

LETTER TO SHAREHOLDERS

Dear Fellow Shareholders:

This Semi-Annual Report covers the six months ended September 30, 2001. Your Fund's net asset value (NAV) per share closed at \$22.98. The NAV reflects a distribution of \$0.68 on July 9, 2001, to shareholders of record on June 29, 2001. This distribution included a \$0.03 income dividend and a \$0.65 capital gains distribution, \$0.45 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 several 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, 2001		
	1 Year	5 Years	10 Years
FPA Capital Fund, Inc. (NAV)	-3.16%*	8.67%*	15.92%*
FPA Capital Fund, Inc. (Net of Sales Charge)	-8.24%‡	7.51%‡	15.30%‡
Lipper Mid-Cap Value Fund			
Average	1.92%	11.26%	12.87%
Russell 2000 Index	-21.21%	4.54%	10.01%
Standard & Poor's 500 Stock Index	-26.62%	10.22%	12.70%

The Fund's six-month return, which includes both the changes in NAV and the reinvestment of distributions paid, was 2.34%*. This compares with total returns of -4.17% for the Lipper Average, -9.47% for the Russell 2000, and -9.69% for the S&P 500. On a calendar year-to-date basis, these same comparisons are: 5.64%* for FPA Capital Fund; -4.93% for the Lipper Average; -15.36% for the Russell 2000; and -20.39% for the S&P 500.

Commentary

Before discussing your Fund's performance, portfolio changes and outlook, we wish to convey our deep sense of shock and sympathy to the families and friends who lost loved ones on September 11. We also want to thank all the police, firefighters and

construction workers who risked their lives trying to save these unfortunate victims. We feel a great sense of pride in the way our country has come together in this time of trial. As in other difficult times, we will not only face this challenge but we will overcome and grow stronger because of it. We Americans have an inner strength that adapts to times of trial and tribulation.

As investment managers, we believe that we have finally been vindicated for the cautious stance that we have taken toward the stock market over the last two years. During the last eighteen months, we have witnessed the greatest capital destruction in history, with consumer wealth contracting at the fastest rate ever. This is a major "bear" market, since the primary indices have declined by the largest magnitudes since 1974. Fortunately, we have avoided this carnage, unlike many other equity funds. A review of growth and aggressive-growth funds will show many with declines of 20% to 75% in 2001, whereas your Fund has experienced a **positive** 5.64% investment return. Many value funds have also lost money this year. The best-performing segments have been in the small/mid-cap value universes, and your Fund is among the better performers within these segments. In a terrible stock-market environment, we are glad to be able to report good news.

We believe that the small/mid-cap universe of stocks will continue to be among the better-performing sectors for the foreseeable future. During this period of uncertainty and fear, we expect value stocks to lead. This past year reminds us of 1990/1991. In that earlier period, small-cap stocks had just completed a six-year period of underperformance. Your Fund suffered through this period as well. As the economic recession took hold in 1991, small/mid-cap stocks began to outperform. In the prior year, many investors had given up on these types of stocks. We can say the same thing occurred in 2000. Value investing was considered dead, especially small/mid-cap value investing.

* 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

Exactly the opposite has occurred since your Fund's re-opening on January 1, 2001.

The universe of stocks that we invest in is valued at a substantial discount to the large-cap universe, in general. Even with the S&P 500 down over 32% from its high, it sells at approximately 24x times trailing twelve-month earnings and over 30x this year's earnings. In contrast, we are selecting and investing in companies that are valued at modest P/E ratios with small price premiums to book value. Over time, we expect our companies to decline less or appreciate more than these higher valuation stocks. This is important to know in highly volatile and uncertain financial markets.

Given the events of September 11, you may be wondering whether we have changed our strategy or our economic outlook. Before discussing this, we believe it would be helpful to briefly review our expectations prior to this date. We had maintained that economic growth would remain languid through 2002. We also had a far more negative outlook for corporate profits than the consensus. We came to this conclusion because, in our opinion, this was the first economic slowdown since the depression that began with a decline in investment spending. Consumer spending held up while corporate spending declined. Rarely does a monetary policy of reducing interest rates help very much when there is excess plant capacity. The excess capacity was a direct result of the over-investment in equipment and structures in the technology area. We believed it would take a prolonged period of low interest rates and slow economic growth to eventually use up this excess capacity. In our opinion, it would take a proactive fiscal policy to help jumpstart the slow economy. We did not see this as a possibility since the focus in Washington was on maintaining a budget surplus that would constrain any significant growth in governmental expenditures.

As a result of September 11, the economic world has changed. Monetary policy has become the most aggressive that I have witnessed in my thirty-year career. The federal funds rate has been lowered twice in approximately two weeks by 100 basis points (there are a 100 basis points in a percentage point). The watchword is liquidity. The Fed is insuring that there is more than sufficient liquidity in the system to contain any negative fallout from the tragedy. In addition, the federal government has become proactive again. It is now politically acceptable to spend money. Recently announced

fiscal policy initiatives total approximately \$60 billion. In all likelihood, we will have another tax cut and some business incentives that could total \$50 to \$70 billion. These combined initiatives could add over 1% to economic growth next year. This is the first time since 1982 and the 1960s that both monetary and fiscal policies have expanded at the same time.

In light of these changes, we now expect economic growth to be more severely hit in the short term, i.e., for the third and fourth quarters of this year. The combination of this tragedy along with the collapse in the stock market has hit consumer confidence severely. These negatives should hurt Christmas sales more than previously expected. As a result, this slowdown will now be classified as a recession that probably began sometime around mid-year. However, we believe that because of the enactment of aggressive monetary and fiscal policies, the second half of next year should prove to be far stronger than the consensus is forecasting currently. We also expect that the consumer will gradually recover from the psychological shock of September 11. Unless there are protracted attacks that hit key infrastructure points in our economy, we Americans will get acclimated to this potential threat. As an example, we can look at Israel's economy that grew every year for the past ten years despite repeated attacks on its homeland.

We believe that this recent chaos again reminds investors that there are risks in this world. It was not too long ago that many were counting on spending the "peace dividend" after the end of the Cold War. Many believed that we had entered a far safer world, where one could justify paying almost any valuation for a growth company. Some "experts" even argued that equities should carry no risk premiums since, over any twenty-year period, stocks provided positive investment returns. We never subscribed to this drivel. We believe the stock market is in the process of coming to grips with the concept of rising equity risk premiums. Furthermore, in our opinion, the recent aggressive monetary and fiscal policy initiatives should lead to higher interest rates next year. With a ten-year Treasury bond yield of 4.49%, there is virtually no value in the Treasury market. If we are correct, the combination of rising equity premiums and interest rates should lead to lower P/E ratios in general. As a result, the major stock market indices should continue generating substandard investment returns. In 1997, we argued

that annual equity investment returns were likely to fall into the 7% or less range for the foreseeable future. We believe that, over the next five years, the S&P 500 could produce annual investment returns of 5% or less. At 24x trailing twelve-month earnings and potentially 22x normalized earnings, there is not much margin for error. In light of this, we are being more vigilant than ever in selecting only companies with modest valuations from an absolute value standpoint.

Our capital commitment to new positions reflects our cautious outlook on investing that existed even before the events of September 11. During July and August we began slowly re-establishing our exposure to energy. We began slowly since we believed the economic growth outlook would likely get worse in 2002 and this would lead to lower share prices. Because of the September 11 tragedy and the government's policy responses, we believe this whole cycle has been put into fast forward. We have accelerated our purchases dramatically. As a result of our active buying in the week of September 17, energy-stock investments now represent almost 8% of the portfolio versus zero two months ago. Our focus has been on natural gas drillers and equipment suppliers. You may read a much more detailed discussion of this area in Rikard Ekstrand's commentary at the end of this shareholder letter. He is another associate who works with me in the management of your Fund. This continues a policy that began with our March shareholder letter of having one of my associates discuss a particular area of interest in each letter. In this way, you should gain a better understanding of the team that is working to invest your assets.

The financial chaos of the past few weeks has created investment opportunities that we have not seen since 1998. We are being very selective since the major stock market index valuation ratios are not at levels that would be considered inexpensive. By past standards, they would still be considered expensive. Besides energy, we added to several of our existing positions. For example, our Reebok International holding, which was almost completely sold recently between \$32 and \$35, is now being reacquired at less than \$20, or 10x earnings. We also added to our Centex position in the \$28 range, when the stock fell to 90% of book value and 5x earnings. Investor fears that housing purchases are likely to collapse drove the share price down to this level. We believe this valuation level more than

discounts the risk. On the other side, we liquidated our position in DRS Technologies, Inc. for a sizeable gain. The stock skyrocketed in price as investors rushed to buy defense company stocks (herd mentality). At 35x earnings, 4x book value and 11x EBITDA, we think we can find far cheaper and more rewarding investments. We held this stock for over thirteen years. This again demonstrates our basic strategy of buying weakness and selling strength.

After the portfolio changes, your Fund continues to maintain a competitive valuation advantage over the market. At the end of September, the Fund's P/E and P/BV ratios (Price/Book Value) were 12.9x and 1.3x, respectively. By comparison, the P/E ratios of the Russell 2000 and the S&P 500 were 24.8x and 23.8x, while the P/BV ratios were 1.8x and 3.3x, respectively. Our companies are financially strong, with a 26.9% average Total-Debt/Total Capitalization ratio, which compares favorably to the 37.7% and 45.0% for the Russell 2000 and the S&P 500. The portfolio's median market capitalization was \$453.6 million, while its weighted-average market capitalization was \$1.3 billion. The Russell 2000's median and weighted-average market capitalizations were \$330 million and \$720 million, while those of the S&P 500 were \$7.0 billion and \$96.2 billion, respectively.

We expect these turbulent financial markets to continue for some period of time. We do not believe the carnage is over. Despite the fear and uncertainty, we have not seen wholesale liquidation of mutual-fund equity positions by investors. We have only had two months of net equity-fund liquidations this year. After the worst stock market collapse since 1974, we still have net inflows for the year. September's record net equity redemptions of over \$22 billion was equal to only 0.7% of U.S. equity mutual-fund assets, according to The Leuthold Group's calculations. This is considerably less than the 3.1% loss of assets in October 1987. Until we see a sustained period of net liquidations of growth and aggressive-growth funds, we will remain very cautious about adding technology stocks. With this final comment, I would like to introduce you to Rikard Ekstrand's investment thoughts.

Rikard Ekstrand's Investment Commentary

These are exciting times to invest in the oil sector because of the multitude of high-quality companies selling at bargain prices. Most companies

in this sector have declined more than 50% and in excess of 70% from their highs. As you know, we invest in superior or potentially superior companies selling at low absolute valuations in relation to free cash flows and asset values. To find investments that fit these criteria, we have to search in sectors that are presently "out of favor," such as the oil industry. Over the last six years, I have followed the oil sector closely and profitably deployed capital in it. In early 1999, when oil prices were depressed, we invested in the sector. A year later, we sold our investments at a sizeable profit. Now, we are getting another chance to participate in the sector because of fears that oil prices will drop significantly with the slowing global economy. Looking at the low stock prices, one would think we were back to the depressed situation of 1999, with oil prices at \$12 per barrel. This is not the case since oil prices are currently substantially above the 1999 price level. Also, the long-term outlook for U.S. natural gas continues to be very positive. Your Fund has taken advantage of this discrepancy between current stock prices and long-term fundamentals by investing in three oil service companies—ENSCO International, Patterson-UTI Energy, and National-Oilwell.

ENSCO is an old winner of ours. We originally purchased ENSCO in early 1999 when the stock was selling at 30% of its replacement cost. We exited the position a year later after the stock quadrupled. We are now again investing in it at a 60% discount from where we exited. It is the leading Gulf of Mexico jackup rig company and an indirect or "backdoor" way to invest in improving natural gas fundamentals. The large natural gas surpluses from the 1980s have now been worked down. Increases in gas demand, on the order of 3% per year, are led by new installations of gas-fired power generating plants. Under-investment in power generation during the past decade has led to inadequate capacity in the existing infrastructure. As a result, gas demand for power generation grew 11% between 1999 and 2000 and is expected to continue double-digit growth for several years. This demand can only be satisfied by increased supply that comes primarily from drilling in the Gulf of Mexico, which provides 23% of U.S. natural gas supplies. ENSCO is a direct beneficiary of this trend.

Patterson-UTI is the number-one U.S. land-drilling company in footage and wells drilled. It was purchased at a depressed valuation of 30% of

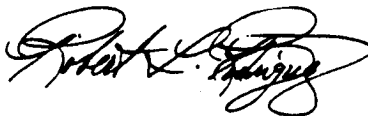
replacement cost. It too benefits from the natural gas trends previously discussed. U.S. land rigs provide two thirds of all natural gas supplies. As natural gas demand increases, these land rigs become an increasingly precious commodity since the land-rig count has declined from a peak of 5,000 units in the early 1980s to a current 1,370. In early 2001, Patterson-UTI rose to a premium to its replacement cost, or triple its current share price. We expect a return to this valuation once utilizations start improving again.

National-Oilwell makes land rigs and key components for both onshore and offshore rigs, including drawworks, mud pumps and top drives. It is an "indirect play" on increasing rig utilizations. With the existing onshore and offshore fleets pushing their useful lives of 20-25 years, the coming upturn in rig utilizations will require substantial upgrading of equipment. Both domestic and international land-rig fleets will require sizeable modernization over the next five years. We were able to acquire this holding at less than 4x estimated peak earnings and 8x free cash flow.

Our energy sector investments again demonstrate our style of buying into pessimism while selling into optimism. We believe that when natural gas prices recover from their currently depressed levels, these holdings will provide substantial future capital gains.

With those closing comments, we thank you for your continued investment and welcome our many new shareholders.

Respectfully submitted,



Robert L. Rodriguez, CFA
President and Chief Investment Officer
October 6, 2001