FPA Capital Fund, Inc.
Fourth Quarter 2017 Commentary

You should consider the Fund's investment objectives, risks, and charges and expenses carefully before you invest. The Prospectus details the Fund's objective and policies and other matters of interest to the prospective investor. Please read this Prospectus carefully before investing. The Prospectus may be obtained by visiting the website at www.fpafunds.com, by calling toll-free, 1-800-982-4372, or by contacting the Fund in writing.

Average Annual Total Returns (%)

As of Date: 12/31/17	Since 8/1/84	20 Years	15 Years	10 Years	5 Years	3 Years	1 Year	YTD	QTR
FPA Capital Fund, Inc.	12.98	7.83	7.79	4.91	3.20	-1.16	-5.11	-5.11	1.84
Russell 2500	11.91	9.12	11.75	9.22	14.33	10.07	16.81	16.81	5.24

Periods greater than one year are annualized. Performance is calculated on a total return basis which includes reinvestment of all distributions.

* Inception of FPA management was July 11, 1984. A benchmark comparison is not available based on the Fund's inception date; therefore, data from August 1, 1984 is presented.

Past performance is no guarantee of future results and current performance may be higher or lower than the performance shown. This data represents past performance and investors should understand that investment returns and principal values fluctuate, so that when you redeem your investment it may be worth more or less than its original cost. The Fund's expense ratio as of its most recent prospectus is 0.80%. Current month-end performance data may be obtained at www.fpafunds.com or by calling toll-free, 1-800-982-4372.

Dennis Bryan and Arik Ahitov have been co-portfolio managers since November 2007 and February 2014, respectively, and manage the Fund in a manner that is substantially similar to the prior portfolio manager, Robert Rodriguez. Mr. Rodriguez ceased serving as the Fund's portfolio manager effective December 2010. Mr. Ahitov has been named sole portfolio manager effective October 1, 2017.

Please see important disclosures at the end of the commentary.

This Time It's Not That Different

Dear Fellow Shareholders,

In our third quarter 2017 letter, we wrote extensively about changes to FPA Capital Fund's portfolio's management structure following weak results in two out of the last three years. In that letter, we listed the steps we were taking to ensure we were doing more of the right things and fewer of the wrong things. In summary, we pledged to:

1. Avoid position inertia
2. Be more nimble
3. Differentiate between long-term and opportunistic investments

We have already started to increase the quality of the portfolio, and we have implemented many changes. To put these changes into perspective, over the past seven years, we initiated four positions a year on average. In the four months since the announcement we did the following:

1. Initiated five new positions
2. Eliminated six positions
3. For the 17 remaining positions:
    a. Increased our weighting by more than 100bps for seven positions
    b. Decreased our weighting by more than 100bps for three positions

You should expect further changes as time goes on. 2017 was one of the worst years in the FPA Capital Fund's history, as the Fund was down 5.11%. Let us briefly recap why we should still have the privilege of managing your capital.

Why Invest With The FPA Capital Fund?

The FPA Capital Fund is, and has always been, a highly differentiated product. Our historical outperformance is a direct result of our ability to position ourselves differently than the competition. As a reminder, here are a few of the key elements that we believe separate us from the pack:

- **Highly Concentrated** – We hold between 20 and 40 positions, which allows our returns to differ materially from our competitors (average of 158 positions for U.S. small- and mid-cap mutual funds and 197 across all Morningstar U.S. equity categories).[1]

- **Benchmark Independent** – Sometimes an entire sector is cheap or expensive, and since our process allows us to position the Fund accordingly, our sector concentrations will differ materially from illustrative benchmarks such as the Russell 2500.[2]

- **Cash for a Rainy Day** – Cash is a residual of our investment process. When our opportunity set is poor (like today) we hold more cash (our cash level, at the end of the fourth quarter of 2017 was 29.6%). However, we are ready to deploy this cash at a moment's notice for compelling opportunities (the average cash and bond positions of U.S. small- and mid-cap mutual funds was 4.8%; this figure was 3.4% across all Morningstar U.S. equity categories).[3]

[1] Morningstar Direct.
[2] Note that references to any benchmark or index are for illustrative purposes only. The Fund does not include outperformance of any benchmark in its investment objectives.
[3] Morningstar Direct as of 12/15/17.

- **Client-centric** - We insist on giving clients a fair deal. Our fees are ranked “Below Average” by Morningstar, and they have been for years.[4]

- **We Eat Our Own Cooking** – We are shareholders alongside you. I am a shareholder, with a significant portion of my net-worth invested in the Fund. I also recently added to my position.

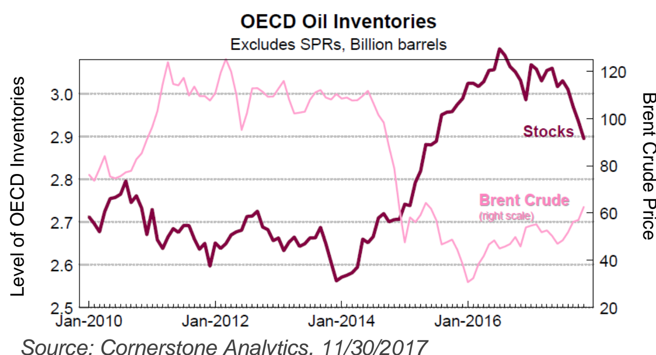
Our portfolio remains highly differentiated today, but we believe there is safety in solitude. Currently, almost 60% of the portfolio is invested in energy-related companies and cash. This compares to less than 5% in energy and 0% in cash for the Russell 2500.[5] The rest of this letter will answer the following two questions:

1. Why do we have such a large exposure to energy?
2. Why is our cash level so high today?

So, let’s dig in!

Why Do We Have Such A Large Exposure To Energy?

We believe we are in the early stages of another historic multi-year oil bull market. This represents a highly contrarian call, with most market watchers underappreciating or flat-out rejecting the prospects for a rally in oil prices despite an ongoing drawdown of global crude inventories.

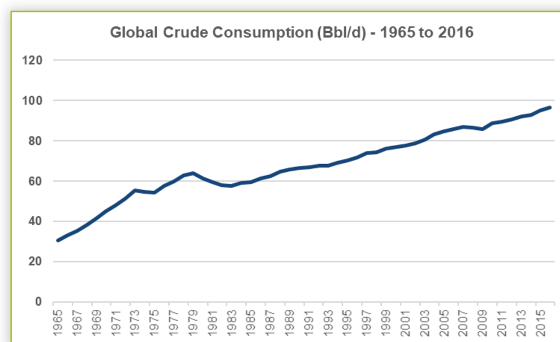


Source: Cornerstone Analytics, 11/30/2017

Our energy investment is not just tied to our belief that oil prices will go higher, however. We also see that extreme investor bearishness, and perhaps apathy, have caused oil-related equity performance to disconnect from crude oil commodity performance.

The Road to Lower Inventories and Higher Prices

Bear argument #1: Global demand growth will fizzle out.



Source: Bloomberg - BP Statistical Review

[4] http://financials.morningstar.com/fund/expense.html?t=FPPTX®ion=usa&culture=en_US.
[5] Note that references to any benchmark or index are for illustrative purposes only. The Fund does not include outperformance of any benchmark in its investment objectives.

Bears will often cite the following:

- Slower global economic growth – That's looking unlikely since the International Monetary Fund is now forecasting that only six of 192 countries will register an economic contraction in 2018, the fewest on record.[6]

- Existential consumption risk in China – Crude demand in China is up 7% YTD versus the same period last year, more than double the consensus figure at the beginning of the year.[7]

- The rise of electric vehicles – EVs make up just 0.1% of the global installed vehicle base, and that miniscule percentage will not change meaningfully over the next five years.[8]

Bear Argument #2: OPEC and its partners, including Russia, will ramp up supply growth.

Actions taken since November 2016 (including a recent decision to extend the 1.8 million barrels per day (bbl/d) cut through the end of 2018) and quota compliance data don't back up this argument.

For the House of Saud, the most obvious incentive to keep oil supplies tight stems from budgetary constraints. The country needs over $70 oil just to neutralize its fiscal deficit and stop the ongoing bleed of foreign currency reserves.[9]

Meanwhile, in the Kremlin, we must assume that Vladimir Putin had his 2018 re-election campaign in mind when he endorsed the 2018 quota extension. Russia's economy is substantially dependent on crude oil, with 70% of Russian exports related to the oil and gas sector.[10]

Bear Argument #3: U.S. shale producers will flood the market.

We believe there are a few interrelated reasons why U.S. shale will surprise to the downside, and that behind closed doors, many exploration and production ("E&P") companies are questioning the sustainability of their target growth rates at today's oil prices. The key factors include:

- Operators focused on their best acreage during the downturn, leaving them with costlier and less productive sites – Researchers at the Massachusetts Institute of Technology found that half of recent well productivity gains in the Bakken came from taking rigs out of fringe acreage and concentrating them in the core.[11]

- Weak financial results at top producers despite higher oil prices and focus on best acreage – A sample of leading E&Ps shows an annualized return on invested capital (ROIC) of just 0.9% at a 20% tax rate despite oil prices at $48/bbl (unhedged) during the third quarter of 2017.

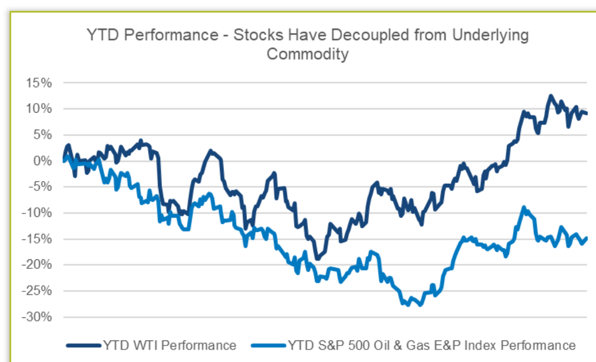
- Investors are pushing E&Ps to better prioritize returns over production growth – In a nod to the airline industry's mindset shift not so long ago, oil and gas companies are starting to embrace more financial discipline. In fact, a number of large E&Ps are now signaling cash-flow-neutral growth (i.e. not overspending), returning cash flow to shareholders, and improving compensation incentives in 2018.

With average global demand growth expected to be at least 1.3 million bbl/d in 2018, we estimate the global inventory overhang would clear before the end of next June, or roughly six months prior to the end of OPEC's current quota agreement. The last time this level of inventory was reached, oil prices were hovering above $100 per barrel, while global demand was about five million bbl/d lower than it is today.

[6] Wall Street Journal, "Economy Has Room to Grow, Here's Why," Dec. 3, 2017.
[7] Cornerstone Analytics, Dec. 11, 2017.
[8] Cornerstone Analytics, Nov. 8, 2017.
[9] IMF, Regional Economic Outlook, Middle East and Central Asia. October 2017.
[10] https://www.eia.gov/todayinenergy/detail.php?id=17231.
[11] http://bit.ly/2zLYjNn.

Closing the Performance Gap

We expect our energy shares to benefit from both continued earnings acceleration (via higher oil prices) and a likely multiple re-rating as the performance gap (shown below) between crude oil and crude oil equities closes over time.



Source: WTI Pricing Data from EIA; XOP data from Capital IQ

If That's Not Enough, Let History Be Our Guide

To conclude, we think it's important to point out how similar this set up looks relative to major oil bull markets of the 1970s and after the dot com bubble. These time periods were preceded by accommodative (that's an understatement in this cycle) monetary policy, sky-high equity valuations (largely as a result of said monetary policy), robust crude demand, and extremely bearish investor sentiment toward the oil patch. Sound familiar? Based on the relative returns you see below during those previous cycles, and our analysis of today's market characteristics above, we believe selling our energy stocks today would be akin to selling the farm before a historic harvest.

Cumulative Returns		
Time Period	**S&P**	**WTI**
1960-1970	59%	16%
1970-1980	47%	1004%
1980-1990	143%	-34%
1990-2000	300%	24%
2000-2010	-5%	162%
2010-2017*	111%	-28%
2018+	?	?

Source: EIA, BLS, Bloomberg

** Through 12/14/2017*

Why Is Our Cash Level So High Today?

Cash Is an Output of Our Process

As a reminder, we do not manage to a particular level of cash. We simply invest in stocks where we believe there is a very favorable risk/reward ratio. When we cannot find enough of those opportunities, we do not stretch our valuation multiples. Instead, we build cash and continue to search for new securities that meet our disciplined investment criteria. When attractive opportunities are plentiful, we expect our cash balance to shrink substantially and quickly.

Artificially Distorted Markets Will Ultimately Correct

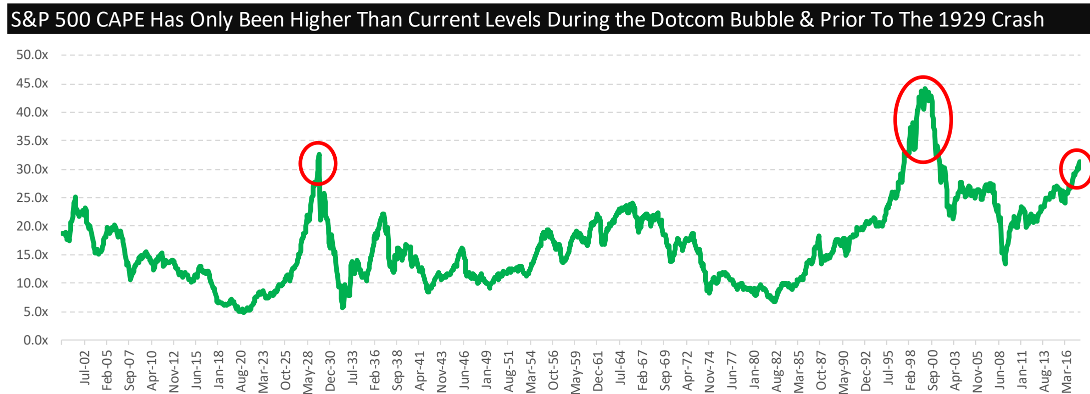
We have simultaneous bubbles across virtually all traditional asset classes. The prices for financial assets have risen steadily over the last decade, as central banks flooded markets with multi-trillion-dollar purchases and kept interest rates at absurdly low levels. The crude mechanics are relatively simple to understand: in a low-interest-rate world, investors must buy riskier assets to generate adequate returns,

and this in turn drives up the price of those assets. So, in a way, there's some logic to the madness – as long as interest rates remain exceedingly low and the economy continues to grow. But what will happen now that central banks have begun to unwind the purchases and raise rates? What if the economy stumbles? We expect these market distortions to eventually collapse under their own weight, providing patient, cash-rich investors with substantial opportunities.

Our Market Is Expensive, And More Expensive Than Most Realize

We believe markets across the world are overvalued and that the market we traffic in, U.S. small/mid-cap equities, is no exception. Let's look at the Russell 2500 Index, which represents the smallest 2,500 companies in the Russell 3000. These companies have market caps ranging from below $50 million to over $10 billion, with a large swath of companies falling right in our investment sweet spot of $1-$4 billion. The current P/E as listed by iShares as of Dec. 29, 2017 is 21.5x.[12] This is near the highest level in at least the last 14 years (which is as far back as we could get reliable data). Currently, the P/E is nearly double the low reached during the last recession. For those who still find a 22x multiple palatable, please note that the real multiple is actually 35x. How is this possible? Russell reports the index's P/E by only capturing companies that are generating profits and excluding the losers, which presents a fanciful view of the index's earnings.

Need some historical context? One great little tool we use is a cyclically adjusted P/E ratio (also known as a CAPE ratio). This metric looks at the average earnings over the past 10 years, smoothing out the lumpiness of the business cycle. For the Russell 2500, we are at the highest level in well over a decade, 25% above the average, and more than double the level we saw during the last recession.[13] To put it bluntly, the average company is trading at valuation levels we have not seen in well over a decade. And it's not just the Russell 2500. Let's take a look at the S&P 500, where we can go much further back to gain some real historical perspective. The current CAPE valuation for the S&P 500 is 31x. We have only been at or above that level twice before: right before the great crash of 1929, and during the dot-com bubble. If that is not a warning sign, we do not know what is (see chart below).



Source: http://www.multpl.com/

Returns Have Historically Been Negative From Current Valuation Levels

So what have returns looked like from this valuation level for the S&P? Terrible. Over the last 100 years, returns have averaged negative 7% over a three-year period at similar valuation levels.

[12] https://www.ishares.com/us/products/288024/.
[13] Our CAPE ratio is modified to include only one recession in a given period, which we believe presents a more consistent view over time.

S&P 500 CAPE	3yr Px Return	Comment
<10x	39%	
10x - 14x	34%	
14x - 18x	13%	
18x - 22x	20%	
22x - 26x	22%	
26x - 30x	-1%	
>30x	-7%	At 31x today

Source: FPA Analysis (Nov 1914-2014)

Bubbles Abound, Further Ratcheting Up Systemic Risk

And it's not just U.S. equity markets that are frothy. Bubbles appear to be cropping up everywhere. Below is a collection of some of our favorite examples of asset prices marching ever higher with what appears to be limited concern for the potential risks these new higher prices present:

- **European Junk Bond Yields Fall to 2.6%** – European "high" yield bonds are yielding near their lowest interest rates on record. The current 2.6% yield compares to a 20-year average of 9%.[14] Readers should ask themselves if the risk of owning European corporate junk bonds is about the same as owning 10yr US treasuries, because right now they have about the same yield.

- **$450 million da Vinci Painting Sale Shatters Previous Record**[15] – This price represents more than a tripling since the same painting was last sold in 2013. The previous highest price for any artwork was $179 million. This is only the 12th artwork to sell for more than $100 million. Amazingly, this particular piece comes with plenty of baggage, including its compromised condition and questions about its authenticity.

- **Even Depreciating Assets Are Appreciating**[16] – A composite index of Porsche 911s has increased in value by more than 30% over the last four years. Sure, they're beautiful cars, but should the average price of a used car really be going up, not down?

- **Bitcoin appreciates over 1,300% in One Year**[17] – No discussion of bubbles in 2017 would be complete without a nod to the skyrocketing interest in cryptocurrencies. While we cannot peg a fundamental value on these cryptocurrencies, we believe some participants are expressing a preference to store at least a portion of their wealth outside of a system that is being manipulated by central banks.

- **Over $3 Trillion Invested in ETFs** – It took nearly 20 years for ETFs to gather their first $1 trillion dollars. The next trillion only took four years, and the trillion after that came in just a bit over two years. Recall that we have called ETFs weapons of mass destruction previously [Second Quarter 2017 Commentary]. We think that that much money piling into a concentrated bucket of assets ratchets up systemic risk.

Don't Try to Time an Avalanche, Just Get Out of the Way

To be clear, this does not mean the market tops out tomorrow. However, it does mean we are getting ever closer to that day. Borrowing (and slightly modifying) an analogy we first heard mentioned in John Mauldin's Endgame, imagine a steep mountain slope covered in snow and a small village perched just below. With every additional snowstorm, the risk of an avalanche increases. While it is impossible to know exactly which particular snowflake, or gust of wind, or overly ambitious skier will ultimately unleash catastrophe on the village below, the more snow, the higher the risk. Right now, we think there is a

[14] https://fred.stlouisfed.org/series/BAMLHE00EHYIEY.
[15] https://www.nytimes.com/2017/11/15/arts/design/leonardo-da-vinci-salvator-mundi-christies-auction.html.
[16] https://www.cargurus.com/Cars/price-trends/Porsche-911-d404.
[17] https://www.coindesk.com/price/.

helluva lot of snow on that proverbial market mountain slope. And with some of the interest rate hikes and quantitative tightening likely to happen in 2018, some of the snow's foundation might be starting to melt.

Cash May Now Be One of the Only Undervalued Asset Class Left

As a reminder, cash's value comes from two sources: 1) yield and 2) optionality. The broader investment community seems focused on cash's current paltry yield (around 1.2% today).[18] But cash's real value, and why we hold so much of it, comes from the optionality it provides – the ability to act when others can't. Thought of another way, when just about every asset class is expensive, cash may be one of the only undervalued asset classes left. The last truly contrarian bet (aside from energy).

Conclusion, This Time It's Not That Different

This is the third time our Fund has underperformed to this extent. The first time was leading up to the dotcom bust, and the second time was leading up to the great financial crisis. During both of those times, valuations were stretched and our portfolio was highly differentiated. Following both of those periods, FPA Capital Fund's performance not only caught up to our target goal, but exceeded it. While we cannot project a specific return over the upcoming months, the setup looks eerily similar to us today. We are grateful for the trust you have placed in us to manage your capital, and we sincerely appreciate your support. We wish you happy holidays and a prosperous, healthy, and rewarding New Year!

As always, please feel free to reach out to me at ahitov@fpafunds.com.

Respectfully submitted,

Arik Ahitov – on behalf of the FPA Capital Fund Team

Portfolio Manager

December 2017

[18] http://www.barrons.com/public/page/9_0204-trmfy.html.

Important Disclosures

The views expressed herein and any forward-looking statements are as of the date of the publication and are those of the portfolio management team. Future events or results may vary significantly from those expressed and are subject to change at any time in response to changing circumstances and industry developments. This information and data has been prepared from sources believed reliable, but the accuracy and completeness of the information cannot be guaranteed and is not a complete summary or statement of all available data.

Portfolio composition will change due to ongoing management of the Fund. References to individual securities are for informational purposes only and should not be construed as recommendations by the Fund, the portfolio managers, or the Distributor. It should not be assumed that future investments will be profitable or will equal the performance of the security examples discussed. The portfolio holdings as of the most recent quarter-end may be obtained at www.fpafunds.com.

Investments in mutual funds carry risks and investors may lose principal value. Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. The Fund may purchase foreign securities, including American Depository Receipts (ADRs) and other depository receipts, which are subject to interest rate, currency exchange rate, economic and political risks; this may be enhanced when investing in emerging markets. Small and mid-cap stocks involve greater risks and they can fluctuate in price more than larger company stocks.

Value stocks, including those selected by the Fund's portfolio managers, are subject to the risk that their intrinsic value may never be realized by the market and that their prices may go down. Securities selected by the portfolio managers using a value strategy may never reach their intrinsic value because the market fails to recognize what the portfolio managers consider to be the true business value or because the portfolio managers have misjudged those values. In addition, value style investing may fall out of favor and underperform growth or other styles of investing during given periods.

Definitions

The Russell 2500 Index consists of the 2,500 smallest companies in the Russell 3000 total capitalization universe offers investors access to the small to mid-cap segment of the U.S. equity universe, commonly referred to as "smid" cap. The Russell 2500 Value Index measures the performance of those Russell 2500 companies with lower price-to-book-ratios and lower forecasted growth values.

The S&P 500 Index includes a representative sample of 500 hundred companies in leading industries of the U.S. economy. The Index focuses on the large-cap segment of the market, with over 80% coverage of U.S. equities, but is also considered a proxy for the total market.

Indices are unmanaged, do not reflect any commissions or fees which would be incurred by an investor purchasing the underlying securities. Investors cannot invest directly in an index.

An **exploration & production (E&P)** company is in a specific sector within the oil and gas industry — companies involved in the high-risk/high-reward area of exploration and production focus on finding, augmenting, producing and merchandising different types of oil and gas.

EBITA (Earnings before interest, taxes and amortization) is a financial indicator used widely as a measure of efficiency and profitability.

Margin of safety - Buying with a "margin of safety" is when a security is purchased at a discount to the portfolio manager's estimate of its intrinsic value. Buying a security with a margin of safety is designed to protect against permanent capital loss in the case of an unexpected event or analytical mistake. A purchase made with a margin of safety does not guarantee the security will not decline in price.

Price/Earnings ratio (P/E) is the price of a stock divided by its earnings per share.

West Texas Intermediate (WTI) - crude oil is the underlying commodity of the New York Mercantile Exchange's oil futures contracts.

The FPA Funds are distributed by UMB Distribution Services, LLC, 235 W. Galena Street, Milwaukee, WI, 53212.

TICKER	SHARES / PRINCIPAL	SECURITY	COUPON RATE (%)	MATURITY DATE	MKT PRICE ($)	MKT VALUE ($)	% OF NET ASSET VALUE
		COMMON STOCKS					
AAN	274,072	AARON'S INC			39.85	10,921,769	2.6%
AGCO	77,408	AGCO CORP			71.43	5,529,253	1.3%
ALGT	116,314	ALLEGIANT TRAVEL CO			154.75	17,999,592	4.3%
ARRS	637,840	ARRIS INTERNATIONAL PLC			25.69	16,386,110	4.0%
ARW	125,952	ARROW ELECTRONICS INC			80.41	10,127,800	2.4%
AVT	516,583	AVNET INC			39.62	20,467,019	4.9%
CFFN	306,449	CAPITOL FEDERAL FINANCIAL			13.41	4,109,481	1.0%
XEC	213,042	CIMAREX ENERGY CO			122.01	25,993,254	6.3%
CUB	88,378	CUBIC CORP			58.95	5,209,883	1.2%
HP	161,624	HELMERICH + PAYNE			64.64	10,447,375	2.5%
HMHC	1,373,115	HOUGHTON MIFFLIN HARCOURT CO			9.30	12,769,970	3.1%
IDCC	260,049	INTERDIGITAL INC			76.15	19,802,731	4.8%
NBL	817,281	NOBLE ENERGY INC			29.14	23,815,568	5.7%
		OTHER				10,646,929	2.6%
PTEN	812,271	PATTERSON UTI ENERGY INC			23.01	18,690,356	4.5%
RDC	1,054,280	ROWAN COMPANIES PLC			15.66	16,510,025	4.0%
SM	867,115	SM ENERGY CO			22.08	19,145,899	4.6%
SAVE	267,968	SPIRIT AIRLINES INC			44.85	12,018,365	2.9%
TEN	97,230	TENNECO INC			58.54	5,691,844	1.4%
VECO	467,061	VEECO INSTRUMENTS INC			14.85	6,935,856	1.7%
WDC	259,823	WESTERN DIGITAL CORP			79.53	20,663,723	5.0%
		TOTAL EQUITIES				**293,882,802**	**70.8%**
		U.S GOVERNMENT AND AGENCIES					
	22,500,000	US TREASURY BILLS	0.000	03/01/2018	99.79	22,453,785	5.4%
	7,500,000	US TREASURY NOTE	0.750	01/31/2018	99.95	7,495,898	1.8%
	15,000,000	US TREASURY NOTE	3.500	02/15/2018	100.25	15,037,208	3.6%
	20,000,000	US TREASURY NOTE	0.750	04/30/2018	99.78	19,956,640	4.8%
	25,000,000	US TREASURY NOTE	0.870	05/31/2018	99.77	24,941,405	6.0%
	20,000,000	US TREASURY NOTE	1.370	06/30/2018	99.92	19,983,594	4.8%
		TOTAL US GOVT AND AGENCIES				**109,868,530**	**26.4%**
		REPURCHASE AGREEMENTS					
	12,796,000	STATE STREET BANK/FICC REPO	0.200	01/02/2018		12,796,000	3.1%
		TOTAL REPURCHASE AGREEMENTS				**12,796,000**	**3.1%**
		CASH & EQUIVALENTS (NET OF LIABILITIES)				(1,207,323)	-0.3%
		TOTAL CASH & EQUIVALENTS				**121,457,207**	**29.2%**
		TOTAL NET ASSETS				**$ 415,340,009**	**100.0%**
		NO. OF EQUITY POSITIONS				**20**	

Portfolio Holding Submission Disclosure

Except for certain publicly available information incorporated herein, the information contained in these materials is our confidential and proprietary information and is being submitted to you for your confidential use with the express understanding that, without our prior written permission, you will not release these materials or discuss the information contained herein or make reproductions of or use these materials for any purpose other than evaluating a potential advisory relationship with First Pacific Advisors.

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