

SOURCE CAPITAL INC /DE/  
Form N-CSR  
March 08, 2006

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

**FORM N-CSR**

**CERTIFIED SHAREHOLDER REPORT OF REGISTERED  
MANAGEMENT INVESTMENT COMPANIES**

Investment Company Act file number 811-1731

SOURCE CAPITAL, INC.  
(Exact name of registrant as specified in charter)

11400 WEST OLYMPIC BLVD., SUITE 1200, LOS ANGELES, CALIFORNIA  
(Address of principal executive offices)

90064  
(Zip code)

J. RICHARD ATWOOD,

11400 WEST OLYMPIC BLVD., SUITE 1200, LOS ANGELES, CALIFORNIA 90064  
(Name and address of agent for service)

Registrant's telephone number, including area code: 310-473-0225

Date of fiscal year DECEMBER 31  
end:

Date of reporting period: DECEMBER 31,  
2005

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Item 1. Report to Stockholders

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**SOURCE CAPITAL, INC.**

**2005**

**ANNUAL REPORT**

for the year ended December 31

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## SUMMARY FINANCIAL INFORMATION

For the year ended December 31,

	2005		2004	
	Total Net Assets	Per Common Share	Total Net Assets	Per Common Share
Beginning of year	\$ 581,728,644	\$ 63.20	\$ 521,248,726	\$ 56.62
Net gain on investments, realized and unrealized	\$ 76,810,042	\$ 9.16	\$ 88,404,339	\$ 10.65
Net investment income	3,556,574	0.42	3,759,389	0.45
Distributions to Preferred shareholders	(4,726,109)	(0.56)	(4,726,109)	(0.57)
Distributions to Common shareholders	(45,901,288)	(5.47)	(33,146,891)	(4.00)
Proceeds from shares issued for distributions reinvested by shareholders	8,505,168	0.04	6,189,190	0.05
Net changes during year	\$ 38,244,387	\$ 3.59	\$ 60,479,918	\$ 6.58
End of year	\$ 619,973,031	\$ 66.79	\$ 581,728,644	\$ 63.20
Common market price per share	\$ 73.75		\$ 71.54	
Common market premium to net asset value	10.4%		13.2%	
Preferred asset coverage	1,145%		1,074%	
Preferred liquidation preference per share	\$ 27.50		\$ 27.50	
Preferred market price per share	\$ 33.60		\$ 34.75	

### DESCRIPTION OF THE COMPANY

**Source Capital, Inc.**, is a major diversified, publicly traded investment company with total net assets of approximately \$620,000,000. Its investment portfolio includes a wide range of securities with primary emphasis on common stock and convertible debentures.

Source Capital has Common and Preferred shares outstanding, both of which are listed and traded on The New York Stock Exchange. Each of the 1,969,212 outstanding Preferred shares has a prior claim of \$27.50 on assets and \$2.40 per year on income. The balance of the Company's assets and income are available to the 8,471,818 shares of Common Stock outstanding.

Source Capital's investment objective is to seek maximum total return for Common shareholders from both capital appreciation and investment income to the extent consistent with protection of invested capital and provision of sufficient income to meet the dividend requirements of Preferred shareholders.

Source Capital is not a mutual fund. Thus, it does not repurchase its own shares on demand and does not need to structure its portfolio securities to provide for possible redemptions. As a publicly traded investment company, Source Capital's Common and Preferred shares are bought and sold on The New York Stock Exchange, and the Company is not involved in such transactions.

Source Capital's investment approach emphasizes primarily equity and equity-related investments in seeking to achieve its growth objective for its Common shareholders. The desirability of equity versus fixed-income investments has been increasingly debated in recent years. Source Capital's position is that without assuming undue risk and recognizing the fixed claim of its Preferred Stock, properly selected stocks offer the better long-term opportunity for overall investment return as well as long-term protection from the large but uncertain threat of inflation. Source Capital's equity investments have been directed toward companies with highly liquid, relatively unleveraged balance sheets and a demonstrated long-term ability to earn above average returns on invested capital. Source Capital's equity investment portfolio is based on fundamental judgments of long-term returns attainable from income and appreciation in the securities of such companies and is not derived from overall economic forecasts or stock market predictions.

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The Company has adopted a flexible distribution policy. This policy is designed to pay Common shareholders quarterly distributions at a rate that is substantially in excess of net investment income. The rate will be adjusted periodically in response to sustained changes in the net asset value, market conditions and changes to investment company regulations and tax laws. Only a portion of such distributions is paid from net investment income. The remainder is paid from any net realized capital gains and/or paid-in capital, as determined by each year's results. To the extent the Company realizes net long-term capital gains for any year in excess of the amounts distributed under the Company's distribution policy, such excess will be distributed to shareholders. For federal income tax purposes, all distributions in excess of current year earnings will be taxable to shareholders as long as the Company continues to have accumulated earnings and profits from prior years.

## LETTER TO SHAREHOLDERS

### TO OUR SHAREHOLDERS:

#### 2005 Investment Portfolio Returns

Total net assets of Source Capital amounted to \$619,973,031 at December 31, 2005. After providing for Preferred Stock equity, Common equity amounted to \$565,819,701 or \$66.79 of net asset value per Common share. This compared with total net assets of \$581,728,644, Common equity of \$527,575,314 and net asset value per Common share of \$63.20 one year ago. These changes reflect payments to Common and Preferred shareholders totaling \$50,627,397. As a result, Source Capital achieved a total investment return during 2005 of 14.9% on its Common net asset value, and 14.2% on total net assets, with both figures reflecting the reinvestment of dividends and distributions.

The table at the bottom of this page compares Source Capital's investment results with the returns of several well-known indices of securities prices. Each of the last five calendar years is shown, as well as annualized returns for longer periods. All the percentage changes shown represent total investment returns from both income and appreciation (depreciation) calculated on the basis of reinvesting all dividends and distributions.

#### Distributions to Common Shareholders

Source Capital's distribution policy allows the Board of Directors to continue to consider changes in net asset value when establishing the quarterly distribution rate, but also provides for the flexibility to consider other factors such as current market conditions and changes to investment company regulations and tax laws. It is the intention of the Board of Directors to continue paying quarterly distributions at a rate that is substantially in excess of net investment income as evidenced by the current annual distribution rate of \$4.00.

Capital gains are the eventual result of successful investments. As in recent years, changes in relative market valuation as well as changing prospects of individual companies led us to sell certain holdings in 2005, and these sales resulted in the realization of significant net capital gains. We believe that we have been able to replace these securities both by adding to existing investments at advantageous prices and by making selected new investments (primarily equity investments) offering potentially better long-term investment returns. As a result of this, the Company realized \$69,253,143 in net capital gains in 2005. Detailed tax information is presented on page 9.

#### Market Prices and Shareholder Returns

In the long run, the future returns for Source Capital Common shareholders will depend primarily on how well we manage the firm's investment portfolio. The longer the period of time involved, the more important portfolio investment returns will be in determining shareholder returns. However, in the short run, changes in the market price of Source Capital Common shares can deviate from the underlying changes in net asset value causing market returns to be either enhanced or diminished.

We continue to see differences between each year's market returns for Source shareholders (the change in Source's quoted price plus dividends received) and the actual investment returns earned by the Source portfolio. These differences can become more dramatic when the premium or discount fluctuates

Period	Source Capital				Stock Market Indices				Fixed-Income Indices				
	Total Net Assets		Common Equity		Russell 2500	S&P 500		DJIA	Lehman Brothers Govt/Credit Index	Treasury Bill Yields			
Annual Rate of Return:													
2005	+	14.2%	+	14.9%	+	8.1%	+	4.9%	0.6%	+	2.4%	+3.0%	
2004	+	18.4	+	19.5	+	18.3	+	10.9	+	3.2	+	4.2	+1.2
2003	+	40.5	+	45.7	+	45.5	+	28.7	+	25.3	+	4.7	+1.1
2002		14.6		17.1		17.8		22.1		15.0	+	11.0	+1.7
2001	+	22.8	+	24.7	+	1.2		11.9		5.4	+	8.5	+4.1
Annual Compound													
Rate of Return:													
3 years	+	23.9	+	26.0	+	23.0	+	14.4	+	8.7	+	3.7	+1.8

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5 years	+	14.8	+	15.6	+	9.1	+	0.5		0.1	+	6.1	+2.2
10 years	+	15.3	+	16.3	+	11.5	+	9.1	+	7.7	+	6.2	+3.7
20 years	+	13.0	+	13.7	+	12.4	+	11.9	+	10.2	+	7.9	+4.7



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considerably. An increase in the premium (or decrease in the discount) will, of course, produce a market return greater than that actually earned on the underlying portfolio, while a decrease in the premium will have the opposite effect.

	Premium/ (Discount)	Market Return	Investment Return	NAV	Year-End Market Price
2005	10.4%	10.7%	14.9%	\$ 66.79	\$ 73.75
2004	13.2%	27.2%	19.5%	\$ 63.20	\$ 71.54
2003	4.9%	19.0%	45.7%	\$ 56.62	\$ 59.38
2002	26.1%	(5.9)%	(17.1)%	\$ 41.90	\$ 52.85
2001	10.1%	24.5%	24.7%	\$ 55.45	\$ 61.02
2000	8.4%	22.5%	9.6%	\$ 48.62	\$ 52.69
1999	(4.8)%	14.4%	23.1%	\$ 50.70	\$ 48.25

The following table presents 2005 market returns for both Common and Preferred shareholders:

	Common Stock	Preferred Stock
Change in Market Value:		
NYSE Closing Price 12/31/2005	\$ 73.75	\$ 33.60
NYSE Closing Price 12/31/2004	71.54	34.75
Net change in 2005	\$ 2.21	\$ (1.15)
Distributions in 2005	5.47	2.40
Total return Amount	\$ 7.68	\$ 1.25
Total return Percent	10.7%	3.6%

Common shareholders who participated in the Company's Automatic Reinvestment Plan experienced a positive return of 11.5% during 2005. On a long-term basis, those shareholders who participated in the Automatic Reinvestment Plan during each of the 29 years since its inception experienced an annual compound rate of return of 17.8%.

### Commentary

The year 2005 brought stock market investors 4-5% returns in both small (Russell 2000, +4.6%) and large stocks (S&P 500, +4.9%). Despite much teeth gnashing by commentators, driven perhaps by a slight decline in the oft-cited but statistically irrelevant Dow Jones Index, we do not regard 2005 as an especially poor stock market year. Rather, it is very much in line with our long-term expectations of future returns of mid single digits.

This forecast is driven by our macro views of long-term economic growth potential (moderate), current stock market valuations (above average), corporate profitability (also above average), and long-term interest rates (unlikely to decline significantly). In other words, with little help from higher P/Es, higher profit margins, or lower interest rates, stock returns will be driven by the growth of the economy, which is unlikely to exceed 2-3% in constant dollars, plus a few points for inflation and dividends.

The modest 4-7% annual returns implied by this analysis are well below the returns that many investors were led to expect during the 1980s and 1990s, when both the S&P and Nasdaq averaged annual gains of about 17%.

We believe that most investors now realize that they are unlikely to see market returns of this magnitude on an ongoing basis into the future, though of course any given year may bring much higher or much lower returns than the future average.

In fact, many investors have been unable to realize any positive returns at all since the market peak in March 2000, now almost a full six years behind us. Both the S&P 500, representative of the market as a whole, and the Nasdaq, a reasonable proxy for a more aggressive investment portfolio, are actually down over this period.

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Fortunately, Source has performed considerably better, helped by its emphasis on smaller companies, and by its refusal to buy overpriced stocks during the late 1990s' bubble market.

The following table shows returns for one-, three-, and five-year periods for the leading large- and small-cap indexes, as well as for Source. The final two columns illustrate how an investor would have fared over the five years and nine months, since the March 2000 market peak.

Since March 31, 2000					Value of \$1.00 Invested
	2005	3 Years*	5 Years*	Return	
Nasdaq	1.4%	18.2%	(2.3)%	(11.9)%*	\$ 0.48
S&P 500	4.9%	14.4%	0.5%	(1.6)%*	\$ 0.91
Russell 2000	4.6%	22.1%	8.2%	5.3%*	\$ 1.34
Source	14.9%	26.0%	15.6%	14.3%*	\$ 2.15

\* Annualized

Source performed quite well in 2005, with a 14.9% gain, well ahead of the benchmark Russell 2500.

The table below shows Source's returns for each year since 2001, as well as those of the Russell 2500.

	2001	2002	2003	2004	2005	Five Years*
Source	24.7%	(17.1)%	45.7%	19.5%	14.9%	15.6%
Russell 2500	1.2%	(17.8)%	45.5%	18.3%	8.1%	9.1%

\* Annualized Return

Recent Source portfolio performance has been helped by the proposed acquisition of two of its holdings. First, **Renal Care** accepted an acquisition offer from Fresenius AG, a German-based company and one of the largest providers of dialysis services and equipment in the world. The \$48 per share

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price represents a 20-25% premium over the pre-announcement trading range, and is 24x earnings for 2005.

We first purchased Renal Care in the summer of 2002, attracted by its ability to grow steadily via acquisitions and de novo expansion, while maintaining excellent returns on capital and a strong balance sheet. Wall Street perception of a slowing growth rate for Renal Care had compressed its valuation from prior levels we had viewed as excessive.

The acquisition price of \$48 per share compares very favorably to our original purchases at just under \$20. Our rate of return over the three-and-a-half-year period is about 30% annually. The acquisition is expected to close in the first quarter of 2006.

Second, **Engelhard**, a producer of catalysts and other specialty chemicals, is the subject of a somewhat unfriendly takeover bid from the huge German chemical firm BASF. The proposed price is \$37 per share, or 19x estimated 2005 earnings, but it is widely believed that BASF or possibly other buyers, would be willing to pay more in a negotiated transaction.

Our initial purchase of Engelhard was in early 2002, four years ago. We paid close to \$30 per share, but were able to reduce our average cost substantially with additional share purchases as the price declined to the low \$20s. As of this writing, we have liquidated most of the position at close to \$40 per share, preferring not to wait for the uncertain outcome. Our rate of return is about 12-15% annually. We view Engelhard as a disappointing investment bailed out by the proposed acquisition.

Seven new companies were added to the Source portfolio during 2005. With consideration to available space and reader interest, I will talk briefly about only a few of them.

**Polaris Industries** is a leading manufacturer of snowmobiles, which it invented in 1954, and all-terrain vehicles (ATVs), which it has made since 1984. More recently, it entered the motorcycle business, where its small but rapidly growing operation is still far behind industry leaders like Harley-Davidson, Honda, Yamaha, Suzuki, and Kawasaki.

Polaris is known for the quality and reliability of its products, as well as its innovative design. It has shown steady growth in sales and earnings for many years, as well as very high returns on capital despite an unleveraged balance sheet.

**Microchip** is the leading manufacturer of 8-bit microcontrollers. These are integrated circuit-based embedded control systems which provide intelligence to a wide range of consumer and industrial products, such as home appliances, consumer electronics, power tools, automotive subsystems, etc. Microchip has steadily increased its market share of the 8-bit microcontroller market, and recently has taken over the #1 position from Motorola.

Despite participating in what many would expect to be a volatile technology business, Microchip's financial results have been remarkably well-behaved, with only one down year in sales and earnings over the past decade – the year following the bursting of the late-90s' tech bubble. Over this period Microchip has grown sales and earnings at a 15-18% pace, earning excellent returns on capital with a debt-free balance sheet.

**Brady** is a leader in high-performance identification solutions and specialty materials that help customers increase safety, security, productivity and performance. Its products include high-performance labels and signs, printing systems and software, label application systems, safety devices and precision die-cut materials. It has over 300,000 customers, with a product focus on the maintenance, repair, and operations (MRO) market. It goes to market both directly, mostly through catalogs, and via industrial distributors like W. W. Grainger.

Although always a leader in its industry, Brady's financial performance has improved markedly over the past few years under a new chief executive. Revenue growth and returns on capital are excellent, and the balance sheet continues to be solid.

We hope to have an opportunity to discuss some of these companies in greater detail in subsequent shareholder letters.

Respectfully submitted,

Eric S. Ende  
President and  
Chief Investment Officer  
January 27, 2006



The discussion of Company investments represents the views of the Company'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 Company's managers believe that the Company'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.

The Russell 2000 Index is an unmanaged index comprised of the 2,000 smallest companies in the Russell 3000 Index. The Russell 2500 Index is an unmanaged index comprised of the 2,500 smallest companies in the Russell 3000 Index. The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization. The S&P 500 Index is an index of 500 companies with large market capitalization. The Dow Jones Industrial Average (DJIA) covers 30 major companies. The Lehman Brothers Government/Credit Index is a broad-based unmanaged index of all government and corporate bonds that are investment grade with at least one year to maturity. The Nasdaq Composite Index is a market capitalization index comprised of over 3,000 stocks.

#### **FORWARD LOOKING STATEMENT DISCLOSURE**

As 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.



## PORTFOLIO OF INVESTMENTS

December 31, 2005

COMMON STOCKS	Shares	Value
<b>BUSINESS SERVICES &amp; SUPPLIES 15.7%</b>		
Brady Corporation	260,000	\$ 9,406,800
CDW Corporation	315,000	18,134,550
Charles River Laboratories International, Inc.*	430,000	18,219,100
Invitrogen Corporation*	212,500	14,161,000
Manpower Inc.	300,000	13,950,000
ScanSource, Inc.*	425,000	23,239,000
		\$ 97,110,450
<b>PRODUCER DURABLE GOODS 13.7%</b>		
Graco Inc.	495,000	\$ 18,057,600
HNI Corporation	270,000	14,831,100
IDEX Corporation	495,000	20,349,450
Oshkosh Truck Corporation	360,000	16,052,400
Zebra Technologies Corporation (Class A)*	365,000	15,640,250
		\$ 84,930,800
<b>ENERGY 12.5%</b>		
Cal Dive International, Inc.*	780,000	\$ 27,994,200
Noble Corporation	460,000	32,448,400
Tidewater Inc.	380,000	16,894,800
		\$ 77,337,400
<b>TECHNOLOGY 10.6%</b>		
Cognex Corporation	590,000	\$ 17,753,100
Microchip Technology Incorporated	270,000	8,680,500
Plantronics, Inc.	670,000	18,961,000
SanDisk Corporation*	320,000	20,102,400
		\$ 65,497,000
<b>FINANCIAL 9.2%</b>		
Brown & Brown, Inc.	580,000	\$ 17,713,200
First American Corporation	155,000	7,021,500
Arthur J. Gallagher & Co.	440,000	13,587,200
North Fork Bancorporation, Inc.	682,500	18,673,200
		\$ 56,995,100
<b>RETAILING 8.5%</b>		
CarMax, Inc.*	750,006	\$ 20,760,166
O'Reilly Automotive, Inc.*	1,000,000	32,010,000
		\$ 52,770,166
<b>HEALTHCARE 8.1%</b>		
AmSurg Corporation*	280,000	\$ 6,400,800
Bio-Rad Laboratories, Inc.*	200,300	13,107,632
Health Management Associates, Inc.	570,000	12,517,200
Lincare Holdings Inc.*	440,000	18,440,400
		\$ 50,466,032
<b>ENTERTAINMENT 4.6%</b>		

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Carnival Corporation	536,600	\$ 28,692,002
<b>CONSUMER DURABLE GOODS 3.5%</b>		
Briggs & Stratton Corporation	370,000	\$ 14,352,300
Polaris Industries Inc.	140,000	7,028,000
		\$ 21,380,300
<b>TRANSPORTATION 3.0%</b>		
Heartland Express, Inc.	670,000	\$ 13,594,300
Knight Transportation, Inc.	255,000	5,286,150
		\$ 18,880,450
<b>MATERIALS 2.3%</b>		
Engelhard Corporation	480,000	\$ 14,472,000
<b>TOTAL COMMON STOCKS 91.7% (Cost \$342,679,001)</b>		\$ 568,531,700



## PORTFOLIO OF INVESTMENTS

December 31, 2005

	Shares or Face Amount	Value
<b>PREFERRED STOCKS</b>		
<b>REAL ESTATE INVESTMENT TRUST</b>		
CBL & Associates Properties, Inc.	100,000	\$ 2,530,000
Duke-Weeks Realty Corp. (Series B)	40,000	2,002,500
Pennsylvania Real Estate Investment Trust (Series A)	59,000	3,298,100
ProLogis (Series G)	120,000	2,964,000
<b>TOTAL PREFERRED STOCKS</b> 1.7% (Cost \$10,179,446)		\$ 10,794,600
<b>CONVERTIBLE BONDS AND DEBENTURES</b>		
<b>TECHNOLOGY 1.0%</b>		
BEA Systems, Inc. 4% 2006	\$ 2,000,000	\$ 1,977,500
International Rectifier Corp. 4.25% 2007	2,000,000	1,947,500
LSI Logic Corporation 4% 2006	2,000,000	1,977,500
		\$ 5,902,500
<b>BUSINESS SERVICES &amp; SUPPLIES 0.3%</b>		
Pegasus Solutions, Inc. 3.875% 2023	\$ 2,000,000	\$ 1,920,000
<b>TOTAL CONVERTIBLE BONDS AND DEBENTURES</b> 1.3% (Cost \$7,690,000)		\$ 7,822,500
<b>NON-COVERTIBLE BONDS AND DEBENTURES</b>		
<b>CORPORATE 3.8%</b>		
Central Garden & Pet Company 9.125% 2013	\$ 2,000,000	\$ 2,120,000
HMH Properties, Inc. 7.875% 2008	1,338,000	1,369,778
Host Marriott Corporation 9.25% 2007	2,000,000	2,135,000
Manitowoc Company, Inc., The 10.5% 2012	1,300,000	1,456,000
Metaldyne Corporation 11% 2012	2,000,000	1,530,000
OM Group, Inc. 9.25% 2011	4,000,000	3,980,000
Orbital Sciences Corporation 9% 2011	3,000,000	3,210,000
PolyOne Corporation 10.625% 2010	950,000	1,022,437
Realty Income Corporation 8.25% 2008	2,000,000	2,150,400
Unisys Corporation 7.875% 2008	1,500,000	1,481,250
Windmere Durable Holdings Inc. 10% 2008	3,000,000	2,913,750
		\$ 23,368,615
<b>U.S. GOVERNMENT AND AGENCIES 0.0%</b>		
Federal Home Loan Mortgage Corporation 6.5% 2023 (Interest Only)	\$ 54,129	\$ 3,180
10.15% 2006 (REMIC)	6	6
Government National Mortgage Association (Mobile Home) 9.75% 2010	264,729	278,131
		\$ 281,317
<b>TOTAL NON-COVERTIBLE BONDS AND DEBENTURES</b> 3.8% (Cost \$23,553,165)		
<b>TOTAL INVESTMENT SECURITIES</b> 98.5% (Cost \$384,101,612)		\$ 23,649,932
<b>SHORT TERM INVESTMENT</b> 1.5% (Cost \$8,926,956)		\$ 610,798,732
Short-term Corporate Note:		
General Electric Capital Corporation 4.12% 01/03/06	\$ 8,929,000	\$ 8,926,956
<b>TOTAL INVESTMENTS</b> 100.0% (Cost \$393,028,568)		\$ 619,725,688

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Other assets and liabilities, net	0.0%	247,343
<b>TOTAL NET ASSETS</b>	<b>100.0%</b>	<b>\$ 619,973,031</b>

\* Non-income producing securities

See notes to financial statements.

## PORTFOLIO SUMMARY

December 31, 2005

<b>Common Stocks</b>	<b>91.7%</b>
Business Services & Supplies	15.7%
Producer Durable Goods	13.7%
Energy	12.5%
Technology	10.6%
Financial	9.2%
Retailing	8.5%
Healthcare	8.1%
Entertainment	4.6%
Consumer Durable Goods	3.5%
Transportation	3.0%
Materials	2.3%
<b>Preferred Stocks</b>	<b>1.7%</b>
<b>Convertible Bonds and Debentures</b>	<b>1.3%</b>
<b>Non-Convertible Bonds and Debentures</b>	<b>3.8%</b>
<b>Short-Term Investments</b>	<b>1.5%</b>
<b>Total Net Assets</b>	<b>100.0%</b>

## MAJOR PORTFOLIO CHANGES

Quarter Ended December 31, 2005  
(Unaudited)

	Shares
<b>NET PURCHASES</b>	
<b>Common Stocks</b>	
AmSurg Corporation	100,000
Brady Corporation	115,000
Cal Dive International, Inc.	180,000
CDW Corporation	10,000
Charles River Laboratories International, Inc.	20,000
Health Management Associates, Inc.	15,000
Invitrogen Corporation	42,500
Microchip Technology Incorporated	70,000
Plantronics, Inc.	50,000
Polaris Industries, Inc.	25,000
<b>NET SALES</b>	
<b>Common Stocks</b>	
SanDisk Corporation	210,000



**FEDERAL INCOME TAX INFORMATION**

Calendar 2005

**Cash Dividends and Distributions:**

<b>Date Paid</b>	<b>Amount Paid Per Share</b>	<b>(1) Ordinary Income Dividends</b>	<b>(2) Long-Term Capital Gain Distributions</b>
<b>PREFERRED STOCK:</b>			
03/15/2005	\$ 0.60	\$ 0.5387	\$ 0.0613
06/15/2005	0.60	0.5387	0.0613
09/15/2005	0.60	0.5387	0.0613
12/15/2005	0.60	0.5387	0.0613
<b>TOTAL</b>	<b>\$ 2.40</b>	<b>\$ 2.1548</b>	<b>\$ 0.2452</b>
<b>COMMON STOCK:</b>			
03/15/2005	\$ 1.00		\$ 1.0000
06/15/2005	1.00		1.0000
09/15/2005	1.00		1.0000
12/15/2005	1.00		1.0000
12/15/2005 (special year-end)	1.47		1.4700
<b>TOTAL</b>	<b>\$ 5.47</b>		<b>\$ 5.4700</b>

**(Unaudited)**

The amount in column (1) is to be included as dividend income on your tax return and 91.4% of this amount is Qualified Dividend Income and qualifies for the 5% and 15% capital gains rates.

In accordance with the provisions of the Internal Revenue Code, the amounts in column (2) are long-term capital gain distributions and qualifies for the 5% and 15% capital gains rates.

A Form 1099 has been mailed to all shareholders of record on dividend record dates setting forth the specific amounts to be included in their 2005 tax returns. For corporate shareholders, 91.4% of the amount in column (1) qualifies for the 70% corporate dividends received deduction. Source Capital did not elect to retain any undistributed long-term capital gains for the year ended December 31, 2005. Therefore, Common shareholders will not receive a Form 2439 for 2005.

**Notice to Dividend Reinvestment Plan Participants:**

The information above shows the cash distributions paid by Source Capital during 2005. When additional shares are issued by Source Capital under the Automatic Reinvestment Plan at a discount from the market price, a participant in the Plan is treated for federal income tax purposes as having received a taxable distribution equal to the market value of the shares purchased. In effect, the discount from market price at which shares are purchased is added to the amount of the cash distribution to determine the total value of the taxable distribution. Such value also becomes the participant's tax basis for the shares purchased under the Plan.

The distributions paid during the year were reinvested at a discount from the market price, and the additional taxable amount of these distributions for each Common share purchased is as follows: March 15, 2005, \$3.5500 per share; June 15, 2005, \$3.5675 per share; September 15, 2005, \$3.7350 per share; December 15, 2005, \$3.6160 per share.

**State Tax Information:**

None of the amounts reported was derived from U.S. Treasury Securities.

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Certain states have reduced tax rates for capital gains attributed to securities that meet certain holding periods. The following percentages should be applied to the amounts in column (2): 17.6% of these gains was derived from assets held 1-2 years, 16.0% 2-3 years, 22.1% 3-4 years, 25.3% 4-5 years, 12.2% 5-6 years, and 6.8% more than 6 years.

**STATEMENT OF ASSETS AND LIABILITIES**

December 31, 2005

<b>ASSETS</b>		
Investments at value:		
Investment securities at market value (cost \$384,101,612) Note A	\$ 610,798,732	
Short-term investments at amortized cost (maturities 60 days or less) Note A	8,926,956	\$ 619,725,688
Cash		648
Receivable for:		
Accrued interest	\$ 610,014	
Dividends	245,900	855,914
		\$ 620,582,250
<b>LIABILITIES</b>		
Payable for:		
Advisory fees	\$ 355,185	
Accrued dividends Preferred Stock	196,921	
Accrued expenses	57,113	609,219
<b>TOTAL NET ASSETS</b> December 31, 2005		\$ 619,973,031
Assets applicable to Preferred Stock at a liquidation preference of \$27.50 per share (asset coverage 1,145%) Note B		\$ 54,153,330
Net assets applicable to Common Stock \$66.79 per share		\$ 565,819,701
<b>SUMMARY OF SHAREHOLDERS' EQUITY</b>		
\$2.40 Cumulative Preferred Stock par value \$3 per share; authorized 3,000,000 shares; outstanding 1,969,212 shares Note B		\$ 5,907,636
Common Stock par value \$1 per share; authorized 12,000,000 shares; outstanding 8,471,818 shares Note B		8,471,818
Additional Paid-in Capital		356,497,733
Undistributed net realized gain on investments		22,398,724
Unrealized appreciation of investments		226,697,120
<b>TOTAL NET ASSETS</b> December 31, 2005		\$ 619,973,031

See notes to financial statements.

**STATEMENT OF OPERATIONS**

For the year ended December 31, 2005

<b>INVESTMENT INCOME</b>		
Income:		
Dividends		\$ 5,104,926
Interest		3,352,383
		\$ 8,457,309
Expenses Note C:		
Advisory fees	\$ 4,085,454	
Transfer agent fees and expenses	296,497	
Reports to shareholders	164,477	
Directors' fees and expenses	124,414	
Taxes, other than federal income tax	75,800	
Custodian fees and expenses	56,970	
Legal and auditing fees	52,305	
Insurance	25,441	
Registration and filing fees	11,951	
Other expenses	7,426	4,900,735
Net investment income Note A		\$ 3,556,574
<b>NET REALIZED AND UNREALIZED GAIN ON INVESTMENTS</b>		
Net realized gain on investments:		
Proceeds from sale of investment securities		
(excluding short-term corporate notes with maturities 60 days or less)	\$ 147,089,470	
Cost of investment securities sold	77,836,327	
Net realized gain on investments Notes A and D		\$ 69,253,143
Unrealized appreciation of investments:		
Unrealized appreciation at beginning of year	\$ 219,140,221	
Unrealized appreciation at end of year	226,697,120	
Increase in unrealized appreciation of investments		7,556,899
Net realized and unrealized gain on investments		\$ 76,810,042
<b>NET INCREASE IN TOTAL NET ASSETS RESULTING FROM OPERATIONS</b>		<b>\$ 80,366,616</b>

See notes to financial statements.



## STATEMENT OF CHANGES IN TOTAL NET ASSETS

For the year ended December 31,

	2005		2004
<b>INCREASE IN TOTAL NET ASSETS</b>			
Operations:			
Net investment income	\$ 3,556,574		\$ 3,759,389
Net realized gain on investments Notes A and D	69,253,143		28,973,841
Increase in unrealized appreciation of investments	7,556,899		59,430,498
Increase in total net assets resulting from operations	\$ 80,366,616		\$ 92,163,728
Distributions to Preferred shareholders:			
From net investment income	\$ (3,771,381)		\$ (3,544,582)
From net realized capital gains	(954,728)	(4,726,109)	(1,181,527)
Distributions to Common shareholders from net realized capital gains		(45,901,288)	(33,146,891)
Proceeds from shares issued for distributions reinvested by shareholders Note B		8,505,168	6,189,190
Increase in total net assets	\$ 38,244,387		\$ 60,479,918
<b>TOTAL NET ASSETS</b>			
Beginning of year, including undistributed net investment income of \$214,807 and zero at December 31, 2004 and 2003, respectively			
		581,728,644	521,248,726
End of year, including undistributed net investment income of zero and \$214,807 at December 31, 2005 and 2004, respectively			
	\$ 619,973,031		\$ 581,728,644

See notes to financial statements.

### Notice of Source of Distributions (Unaudited) (Common Stock Only)

Since the sources from which distributions are paid cannot be determined until the end of each fiscal year, the following information amends the statements forwarded to Common shareholders with each distribution.

Date Paid	Amount Paid Per Share	Source of Distributions	
		Net Investment Income	Net Realized Capital Gains
3/15/2005	\$ 1.00		\$ 1.00
6/15/2005	1.00		1.00
9/15/2005	1.00		1.00
12/15/2005	1.00		1.00

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12/15/2005 (special year-end)	1.47	1.47
	\$ 5.47	\$ 5.47

See page 9 for federal income tax information.



## FINANCIAL HIGHLIGHTS

Selected data for a share of Common Stock outstanding throughout each year

	Year ended December 31,				
	2005	2004	2003	2002	2001
<b>Common Stock:</b>					
Per share operating performance:					
Net asset value at beginning of year	\$ 63.20	\$ 56.62	\$ 41.90	\$ 55.45	\$ 48.62
Income from investment operations:					
Net investment income	\$ 0.42	\$ 0.45	\$ 0.41	\$ 0.49	\$ 0.54
Net realized and unrealized gain (loss) on investment securities	9.16	10.65	18.36	(8.97)	11.40
Total from investment operations	\$ 9.58	\$ 11.10	\$ 18.77	\$ (8.48)	\$ 11.94
Distributions to Preferred shareholders:					
From net investment income	\$ (0.45)	\$ (0.43)	\$ (0.51)	\$ (0.49)	\$ (0.59)
From net realized capital gains	(0.11)	(0.14)	(0.06)	(0.10)	
Distributions to Common shareholders:					
From net investment income					(0.30)
From net realized gains	(5.47)	(4.00)	(3.50)	(4.60)	(4.30)
Total distributions	\$ (6.03)	\$ (4.57)	\$ (4.07)	\$ (5.19)	\$ (5.19)
Effect of shares issued for distributions reinvested by shareholders	\$ 0.04	\$ 0.05	\$ 0.02	\$ 0.12	\$ 0.08
Net asset value at end of year	\$ 66.79	\$ 63.20	\$ 56.62	\$ 41.90	\$ 55.45
Per share market value at end of year	\$ 73.75	\$ 71.54	\$ 59.38	\$ 52.85	\$ 61.02
Total investment return(1)	11.5%	28.4%	20.6%	(6.2)%	26.0%
Net asset value total return(2)	14.9%	19.5%	45.7%	(17.1)%	24.7%
Ratios/supplemental data:					
Net assets at end of year (in thousands)	\$ 619,973	\$ 581,729	\$ 521,249	\$ 395,176	\$ 498,726
Ratios based on average net assets applicable to					
Common Stock:					
Expenses(3)	0.91%	0.95%	0.99%	0.99%	0.97%
Net Investment Income(3)	0.66%	0.77%	0.85%	0.99%	1.07%
Ratios based on average net assets:					
Expenses(3)	0.83%	0.85%	0.87%	0.87%	0.85%
Net Investment Income(3)	0.60%	0.69%	0.75%	0.87%	0.95%
Portfolio turnover rate	22.92%	22.86%	18.43%	16.62%	25.13%
Preferred Stock:					
Total shares outstanding(4)	1,969,212	1,969,212	1,969,212	1,969,212	1,969,212
Asset coverage per share(4)	\$ 314.83	\$ 295.41	\$ 264.70	\$ 200.68	\$ 253.26

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Involuntary liquidation preference per share	\$ 27.50	\$ 27.50	\$ 27.50	\$ 27.50	\$ 27.50
Average market value per share(5)	\$ 34.21	\$ 34.04	\$ 31.87	\$ 31.15	\$ 30.05

(1) Based on market value per share, adjusted for reinvestment of distributions

(2) Based on net asset value per share, adjusted for reinvestment of distributions

(3) Does not reflect the effect of dividend payments to Preferred shareholders

(4) Information shown as of the end of the year

(5) The average of all month-end market values during each year

See notes to financial statements.



## NOTES TO FINANCIAL STATEMENTS

### NOTE A Significant Accounting Policies

Source Capital, Inc. (the "Company"), is registered under the Investment Company Act of 1940 as a diversified, closed-end management investment company. The investment objective of the Company is to seek maximum total return for Common shareholders from both capital appreciation and investment income to the extent consistent with protection of invested capital and provision of sufficient income to meet the dividend requirements of Preferred shareholders. The significant accounting policies followed by the Company in the preparation of its financial statements include the following:

1. **SECURITIES VALUATION** Securities, including any outstanding written call options, listed or traded on a national securities exchange are valued at the last sale price. Securities traded on the NASDAQ National Market System are valued at the NASDAQ official Closing Price. If there was not a sale that day securities are valued at the mean between the most recent bid and asked prices. Securities that are unlisted and debt and convertible securities listed on a national securities exchange for which the over-the-counter market more accurately reflects the securities' value in the judgment of the Company's officers, are valued at the mean between the most recent bid and asked prices or other ascertainable market value. Short-term corporate notes with maturities of 60 days or less are valued at amortized cost, which approximates market value. Securities for which market quotations are not readily available are valued at fair value as determined in good faith by, or under the direction of, the Board of Directors.

2. **USE OF ESTIMATES** The preparation of the financial statements in accordance with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported. Actual results could differ from those estimates.

3. **OTHER** Securities transactions are accounted for on the date the securities are purchased or sold. Dividend income is recorded on the ex-dividend date. Interest income and expenses are recorded on an accrual basis. Dividends payable by the Company on the Preferred Stock are recorded on an accrual basis, and distributions payable on the Common Stock are recorded on the ex-dividend date. The ratios of expenses and net investment income to average net assets do not reflect the effect of dividend payments to Preferred shareholders.

### NOTE B Capital Stock

The Preferred Stock is entitled in liquidation to \$27.50 per share plus accrued dividends and may be called for redemption, at the discretion of the Company, at \$27.50 per share plus accrued dividends. Dividends may not be declared on the Common Stock if Preferred dividends are in arrears or if the Preferred Stock would not thereafter have an asset coverage of 200% or more. Preferred asset coverage was 1,145% at December 31, 2005.

During the year ended December 31, 2005, the Company issued 123,820 shares of Common Stock, under its Dividend Reinvestment Plan for Common and Preferred shareholders.

### NOTE C Advisory Fees and Other Affiliated Transactions

Pursuant to an investment advisory agreement, the Company pays First Pacific Advisors, Inc. ("Investment Adviser"), monthly investment advisory fees calculated at an annual rate of 0.725% for the first \$100 million of total net assets, 0.700% for the next \$100 million of total net assets, and 0.675% for any total net assets in excess of \$200 million. The Agreement obligates the Investment Adviser to reduce its fee to the extent necessary to reimburse the Company for any annual expenses (exclusive of interest, taxes, the cost of any supplementary statistical and research information, legal expenses related to portfolio securities, and extraordinary expenses such as litigation) in excess of 1 1/2% of the first \$30 million and 1% of the remaining average total net assets of the Company for the year.

For the year ended December 31, 2005, the Company paid aggregate fees of \$123,750 to all Directors who are not affiliated persons of the Investment Adviser.

### NOTE D Federal Income Tax

No provision for federal taxes is considered necessary because the Company has elected to be taxed as a "regulated investment company" under the Internal Revenue Code. The Company intends to maintain this qualification and to distribute each year all of its taxable net investment

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income and taxable net realized gain on investments to shareholders in accordance with the minimum distribution requirements of the Code.

Dividends and distributions paid to shareholders are based on net investment income and net realized gains determined on a tax reporting basis, which may differ from financial reporting. For federal income tax purposes, the components of distributable earnings at December 31, 2005, were as follows:

Undistributed net investment income	
Undistributed net realized gains	\$ 22,398,724

The tax status of dividends and distributions paid during the fiscal years ended December 31, 2005 and 2004 were as follows:

	2005	2004
Dividends from Ordinary Income:		
Preferred	\$ 4,243,203	\$ 4,726,109
Common		\$ 5,301,378
Distributions from		
Long-term Capital Gains:		
Preferred	\$ 482,906	
Common	\$ 46,348,928	\$ 28,171,260

The cost of purchases of investment securities (excluding short-term corporate notes with maturities of 60 days



or less) aggregated \$133,204,550 during the year ended December 31, 2005. Realized gains and losses are based on the specific identification method.

All of the amounts reported in the financial statements at December 31, 2005, were the same for federal income tax and financial reporting purposes. A permanent difference of \$447,640 as of December 31, 2005, was reclassified from Undistributed Net Realized Gain on Investments to Additional Paid-in Capital. The permanent difference related to the accounting for market discount on Common Shares issued under the Dividend Reinvestment Plan, which differs between income tax regulations and accounting principles generally accepted in the United States of America. Gross unrealized appreciation and depreciation for all investments at December 31, 2005, for federal income tax and financial reporting purposes was \$230,023,354 and \$3,326,234, respectively, resulting in net unrealized appreciation of \$226,697,120. Refer to page 9 for detailed information regarding the tax character of distributions paid during the year ended December 31, 2005.

## **REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

### **TO THE SHAREHOLDERS AND BOARD OF DIRECTORS OF SOURCE CAPITAL, INC.**

We have audited the accompanying statement of assets and liabilities of Source Capital, Inc. (the "Company"), including the portfolio of investments, as of December 31, 2005 and the related statement of operations for the year then ended, the statements of changes in total net assets for each of the two years in the period then ended, and the financial highlights for each of the four years in the period then ended. These financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits. The financial highlights of Source Capital, Inc. for the year ended December 31, 2001 was audited by other auditors whose report, dated February 1, 2002, expressed an unqualified opinion on those financial highlights.

We conducted our audits in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Our procedures included confirmation of securities owned as of December 31, 2005, by correspondence with the custodian. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of Source Capital, Inc. as of December 31, 2005, the results of its operations for the year then ended, the changes in net assets for each of the two years in the period then ended, and the financial highlights for each of the four years in the period then ended, in conformity with accounting principles generally accepted in the United States of America.

Los Angeles, California  
February 6, 2006



**DIRECTORS AND OFFICERS**

(Unaudited)

	<b>Position(s) with Company</b>	<b>Principal Occupation(s) During the past 5 years</b>	<b>Portfolios in Fund Complex Overseen</b>	<b>Other Directorships</b>
Willard H. Altman, Jr. - (70)*	Director Term: 1 Year Time Served: 7 Years	Retired. Formerly, until 1995, Partner of Ernst & Young LLP a public accounting firm.	6	
Wesley E. Bellwood - (82)*	Director Term: 1 Year Time Served: 25 Years	Retired. Formerly, until 1999, Chairman Emeritus and director of Wynn's International, Inc.	1	
David Rees - (82)*	Director Term: 1 Year Time Served: 37 Years	Private investor. Formerly President and Chief Executive Officer of the International Institute of Los Angeles. Formerly, until 1995, the Senior Editor of Los Angeles Business Journal.	1	International Institute of Los Angeles
Paul G. Schloemer - (77)*	Director Term: 1 Year Time Served: 6 Years	Retired President and Chief Executive Officer (1984-1993) of Parker Hannifin Corporation.	1	
Lawrence J. Sheehan - (73)*	Director Term: 1 Year Time Served: 14 Years	Retired. Formerly Partner (1969 to 1994) and of counsel employee (1994 to 2002) of the firm of O'Melveny & Myers LLP.	5	
Eric S. Ende - (61)	Director, President & Chief Investment Officer Term: 1 Year Time Served: 5 Years	Senior Vice President of the Adviser.	3	
Steven R. Geist - (52)	Senior Vice President & Fixed-Income Manager Time Served: 9 Years	Vice President of the Adviser.		
J. Richard Atwood - (45)	Treasurer Time Served: 8 Years	Principal and Chief Operating Officer of the Adviser. President of FPA Fund Distributors, Inc.		First Pacific Advisors, Inc., and FPA Fund Distributors, Inc.
Sherry Sasaki - (51)	Secretary Time Served: 23 Years	Assistant Vice President and Secretary of the Adviser and Secretary of FPA Fund Distributors, Inc.		
Christopher H. Thomas - (48)	Chief Compliance Officer Time Served: 10 Years	Vice President and Chief Compliance Officer of the Adviser and Vice President of FPA Fund Distributors, Inc.		FPA Fund Distributors, Inc.
E. Lake Setzler III - (38)	Assistant Treasurer Time Served: <1 Years	Vice President and Controller of the Adviser since 2005. Formerly Chief Operating Officer of Inflective Asset Management, LLC (2004-2005) and Vice President of Transamerica Investment Management, LLC (2000-2004).		

Each of the above individuals can be contacted at 11400 W. Olympic Blvd., Suite 1200, Los Angeles, CA, 90064.

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\* Audit committee member

The Company's schedule of portfolio holdings, filed the first and third quarter on Form N-Q with the SEC, is available on the SEC's website at [www.sec.gov](http://www.sec.gov). Form N-Q is available at the SEC's Public Reference Room in Washington, D.C., and information on the operations of the Public Reference Room may be obtained by calling 1-202-942-8090. To obtain information on Form N-Q from the Company, shareholders can call 1-800-982-4372.

The Company's complete proxy voting record for the 12 months ended June 30, 2005, is available without charge, upon request, by calling 1-800-982-4372 and on the SEC's website at [www.sec.gov](http://www.sec.gov).

The Company's Audit Committee Charter is available on its website, [www.fpfunds.com](http://www.fpfunds.com), and is available without charge, upon request, by calling 1-800-982-4372. The Company's Annual CEO Certification as required by the NYSE's Corporate Governance listing standards for the fiscal year ended December 31, 2004, was submitted to the NYSE on May 10, 2005.

## **SOURCE CAPITAL, INC.**

### **INVESTMENT ADVISER**

First Pacific Advisors, Inc.

11400 West Olympic Blvd., Suite 1200

Los Angeles, California 90064-1550

(800) 982-4372 or (310) 473-0225

### **CUSTODIAN**

State Street Bank and Trust Company

Boston, Massachusetts

### **COUNSEL**

O'Melveny & Myers LLP

Los Angeles, California

### **INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Deloitte & Touche LLP

Los Angeles, California

### **TRANSFER AND SHAREHOLDER SERVICE AGENT**

Mellon Investor Services LLC

480 Washington Boulevard

Jersey City, NJ 07310

(800) 279-1241 or (201) 329-8660

<http://melloninvestor.com/isd>

### **REGISTRAR**

Mellon Investor Services LLC

Ridgefield Park, New Jersey

### **STOCK EXCHANGE LISTING**

New York Stock Exchange:

Symbols: SOR Common Stock

SOR+ Preferred Stock

### **DIVIDEND REINVESTMENT PLAN**

Holders of record (other than brokers or nominees of banks and other financial institutions) of Common and Preferred Stock are eligible to participate in the Dividend Reinvestment Plan ("Plan"), pursuant to which distributions to shareholders are paid in or reinvested in shares of Common Stock of the Company ("Dividend Shares"). Mellon Bank, N.A. ("Agent") c/o Mellon Investor Services LLC, Investment Services, P.O. Box 3338, South Hackensack, New Jersey 07606-1938, acts as agent for participants under the Plan.

A shareholder may join the Plan by signing and returning an authorization form that may be obtained from the Agent. A shareholder may elect to withdraw from the Plan at any time by written notice to the Agent and thereby elect to receive cash in lieu of Dividend Shares. There is no penalty for withdrawal from the Plan, and shareholders who have previously withdrawn from the Plan may rejoin at any time. The Company reserves the right to amend or terminate the Plan.

Purchases of the Company's shares are made by the Agent, on behalf of the participants in the Plan, promptly after receipt of funds, and in no event later than 30 days from such receipt except when restricted under applicable federal securities laws. The Agent purchases outstanding shares in the market when the price plus estimated commissions of the Company's Common Stock on the NYSE is lower than the Company's most recently calculated net asset value per share. To the extent that outstanding shares are not available at a cost of less than per share net asset value, the Agent, on behalf of the participants in the Plan, accepts payment of the dividend, or the remaining portion thereof, in authorized but unissued shares of Common Stock of the Company on the payment date. Such shares are issued at a per share price equal to the higher of (1) the net asset value per share on the payment date, or (2) 95% of the closing market price per share on the payment date. There are no brokerage charges with respect to shares issued directly by the Company to satisfy the dividend reinvestment requirements. However, each participant pays a pro rata share of brokerage commissions incurred with respect to the Agent's open market purchases of shares. In each case, the cost per share of shares purchased for each shareholder's account is the average cost, including brokerage commissions, of any shares purchased in the open market plus the cost of any shares issued by the Company.

For Federal income tax purposes, shareholders who reinvest distributions are treated as receiving distributions in an amount equal to the fair market value, determined as of the payment date, of the shares received if the shares are purchased from the Company. Such value may exceed the amount of the cash distribution that would have been paid. If outstanding shares are purchased in the open market, the taxable distribution equals the cash distribution that would have been paid. In either event, the cost basis in the shares received equals the amount recognized as a taxable distribution.

In the case of foreign participants whose dividends are subject to United States income tax withholding and in the case of any participants subject to 31% federal backup withholding, the Agent will reinvest dividends after deduction of the amount required to be withheld.

All record holders of Common Stock are also offered the opportunity, on a voluntary basis, to send in cash payments of not less than \$100 each up to a total of \$7,500 per month to purchase additional shares of the Common Stock of the Company through participation in the Cash Investment Plan ("Cash Plan"). Under the Cash Plan, shares are purchased in the market and no shares are issued by the Company. A brochure describing the terms and conditions of the Cash Plan, including fees and expenses, is available from the Agent.



**SOURCE CAPITAL, INC.**

11400 West Olympic Boulevard, Suite 1200

Los Angeles, California 90064-1550

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Item 2. Code of Ethics.

- (a) The registrant has adopted a code of ethics that applies to the registrant's senior executive and financial officers.
- (b) Not Applicable
- (c) During the period covered by this report, there were not any amendments to the provisions of the code of ethics adopted in 2(a) above.
- (d) During the period covered by this report, there were not any implicit or explicit waivers to the provisions of the code of ethics adopted in 2(a).
- (e) Not Applicable
- (f) A copy of the registrant's code of ethics is filed as an exhibit to this Form N-CSR. Upon request, any person may obtain a copy of this code of ethics, without charge, by calling (800) 982-4372.

Item 3. Audit Committee Financial Expert.

The registrant's board of directors has determined that Willard H. Altman, Jr., a member of the registrant's audit committee and board of directors, is an audit committee financial expert and is independent, as those terms are defined in this Item. This designation will not increase the designee's duties, obligations or liability as compared to his duties, obligations and liability as a member of the audit committee and of the board of directors. This designation does not affect the duties, obligations or liability of any other member of the audit committee or the board of directors.

Item 4. Principal Accountant Fees and Services.

		2004		2005
(a)	Audit Fees	\$	27,380	\$ 30,000
(b)	Audit Related Fees		-0-	-0-
(c)	Tax Fees	\$	5,765	\$ 6,050
(d)	All Other Fees		-0-	-0-

- (e)(1) Disclose the audit committee's pre-approval policies and procedures described in paragraph (c)(7) of Rule 2-01 of Regulation S-X. The audit committee shall pre-approve all audit and permissible non-audit services that the committee considers compatible with maintaining the independent auditors' independence. The pre-approval requirement will extend to all non-audit services provided to the registrant, the adviser, and any entity

controlling, controlled by, or under common control with the adviser that provides ongoing services to the registrant, if the engagement relates directly to the operations and financial reporting of the registrant; provided, however, that an engagement of the registrant's independent auditors to perform attest services for the registrant, the adviser or its affiliates required by generally accepted auditing standards to complete the examination of the registrant's financial statements (such as an examination conducted in accordance with Statement on Auditing Standards Number 70 issued by the American Institute of Certified Public Accountants), will be deemed pre-approved if: (i) the registrant's independent auditors inform the audit committee of the engagement, (ii) the registrant's independent auditors advise the audit committee at least annually that the performance of this engagement will not impair the independent auditor's independence with respect to the registrant, and (iii) the audit committee receives a copy of the independent auditor's report prepared in connection with such services. The committee may delegate to one or more committee members the authority to review and pre-approve audit and permissible non-audit services. Actions taken under any such delegation will be reported to the full committee at its next meeting.

- (e)(2) Disclose the percentage of services described in each of paragraphs (b)–(d) of this Item that were approved by the audit committee pursuant to paragraph (c)(7)(i)(C) of Rule 2-01 of Regulation S-X. 100% of the services provided to the registrant described in paragraphs (b)–(d) of this Item were pre-approved by the audit committee pursuant to paragraph (e)(1) of this Item. There were no services provided to the investment adviser or any entity controlling, controlled by or under common control with the adviser described in paragraphs (b)–(d) of this Item that were required to be pre-approved by the audit committee.
  - (f) If greater than 50%, disclose the percentage of hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees. All services performed on the engagement to audit the registrant's financial statements for the most recent fiscal year end were performed by the principal accountant's full-time, permanent employees.
  - (g) Disclose the aggregate non-audit fees billed by the registrant's accountant for services rendered to the registrant, and rendered to the registrant's investment adviser (not including any sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under
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common control with the adviser that provides ongoing services to the registrant for each of the last two fiscal years of the registrant. None.

- (h) Disclose whether the registrant's audit committee of the board of directors has considered whether the provision of non-audit services that were rendered to the registrant's investment adviser (not including any sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the investment adviser that provides ongoing services to the registrant that were not pre-approved pursuant to paragraph (c)(7)(ii) of Rule 2-01 of Regulation S-X is compatible with maintaining the principal accountant's independence. Not Applicable.

Item 5. Audit Committee of Listed Registrants.

The registrant has a separately-designated standing audit committee established in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934, consisting of all the independent directors of the registrant. The members of the audit committee are: Willard H. Altman, Jr., Wesley E. Bellwood, David Rees, Paul G. Schloemer and Lawrence J. Sheehan.

Item 6. Schedule of Investments. The schedule of investments is included as part of the report to stockholders filed under Item 1 of this Form.

Item 7. Disclosure of Proxy Voting Policies and Procedures for Closed-End Management Investment Companies.

POLICY

First Pacific Advisors, Inc. ( Adviser ) acts as discretionary investment adviser for various clients, including SEC-registered closed-end and open-end investment companies ( RIC clients ) and separately managed accounts (including those governed under the laws and provisions of ERISA) (collectively referred to as client or clients). The Adviser is authorized to vote proxies on behalf of its clients, unless a client specifically retains or delegates this authority to another party, in writing. The Adviser will vote all proxies in a timely manner as part of its full discretionary authority over client assets in accordance with these Policies and Procedures.

When voting proxies for clients, the Adviser's utmost concern is that all decisions be made solely in the best interest of the client (and for ERISA accounts, plan beneficiaries and participants, in accordance with the letter and spirit of ERISA). The Adviser will act in a prudent and diligent manner intended to enhance the value of the assets of the client's account.

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## PURPOSE

The purpose of these Policies and Procedures is to enable the Adviser to comply with its fiduciary responsibilities to clients and the requirements under the Investment Advisers Act of 1940, as amended ( Advisers Act ), and the Investment Company Act of 1940, as amended ( 1940 Act ). These Policies and Procedures also reflect the fiduciary standards and responsibilities set forth by the Department of Labor for ERISA accounts.

## PROCEDURES

The Adviser is ultimately responsible for ensuring that all proxies received by the Adviser are voted in a timely manner and in a manner consistent with the Adviser's determination of the client's best interests. Although many proxy proposals can be voted in accordance with the Adviser's guidelines (see Guidelines below), the Adviser recognizes that some proposals require special consideration which may dictate that the Adviser make an exception to the Guidelines.

## CONFLICTS OF INTEREST

Where a proxy proposal raises a material conflict between the Adviser's interests and a client's interest, the Adviser will resolve such a conflict in the manner described below:

Vote in Accordance with the Guidelines. To the extent that the Adviser has little or no discretion to deviate from the Guidelines with respect to the proposal in question, the Adviser shall vote in accordance with such pre-determined voting policy.

Obtain Consent of Clients. To the extent that the Adviser has discretion to deviate from the Guidelines with respect to the proposal in question, the Adviser will disclose the conflict to the relevant clients and obtain their consent to the proposed vote prior to voting the securities. The disclosure to the client will include sufficient detail regarding the matter to be voted on and the nature of the Adviser's conflict that the client would be able to make an informed decision regarding the vote. If a client does not respond to such a conflict disclosure request or denies the request, the Adviser will abstain from voting the securities held by that client's account.

Client Directive to Use an Independent Third Party. Alternatively, a client may, in writing, specifically direct the Adviser to forward all proxy matters in which the Adviser has a conflict of interest regarding the client's securities to an identified independent third party for review and recommendation. Where such independent third party's recommendations are received on a timely basis, the Adviser will vote all such proxies in accordance with such third party's recommendation. If the third party's recommendations are not timely received, the Adviser will abstain from voting the securities held by that client's account.

The Adviser will review the proxy proposal for conflicts of interest as part of the overall vote review process. All material conflicts of interest so identified by the Adviser will be addressed as above. Matters to be reviewed include: (i) whether the issuer of the portfolio security to be voted, or an affiliate or employee group of the issuer, is a client of the Adviser; (ii) whether the Adviser has made or is actively considering a business proposal to provide services to the

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issuer or an affiliate or employee group of the issuer; (iii) whether the Adviser has any other material business relationship with the issuer or an affiliate of the issuer; (iv) whether an officer or director of the Adviser or the portfolio manager responsible for recommending the proxy vote is a close relative or has a personal or business relationship with an executive, director or director candidate of the issuer or is a participant in a proxy contest; and (v) whether there is any other business or personal relationship where the portfolio manager has a personal interest in the outcome of the matter to be voted upon.

#### LIMITATIONS

In certain circumstances where the Adviser has determined that it is in the client's best interest, the Adviser will not vote proxies received. The following are some, but not all, circumstances where the Adviser will limit its role in voting proxies:

Client Maintains Proxy Voting Authority. Where the client has instructed the Adviser in writing, the Adviser will not vote the securities and will direct the relevant custodian to send the proxy material directly to the client. If any proxy material is received by the Adviser, it will promptly be forwarded to the client or a specified third party.

Terminated Account. Once a client account has been terminated with the Adviser in accordance with the investment advisory agreement, the Adviser may refrain from voting any proxies received after the termination. However, the client may specify in writing who the proxies shall be forwarded to.

Securities No Longer Held. The Adviser may refrain from voting proxies received for securities which are no longer held by the client's account.

Securities Lending Programs. When securities are out on loan, they are transferred into the borrower's name and are voted by the borrower, in its discretion. However, where the Adviser determines that a proxy vote is materially important to the client's account, the Adviser may recall the security for purposes of voting.

#### PROCEDURES FOR VOTING

Proxies and annual or other reports received by the Adviser for issuers in clients' accounts under management are promptly forwarded to the appropriate portfolio manager, who votes the proxy and returns it to the operations department to process the votes.

When voting telephonically. The telephone number on the proxy is called and voted, verification of the vote is made after all proposals have been voted, the date of the telephone call is noted on the proxy and filed in the account's file. Note of the date of the telephone call is also made on the cross-reference report and filed alphabetically in a binder by

issuer.

When voting manually. Sign and date after manually checking each proposal being voted and send through the regular postal service. A copy of the proxy is filed in the account's file.

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Note of the date of mailing is also made on the cross reference report and filed alphabetically in a binder by issuer.

When voting electronically. Go online and vote each proxy as designated. A confirmation is then returned through e-mail. These confirmations are printed and are then filed with the proxy in the account's file. Note of the date of voting is also made on the cross reference report and filed alphabetically in a binder by issuer.

If there is a disagreement as to how a proxy is to be voted, it is the responsibility of the portfolio managers of the Adviser to discuss and substantiate their voting. See Guidelines below for further explanation of standard voting procedures.

#### RECORD KEEPING

In accordance with the Rules under the Advisers Act, the Adviser will maintain for the time periods set forth in the Rules the following information:

1. these proxy voting policies and procedures, and all amendments thereto;
2. all proxy statements received regarding client securities (provided however, that the Adviser may rely on the proxy statement filed on EDGAR as its records);
3. a record of all votes cast on behalf of clients;
4. records of all client requests for proxy voting information;
5. any documents prepared by the Adviser that were material in making a decision and/or used as the basis for the decision; and
6. all records relating to requests made to clients regarding conflicts of interest in voting the proxy. These requests will be kept in the client proxy file.

The Adviser will disclose its proxy voting policies and procedures and will inform clients how they may obtain information on how the Adviser voted proxies with respect to the clients' portfolio securities. Clients may obtain information on how their securities were voted or a copy of the Adviser's Policies and Procedures by written request addressed to the Adviser. The Adviser will prepare all the information required to be filed by its RIC clients on Form N-PX with the Securities and Exchange Commission.

#### GUIDELINES

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Each proxy issue will be considered individually. The following guidelines are a partial list to be used in voting proposals contained the proxy statements, but will not be used as rigid rules.

1. Issues regarding the issuer's Board entrenchment and anti-takeover measures such as the following: Oppose
1. Proposals to stagger board members' terms;
  2. Proposals to limit the ability of shareholders to call special meetings;
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3.	Proposals to require super majority votes;	
4.	Proposals requesting excessive increases in authorized common or preferred shares where management provides no explanation for the use or need of these additional shares;	
5.	Proposals regarding fair price provisions;	
6.	Proposals regarding poison pill provisions; and	
7.	Permitting green mail.	
2.	Providing cumulative voting rights	Oppose
3.	Social issues, unless specific client guidelines supersede	Oppose
4.	Election of directors recommended by management, except if there is a proxy fight	Approve
5.	Election of independent auditors recommended by management, unless seeking to replace if there exists a dispute over policies	Approve
6.	Date and place of annual meeting	Approve
7.	Limitation on charitable contributions or fees paid to lawyers	Approve
8.	Ratification of directors actions on routine matters since previous annual meeting	Approve
9.	Confidential voting	Approve
	Confidential voting is most often proposed by shareholders as a means of eliminating undue management pressure on shareholders regarding their vote on proxy issues	
	The Adviser will generally approve these proposals as shareholders can later divulge their votes to management on a selective basis if a legitimate reason arises	
10.	Limiting directors liability	Approve
11.	Eliminate preemptive right	Approve
	Preemptive rights give current shareholders the opportunity to maintain their current percentage ownership through any subsequent equity offerings. These provisions are no longer common in the U.S., and can restrict managements ability to raise new capital	

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The Adviser generally approves the elimination of preemptive rights, but will oppose the elimination of limited preemptive rights, e.g., on proposed issues representing more than an acceptable level of total dilution

12. Employee Stock Purchase Plan	Approve
13. Establish 401(k) Plan	Approve
14. Pay director solely in stocks	Case-by-case
15. Eliminate director mandatory retirement policy	Case-by-case
16. Rotate annual meeting location/date	Case-by-case
17. Option and stock grants to management and directors	Case-by-case
18. Allowing indemnification of directors and/or officers after reviewing the applicable laws and extent of protection requested	Case-by-case
19. Sale of assets, divisions, product rights, etc.	Case-by-case
20. Other business that may arise at the annual meeting	Case-by-case
21. Other issues not included on this list	Case-by-case

NOTICE TO CLIENTS OF FIRST PACIFIC ADVISORS, INC.

REGARDING PROXY VOTING POLICIES AND PROCEDURES

Unless specifically noted otherwise in writing by the Client, First Pacific Advisors, Inc. ( Adviser ) retains all authority and responsibility to vote proxies for any stocks held in Accounts under its management.

In accordance with Rule 207.206(4)-6 of the Advisers Act of 1940 with respect to proxy voting procedures of the Adviser, we are hereby notifying you of your right to obtain information about our proxy voting policy and procedures, including how we vote shares held in your Account. If at any time you would like information on our proxy voting policy and procedures, you may send a request in writing to J. Richard Atwood, Compliance Officer, First Pacific Advisors, Inc., 11400 West Olympic Boulevard, Suite 1200, Los Angeles, CA 90064, or fax your request to (310) 996-5450, or by e-mail to [atwood@firstpacad.com](mailto:atwood@firstpacad.com)

Item 8. Portfolio Managers of Closed-End Management Investment Companies.

(a)(1) Eric S. Ende and Steven R. Geist are primarily responsible for the day-to-day management of the registrant. Mr. Ende has been the President, Chief Investment Officer and Director of the registrant and Senior Vice President of the Adviser for more than the past five years. Mr. Ende also serves as Director, President and Portfolio Manager of FPA Paramount Fund, Inc. and of FPA Perennial Fund, Inc., and as Vice President of FPA Capital Fund, Inc., FPA New Income, Inc. and FPA Funds Trust's FPA Crescent Fund for more than the past five years (except since 2002 for FPA Crescent Fund). Mr. Geist has been the Senior Vice President and Fixed-Income Manager of the registrant and Vice President of the Adviser for more than the past five years. Mr. Geist also serves as Executive Vice President and Portfolio Manager of FPA Paramount Fund, Inc. and of FPA Perennial Fund, Inc. for more than the past five years. This information is as of March 8, 2006.

FPA Capital Fund, Inc., FPA Funds Trust's FPA Crescent Fund, FPA New Income, Inc., FPA Paramount Fund, Inc. and FPA Perennial Fund, Inc. are registered investment companies managed by the Adviser.

(a)(2) The Portfolio Managers, Eric S. Ende and Steven R. Geist, are also responsible for the day-to-day management of two open-end investment companies and eight other accounts, with total aggregate assets of \$1.2 billion at December 31, 2005. In addition, Mr. Geist assists in the management of a small portion of another open-end investment company and nine other accounts with total aggregate assets of \$2.2 billion at December 31, 2005. None of these accounts have an advisory fee based on the performance of the account. The Adviser does not believe any material conflicts of interest exist as a result of the Portfolio Managers managing the registrant and the other accounts noted above. The Adviser seeks to allocate portfolio transactions equitably whenever concurrent decisions are made to purchase or sell identical securities for several clients managed by the Adviser. The Adviser may aggregate orders for its client accounts for the same security where concurrent decisions are made to purchase or to sell identical securities for several clients managed by the Adviser and such aggregation will generally result in more favorable net results for its clients. In these cases, the Adviser will allocate the securities or proceeds arising out of those transactions (and the related expenses) on an average price basis among the various participants. While the Adviser believes combining orders in this way will, over time, be advantageous to all participants, in particular cases, this procedure could have an adverse effect on the price or the amount of securities purchased or sold by any one client. In making such allocations, the main factors considered by the Adviser are the respective investment objectives, the relative

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size of portfolio holdings of the same or comparable securities, the availability of cash for investment, the size of investment commitments generally held and the opinions of the persons responsible for recommending the investment.

- (a)(3) Compensation of the Adviser's Portfolio Managers includes a fixed salary plus a bonus. The bonus is primarily based on the revenues received on the assets under management, including the registrant's assets, and partly based on the overall profitability of the Adviser. The Adviser offers a 401(k) plan whereby the Portfolio Managers, as well as all permanent employees of the Adviser, may elect to contribute up to the legal limit.
- (a)(4) The dollar value of shares of Common Stock of the registrant owned at December 31, 2005 by Mr. Ende was between \$10,001 and \$50,000 and by Mr. Geist was between \$10,001 and \$50,000.
- (b) Not Applicable.

Item 9. Purchases of Equity Securities by Closed-End Management Investment Company and Affiliated Purchasers. Not Applicable.

Item 10. Submission of Matters to a Vote of Security Holders. There has been no material change to the procedures by which shareholders may recommend nominees to the registrant's board of directors.

Item 11. Controls and Procedures.

- (a) The principal executive officer and principal financial officer of the registrant have concluded that the registrant's disclosure controls and procedures (as defined in Rule 30a-3(c) under the Investment Company Act of 1940) are effective based on their evaluation of the disclosure controls and procedures as of a date within 90 days of the filing date of this report.
  - (b) There have been no significant changes in the registrant's internal controls over financial reporting (as defined in Rule 30a-3(d) under the Investment Company Act of 1940) that occurred during the second fiscal quarter covered by this report that have materially affected, or is reasonably likely to materially affect, the registrant's internal controls over financial reporting.
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Item 12. Exhibits.

- (a)(1) Code of ethics as applies to the registrant's officers and directors, as required to be disclosed under Item 2 of Form N-CSR. Attached hereto as Ex.99.CODE.ETH.
  - (a)(2) Separate certification for the registrant's principal executive officer and principal financial officer, as required by Rule 30a-2(a) under the Investment Company Act of 1940. Attached hereto.
  - (a)(3) Not Applicable
  - (b) Separate certification for the registrant's principal executive officer and principal financial officer, as required by Rule 30a-2(b) under the Investment Company Act of 1940. Attached hereto.
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SIGNATURES

Pursuant to the Securities Exchange Act of 1934 and the Investment Company Act of 1940, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SOURCE CAPITAL, INC.

By: /s/ ERIC S. ENDE  
Eric S. Ende

Date: March 8, 2006

Pursuant to the Securities Exchange Act of 1934 and the Investment Company Act of 1940, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SOURCE CAPITAL, INC.

By: /s/ J. RICHARD ATWOOD  
J. Richard Atwood, Treasurer

Date: March 8, 2006

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