-Baptiste Alphonse Karr might say about the equity market, the more things change, the more they stay the same.

Portfolio Commentary

Winners[1]	Performance Contribution	Losers[1]	Performance Contribution
Aaron's Inc	1.17%	Houghton Mifflin Harcourt Co	-0.47%
Veeco Instruments Inc	1.16%	SM Energy Company	-0.14%
DeVry Education Group Inc.	1.12%	Undisclosed 1	-0.07%
Western Digital Corp.	1.06%	Undisclosed 2	-0.04%

Before discussing the Fund's portfolio in greater detail, we are very pleased to note that the Fund performed quite well in the fourth quarter and was able to exceed its benchmark's return by 330 basis points. The strong quarter helped the Fund outperform the Russell 2500 for the full year by over 500 basis points. To be able to achieve that kind of result with cash levels averaging nearly 30% only makes it more noteworthy. As our shareholders know, cash is a residual of investment opportunity, and currently the opportunity set is among the most limited we have experienced over the past three decades.

Let's now discuss what impacted the portfolio in the fourth quarter and review the trading activity during

[1] Reflects the top contributors and top detractors to the Fund's performance based on contribution to return for the quarter. Contribution is presented as the gross of investment management fees, transactions costs, and Fund operating expenses, which if included, would reduce the returns presented.

the period. On the positive side of the ledger, roughly 85% of the Fund's positions appreciated during the quarter, and all industries made positive contributions to the Fund's return.

While all industry sectors positively contributed to the Fund's performance in the quarter, no one industry really stood out. The technology sector, led by Veeco Instruments (VECO); the Education sector, led by DeVry Education (DV); the retail sector, led by Aaron's (AAN); and the energy sector, led by Patterson-UTI Energy (PTEN), all performed nicely for the fund.

In terms of individual stocks, AAN led the way by contributing 1.17% to the Fund's quarterly return. AAN appreciated nearly 26% in the last quarter of the year. The company's Progressive Finance unit continues to post excellent growth in profits as it expands its services to more retailers in America.

VECO contributed 1.16% to the Fund's quarterly return, nearly equaling AAN's contribution in the quarter. VECO appreciated over 48% in the quarter due to an acceleration of orders for its key MOCVD tools. These tools are the main manufacturing equipment used to produce LEDs, whether they are for display screens or, increasingly, for lighting products. We estimate that VECO currently has roughly 80% global market share for MOCVD tools used to make LEDs.

The biggest negative contributor for the Fund was Houghton Mifflin (HMHC), which detracted 47 basis points from the Fund's performance in the quarter. HMHC has not performed well for the Fund since we first purchased its shares. The company has missed quarterly earnings expectations, and the Board of Directors recently chose to terminate the CEO.

We like HMHC's core business of publishing K-12 textbooks in the U.S., but the former CEO, who previously worked at Microsoft, chose to expand the business into the Educational Technology industry by purchasing a division from Scholastic Corp. In our opinion, this acquisition has taken management's eye off the core business, and the former CEO paid a substantial premium to acquire the business. Nonetheless, we believe the board now understands it needs to find an operator who can manage the core business and generate the kind of free cash flow we believe is reasonably possible for HMHC, given the concentrated competitive landscape and barriers to entry. We have materially increased the Fund's position in HMHC since our initial purchase and as the stock declined closer to our downside-case scenario level.

SM Energy(SM) also detracted from the Fund's performance in the quarter by 14 basis points. SM declined in the quarter because the company issued a large secondary offering of stock to help pay for a couple of large properties it acquired in the Permian Basin. We agree with management that the Permian Basin offers very attractive oil and gas properties, but these properties will take a couple of years to develop and start producing cash flow for shareholders. In anticipation of a large equity offering, and after benefitting from the stock's substantial appreciation during 2016, we had already reduced the Fund's position in the stock by over 60% before the quarter commenced. Notably, SM was up 75% for the year, even after an approximately 11% decline in the fourth quarter.

As is expected in a rising market, we trimmed a number of positions as some individual stocks performed much better than others for the Fund. For example, as oil prices rose during the quarter, we were very active in reducing five of the six energy stocks in the Fund. Moreover, we eliminated the Fund's position in Atwood Oceanic bonds. If you recall, we invested in two high-yield energy bonds when oil prices were trading at a very depressed level a year or so ago. Subsequent to these two bond investments, oil prices rebounded and the bond prices rose materially in its aftermath.

The largest stock reduction in terms of weighting percentage was Apollo Education (APOL), which we reduced by over 80%. The reason is that APOL appreciated nearly 25% and approached the buyout price the board and shareholders agreed to earlier in the year. The Department of Education finally approved the acquisition of APOL by a private equity group with just a couple of conditions.

We added a new healthcare name to the portfolio in the quarter, but it is too small of a weighting to discuss at this time. We slightly increased the Fund's Babcock & Wilcox (BW) holding as the stock declined a bit more than 6% in the quarter. Thus, we continue to actively manage the Fund by trimming stocks that rise toward their intrinsic value and adding to positions when stock values provide a nice margin of safety and trade at a discount to their fair value.

Market Commentary

In this section, we will address what occurred during the fourth quarter and in 2016 as a whole. What is remarkable is how resilient the equity market was during the year despite the many surprises mentioned earlier in the letter. It reached new highs again, as it has over the previous couple of years.

For the fourth quarter and 2016, small- and mid-capitalized stocks performed better than larger-cap stocks. For instance, the Russell 2500 rose 6.1% and 17.6% in the fourth quarter and full year, respectively, while the S&P 500 rose 3.8% and 12.0%, over the same periods.

We have been asked a few times why small- and mid-cap stocks performed better than larger caps in the quarter and 2016, despite entering the year with much higher valuations than larger-cap stocks. While nobody knows for sure, one reasonable explanation is that small- and mid-cap companies generally have more domestic-oriented revenues and profits than larger multi-national corporations. If the expectation is that the U.S. economy will grow faster than the economies of Europe and Japan, for example, then the reason for the outperformance is fairly intuitive.

Speaking specifically about the fourth quarter, after Trump was elected, investors likely started discounting lower future corporate tax rates, as well as something called Border Adjustability. Without going into all the potential possibilities, the result of Border Adjustability is that exporters could benefit by receiving something akin to a rebate for products shipped to other countries. On the other hand, importers could be faced with an additional tax on products they procure from other countries.

President-elect Trump has talked about imposing high tariffs on products he believes are being dumped illegally into the U.S. In our opinion, if it is not too onerous, Border Adjustability is a more elegant way to lessen Trump's concerns and keep his promise to level the playing field for domestic producers. The skeptic in us believes Border Adjustability will be used to raise money to help pay for Trump's and Congress's widely-touted infrastructure programs. Nonetheless, the net effect of Border Adjustability may be a stronger dollar should the country export more and import less than the current paradigm.

As 2016 progressed and stocks maintained their upward bias, the dollar strengthened further when it became clear that the Federal government was going to try to stimulate the U.S. economy with large infrastructure projects—irrespective of who won the presidential election. A stronger dollar, all else being equal, typically has a negative impact on foreign earnings once those earnings are translated into U.S. GAAP net income. Generally, larger-cap companies earn more of their profits from overseas activities than smaller-cap companies. Hence, at the margin, investors had another reason to gravitate more toward small- and mid-cap companies.

Moreover, many investors want exposure to potentially faster economic growth, which the hoped-for large fiscal spending and lower income tax rates could bring to the U.S. economy. Additionally, when investors look abroad, they see Europe's economy being challenged by internal dissention, which Brexit perfectly illustrates. Investors are also cautious about emerging markets and what a stronger dollar portends for those economies. Thus, the perceived safe haven is U.S companies that generate much of their profitability domestically.

This safe haven perception has been boosted by comments from Trump, who said he would focus his administration's efforts on accelerating economic growth in the U.S. Trump has said he intends to lower corporate and individual tax rates, reduce regulations, and spend more money improving vital infrastructure assets in the country.

The uncertainty of whether any of these initiatives will be passed by Congress and signed by the new president, let alone actually result in faster earnings growth, does not seem to bother equity investors at this time. Our concern is not whether Trump's initiatives will work. Rather, our concern is that interest rates are already rising, and the Federal Reserve on Dec. 14, 2016, signaled that it may raise rates three times in 2017. While interest rates are still very low compared to rates over the past few decades, at some point interest rates could reach a high enough level to draw substantial capital away from equities and back into bonds, and impede economic growth.

Another concern we have is the very high price-to-earnings ratio investors are paying today for securities on the lowest rung of corporate capital structures—that is, equities. Noted Yale economist Robert Shiller constructed a P/E ratio called CAPE, or cyclically adjusted P/E. The CAPE ratio was used to justify Allan Greenspan's comment back in the mid- to late-1990s that the stock market was displaying "irrational exuberance." At that time, the CAPE ratio was 27.7, and today it is 27.5—meaning stock prices are 27.5 times higher than cyclically-adjusted earnings. As a point of reference, the long-term average CAPE ratio is 16.7, according to Grant's Interest Rate Observer.

Speaking of earnings, we recently reviewed the last 12 months of reported profits for both the S&P 500 and the Russell 2500 to see if the growth rate in reported profits justifies paying such high multiples. We were struck by the weak results. For instance, operating pre-tax cash flow, or EBITDA, for the S&P 500 grew only 0.5% over the past year, and it actually declined 0.5% for the Russell 2500 over the same time period. A word of caution: When this letter was written, fourth quarter earnings results for publicly-traded companies were unavailable. If fourth quarter earnings meet consensus expectations, annual profit growth for 2016 likely would be higher than the essentially flat year-over-year trend line.

It's also remarkable to us that the U.S. equity market has shrugged off nearly every risk we have been able to identify over the past few years, including weak growth in corporate earnings, higher interest rates, a dysfunctional European Union, terrorism, cyber-security threats, and other, less immediate threats. In our opinion, eventually one or more of these risks will likely cause the equity market to fall back to equilibrium. The reason is that these risks have tangible costs to society.

For instance, we were in Germany over the holidays when the Berlin terrorist attack occurred. Immediately, the German government mobilized the military, police, and other security agencies and placed large armed forces in German cities. Overnight, the medium-sized city of Bremen went from its regular police force patrols to a massive display of machine-gun armed military forces patrolling its airport, train station, and even its Christmas market. While we were thankful for the increased security, it's clear that terrorism, cyber security, and higher interest rates have real tangible impacts on society, which must bear the costs.

It seems as though the equity market is seemingly unaware of these costs or does not believe the costs will have a substantive effect on corporate profitability. We disagree, and the evidence has been a materially slower growing global economy than the past couple of decades, as well as rising global leverage. For instance, on Jan. 4, 2017, the Institute for International Finance announced that global debt rose to 325% of the world's GDP or to a staggering $217 trillion by the end of the third quarter 2016.

As economists like to say, on the other hand, there are some fiscal initiatives being proposed that we believe will be positive for the stock market. For example, we are in favor of lower corporate tax rates as long as many of the tax loopholes and corporate subsidies are eliminated. The U.S. tax code is a Rubik's Cube of rules that distort many markets and create inefficiencies in the free flow of goods and services in the country. As with any large change, there will be winners and losers, but a lower income tax rate, if coupled with the removal of questionable corporate subsidies, has the potential to provide a nice windfall for equity owners. This potential has not gone unnoticed by the market, given the nearly 10% rise over the last couple months of the year.

Let's now turn to our economic outlook for 2017. Again, we are not in the doom-and-gloom camp that seems to have hung over the market at the beginning of each of the past few years. However, we are also not in the camp that expects a huge acceleration in economic growth for the year. Given the large debt the country has accumulated over the last decade, rising interest rates, and unstable international markets, we think economic growth will pick up only slightly from the very anemic results of the last few years. Irrespective of the enthusiasm regarding lower tax rates and less regulation, we would not be surprised if real GDP rose between 2% and 3% in 2017.

Should the pace of economic growth modestly increase, we believe that it is not unreasonable to expect corporate earnings to improve from last year's level. However, a stronger dollar could be a headwind for companies with large foreign earnings, and rising interest rates would increase borrowing costs and interest expenses. The potential revamping of the corporate tax code will likely create headaches for some businesses, but, frankly, it is too early to say for sure who the winners and losers might be.

Finally, we believe the new Trump administration, along with the Republican-controlled Congress, will try to restructure the regulatory framework for many U.S. industries. Washington politicians will also attempt to simplify the labyrinthine tax code, and we could see a significant change in how imports and exports are treated at the Federal government level. Some of these potential changes could result in material, long-term structural adjustments to how industries are regulated.

When we throw higher interest rates and potentially large swings in currencies into the mix, we would not be surprised to see increased volatility as the year develops. Last, several important European countries have national elections in 2017, and some leading candidates are calling for radical changes—including replacing the Euro currency with the former currency from their respective countries. However, the Fund is well-positioned to seize opportunities that may arise should we experience an increase in volatility, and we are ready to buy stocks that meet our strict investment philosophy.

In closing, we remain confident about our strategy's future. Our pipeline of potential investments remains robust, as evidenced by the new healthcare stock that went into the portfolio during the fourth quarter. This is an example of a domestic company's stock being depressed partly because of concerns that the expected Clinton administration would have been tough on the overall healthcare industry. As it turns out, Clinton was not elected and, therefore, these particular concerns for this stock have not materialized. As we have mentioned numerous times, volatility is our friend, and we are prepared to aggressively deploy more of the Fund's liquidity into good businesses selling at cheap valuations.

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

Respectfully submitted,

Arik Ahitov Portfolio Manager	Dennis Bryan Portfolio Manager

January 12, 2017

Important Disclosures

The views expressed herein and any forward-looking statements are as of the date of the 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.

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 Fund, the portfolio managers, or the Distributor. It should not be assumed that future investments will be profitable or will equal the performance of the security examples discussed. The portfolio holdings as of the most recent quarter-end may be obtained at www.fpafunds.com.

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.

Value stocks, including those selected by the Fund's portfolio managers, are subject to the risk that their intrinsic value may never be realized by the market and that their prices may go down. Securities selected by the portfolio managers using a value strategy may never reach their intrinsic value because the market fails to recognize what the portfolio managers consider to be the true business value or because the portfolio managers have misjudged those values. In addition, value style investing may fall out of favor and underperform growth or other styles of investing during given periods.

Definitions

The Russell 2500 Index consists 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.

The S&P 500 Index includes a representative sample of 500 hundred 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.

Indices are unmanaged, do not reflect any commissions or fees which would be incurred by an investor purchasing the underlying securities. Investors cannot invest directly in an index.

EBITA (Earnings before interest, taxes and amortization) is a financial indicator used widely as a measure of efficiency and profitability.

Margin of safety - Buying with a "margin of safety" is when a security is purchased at a discount to the portfolio manager's estimate of its intrinsic value. Buying a security with a margin of safety is designed to protect against permanent capital loss in the case of an unexpected event or analytical mistake. A purchase made with a margin of safety does not guarantee the security will not decline in price.

Price/Earnings ratio (P/E) is the price of a stock divided by its earnings per share.

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