

LETTER TO SHAREHOLDERS

Dear Fellow Shareholders:

This Annual Report covers the fiscal year ended March 31, 1994. The following table shows the average annual total return for several different periods ended on that date for the Fund and comparative indices of securities prices. The data quoted represents past performance, and an investment in the Fund may fluctuate so that an investor's shares when redeemed may be worth more or less than their original cost. Also, since First Pacific Advisors, Inc. commenced serving as investment adviser to the Fund in July 1984, the ten-year period includes the performance results of the prior investment adviser.

**Average Annual Total Return
Periods Ended March 31, 1994**

| | <u>1 Year</u> | <u>5 Years</u> | <u>10 Years</u> |
|---|---------------|----------------|-----------------|
| FPA Capital Fund, Inc. (NAV) | 13.13%* | 18.63%* | 17.37%* |
| FPA Capital Fund, Inc. (Net of Sales Charge) | 5.78%‡ | 17.04%‡ | 16.59%‡ |
| Lipper Growth Fund Average | 3.79% | 12.24% | 13.34% |
| Standard & Poor's 500 Stock Average | 1.44% | 12.08% | 14.64% |
| Russell 2000 | 11.01% | 11.70% | 11.38% |

For the calendar year ended December 31, 1993, these same comparisons are 16.74%* for FPA Capital Fund, 10.61% for the growth fund average, 10.00% for the S&P 500, and 18.91% for the Russell 2000.

Your Fund's net asset value (NAV) per share on March 31, 1994 was \$19.30. Dividends of \$1.07 and \$1.03 per share were paid on July 15, 1993 and January 7, 1994 to holders of record on June 30 and December 31, 1993, respectively. The July distribution was comprised of a \$0.02 income dividend and a \$1.05 capital gains distribution, which included \$1.04 of long-term gains. The January distribution included an

income dividend of \$0.01 and a capital gains distribution of \$1.02 with \$1.00 being long-term.

Commentary

It's hard to believe that this is the last letter before we celebrate the tenth anniversary, on July 11, 1994, of managing FPA Capital Fund, Inc. Our first Shareholder Letter described the investment methodology and its key elements that we would utilize in the management of your Fund. We referred to it as the value approach to investing. As we said then, and on many subsequent occasions, our goal would be one of superior long-term investment results, selecting investments with an emphasis on a long-term time horizon. We believed that this would give us a competitive advantage since the investment community tends to focus on short-term criteria. The Fund's annual turnover ratio has generally averaged less than 25%, implying an average holding period of slightly greater than four years for an investment. This has led to a disproportionately high level of long-term versus short-term capital gains distributions, a tax benefit for you.

What has been the result of this investment methodology? For the ten-year period ended March 31, 1994, your Fund ranked 10th of 122 growth funds and 26th of 566 total funds, as measured by Lipper Analytical Services, Inc. As the time-frame lengthens, relative results tend to reflect more of the investment manager's decision making and less of the stock market's influence. Over shorter time-frames, such as one or three years, luck or the lack of it can significantly influence the investment results. A good manager can look bad while an average or poor manager can look good.

Now we shift to an analysis and commentary of the latest fiscal year performance results. Fiscal

* Does not reflect deduction of the sales charge which, if reflected, would reduce the performance shown

‡ Reflects deduction of the maximum sales charge of 6.5% of the offering price

1994 was another excellent year for your Fund. It outperformed the major indices as well as the Lipper Growth Fund Average. A review of the performance results at the beginning of this Letter detail this. The Russell 2000 was the only index that outperformed your Fund for calendar 1993. As a result of the recent stock market decline, we were able to reverse this. For the quarter ended March 31, 1994, the S&P 500, the Russell 2000 and the Lipper Growth Fund Average had **negative** total returns of 3.81%, 2.65% and 3.44% respectively, while FPA Capital Fund had a **positive** total return of 1.46%*.

The March 1994 quarter marks the first period of negative stock market returns since 1990. Your Fund was a superior performer for two reasons. First, this stock market decline has been relatively gradual and second, the portfolio has maintained a substantial competitive valuation advantage to that of the major stock market indices. During the stock market declines of 1987 and 1990, the emotional reactions by investors to unusual events occurred very rapidly. The practice of fundamental investment evaluation seemed non-existent for many stocks—fear ruled the day. Subsequently, a period of more rational investment behavior returned. This decline is taking more time to develop and therefore, improving corporate profitability has a greater chance of influencing a stock's valuation. Your Fund's competitive valuation advantage continues. At March 31, 1994, its average P/E (Price/Earnings) ratio and P/BV (Price/Book Value) ratio were 14.7x and 1.7x, respectively. By comparison, the P/E ratios of the S&P 500 and the Russell 2000 were 20.4x and 22.1x, while the P/BV ratios were 3.1x and 2.2x, respectively. With only a small amount of earnings growth in 1994, your portfolio's P/E ratio should fall into the 12x area, assuming its NAV remains unchanged. A combination of earnings growth and selective portfolio repositioning has led to the continued improvement in the Fund's valuation characteristics.

During the second half of fiscal 1994, the Fund's short-term investments rose from 6% to a high of slightly more than 11%. This increased

liquidity came from portfolio asset sales and increased contributions. The asset sales reflected any one of the following: the current price level was ahead of the stock's fundamentals, a better investment was available, or the particular holding was becoming too large a percentage of the portfolio. We eliminated two holdings, Quanex Corporation and Oregon Steel Mills, Inc. Countrywide Credit Corporation, Ross Stores, Inc. and Rouge Steel Company were added. Countrywide is the largest U.S. mortgage banker. Its share price had fallen sharply due to investor fears of the effects that rising interest rates and price competition would have on its profitability. Because these risks were widely known, we believed the stock price had already substantially discounted them. Ross Stores is a leading discount clothing retailer with almost 50% of its stores located in California. Its heavy California exposure, good profitability and low valuation characteristics were attractive to us. Both of these reflect our contrarian investment instincts. Rouge Steel was an unusual addition for two reasons: first, it was in a "hot" stock market group, steel, and second, it was a new stock issue. Over the past ten years, we have invested in approximately six new issues. Rarely do you find real values in this area, although there are exceptions. We prefer purchasing stocks from fearful, ill-informed investors. In any event, this is an essentially debt-free company, with almost no post-retirement medical benefit liabilities, and its former owner indemnified it from environmental liabilities for ten to twenty years. It was purchased at 7x earnings and 65% of what the original owner had invested in capital improvements. The addition of these three new positions as well as increases in existing holdings reduced short-term liquidity back to 6%. What these actions reflect is that as long as we can find attractively valued investments on an **absolute** rather than on a **relative** value basis, we will invest your capital.

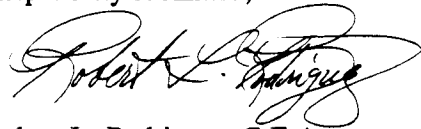
Where are we today on both an economic and stock market basis? The economy continues to grow as reflected in the strong Gross Domestic Product numbers reported for the past six months. Capacity utilization is at the highest level since

* Does not reflect deduction of the sales charge which, if reflected, would reduce the performance shown

1989. Average hours worked are at the highest levels since 1945. Both of these factors would indicate that the odds are rising for increased capital spending and employment. Europe and Japan are likely to recover in either 1994 or 1995, which will help our trade account. A growing fear is that the recent rise in interest rate levels will significantly slow or truncate the economic recovery. We do not believe it will do either. Long-term rates in the ten- to thirty-year area are up only marginally or down slightly from where they have been during the past two years. It's only when one compares current levels to the non-sustainable levels of last fall that they seem high. Even short-term rates at current levels are still low by comparison to the last five years. The stock market's decline over the past two months reflects investors' fears of the effects that rising interest rate levels might have on the economy and corporate profitability. This does not come as a surprise to us. In our September 30, 1993 Shareholder Letter, we addressed this potential risk. At the present time we believe the stock market is in a transition phase, with the driving force behind it shifting from an emphasis on

falling interest rates to one of improved corporate profitability. This is a common occurrence. Increased stock and bond market volatility are a natural outgrowth of this phase. Not until a plateau in interest rate levels is widely perceived to have occurred will improving corporate profitability become the primary stock market driver. We find this period more agreeable to us since it creates the opportunity for stock market inefficiencies. Our primary focus continues to be one of individual stock selection rather than stock market forecasting. It has been a pleasure conveying your Fund's positive investment results. We will strive to maintain this trend. Thank you for your support.

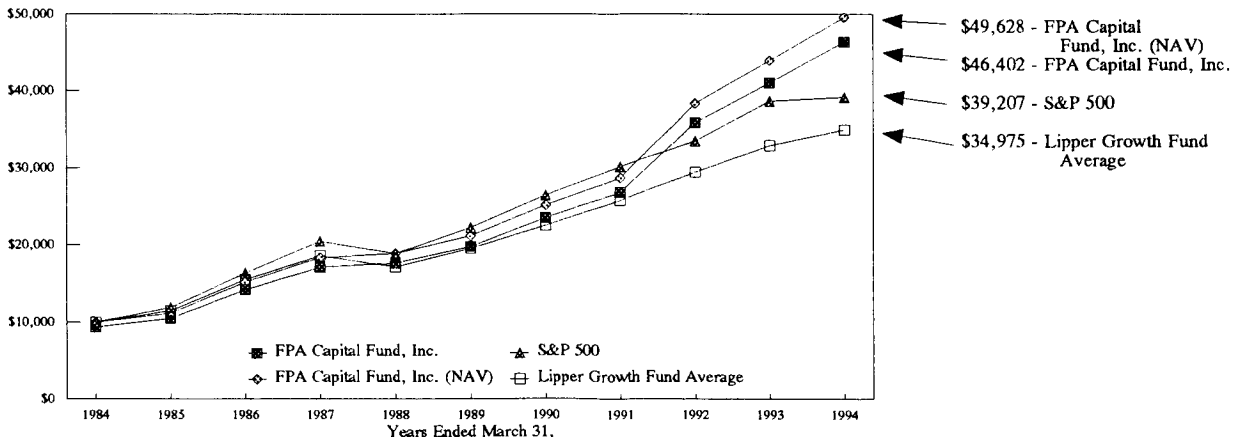
Respectfully submitted,



Robert L. Rodriguez, C.F.A.
President and Chief Investment Officer

April 29, 1994

Change in Value of a \$10,000 Investment in FPA Capital Fund, Inc. vs. S&P 500 and Lipper Growth Fund Average from April 1, 1984 to March 31, 1994



Past performance is not indicative of future performance. The Standard & Poor's 500 Stock Average (S&P 500) is a broad-based unmanaged index of publicly traded stocks. The S&P 500 does not reflect any commissions or fees which would be incurred by an investor purchasing the stocks it represents. The Lipper Growth Fund Average provides an additional comparison of how your Fund performed in relation to other mutual funds with similar objectives. The Lipper data does not include sales charges. The performance shown for FPA Capital Fund, Inc., with an ending value of \$46,402, reflects deduction of the current maximum sales charge of 6.5% of the offering price. In addition, since investors purchase shares of the Fund with varying sales charges depending primarily on volume purchased, the Fund's performance at net asset value (NAV) is also shown, as reflected by the ending value of \$49,628. The performance of the Fund and of the Averages is computed on a total return basis which includes reinvestment of all distributions.