LETTER TO SHAREHOLDERS

Dear Fellow Shareholders:

This Annual Report covers the fiscal year ended March 31, 1997. Your Fund's net asset value (NAV) per share closed at $32.28. Dividends of $0.74 and $1.89 per share were paid on July 15, 1996, and January 6, 1997, to holders of record on June 28 and December 31, 1996, respectively. The July distribution was composed of a $0.17 income dividend and a $0.57 capital gains distribution, $0.56 of which was long-term. The January distribution included an income dividend of $0.20 and $1.69 capital gains distribution, $1.55 of which was long-term.

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.

	Average Annual Total Return Periods Ended March 31, 1997		
	1 Year	5 Years	10 Years
FPA Capital Fund, Inc. (NAV)	27.30%*	21.94%*	18.92%*
FPA Capital Fund, Inc. (Net of Sales Charge)	19.03%‡	20.31%‡	18.12%‡
Lipper Growth Fund Average	11.74%	13.39%	11.63%
Standard & Poor's 500 Stock Index	19.94%	16.46%	13.35%
Russell 2000	5.11%	12.78%	9.40%

For the calendar year ended December 31, 1996, these same comparisons are 37.76%* for FPA Capital Fund, 19.24% for the Growth Fund average, 23.25% for the S&P 500, and 16.49% for the Russell 2000.

Commentary

Fiscal 1997 was another exceptional year for your Fund. Despite a large liquidity position and a focus on small- to mid-size capitalization stocks, your Fund was able to outperform the major indices. (See the preceding table.) This was difficult to do since small-cap stocks, as measured by the Russell 2000 index, continue their trend of underperforming the S&P 500, a measure of large-cap performance. Stock selection was key to your Fund's superior relative performance. More importantly, your Fund continues to materially outperform the indices over longer periods. As an example, Lipper Analytical Services, Inc. ranks your Fund 5th out of 686 and 11th out of 355 equity mutual funds for the ten- and fifteen-year periods ended March 31, 1997, respectively. What is interesting in the ten-year rankings is that the top four funds are sector funds—three financial service and one technology. Typically, when such a fund reaches the top, it is late in the cycle for that particular sector.

Calendar 1996 was a challenging year in that about 40% of all stocks declined and larger capitalization stocks skewed index returns. For example, the total return for the 100 largest Nasdaq companies (over-the-counter) was 42.5% while the index itself was up only 22.7% and the median return was just 6.6%. In the case of the S&P 500, the performance of each quintile improved as market capitalization increased.

This trend of larger stocks outperforming smaller ones has led to an increasing interest in stock indexation. It reflects a growing belief that since active portfolio management cannot outperform the market, it is better to own an index fund; and this is supported by the fact that capitalization-weighted index funds have outperformed 90% of actively managed equity mutual funds over the past three years. An active manager would not own the same percentage of a stock represented in an index since it would be too large a position in some cases. For example, the largest company in the S&P 500 has 400 times the weighting of the smallest. When an active manager is fired and the proceeds are re-invested in an index fund, it puts greater buying pressure on the larger stocks and more selling

* 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

pressure on the smaller ones. Even if new money is invested in an index fund, it will place proportionally greater buying pressure on the larger companies in that index. Such trends do reverse. As an example, between 1984 and 1996 the capitalization-weighted S&P 500 outperformed the equal-weighted S&P 500 70% of the time. In contrast, between 1958 and 1983 the equal-weighted outperformed the capitalization-weighted 73% of the time. Our hope is that increasing amounts of capital will be invested in index funds. Eventually this would lead to massive stock market inefficiencies, as index funds do not do any equity research.

The past two calendar years are among the best on record for the stock market. Two years of your Fund averaging 38%* total returns is just unbelievable and to achieve a third year of similar return is extremely unlikely. We do not believe that the key factors influencing stock prices going forward will be as favorable as they have been for the last two years. For example, during this period, the financial and technology groups accounted for 74% of the profit increase recorded by the S&P 500. Concentrated profit increases are generally more unstable than well-diversified increases. For 1997, DRI/McGraw-Hill is predicting the S&P 500's earnings per share growth will average only 4.7% versus an annual rise of 12.6% over the previous two years. In the fourth quarter of 1996, the Commerce Department's data show that profit margins for non-financial corporations fell. In the first quarter of 1997, it appears that unit labor costs have risen faster than prices and therefore, a squeeze on the cost side is developing. As you may recall, during the past year our shareholder letters addressed the likelihood of such eroding profit margins and rising labor costs becoming challenges to the ever-rising stock market.

On March 25, the Federal Reserve increased the Federal Funds rate for the first time in slightly more than two years. We believe that Alan Greenspan, chairman of the Federal Reserve, is serious in trying to reduce the acceleration in inflation and the stock markets' speculative excesses. Both areas can be potentially destabilizing to the economy should they begin to get out of control. We have felt for some time that economic growth was building faster than consensus expectations. Consumer confidence is at its highest level in 25 years and we are at record levels of employment as a percentage of the adult population. Given the low level of unemployment, we believe there is growing risk from accelerating wages and employment costs. The consensus appears to be shifting towards this viewpoint. In light of this, we expect the Fed to hike short-term interest rates at least one or possibly two more times with the increase totaling an additional 50 basis points. The key to the magnitude of increase is dependent upon the strength and duration of the economic acceleration. The second half of 1997 should be influenced by the dimension of recovery of our foreign trading partners' economies. The shape and level of their yield curves indicate that the odds of accelerating growth are rising, and this is apt to place additional stress on our interest rate markets. Finally, we believe the Fed will be monitoring progress on the budget. The likelihood of meaningful budgetary reform appears to be waning. The President's budget proposal has 99% of the expenditure cuts occurring in the final two years, after he has left office. We understand that this is a negotiating ploy but it does raise questions about a potential compromise with Congress. Should no real budgetary reform occur by April or May of 1998, nothing is likely until after the year 2000. This set of events could place even greater pressure on the Fed.

We see growing risks to the stock market. Liquidity levels at U.S. equity funds are at 5.3%, the lowest in 21 years. During the ten days after the 1987 crash, net redemptions amounted to 4.5% of equity mutual fund assets. In a stock market decline, these meager liquidity reserves could be redeemed very quickly. Forced sales of securities might occur if the redemptions continued. It also concerns us that the number of investors in mutual funds has about doubled in seven years with 67% of the increase in the past four years. In essence, more than 80% of all the money ever invested has come in since 1990—the last major decline in share prices.

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Our response to these trends and the rising level of stock valuations has been to increase your Fund's liquidity and bond holdings to 30%, a new high, from 21% at this time last year.

During the past two weeks, the stock market began a broad-based decline, as long-term U.S. Treasury bond yields rose above the 7% level. We believe that Treasury yields above 7% provide serious competition to stocks. Large and small cap indices are down between 7% and 13% from their peaks. During the first calendar quarter of 1997, the average equity mutual fund declined about 2%, while the small- and mid-cap funds were down 6.9% and 5.8%, respectively. Many growth and momentum-oriented funds declined about 20%. Your Fund was up 0.6%*. Our defensiveness is beginning to be rewarded. Should this decline persist, it may give us the opportunity to deploy some of the liquidity we have been holding. Our feeling is that it will take a more substantial decline before attractive investments develop and we are patiently waiting.

It has been extremely difficult for us to find new companies at attractive valuations since the market is richly priced across virtually all market capitalization ranges. Our latest computer screens show the lowest level of qualifying companies in five years. In light of this, we added only one new company, Michaels Stores, Inc., the leading U.S. retailer of arts and crafts merchandise, since our September shareholder letter. In the past year, new senior management has been mounting a major business turnaround. Prior to this period, we had little interest in the company since we believed it to be mismanaged, with poor management information systems. R. Michael Rouleau, the new chief executive officer, is a well-respected manager who came from the Lowe's Companies, where he led a major turnaround. He brought in several new managers to evaluate and improve all areas of the company's operations. Our research indicates that they are making the right moves. We acquired the Fund's position at an average cost of $11.78, at which price the stock sold at approximately 80% of book value and 20% of revenues. When this stock was in favor three years ago, it sold as high as $46.50. During the past year, the chairman purchased, at similar price levels, almost $50 million in stock. If we are correct in our analysis, within two or three years this company could be earning $2.50 to $3 per share. We also purchased some of the company's outstanding debt since it too had become severely depressed in price.

Only one holding, Photronics Inc., has been eliminated since our September shareholder letter. Valuation was the key factor in the sale decision. Should the stock decline significantly, we would most likely own it again. It is a very profitable company with a leading market share position in the photo mask industry.

The Fund's portfolio retains a competitive valuation advantage to that of the market. At the end of March, the P/E (Price/Earning) and P/BV (Price/Book Value) ratios were 16.0x and 2.2X, respectively. By comparison, the P/E ratios of the Russell 2000 and the S&P 500 were 21.4x and 19.0x, while the P/BV ratios were 2.3x and 3.4x, respectively. Our companies are financially strong with a 21.7% total debt to total capitalization ratio. This compares favorably to 37.7% and 47.4% for the Russell 2000 and the S&P 500. Finally, the portfolio's average return on equity is 14.3%, while those of the Russell 2000 and the S&P 500 are 14.4% and 22.4%, respectively.

This shareholder letter continues a more cautionary trend, as the stock market skyrockets upwards. We are striving to protect your capital so that we may invest it when we believe the return versus risk ratios are more heavily skewed in our favor. Ours is a very patient, "pick one stock at a time" approach. We thank you for your investment and continued support.

Respectfully submitted,

Robert L. Rodriguez, C.F.A.
President and Chief Investment Officer
April 6, 1997

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