LETTER TO SHAREHOLDERS

Dear Fellow Shareholders:

This Annual Report covers the fiscal year ended March 31, 2007. Your Fund's net asset value (NAV) per share closed at $44.28. Distributions of $1.48 and $2.26 per share were paid on July 7 and December 22, 2006 to holders of record on June 30 and December 15. Included within these distributions were income dividends of $0.38 and $0.25 and long-term capital gains of $1.10 and $2.01, respectively.

The following table shows the average annual total return for several different periods ended on March 31, 2007 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, 2007				
	1 Year	5 Years	10 Years	15 Years	20 Years
FPA Capital Fund, Inc. (NAV	7.37%*	13.03%*	13.38%*	16.16%*	16.11%*
FPA Capital Fund, Inc (Net of Sales Charge)	1.73%**	11.82%**	12.77%**	15.74%**	15.80%**
Lipper Mid-Cap Value Fund Avg.	13.37%	12.39%	12.03%	12.79%	11.59%
Russell 2000	5.91%	10.95%	10.23%	11.08%	9.82%
Russell 2500	8.23%	12.15%	12.03%	12.76%	11.64%
Standard & Poor's 500 Index	11.83%	6.27%	8.20%	10.88%	10.76%

The Fund's six-month total return, which includes both the changes in NAV and the reinvestment of distributions paid, was 12.00%*. This compares with total returns of 13.01% for the Lipper Mid-Cap Value Fund Average, 11.02% for the Russell 2000, 12.56% for the Russell 2500 and 7.38% for the S&P 500. On a calendar year basis, these same comparisons are 5.42%* for FPA Capital Fund, 15.97% for the Lipper Mid-Cap Value Fund Average, 18.37% and 16.17% for the Russell 2000 and 2500, and 15.79% for the S&P 500.

Commentary

For the fiscal year ended March 31, 2007, your Fund's total return was between that of the Russell 2000 and the 2500 and materially less than the Lipper Mid-Cap Value Fund Average; while for the calendar year ended 2006, your Fund underperformed all the comparative measures of performance, as listed above. We think it is important to consider that your Fund's performance should actually be viewed over a two-year period for both fiscal 2005 and 2006. These two years are mirror images of themselves because a significant amount of the Fund's performance in 2005 actually took performance from 2006. We had several takeover situations in 2005 that did not occur to the same extent in 2006. Furthermore, as a result of these takeovers, as well as our continuing to sell stocks that were reaching elevated valuation levels, the Fund's allocation to short-term liquidity and bonds grew from 34.5% to 38.7%. This high liquidity level helped to retard your Fund's performance.

Some of you may be asking, why are we holding such an elevated level of liquidity? Should we not invest this so that we may either maximize returns or be more competitive with the returns being generated by the market averages as well as by other value funds? We think these are both good questions and we will attempt to answer them. Our liquidity level is the residual of investment opportunity. We do not attempt to forecast how much liquidity we should have. For many years, we had a minimal level of liquidity because attractive investment opportunities were quite abundant. This is not the case at the current time. As you may recall, we are an absolute value rather than relative value style investor. What this means is that we have a strict valuation methodology that does not shift with the winds of the stock or bond markets. We explained this philosophy in our initial shareholder letter in September 1984. This is what drives us in our investment selection process. Because we have had several takeovers and other stocks that performed extremely well, our selling has been at a pace that has been considerably faster than our ability to redeploy capital. Many other value style funds, and funds in general, utilize a relative value methodology whereby

* 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

an investment is attractive because its valuation, in relation to some other metric, makes it appear to be attractive. We are of the opinion that relative value investing can and will get you into investment trouble since it can be used to justify almost any purchase. We will not compromise our standards. Furthermore, we will not allow the market or what other funds may be doing influence us in our investment decision making. One does not know to what degree these other funds may be accepting an elevated level of investment risk. In our judgment, we do not believe there have been sufficient investment opportunities that might compensate us appropriately for the potential risks. The ratio of upside return versus downside risk, for the many investments we have evaluated, has been inadequate, in our opinion.

We have been active, but it has been more on the sell side than on the buy side. The primary reason for our liquidity rising nearly five percentage points since last September was because the Michaels Stores acquisition transaction closed. During the nearly twelve years we held this stock, Michaels' share price appreciated approximately seventeen fold. We were very happy to accept the offer since we viewed it to be highly generous. In our opinion, for the new owners to generate an acceptable return from their acquisition price, operating profit margins will likely have to rise by at least another two or three percentage points and they will have to convince prospective buyers, should it become a public company again, that there is additional margin improvement to be captured. We wish them well, but we believe that we made the "easy" money over these past twelve years. In addition to eliminating Michaels, we also sold our position in Big Lots, as it rose 124% in the twelve month period ended this March. Again, we are of the opinion that the current share price discounts some very optimistic profitability assumptions. We do not believe there is a sufficient margin of safety that justifies its continued retention. In addition to these sales, we also reduced our Avnet and Ross Stores holdings. Avnet's share price performance has been truly spectacular since July of last year. Between April and July, its share price declined from approximately $27 to $16, or nearly 40%. In our opinion, it was unlikely that the stock might remain in the $16 area since it would have required possibly a 40% decline in Avnet's earnings, for the fiscal year ended June 2007. Investor pessimism was quite high at the time. We did not view this as a highly probable outcome and, therefore, we increased our ownership by almost 40%. Since then, the stock has risen just under 150%. We are now gradually reducing our exposure because this investment rose to over 9% of the Fund's net assets. This is a perfect example that, if an attractive investment becomes available, we will act and act aggressively. Since July 2006, Avnet's earnings have not declined but have exceeded the consensus forecast for its June 2007 fiscal year, and now Wall Street analyst earnings estimates for the June 2008 fiscal year are being raised. Recently, Avnet's share price established a new all time high. We eliminated our holding in Apria Healthcare after we reassessed the fundamental reasons for owning the company. The cash flows were not developing, as we had expected, and the cost reimbursement environment from Medicare has become progressively more negative. We did not believe that the holding warranted our continued investment. We did achieve a long-term capital gain, as we did on all our other sales.

In our September 2006 shareholder letter, we wrote an extensive explanation as to why we are very positive on the energy sector. We did this since many of our energy stocks had disappointing price performance earlier in the year. In response to these price declines, we significantly increased our holdings in both Patterson-UTI and the Rowan Companies. We also added a new energy holding, Atwood Oceanics, so that at March 31, this sector accounts for nearly 21% of your Fund versus 17% at September 30, 2006. This is typical of the portfolio management process we have deployed for nearly twenty-three years and that is we recycle capital from strong performing sectors into underperforming ones.

Our new holding, Atwood Oceanics was added at approximately $50 per share, after my associate, Rikard Ekstrand, recommended it. Atwood owns and operates eleven offshore drilling rigs, including one new-build jackup rig to be delivered in the fall next year. The breakdown is four semi-submersible rigs, three jackup rigs, one tender rig, one submersible rig, and two platform rigs. Atwood operates in international markets and should continue to benefit from increased E&P (Exploration and Production) spending internationally – only one low end

rig is in the Gulf of Mexico accounting for 3% of its asset value. International E&P spending is estimated to be up 13% for 2007, according to an extensive survey of oil company executives by Lehman Brothers.

We purchased Atwood at 70% of its asset replacement value and 11x this year's earnings. Earnings may increase substantially over the next several years as Atwood's drilling rigs have old contracted day rates below current market rates. As the old contracts roll over and new contracts already in place for 2008 and 2009 kick in, earnings could more than double from this year's level. The management team has been in place for more than a decade and has done a solid job operating the company and allocating capital intelligently. The balance sheet is solid with little debt. Free cash flows this year more than support the payments on the new-build jackup rig to be delivered next year. In 2008 and 2009, free cash flows should increase substantially as new contracts with higher day rates begin. The risk is that oil prices come down since Atwood's rigs drill mostly for oil. If oil prices are down 50% from current levels, the stock could trade down 30% to around half of its replacement value, maybe even lower. We think it's a low probability that oil prices break $30 per barrel. Should this happen, we'd be likely to significantly increase our investment in Atwood and other investments in the energy space.

We believe we are finally being vindicated in that we entered 2006 with a rather cautious economic outlook. It was our opinion that economic growth was likely to decelerate into the 2% range in the second half of the year and that S&P earnings growth was likely to be in the range of 5-7% for the fourth quarter. The fourth-quarter earnings numbers came in at approximately 13% and thus, our forecast looked materially wrong; however, our real GDP expectation was pretty close to the mark. Since then, more economic and profit data has been released. On a much broader national and income account basis, corporate profit margins peaked in the third quarter. Wall Street's optimistic earnings growth expectations continued at the beginning of the year, when Thomson Financial reported that consensus first-quarter S&P 500 earnings growth was estimated to be 8.7%. Since then, the consensus forecast has now fallen to 3.3%, with second-quarter growth anticipated to be 3.5%. For 2007, the consensus forecasts 6.3% growth and thus, to achieve this number, requires double-digit growth in the third and fourth quarters, should the first and second quarter estimates prove to be reasonably accurate. With this latest data, it looks as though we were only a little early in our earnings slowdown expectation, but we had the right direction and magnitude.

Fear seems to last only briefly in this market. As some of the major indexes set new highs, the high volatility day of February 27 seems to be fading into a distant memory. Measures of stock market volatility have returned to levels close to where they began prior to this day. Credit spreads seem anchored, despite the growing problems in the sub-prime sector. The consensus is expecting a slowing in earnings growth with the prospect of rising P/Es since inflation seems to be moderating and the Fed is on hold. In other words, it's safe to take on risk again because the "Goldilocks" environment is alive and well. We are of a different opinion.

What February 27 demonstrated was how illiquid the markets can become on short notice. While conducting a client conference call at the moment the disruption occurred, in less than four minutes, the Dow Jones Industrial average fell from down 290 points to nearly minus 560 points and then proceeded to close down "only" 416 points. The NYSE disclosed that they had a computer issue that affected the reporting of prices and that this was now corrected. As I pointed out on this call, had this occurred at 3:56 p.m. Eastern Standard Time, the market would have closed on its lows and a mountain of margin calls might have gone out. Because it occurred earlier in the day, there was time to correct the problem. We were lucky. This episode demonstrates that in an electronic market things can go wrong very quickly and can lead to unanticipated outcomes. I reminded this client that, unless you had liquidity already, it would have been impossible to raise any or to do a repositioning of the portfolio. As I have said on many a previous occasion, "you never know the value of liquidity until you need it and don't have it."

We remain concerned about the level of leveraged investment strategies that are being deployed in the financial markets today. It is impossible to know when one of these may trigger an "event" that sets in motion other actions or events. In our opinion, with the small premiums required to take on elevated levels of credit,

interest-rate or market-volatility risk, the system requires almost perfection, which is rarely attainable.

Given the uncertain outlook for economic growth and profits, we are being even more deliberate in our investment selections. Your Fund's equity holdings have significant valuation advantages, when compared to the various metrics for the benchmark indexes. As of March 31, 2007, the Fund's P/E and P/BV (Price/Book Value) ratios were 13.9x and 2.1x, respectively. By comparison, the P/E ratios of the Russell 2000 and the 2500 were 25.3x and 23.0x, while the P/BV ratios were 2.4x and 2.5x. Our companies are financially stronger, with a 23.5% Total-Debt/Total-Capitalization ratio, which compares favorably to the 39.1% and 43.3% for the Russell 2000 and 2500. Finally, our companies are considerably more profitable, with a weighted Return on Average Equity of 16.2% versus the Russell 2000 and 2500 indexes of 12.6% and 14.6%.

In summary, we will maintain a high level of liquidity until we discover a sufficient number of qualifying companies. This will not take place unless we are well compensated, through lower valuations, for the various possible risks that we perceive. We believe the following special commentary section will help you understand why we believe there are some serious storm clouds gathering over the horizon of the investment landscape.

Special Commentary

Nearly two years ago we began discussing the risks in the sub-prime area and then went on to mention an area referred to as Alt-A, in FPA New Income's shareholder letter (our bond fund). We were of the opinion that the lack of underwriting standards would come back to haunt the sub-prime area. At the beginning of last year, we forecast that the sub-prime sector was likely to come under duress in the second half of 2006 and that this was likely to hurt the economy and the housing sector into 2007. As it developed, the process really did not get going until December and then picked up steam in February 2007. There have now been over 50 sub-prime organizations that have been taken over or have filed for bankruptcy since the end of November. The second largest, New Century Financial, has filed for bankruptcy, while the largest, HSBC Holdings Plc, has fired the senior management of its U.S. operations that included the sub-prime credit operation, the former Household International Inc.

Fear of a general contagion from the sub-prime fallout has worried the financial markets and especially the housing sector. So far, the general belief is that it will be contained. Federal Reserve Chairman Bernanke said that the fall-out from "the sub-prime markets seems largely to be contained." We are not so sure. In 2005, we reviewed three mortgage-backed securities that we owned in FPA New Income. What caught our attention was that they were experiencing an elevated rate of delinquency and foreclosures, after only nine months of seasoning. This did not seem to make sense to us since these securities had high FICO scores (710-720). They were Alt-As and we did not understand what was going on, but we were unwilling to stay around to find out, so we sold them without any trouble. At the time, I had conversations with others who noticed these same trends. They were cautious in their outlook toward this sector as well. Now we are witnessing a growing concern regarding Alt-A securitizations. In the April 3, 2007 *Wall Street Journal*, it reported that M&T Bank Corp. shares, in which Berkshire Hathaway Inc. is a big investor, declined 8.5%. The company announced that it was having trouble selling their Alt-A loans and thus, they would keep the loans, "a move that could knock about $7 million off its first-quarter earnings." In another article that same day, SouthStar Funding LLC, an Atlanta lender, announced that it would be closing down because the type of loans that it originates, Alt-A, are experiencing the same problems as sub-prime. Alt-A loans are loans that are supposed to be of a materially higher credit quality level than sub-prime and can have characteristics that are equal to prime mortgage loans.

As we researched this area, we ran across the First American Real Estate Solutions report, "Alt-A Credit — The Other Shoe Drops?" In it the data shows how far the underwriting quality has deteriorated since 2003. The report details how ARM loans have escalated from 1.7% to nearly 70% of total originations, with low documentation rising from 58% to nearly 80%. Furthermore, between 2002 and 2006, IO (interest only) loans rose from 7.7% to 35.6%, of total loans, while negative amortization loans grew from 0.4% to 42.2%,

respectively. I could go on but the data obviously demonstrates the deterioration in underwriting standards.

Why are these two areas important? Sub-prime and Alt-A originations accounted for nearly 40% of total mortgage loans in 2006. The hunger for housing on the part of the individual, along with the hunger for profits by the originating organizations, created a perfect storm for excesses to develop. In our opinion, all of this is a direct result of the Federal Reserve's misguided interest-rate policy that led to the steepest yield curve ever. It helped to create a housing bubble of massive proportions that then encouraged buyers and lenders to speculate. The development of liar loans, i.e., low or no documentation loans were able to proliferate because everyone knew that home prices only went up. All of this would not have been possible without the development of the securitization market. The development of sub-prime ABS securities allowed many organizations to rapidly grow their origination base with the goal of selling these securities into the secondary market and, as such, sub-prime loans grew from slightly less than 5% of mortgage origination in 2001 to nearly 20% in 2006. With the easing of credit standards and the ability to sell these securities into the secondary market, an excess demand for housing was created.

I go through this long discussion since there is quite a bit of debate as to how big and how long the housing downturn might be. There are questions as to how much, if any, house price depreciation might occur. I have seen various studies try to estimate what the decline in home prices might be. These estimates generally range in the 10% to 20% area; however, Robert Shiller of Yale estimates that, if housing were to come back into alignment, after adjusting for inflation and the expansion in the average size of a home, the price adjustment would have to be approximately 45%. This may all sound a bit extreme since there has not been an annual decline in the national average price of a home in the post-WWII period.

My associates and I wondered, how might a house price decline affect the models that rating agencies use in determining the credit rating of a mortgage-backed ABS? On a conference call with Fitch on March 22, Fitch presented its assessment of the sub-prime ABS market. During the question-and-answer period, my associate, Tom Atteberry, asked the question, "What are the key drivers in your credit rating model?" Fitch responded that it would be the FICO score along with the assumption that home price appreciation (HPA) of low- to mid-single digit would continue, as it has for the last fifty years. Tom then asked, "What would happen to your model if HPA were flat?" They responded that the model would start to break down. If HPA were a negative 1% or 2%, the model would completely breakdown. Thus, if forecasts of 10% to 20% declines in home prices were to occur over a ten-year period rather than one or two, the model that Fitch uses would breakdown and various securitizations with credit ratings of AA or even AAA would experience considerable difficulty. This aspect of risk is not factored into the market today.

The potential of a breakdown in the rating agency models has serious implications for various types of financial institutions and debt origination structures. It could potentially strike at the confidence in the rating agencies themselves. My associate, Julian Mann, has been studying the area of sub-prime and rating agency involvement. He recently showed me a very garden variety Libor sub-prime floating rate security. The Standard & Poor's pricing service valued this bond at par while on March 19, 2007, Moody's rated this bond A3. To affirm the accuracy of this bond's pricing valuation, Julian went to two brokerage firms that traffic in this type of security and requested what might their bid be, if we were to request a bid. One responded that it would likely be in the $7 area. This does not mean 70% of par but 7% of par, a differential of nearly 93% between what the Standard & Poor's pricing service indicated and what might occur in the actual market. The other firm declined to indicate a bid but did say that the 7% of par bid was probably the correct one. Julian is continuing to investigate this area to determine whether this is an isolated occurrence or whether this may be the tip of something even larger. It does raise a serious question in our minds.

Since the conference call with Fitch, there has been a heightened level of discussion by many of our elected representatives as well as from some of the federal agencies. On April 12, Congressman Barney Frank of Massachusetts suggested that mortgage bond investors should be held liable for deceptive lending practices. This

was followed up on April 17 when FDIC Chairman, Sheila Bair, said that mortgage investors failed to do due diligence before buying all these mortgages and that "everybody needs to share the pain." Should any of these misguided comments create the environment to legislate this type of liability, I can assure you that less capital will become available for mortgage loans. This I can say with absolute certainty in the case of the Funds we manage at First Pacific Advisors.

One additional risk to the sub-prime and possibly the Alt-A and other credit ABS structures is that the credit pipeline has gotten very extended between the providers of capital and the borrowers of capital. With so many different entities between borrower and lender, and with each taking their fractional share of fees, the discipline of the credit underwriting process can become tenuous since the loan is being passed on to another entity. In this case, should the borrower get into trouble, the ability to manage or restructure the loan terms becomes more difficult as these loans are securitized. It is estimated that approximately 75% of all sub-prime loans have been securitized so that a modification of the loan terms may be restricted by the prospectus or legal agreements. With many of these loans held in CDOs (collateralized debt obligations) that are owned by distant third parties, an effective loan restructuring is difficult, if not nearly impossible. This is a decidedly different scenario than what happened in the last credit contraction of 1990-93. Back then, most loans were held in a portfolio by the originating organization and, therefore, a loan restructuring could be done more easily. It will be interesting to see how these new structures operate and how they might affect the economy in a credit contraction. For the past two years, we have been weeding out any questionable loan-structured securities in FPA New Income.

Should the economy experience a reduction in job growth or the beginning of a rise in the unemployment rate, this could accelerate the negative price adjustment in housing and further cause a weakening in consumer disposable income and spending. Any weakening in employment would also occur at a time when between $1.1 and $2.2 trillion in mortgages will be subject to rate resets this year, according to *The Bank Credit Analyst*. We feel the risks of this negative scenario are rising, but this risk is not being factored into valuations in the stock market or into credit spreads in the bond market. Again, the word "risk" does not seem to be in the vocabulary of many investors.

Outlook

We remain convinced that corporate earnings growth is in a rapidly decelerating trend. The economy, in several areas, appears to be slowing. At this time last year, we argued the same point; however, the optimists were claiming that capital spending growth would ride to the rescue. So far, that has not been the case with decidedly weak capital spending reports. With the growing risk of a housing recession, it would seem that capital spending plans will likely be reduced further, unless the capital spending is being directed to overseas markets. The prospect of rising delinquencies and foreclosures would seem to increase the risk that financial institutions will have to begin increasing their provision for loan losses. Unless the Fed lowers the Funds rate rapidly this year, net interest margins will be pressured by the shape of the yield curve. Prior to this, financial institutions were able to offset the flat yield curve by going down in credit quality. It would appear that option is now closing. Financial service stocks represent nearly 22% of the S&P 500 and 28% of its earnings. If one adds in the financial subsidiaries of GE, GM and others, it is quite easy to get the financial share of the S&P 500's earnings above 30%. This segment's profitability is at risk. Energy company earnings are also likely to suffer by comparison to last year's robust earnings. This too adds an element of risk to the earnings equation. In summary, we expect that there will be a growing chorus of negative earnings surprises as we go through this year.

We are hopeful that the process of negative earnings surprises will increase the likelihood of stock-market volatility. Under these circumstances, we may see more companies become attractively priced. This will have to occur since the number of qualifying companies identified by our value screens, as well as the number that appear in the new low list, continue to be quite meager. The number of companies identified by my value screen continues to hover just above the all time low number of qualifiers.

In our opinion, the odds of the Fed beginning to lower the Fed Funds rate rise as we go through this year. Our best guess is that this process will likely start on or around September. Unless the economy is slowing more rapidly and unemployment is rising, the Fed is likely to be initially slow in lowering the Funds rate. This may be a challenge for them since they are still focused on inflation. Given the price action of commodities last year, we see the likelihood of rising CPI inflation in the second half of the year; thus, the Fed faces the prospect of slowing economic growth at the same time there are deteriorating CPI comparisons.

Should we be correct about the worsening profitability environment, this could begin the process of credit risk being reintroduced to the corporate bond market and, thus, high-yield credit spreads would likely expand. As this trend unfolds, a key element that has allowed private equity firms to thrive—their access to cheap credit to finance their deals—would begin to fade away. Without cheap credit, they cannot continue to make their aggressive bids for companies. In our opinion, many stocks have been bid up in anticipation of a private equity bid.

The common thread that is flowing through the housing market, private equity, hedge funds and other aggressive forms of investing is the absence of fear. They are all using elevated levels of financial leverage. The penalties for excessive leverage are just now beginning to show up in the housing market. As with any aggressive investment strategy, there will be a high price to be paid for excess, just ask those aggressive growth fund equity managers who could see little risk in investing in internet stocks and other types of technology stocks in 2000. Many of their investors are still licking their wounds from that period.

This sure looks like it is going to be a fascinating year. Our goal is to protect your capital while patiently waiting for attractively valued investment opportunities.

We thank your for your patience, support and trust that you have demonstrated in us by your investment in FPA Capital Fund.

Respectfully submitted,

Robert L. Rodriguez
President and Chief Investment Officer
May 1, 2007

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.

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.