

LETTER TO SHAREHOLDERS

Dear Fellow Shareholders:

This Annual Report covers the fiscal year ended March 31, 2006. Your Fund's net asset value (NAV) per share closed at \$44.99. Total distributions of \$0.82 and \$2.83 per share were paid on July 7 and December 23, 2005 to holders of record on June 30 and December 15, respectively, of which \$0.73 and \$2.66 were from long-term capital gains.

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, 2006				
	1 Year	5 Years	10 Years	15 Years	20 Years
FPA Capital Fund, Inc. (NAV)	18.33%*	19.67%*	15.32%*	17.88%*	16.79%*
FPA Capital Fund, Inc. (Net of Sales Charge)	12.12%**	18.38%**	14.70%**	17.46%**	16.47%**
Lipper Mid-Cap Value Fund Average	16.97%	13.37%	12.26%	13.37%	12.39%
Russell 2000	25.85%	12.59%	10.15%	12.07%	10.28%
Russell 2500	24.05%	13.51%	12.08%	13.66%	12.15%
Standard & Poor's 500 Index	11.73%	3.97%	8.95%	10.83%	11.43%

The Fund's six-month total return, which includes both the changes in NAV and the reinvestment of distributions paid, was 6.09%*. This compares with total returns of 8.84% for the Lipper Mid-Cap Value Fund Average, 15.23% for the Russell 2000, 13.15% for the Russell 2500 and 6.39% for the S&P 500. On a calendar year basis, these same comparisons are 16.53%* for FPA Capital Fund, 9.15% for the Lipper Mid-Cap Value Fund Average, 4.55% and 8.11% for the Russell 2000 and 2500, and 4.91% for the S&P 500.

Commentary

Your Fund outperformed all of the major indexes and the Lipper Mid-Cap Value Fund Average in calendar 2005 by substantial margins, despite carrying a very elevated cash and bond position. During this period, liquidity (cash and bonds) rose to nearly 41% from 33%. A large percentage of the Fund's positive relative performance came in the first calendar quarter of 2005, when it had positive performance while the other indexes declined in value. Our large liquidity holding helped protect the Fund from negative performance. In contrast to last year, this year's calendar first quarter was quite different, with the Russell 2000 setting a blistering pace by achieving a 13.94% total return, while the Russell 2500 participated with an 11.14% total return. Your Fund lagged the performances of both of these indexes by a wide margin, when it achieved "only" a 4.92% quarterly return. It did slightly outperform the S&P 500's 4.21% return. Your Fund's liquidity level rose to nearly 44% at March 31, 2006, which held back its performance.

Your Fund's liquidity level increased because of actions we took (we reduced the position size in several holdings) or because of the actions by others (three of our holdings were acquired). During this past fiscal year, Maxtor, Reebok International and WFS Financial received very attractive takeover bids from Seagate Technology, Adidas AG, and Wachovia Corp., respectively. In the case of Maxtor, we were lucky. We had just begun to reduce our position because we considered it to be an investment mistake. Fortunately, we were able to sell the balance of our holding at substantially higher prices. The Reebok takeover, though at an attractive price, did cause a momentary bit of remorse, given that it had been a long-term holding. But on second thought, we were very pleased with the outcome. WFS Financial, a holding for nearly twenty years, also fit into this same "remorse" category, but we believe the acquisition price was a very full one. These three sales added approximately 6% to the Fund's liquidity. We increased liquidity further by

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

** Reflects deduction of the maximum sales charge of 5.25% of the offering price.

selling the balance of our Hutchinson Technology (HTCH) holding. When we initially acquired this stock, the Nasdaq was climbing to nearly 5,000, while HTCH was languishing around \$19. When it rose into the mid \$30s and then into the low \$40s, we felt that the share price was discounting a very optimistic outlook, so we sold most of our position. In a subsequent rally, we sold the balance. Finally, we reduced our exposure in a couple of other holdings. For example, National Oilwell Varco has been spectacular these past four years. It has risen nearly 700% since we first began buying it. Its outlook has never been better, but we feel that we should hold a considerably smaller position because of valuation considerations. Should its price rise further, we could be forced out of the position entirely. Michaels Stores announced on March 20 that it would explore the possibility of a sale of the company. We do not know if it will be successful, but if it is, your Fund's liquidity level would likely rise by another 4%.

During the year, we added to several of the Fund's holdings on price weakness. Unfortunately, these periods have been few and far between. We did get the opportunity to add two new holdings: Rosetta Resources and Mercury General Insurance. Rosetta was discussed in the September 30, 2005 Shareholder Letter. Mercury General is a leading property and casualty insurer with a large market share in California. Its competitive advantage is its low expense ratios for overhead and underwriting losses. Mercury's combined ratio (an industry standard ratio that includes underwriting expenses, losses and general and administrative expenses) has averaged 8.5 percentage points better than the industry for the last ten years. As a result of its expansion outside the state of California, this endeavor has required a substantial capital investment to reach critical mass. Furthermore, it is rolling out a new back-end accounting system as well as a new front-end internet system. These added costs, as well as potential execution risks, have created, we believe, a buying opportunity. We were able to initiate a position at a price that approximates 12x our estimate for normalized earnings, along with a 3.5% dividend

yield. With the likelihood of rising interest rates and increased stock-market volatility, we may have the opportunity to add to our holding on price weakness.

Despite adding two new holdings and increasing our ownership in several of the Fund's other positions, portfolio liquidity is at a record level since we began managing your Fund in July 1984. This elevated liquidity level is not a statement that we feel the stock market is going to decline imminently, but rather that we are finding it difficult to uncover sufficient investment opportunities that meet our valuation requirements. We have always written that we consider the level of liquidity to be the residual of investment opportunities. As an example, the value screen that I have used for many years recently identified only 73 names, close to the record low of 47, out of a universe of 9,440 in the Compustat database. This screen included stocks with market capitalizations between \$150 million and \$3 billion. Of the 73 names, 53 were between \$150 million and \$1 billion. When I expanded the screen to include stocks with market capitalizations up to \$20 billion, only 20 additional companies were identified. Finally, below \$150 million, 97 companies were identified. What these results convey to us is that between market capitalizations of \$1 billion and \$20 billion, the market's valuation landscape is very flat. Only when you get into very small market caps and micro caps do a greater number of companies begin to be identified. Most of these companies are not viable investment candidates for us, primarily because of their lack of stock trading liquidity. The results of this screen are a far cry from the output that we got in late 1998, early 1999 and 1994. The stock market's flat valuation landscape is proving to be a challenge for us in the rational deployment of your capital.

We should clarify one aspect of our investment methodology — it is based upon a process of absolute valuation rather than relative valuation. Because of this, we can be at odds with other value-style managers that use more of a relative valuation metric. This difference in methodology can show up in the construction of style indexes, as well. For example,

both the Russell 2000 and 2000 Value indexes had spectacular performances for the quarter ended March 31, 2006, with total returns of 13.94% and 13.51%, respectively. In both cases, there were several stocks with total returns in excess of 100%. The list of high-performance stocks included technology, biopharmaceutical, cyclicals and energy. On closer inspection, many of these would, in our opinion, be nothing more than mere speculations. Some of these companies have not earned any money in five years; their market capitalization is in excess of revenues and many have little in the way of tangible assets. This observation applies to many of the top-performing stocks that are included in the Value index. We would not consider such stocks to be part of our investment universe and therefore, their performance is irrelevant to us.

During a period when high-expectation stocks, i.e., speculative-type stocks, are leading the way, your Fund is likely to lag in performance, even without its high liquidity level. It is our discipline that prevents us from participating in a stock market that has these valuation tendencies. Though we did have winners during this last quarter, we did not have enough of them to overcome the lagging performance of several of our holdings, as well as our high liquidity level. This same observation applies for your Fund's fiscal-year performance. Though it did underperform the Russell 2000 and the Russell 2500 for the fiscal year, it did outperform the Lipper Mid-Cap Value Fund Average and the S&P 500. We believe the Fund's lower relative return reflects both our selectivity and defensiveness, at a time when we perceive that investment risks are rising. We know we are at odds with most of the mutual-fund industry. As an example, the average liquidity of all equity mutual funds recently hit an all-time **low** of **3.7%**, versus your Fund's record **high** of **43.6%**. While we are being cautious, our competition seems to be very confident, and this is reflected in low stock-market volatility measures. Wherever we look, it appears that most investors are highly confident. Volatility in the bond market recently hit an all-time low as well. Yield spreads are quite narrow throughout all credit segments

of the bond market. There seems to be very little worry about credit risk. Again, while others seem to be highly confident, we believe that it is prudent to exercise a higher degree of caution.

The Fund's two largest sectors are energy and retailing, with each at slightly more than 18% of the portfolio. Despite large price rises in several of our energy stocks, we continue to hold most of them since we do not believe their share prices fully discount the expected growth in profitability that we anticipate. If we are correct in our estimates, most of them are valued at a single-digit or low double-digit P/E ratio. Furthermore, we believe they will be able to maintain this level of profitability for several years. Should we get a decline in energy prices (reasonably likely), we hope to use any period of price weakness to add new energy holdings to the portfolio, since we consider this area to be a strategic one for us. As for retailing, we believe our investments are directed toward retailers that have strong competitive positions and provide an attractive value proposition. Should the economy weaken, as we will discuss shortly, our retail holdings will probably experience some price weakness. In several cases, should this occur, we may add to some of our existing holdings. If Michaels were acquired, we would likely use any retail segment price weakness to try to establish another holding. Outside of these two segments, we are monitoring several new ones. In most cases, we are awaiting share price weakness before we are willing to commit capital.

As of March 31, 2006, the Fund's P/E and P/BV (Price/Book Value) ratios were 21.4x and 2.5x, respectively. By comparison, the P/E ratios of the Russell 2000 and 2500 were 28.8x and 25.6x, while their P/BV ratios were 2.6x and 2.7x, respectively. Our companies are financially stronger, with a 22.4% Total-Debt/Total-Capitalization ratio, which compares favorably to the 39.3% and 41.8% for the Russell 2000 and the Russell 2500. Your Fund's P/E ratio is currently elevated because of its large exposure to energy. During the next twelve months, P/E ratios of several of our energy companies should decline significantly,

given their extremely positive outlooks for earnings growth.

Outlook

We began calendar 2006 with the expectation that first-half real GDP growth was likely to be considerably stronger than the consensus expectation and then growth would likely decelerate in the second half. If we are correct, this trend should impact both the stock and bond markets. In our opinion, stock prices would initially begin to move higher but then they would likely be constrained by the negative effects of higher interest rates. As economic growth slowed in the second half, so would corporate profitability. We still hold this view.

Recently, consensus first-quarter real GDP growth expectations have risen from the low 3% range to the 4.5% to 5% level. As this process unfolded, the expected peak in the Fed Funds rate has shifted from 4.25% to 4.75 - 5%. Since the end of the March quarter, stronger economic data has moved this expectation to a range of 5% to 5.25%. In light of these changes, the ten-year Treasury bond yield has risen from 4.39% to 5.05%, while the two-year yield increased from 4.40% to 4.95%. As a result of these higher yields, the bond market is likely becoming far more competitive with the stock market.

We are of the opinion that these higher rates will gradually take their toll on the economy and the financial markets. In our September 2005 Shareholder Letter Outlook section, we commented, "We remain very cautious because we believe there are pressures building in the financial system." This process continues to unfold. For example, we believe that interest rates are now starting to have an effect on the real estate market. The inventory of homes waiting to be sold has risen dramatically in the last six-months. At current selling rates, the inventory of unsold homes has increased from less than four months to more than six months. Further interest rate increases should exacerbate this situation. Builders are now rapidly reducing new construction home prices so that they can reduce some of their excess inventory. Existing

home prices continue to rise, but this has always been a lagging indicator. It takes time for individuals, who have an emotional attachment to their home, to adjust to the new price realities. The rise in rates, particularly short-term rates, is hitting homeowners who have an adjustable rate mortgage, especially ones with a negative amortization feature. It is estimated that nearly \$600 billion in sub-prime mortgage loans alone will re-price this year. As this price reduction trend becomes more obvious, it will likely reduce consumer optimism and therefore, negatively affect measures of consumer confidence.

We see pressures building that are likely to slow corporate profitability growth. The rising tide of interest rates and a flat yield curve are not positive for the profitability of financial institutions in general. To maintain their existing profitability level, they must accept either more credit risk or more interest-rate risk and in some cases, both. In either case, it results in a higher risk profile. This trend is likely to lead to a higher degree of profit variability for financial institutions. With the financial sector near an all time high percentage of the various stock-market indices, any profitability disappointments could lead to a higher level of stock-market volatility with a negative bias. Rising commodity costs pose a risk as well since, unless a corporation is able to pass along these increased costs or reduce their negative effects by efficiency improvements, its profit margins are likely to suffer. Finally, various measures of wage expense growth show that this area is rising at a rate of approximately 3.5%. We are entering the fourth year of an economic recovery and therefore, it is likely that productivity improvements should be harder to come by to offset this rising cost. Again, corporate profitability may suffer. With after-tax corporate profit margins at post-war highs, there is little margin for error going forward. This process may be more visible by the end of this year, when we expect that S&P 500 profit growth will have decelerated to an approximately mid single-digit growth rate.

Our sense that there is little margin for error is in stark contrast to measures of stock-market volatility

and bullishness. As we mentioned before, stock-market volatility measures are near all-time lows. Several measures of stock market bullishness are at elevated levels while, at the same time, mutual-fund industry liquidity is at an all-time low. We have no idea what the future will bring, but we do know that rarely are so many confident people correct. This is our natural contrarian way of thinking. As I once was told, “You never know the value of liquidity until you need it and don’t have it.” We hope to be a liquidity provider when others desperately need it. We will do so but at a very high price. Who knows, with our high liquidity, we may begin to become known as the “Tylenol Fund” because of the pain relief that we can provide to those who need our help.

Until individual stocks fall to a level that meets our exacting valuation criteria, or the market does, we will retain our liquidity. With shorter-term Treasury bonds (2-3 years) at a nearly 5% yield and short-term money markets at 4.75%, both of these are close to the 5% total return that we believe will be the stock market’s prospective total return for the foreseeable future. We remain convinced that the opportunity cost of holding an elevated level of liquidity is rather small.

The discussion of Fund investments represents the views of the Fund’s managers at the time of this report and are subject to change without notice. References to individual securities are for informational purposes only and should not be construed as recommendations to purchase or sell individual securities. While the Fund’s managers believe that the Fund’s holdings are value stocks, there can be no assurance that others will consider them as such. Further, investing in value stocks presents the risk that value stocks may fall out of favor with investors and underperform growth stocks during given periods.

Fund shares are presently offered for sale only to existing shareholders and to directors, officers and employees of the Fund, the Adviser and affiliated companies, and their immediate relatives.

FORWARD LOOKING STATEMENT DISCLOSURE

As mutual fund managers, one of our responsibilities is to communicate with shareholders in an open and direct manner. Insofar as some of our opinions and comments in our letters to shareholders are based on current management expectations, they are considered “forward-looking statements” which may or may not be accurate over the long term. While we believe we have a reasonable basis for our comments and we have confidence in our opinions, actual results may differ materially from those we anticipate. You can identify forward-looking statements by words such as “believe,” “expect,” “may,” “anticipate,” and other similar expressions when discussing prospects for particular portfolio holdings and/or the markets, generally. We cannot, however, assure future results and disclaim any obligation to update or alter any forward-looking statements, whether as a result of new information, future events, or otherwise. Further, information provided in this report should not be construed as a recommendation to purchase or sell any particular security.

Other than the possible additional liquidity that may come from a Michaels Stores acquisition, we do not anticipate that the Fund’s liquidity level will rise much further; however, circumstances beyond our control can always change this expectation.

We thank you for the support and trust that you have demonstrated in us by your investment in FPA Capital Fund. We will strive to continue to earn it.

Respectfully submitted,



Robert L. Rodriguez, CFA
President and Chief Investment Officer
April 16, 2006