

LETTER TO SHAREHOLDERS

Dear Fellow Shareholders:

This Semi-Annual Report covers the six months ended September 30, 1998. Your Fund's net asset value (NAV) per share closed at \$27.00. The NAV reflects a distribution of \$3.07 on July 8, 1998, to shareholders of record on June 30, 1998. This distribution was composed of a \$0.26 income dividend and a \$2.81 capital gains distribution, \$2.755 of which was long-term.

The following table shows the average annual total returns for several different periods ended September 30 for the Fund and comparative indices. 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 September 30, 1998

	<u>1 Year</u>	<u>5 Years</u>	<u>10 Years</u>
FPA Capital Fund, Inc. (NAV)	(16.50)%*	16.82%*	17.34%*
FPA Capital Fund, Inc. (Net of Sales Charge)	(21.93)%‡	15.26%‡	16.55%‡
Lipper Growth Fund Average	(1.45)%	14.72%	14.96%
Russell 2000	(19.02)%	9.10%	11.15%
Standard & Poor's 500 Stock Index	9.15%	19.99%	17.29%

The Fund's six-month return, which includes both the changes in NAV and the reinvestment of distributions paid, was -23.47%*. This compares with total returns of -11.84% for the Lipper Growth Fund Average, -23.87% for the Russell 2000, and -6.86% for the S&P 500. On a calendar year-to-date basis, these same comparisons are: -14.92%* for FPA Capital Fund; -0.21% for the Lipper Average; -16.21% for the Russell 2000; and 6.14% for the S&P 500.

Commentary

We now know that this market is no longer like the "Energizer Bunny," and serves to prove that batteries and markets do have a finite life. As it turned out, we wrote our highly cautionary shareholder letter on April 21, 1998, the exact day the broader market hit its peak. In our opinion, we are in the midst of a "bear" market. In the initial stages, there is a certain degree of

randomness that hits a portfolio's performance. Your Fund was not spared in this rout; however, it did slightly outperform the Russell 2000 during the nine months ended September 30. We did poorly versus the average growth fund and the S&P 500. It was particularly frustrating this last quarter since your Fund declined 23.64%* versus the 20.15% decline of the Russell 2000 (a measure of small stock performance). We entered this period with a portfolio P/E ratio considerably less than that of the market, as well as having approximately 30% in short-term liquidity and bonds. This high level of defensiveness did not moderate the decline as much as we had anticipated. We did not do as well as the average fund in the Lipper Growth category since we refused to follow the crowd and buy the most favored companies. This is the price one pays sometimes for being a contrarian. We believe that our value discipline will eventually be rewarded as our performance diverges from the pack in a positive way.

As we have explained in previous shareholder letters, your Fund focuses primarily on small and mid-size companies, and these stocks were especially hard hit in the initial stages of the "bear" market. During the nine months ended September 30, stocks declined across a broad front with 50% of more than 10,000 stocks falling at least 40% from their highs. In contrast, only 21% of the S&P 500's stocks fell at least 40%, during this same time frame. When we dissect this decline, the one underlying conclusion is: bigger was better. The largest stocks in the S&P 500 generally did better than the balance of the stocks in that index. If we look at the Nasdaq market of "over-the-counter" stocks, the largest stocks did better. For example, the Nasdaq 100, comprised of the largest 100 stocks in the Nasdaq market, had a negative total return of 8.2% from its high, while the balance of the Nasdaq stocks had a negative total return of 23.6%. The total returns from their respective highs of the Russell 2000 and the S&P 500 were -25.6% and -14.01%. Your Fund's total return was -26.96%*. We calculated these total returns from their respective highs, which did not occur on the same day. This analysis is an approximation of how the various markets performed.

* 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

We believe there are four questions you would like to have answered: What caused this decline? How long will it last? What is our response? Why do we believe we will be successful?

We believe this decline reflects the realization on the part of investors that economic and corporate earnings growth will be much lower than previously anticipated. Investors have been forced to return to reality. For the past year, we have been growing more cautious in our communications with you. We wrote that the investment environment reflects "a gaming or casino mind set" (September 1997 shareholder letter) and that earnings expectations were exceedingly optimistic and therefore, "At current valuation levels, we do not believe the market can withstand virtually any earnings disappointments later this year." (March 1998 shareholder letter) The "Asian contagion" is finally starting to depress corporate earnings. We have also seen growing pressures in the international market, as witnessed by the collapse of the Russian economy and the subsequent default on their government debt obligations. The combination of these has thrown the financial markets into a state of disarray. What we did not know was how widespread speculation had grown. In just the last few weeks, we have read about several hedge funds that have blown up because of their aggressive investment and financing strategies. Fear and aversion to risk are beginning to rise to high levels. Liquidity is now no longer viewed with contempt.

It is impossible to forecast how long this market decline will last or how deep it will be. Previous "bear" markets have generally lasted from one to two years. In our opinion, the last true "bear" market occurred in 1981 and 1982. The market declines of 1987 and 1990 were severe but very short-lived, and were caused by outside events that were over quickly. The Federal Reserve was able to lower interest rates dramatically in order to stabilize and then spur economic growth. In contrast, the events that are impacting the economy and the financial markets currently are likely to be of a much longer duration and, therefore, will have a more sustained impact. It will take time for the international economy to recover. The slowdown in international economic activity is deeper and more widespread than we previously anticipated. As a result, the mending process should take longer. It is also unclear whether the "Asian contagion" will hit Latin America. Should it spread to Brazil and then to Mexico, the risk of a U.S. economic recession, as opposed to the current profit recession, would rise materially. Unlike the 1987 and 1990 periods, U.S. interest rates are already low; therefore, the beneficial impact from an additional Fed lowering

of interest rates should be less than in prior periods. This potential recession risk as well as the continuation of subdued corporate profitability growth should limit the stock market's potential rise from current levels. In our opinion, earnings expectations for 1999 are still excessively optimistic with a forecast growth rate of 18%, as measured by the First Call survey. We believe these expectations are in the process of being lowered. It takes time for analysts to get their numbers closer to the mark. Usually, the stock market gets to the answer faster than analysts do.

Our response to this environment is one of gradually growing optimism. As fear re-enters the marketplace, a greater number of investment opportunities are a logical outcome. Over the next year, we do believe the financial markets and the economy will be quite challenging and the uncertainty this creates will lead to a higher level of investor anxiety. It is this anxiety and fear we hope to take advantage of in our future investment selections. We have already begun this process. During the six months ended September 30, we have gradually accelerated the deployment of capital. We have committed approximately \$82 million, or 33% of the liquidity and bonds, that we had as of March 31. This process is continuing at an accelerating rate as the market declines. During the chaos in the early part of October, we became quite aggressive. At the end of September, liquidity and bonds represented 25%, while as of October 16 they totaled 21%. These percentages tend to understate the activity, because asset values were falling almost as fast as we were deploying capital. If we calculated the current liquidity and bonds as a percentage of the total assets as of March 31, they would represent 15% instead of the 30% reported. We intend to invest the liquidity as we have always done, one stock at a time.

We are encouraged since we believe absolute value opportunities are now reappearing. Since April, the number of companies qualifying in our computer screens for value has increased sixfold. The new low list has recently grown to over 1,000 companies versus less than a handful at the market's peak. In response, we added three new positions while increasing our investment exposure to eleven existing holdings. Proceeds from the acquisition of two of our holdings, Devon Group and Fluke, are being recycled into new investments. Our new company holdings are Gymboree, Kemet and Lam Research. All are leaders in their respective fields and were acquired at price levels that were at either modest premiums or discounts to book value. All have very strong balance sheets with modest levels of debt. Gymboree is a

leading retailer of premium-quality young children's clothing that is experiencing, in our opinion, temporary operating difficulties. It is selling at its lowest valuation ever. Kemet is a leading producer of capacitors, but its price is suffering from the slowdown in sales of computers and electronics. This is a "backdoor" way to participate in the growth of technology. The more complex the electronics, the greater the number of capacitors required. Lam Research is the second largest producer of semiconductor capital equipment. Its share price has collapsed from \$73 to \$10 due to the slowdown in semiconductor capital equipment spending. We have been acquiring the position at these lower price levels since we believe there will be an eventual equipment recovery and Lam will be a successful participant.

Most of the investments that we are making or considering today are in companies that have large international exposure or are being significantly impacted by the Asian debacle. We are attracted to them since we believe there will be an eventual recovery in the international economy. The consensus investment thinking is to avoid these types of investments because there is so much economic uncertainty. It was not so long ago that having a large international exposure was viewed as an advantage, especially if it was in Asia. Now we believe investment psychology has swung so decidedly negative against these kinds of companies that one is essentially getting a free call option on the eventual international recovery. We believe this investment strategy shares many similarities to our "California" investment theme five years ago. We hope it will work equally well. Only time will tell.

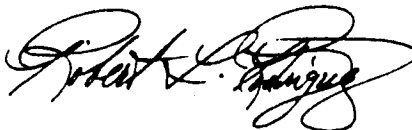
The seeds of our future success lie not only in recent purchases, but also in the existing portfolio. We believe this combination is setting the stage for another period of robust performance. We are encouraged since our value screens are uncovering the highest level of potential investment opportunities in the last five years. Unlike our last letter, when we wrote, "Even though our portfolio P/E is substantially less than the market comparisons, we are still uncomfortable with its absolute level," today, we are convinced that your Fund is at its most attractive valuation level since 1990. Its competitive valuation advantage is at one of its widest levels ever. At the end of September, the Fund's P/E and P/BV (Price/Book Value) ratios were 12.8x and 1.7x, respectively. By comparison, the P/E ratios of the Russell 2000 and the S&P 500 were 20.6x and 24.4x, while the P/BV ratios were 2.2x and 3.9x, respectively. Our companies are financially strong with a 22.3% average Total-Debt-to-Total-Capitalization

ratio. This compares favorably to the 38.7% and the 45.8% for the Russell 2000 and the S&P 500.

On a relative valuation basis, small-capitalization stocks, when compared to large-capitalization stocks, are at their cheapest levels since 1990. We are still somewhat cautious since the absolute valuation levels remain very high for both the Russell 2000 and S&P 500. By comparison, your Fund's valuation characteristics are at their lowest levels since 1990. We hope that this will help provide some downside protection should the stock market experience another sharp decline. However, as we have written in previous letters, low portfolio valuation characteristics alone may not provide sufficient downside protection, if fear and panic re-enter the market. What they do provide is a sound basis from which to launch a recovery, when reason and confidence return. An example of this was in 1991, when your Fund exploded to the upside.

We hope that we have addressed some of your questions and concerns satisfactorily. It is far more interesting for Dennis Bryan and me to come to the office these days since there are so many more potential investment opportunities. We thank you for your continued support.

Respectfully submitted,



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

October 17, 1998