LETTER TO SHAREHOLDERS

Dear Fellow Shareholders:

This Annual Report covers the fiscal year ended March 31, 1999. Your Fund's net asset value (NAV) per share closed at $30.34. Dividends of $3.07 and $0.53 per share were paid on July 8 and December 29, 1998 to holders of record on June 30 and December 22, 1998, respectively. The July distribution was composed of a $0.26 income dividend and $2.81 capital gains distribution, $2.755 of which was long-term. The December distribution included an income dividend of $0.14 and $0.39 capital gains distribution, all 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, 1999		
	1 Year	5 Years	10 Years
FPA Capital Fund, Inc. (NAV)	(12.45)%*	18.90%*	18.76%*
FPA Capital Fund, Inc. (Net of Sales Charge)	(18.14)%‡	17.31%‡	17.97%‡
Lipper Growth Fund Average	13.58%	20.89%	16.80%
Russell 2000	(16.26)%	11.22%	11.46%
Standard & Poor's 500 Stock Index	18.45%	26.25%	18.97%

The Fund's six-month total return, which includes both the changes in NAV and the reinvestment of distributions paid, was 14.40%*. This compares with total returns of 28.00% for the Lipper Growth Fund Average, 10.00% for the Russell 2000, and 27.34% for the S&P 500. On a calendar year basis, these same comparisons are (0.42)%* for FPA Capital Fund, 22.89% for the Growth Fund Average, (2.55)% for the Russell 2000, and 28.57% for the S&P 500.

Commentary

Before discussing your Fund's investment performance, I thought it would be appropriate, at this time when many are questioning the timeliness and relevance of value investing, to review some of the basic tenets of the investment style and philosophy that have guided your Fund to a successful long-term investment record. July 11, 1999 will mark the fifteenth anniversary of First Pacific Advisors' stewardship of your Fund. During these years, I have tried to use these shareholder letters not only as a performance-reporting tool but also as a vehicle to help educate and assist you in becoming a more informed shareholder and investor.

In our first shareholder letter, dated November 2, 1984, we laid out the investment philosophy and methodology that would guide us in our management of your Fund. We stated that "FPA does not generally depend upon a 'top-down' strategy of economic or stock market forecast, as it is difficult to consistently foresee these trends. Our selection process begins at the 'bottom' by researching and selecting superior or potentially superior companies. Attractive companies generally possess a position of business leadership or a market niche. Financially strong balance sheets, improving cash flow and hidden asset values are characteristics we like to see. We emphasize cash flow and balance sheet values as opposed to earnings per share growth. This methodology is somewhat different from Wall Street's general preoccupation with earnings per share growth models that may at times lead to extremes in valuation." We also said that we would endeavor to reduce stock market risk by avoiding companies with high price/earnings ratios and that our investments would be directed towards the "out-of-favor" sectors of the stock market and be concentrated in a limited number of companies. This value style requires discipline, patience and a longer-term time frame to be successfully implemented and, therefore, we are not overly preoccupied with short-term performance numbers.

In today's fast-moving, dynamic stock market, value investing is not a particularly popular style. Valuations have reached levels that are, in many cases, unfathomable to disciplined value investors. Just recently, I was reading Graham and Dodd's *Security Analysis*, the 1934 edition, for some perspective on

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* 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

today's investment environment. In it, they describe "the new-era theory" of investing. "The new-era concepts had their root first of all in the obsolescence of the old-established standards." They evolved because "economic change has been speeded up." The investing public had turned their attention from earnings, asset values and dividends "almost exclusively to the earnings trend, i.e., the *changes* in earnings expected in the future." Very little attention was being paid to the connection between assets and earnings, so that by 1929, the importance of "net worth" or "book value" had practically disappeared. In such an era, the fundamental distinction between investment and speculation had all but disappeared. "The new era based its standards of value upon the market price."

We find some eerie parallels in today's marketplace as exemplified by the Internet stocks. I was recently quoted as saying that for me to invest in them I would have to have God as my partner, since these prices are not only discounting the future but also the hereafter. There are no true standards of value. This is nothing more than speculation masquerading in the costume of investment. Now that some of these stocks are large enough, in terms of market value, to be included in the major market indices, many investment managers are being "forced" to buy them. They believe this is necessary to successfully compete with the indices. A certain degree of respectability has been draped over them, as brokerage firms churn out research recommendations. This doesn't surprise us since, if they don't participate, they will lose the underwriting fees and subsequent commissions. I have reminded several of our clients that one might consider RCA (Radio Corporation of America), to be among the earliest electronic communications companies. Between 1921 and 1929 its split adjusted price rose from $7.50 to $575.00. It took only a full generation for its share price to recover to its high price of 1929, when it sold for 73x earnings, and this was for one of the successful companies. A similar experience occurred with several companies from the early 1970s known as the Nifty Fifty.

We still believe that we are in the midst of a "bear" market for the broader market of stocks that began in April of 1998. The average stock on the New York Stock Exchange was down 8% in 1998. In contrast, the top 25 stocks of the S&P 500 accounted for 63% of its 28.6% total return, while the top 25 of the Russell 1000 represented 59% of its 27% return. There was almost perfect correlation in that the smaller the market capitalization of a company, the worse its performance. In a study of the 1998 market by Salomon Smith Barney, companies with market capitalizations of $20 billion and higher were up 26%, while those with $250 million and lower declined 24%. The average company, with a market capitalization of less than $5 billion, was down for the year. This study also showed that the percentage of companies underperforming the S&P 500 by more than 15% was 71.6%, the highest since 1971. The previous high occurred in 1973, when 60% of all companies underperformed. It is interesting to note that this earlier period was dominated by the Nifty Fifty. If you did not own them, you had great difficulty outperforming the market. It was what we called a narrow market. Investors believed that this select group of companies could be owned at almost any price since their expected growth rates were thought to be highly predictable and, therefore, they were "one-decision stocks." The 1974 stock market collapse demonstrated the fallacy of this thinking, when most of them experienced massive price declines. I have an old red tie from that period that I call "big red." On it are several of these Nifty Fifty companies and their prices. Some have never regained their earlier price level while others took anywhere from twelve to twenty-four years to recover.

We are not part of this frenzy. We strongly believe that directing investments towards reasonably priced "out-of-favor" companies will generate above-average long-term investment returns with considerably less financial and stock market risk. Over the years, our focus has been directed towards small- to medium-sized companies since they tend to be easier to analyze and are generally more inefficiently priced. This strategy was severely penalized in calendar 1998, as shown by your Fund's (0.42)% return versus the S&P 500's 28.57% return. If it's any consolation, we did outperform the Russell 2000's (2.55)% return. In calendar 1998 Russell had the worst performance relative to the S&P 500 since Russell's inception twenty years ago. Prior to 1998, your Fund approximated the S&P 500's three-year return while outperforming it for the five- and ten-year periods and since inception.

We are amazed by the S&P 500's 1998 performance—the index exploded to the upside while its underlying investment fundamentals were deteriorating. At the beginning of 1998, we expected that earnings growth for this index would have difficulty exceeding 5%. Several "top-down" investment strategists were expecting growth of at least 10% to 12%, while the "bottom-up" analysts' expectations were for 19% growth, as measured by Zacks Investment Research. In reality, S&P earnings were down for the first three quarters, and despite a very strong fourth-quarter performance, ended the year down 1%. On April 1, the U.S. Commerce Department reported that corporate profits fell by 2.2% in 1998, the first annual drop since 1989. As a result of the combination of rising share prices and stagnant profits, the S&P 500 is at a record valuation level. There is absolutely no margin for error in many of these larger-capitalization stocks. At 31x earnings, the earnings' yield (earnings divided by price) of the S&P 500 is 3.23%, or less than the 3.85% you can earn on a thirty-year U.S. Treasury inflation index bond. At least the inflation index bond will provide this yield plus whatever the inflation rate is for the Consumer Price Index. Will the S&P 500 provide at least that amount from its current valuation level? We still believe the S&P 500 will have difficulty generating a return much greater than 5% to 7%. You can reference our reasoning in our April 1998 shareholder letter.

We believe that the current trend of smaller stocks underperforming larger stocks will eventually reverse itself, but we cannot tell you when that will be. We are encouraged by a series of recent occurrences that are examples of what typically happens towards the end of a cycle rather than at the beginning of one. For example, preliminary estimates show that net redemptions of small-cap funds, in the first quarter of 1999, have eliminated all the net contributions of 1997 and 1998 combined. We recently heard that a major New York brokerage firm terminated its small-cap research department. We have even been asked by institutional pension consultants when this negative performance trend will end. It was not long ago that they were quite confident in recommending this market segment to their clients. All of these indications reflect the high level of frustration that exists among investors in this market sector. We may even be entering the period of capitulation. You generally have to go through a capitulation phase before a trend reverses itself. In a perverse sense, the more negative the environment becomes, the more optimistic we feel. That is the essence of being a contrarian investor.

Your Fund has been experiencing net redemptions but to a lesser degree than has hit other small capitalization funds. Almost four years ago, we closed your Fund to new investors. Our goal at that time was to minimize the potential risk of uncontrolled rapid growth since smaller-capitalization oriented funds were the rage among fund investors. We did not want to get a large number of "LIFO" shareholders, i.e., last-in, first-out, since they cause a great deal of trouble in the management of a fund. Massive cash inflows may cause the manager to deploy capital into mediocre investments while rapid outflows may require the selling of stocks solely because they are liquid rather than evaluating them on their investment merits.

This past fiscal year has been a busy one. Our short-term liquidity and bond positions began the year at 27.5%, with a high of 32%, and ended the year at 6%. We have continued to deploy capital as individual stocks have come under selling pressure. This is our style of focusing on individual companies rather than trying to forecast the stock market's direction. During the past six months, more and more companies became attractively valued in terms of absolute rather than relative valuation measures. This is to be expected since small-cap stocks are entering their sixth year of underperformance relative to that of the S&P 500.

Since our September 1998 shareholder letter, we added the following new companies: AVX Corporation, Belden Inc., ENSCO International Incorporated, and Hutchinson Technology Incorporated. For the entire year, we added seven new holdings. AVX is a leading producer of capacitors and is a competitor to our KEMET holding. It was purchased at a small premium to book value and with virtually no debt. Both KEMET and AVX have been very profitable historically. A combination of negative pricing and cost trends, both of which we view as temporary, has caused a decline in the level of the companies' profitability. Belden is a leader in wire and cable manufacturing and a prime beneficiary of the expansion in local and wide-area networks. It was recently purchased at a small premium to book value and less than 10x earnings. ENSCO, our first energy holding and my first energy stock purchase since 1978, is a leading company in the deep-shallow offshore drilling field. Approximately 70% of its drilling rigs are working on natural gas wells, mostly in the Gulf of Mexico. After ENSCO experienced an 80% decline in its share price, we purchased it at book value and 30% of the estimated replacement cost of its rigs. Cash exceeds debt and the company is cash-flow positive. Our new analyst, Rikard Ekstrand, led the charge on this investment. Finally, our latest addition is Hutchinson Technology, which Dennis Bryan and I visited two years ago. It is the dominant manufacturer of suspension assemblies used by the data storage industry in disc drives. Two months ago the company sold 4.9 million shares at an average price of $45.50. This doubled the size of shareholders' equity and made the company debt free, net of its cash position. Since our initial visit, their new suspension assemblies, patent protected, have gone from a small percentage of their production to 50%. We recently acquired the stock at $22, which was at a slight premium to book value and less than 10x earnings. In addition to these changes, we added to existing positions while reducing others. We did reduce our holdings significantly in Lam Research and Komag. Both of these reductions were in response to spectacular price increases from when we bought them last fall.

Your Fund continues to maintain its valuation advantage over the Russell 2000 and the S&P 500. As of March 31, the Fund's P/E and P/BV (price/book value) ratios were 15.2x and 1.7x, respectively. By comparison, the P/E ratios of the Russell 2000 and the S&P 500 were 26.3x and 32.2x, while the P/BV ratios were 2.4x and 5.1x, respectively. Our companies are financially strong with an average Total-Debt-to-Total-Capitalization ratio of 23.7%. This compares favorably to 37.3% and 44.5% for the Russell 2000 and the S&P 500.

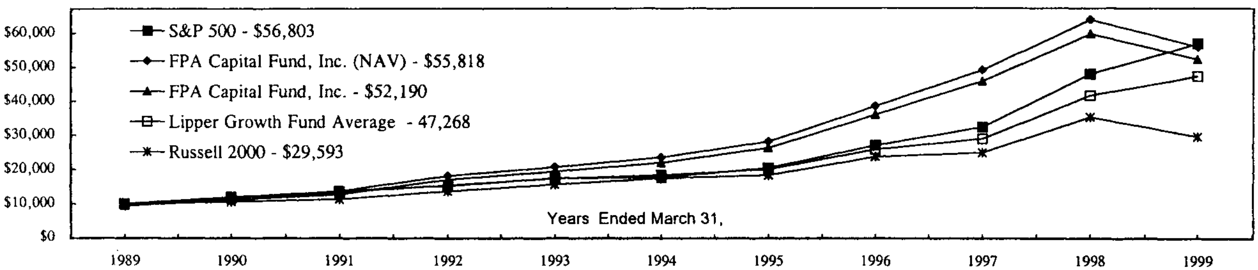
Before closing, I would like to take a brief moment to introduce you to our new associate, Rikard Ekstrand. He has graduate degrees from the University of Southern California and the University of Chicago, in chemical research and business administration. His business experience encompasses both the corporate and investment fields. He has deployed his value investment style in both the domestic and international stock arenas. We are looking forward to his meaningful contributions to the management of your assets. We thank you for your patience and support, especially during these challenging times.

Respectfully submitted,

Robert L. Rodriguez, C.F.A.
President and Chief Investment Officer
April 3, 1999

HISTORICAL PERFORMANCE

Change in Value of a $10,000 Investment in FPA Capital Fund, Inc. vs. Russell 2000, S&P 500 and Lipper Growth Fund Average from April 1, 1989 to March 31, 1999



Past performance is not indicative of future performance. The Russell 2000 Index consists of the 2,000 smallest companies in the Russell 3000 total capitalization universe. This index is considered a measure of small capitalization stock performance. The Standard & Poor's 500 Stock Index (S&P 500) is a capitalization-weighted index which covers industrial, utility, transportation and financial service companies, and represents approximately 75% of the New York Stock Exchange (NYSE) capitalization and 30% of NYSE issues. This index is considered a measure of large capitalization stock performance. These indices do not reflect any commissions or fees which would be incurred by an investor purchasing the stocks they represent. 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 $52,190 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 $55,818. The performance of the Fund and of the Averages is computed on a total return basis which includes reinvestment of all distributions.