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SOURCE CAPITAL INC /DE/  
Form N-CSRS  
September 03, 2004

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 90064  
(Address of principal executive offices)

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 end: DECEMBER 31

Date of reporting period: JUNE 30, 2004

Item 1. Report to Stockholders

[LOGO]

SOURCE CAPITAL, INC.

SEMIANNUAL REPORT  
FOR THE SIX MONTHS ENDED JUNE 30, 2004

SOURCE CAPITAL, INC.

[LOGO]

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

LEGAL COUNSEL  
O'Melveny & Myers LLP  
Los Angeles, California

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INDEPENDENT AUDITORS  
Deloitte & Touche LLP  
Los Angeles, California

TRANSFER AND SHAREHOLDER SERVICE AGENT  
Mellon Investor Services LLC  
85 Challenger Road  
Overpeck Centre  
Ridgefield Park, NJ 07660  
(800) 279-1241 or (201) 329-8660  
www.melloninvestor.com

REGISTRAR  
Mellon Investor Services LLC  
Ridgefield Park, New Jersey

STOCK EXCHANGE LISTING  
New York Stock Exchange:  
Symbols: SOR Common Stock  
          SOR+ Preferred Stock

### SUMMARY FINANCIAL INFORMATION

|   | SIX MONTHS ENDED<br>JUNE 30, 2004 |                        | YE<br>DECEMBER         |
|---|-----------------------------------|------------------------|------------------------|
|   | TOTAL<br>NET<br>ASSETS            | PER<br>COMMON<br>SHARE | TOTAL<br>NET<br>ASSETS |
|   | -----                             | -----                  | -----                  |
| Beginning of period   | \$ 521,248,726                    | \$ 56.62               | \$ 395,175             |
| Net gain on investments, realized and unrealized                            | \$ 44,622,268                     | \$ 5.40                | \$ 150,721             |
| Net investment income   | 2,099,774                         | 0.25                   | 3,348                  |
| Dividends to Preferred shareholders   | (2,363,054)                       | (0.29)                 | (4,726)                |
| Distributions to Common shareholders  | (16,523,005)                      | (2.00)                 | (28,645)               |
| Proceeds from shares issued for distributions reinvested<br>by shareholders | 3,087,002                         | 0.03                   | 5,374                  |
| Net changes during period   | \$ 30,922,985                     | \$ 3.39                | \$ 126,072             |
| End of period   | \$ 552,171,711                    | \$ 60.01               | \$ 521,248             |
|   | =====                             | =====                  | =====                  |

|  | JUNE 30, 2004 | DECEMBER 31, 2003 | DE    |
|--|---------------|-------------------|-------|
|  | -----         | -----             | ----- |
| Common market price per share              | \$ 65.02      | \$ 59.38          |       |
| Common market premium to net asset value   | 8.4%          | 4.9%              |       |
| Preferred asset coverage                   | 1,020%        | 963%              |       |
| Preferred liquidation preference per share | \$ 27.50      | \$ 27.50          |       |
| Preferred market price per share           | \$ 33.16      | \$ 33.81          |       |

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### DESCRIPTION OF THE COMPANY

SOURCE CAPITAL, INC., is a major diversified, publicly traded investment company with total net assets approximating \$552,000,000. Its investment portfolio includes a wide range of securities with primary emphasis on common stocks.

Source Capital has Common and Preferred shares outstanding, both of which are 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 8,299,387 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 the transaction.

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.

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. All distributions are taxable to shareholders as dividend income or capital gain distributions since the Company has accumulated earnings and profits from prior years.

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### LETTER TO SHAREHOLDERS

TO OUR SHAREHOLDERS:

Source Capital's total net assets increased from \$536,928,646 to \$552,171,711

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during the second quarter. Net asset value per Common share amounted to \$60.01 at June 30, 2004, compared with \$58.35 at March 31, 2004, and \$56.62 at year-end 2003. These changes in net asset value were net of cash distributions of \$1.00 paid in both the first and second quarters.

### INVESTMENT RESULTS, 2004 FIRST HALF

For the six months ended June 30, 2004, the net asset value per share of Source Capital's Common Stock increased by 9.7%, as adjusted for reinvestment of distributions paid during the period, while total net assets rose 9.1%. These returns compare with a 6.2% increase in the Russell 2500 Index, a measure of small to medium capitalization stock performance. The foregoing changes were calculated on the basis of reinvesting all dividends and distributions.

### INVESTMENT RESULTS, 2004 SECOND QUARTER

In the most recent quarter, Source Capital's net asset value per share of Common Stock increased 4.7%, as adjusted for reinvestment of the \$1.00 distribution paid during the period, while total net assets rose 4.4%, both on a reinvestment basis. In comparison, the Russell 2500 Index increased 0.3% during the quarter, also on a reinvestment basis.

### DISTRIBUTIONS TO COMMON SHAREHOLDERS

A regular quarterly distribution of \$1.00 per share was paid on June 15, 2004, to shareholders of record on May 28, 2004. In February 2004, the Board of Directors adopted a flexible distribution policy. This new policy allows the Board of Directors to continue to consider changes in net asset value when establishing the quarterly distribution rate, but also provides 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.

### PREFERRED DIVIDENDS

The regular Preferred dividend of \$0.60 per share was paid on June 15, 2004, to shareholders of record on May 28, 2004. The changes in the Company's total net assets since year-end 2003 have resulted in changes in the Preferred shares' asset coverage from 963% at December 31, 2003, to 992% at March 31, 2004, and 1,020% at June 30, 2004. Net investment income provided Preferred dividend coverage of 57% for the second quarter and 89% for the six months, compared with 68% and 77% for the corresponding periods of 2003.

### MARKET PRICE OF SOURCE CAPITAL SHARES

The market price of Source Capital Common Stock increased from \$59.38 to \$65.02 during the first half of 2004. As this \$5.64 increase in market price was more than the \$3.39 rise in the underlying net asset value, the market premium to net asset value of 4.9% at year-end 2003 increased to 8.4% at June 30, 2004. The market price of Source Capital Preferred Stock decreased to \$33.16 at June 30, 2004, from \$33.81 at year-end 2003.

### COMMENTARY

The stock market has continued to advance in 2004, though at a modest rate when compared to the big gains of last year. In addition, small-cap stocks continue to outperform, with the Russell up twice as much as the 3% gain in the S&P 500 as of June 30.

Source had an especially strong second quarter, with the net asset value up

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4.7%, compared to just a nominal gain in the benchmark Russell 2500. For the year-to-date period, Source is up 9.7%, comfortably ahead of both the Russell 2500 and the larger-cap S&P 500 and Nasdaq. For the longer three- and five-year periods, Source has significantly outperformed each of these indexes.

|              | PERIODS ENDED JUNE 30, 2004 |      |             |                 |                |
|--------------|-----------------------------|------|-------------|-----------------|----------------|
|              | SECOND<br>QUARTER           | YTD  | ONE<br>YEAR | THREE<br>YEARS* | FIVE<br>YEARS* |
| Source (NAV) | 4.7%                        | 9.7% | 35.8%       | 12.2%           | 14.0%          |
| Russell 2500 | 0.3%                        | 6.2% | 32.2%       | 7.4%            | 8.5%           |
| S&P 500      | 1.7%                        | 3.4% | 19.1%       | (0.7)%          | (2.2)%         |
| Nasdaq       | 2.7%                        | 2.2% | 26.2%       | (1.8)%          | (5.3)%         |

\* Annualized Returns

SANDISK first entered Source's portfolio in early 2001 and continues to be a significant holding. It is a leading designer, manufacturer, and distributor of flash memory products. Flash is used primarily in portable consumer electronic devices such as digital cameras, multimedia phones, MP3 players and USB flash drives. Consumers generally encounter flash memory in the form of a removable card. These are available in a confusing array of different formats, with names like Memory Stick, Compact Flash, Secure Digital (SD) cards, Smart Media, or xD cards, all of which perform similar functions. Because the products that use it are growing so rapidly, flash memory has been a dynamic industry with growth rates exceeding 50% annually.

Flash has a number of significant advantages over other types of data storage (like disk drives, CDs, or DRAM). These include:

- Non-volatile--doesn't need continuous power to retain its data
- Can be written and erased many times
- Durable--has no moving parts
- Small size
- Low power requirements

SanDisk is, in many respects, the leading company in the flash memory industry. It has a number of important competitive strengths that, we believe, will help it maintain its strong position.

SanDisk manufactures flash memory chips in a joint venture with Toshiba, which holds the #2 market share position world

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wide, behind Samsung. The joint venture is currently building a new fab (tech-speak for a factory which makes semiconductors). The new plant will greatly expand the joint venture's capacity and ensure its continued low-cost position.

SanDisk has an extremely strong intellectual property position, holding many basic flash memory patents. It will receive close to \$200 million this year in

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royalties and license fees, including a substantial sum from Samsung.

SanDisk has the strongest position at retail, selling all flash memory formats, with the best recognized brand in an industry with, admittedly, relatively low brand recognition. The Company has recently started an advertising campaign to further enhance its brand strength.

SanDisk's competitive position is further reinforced by its financial strength. It has over \$1 billion in net cash (after deducting debt), or \$7 per share.

The SanDisk story is not without some risks, unfortunately. In the short term these center on margin pressures, mostly the result of price reductions and extra costs associated with manufacturing transitions. In the longer term, there are worries about new market entrants, including Micron, Hynix, and Infineon, and the possibility that they will commoditize the business, making it impossible for any participant to earn decent returns.

We agree that these concerns, especially the risk of too many competitors destroying margins, are well worth worrying about. We believe, however, that the competitive strengths outlined will provide strong defense and protect SanDisk's position.

- Just as Samsung is paying royalties to SanDisk, we expect that the new market entrants will have to do the same, though there are no announced agreements so far, adding to their costs while increasing SanDisk's profits.
- The traditional flash manufacturers, Samsung, Toshiba, and SanDisk, are generations ahead in manufacturing technology, and we expect this to enable them to maintain their low-cost position.
- SanDisk's increasing brand strength, and its unique ability to be a single source to retailers of all flash memory formats, will serve to maintain its position as the leading company at the retail end of the business.

As of the end of the quarter, SanDisk was selling at about 15x estimated 2004 earnings of \$1.50 per share. This PE would be closer to 11x if we adjusted for SanDisk's cash position. Its operating margin is about 25% and return on equity close to 20%, despite the large cash position. These represent quite high returns and a modest valuation.

During 2003, SanDisk was a major contributor to Source's strong investment performance, rising from \$10 a share at the start of the year to a November high of \$43, as we sold over 70% of Source's position, before backing off to \$31 at year-end.

This price decline has continued during 2004. On June 30, SanDisk was \$22, fifty percent below its high in late 2003. When combined with our continued enthusiasm for SanDisk's business, this lower price has made the stock more attractive, and we have increased our position by about 40% over the past few months. At over 3% of net assets, SanDisk is again one of Source's more significant positions.

Respectfully submitted,

/s/ Eric S. Ende

Eric S. Ende  
President and  
Chief Investment Officer

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July 27, 2004

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PORTFOLIO OF INVESTMENTS  
June 30, 2004

| COMMON STOCKS                             | SHARES    |
|---|-----------|
| -----                                     |           |
| PRODUCER DURABLE GOODS -- 16.4%           |           |
| Checkpoint Systems, Inc.*                 | 68,462    |
| Cognex Corporation                        | 495,000   |
| Crane Co.                                 | 435,000   |
| Graco Inc.                                | 514,500   |
| IDEX Corporation                          | 511,500   |
| Oshkosh Truck Corporation                 | 110,500   |
| Zebra Technologies Corporation (Class A)* | 195,000   |
| <br>                                      |           |
| BUSINESS SERVICES & SUPPLIES -- 14.5%     |           |
| Bio-Rad Laboratories, Inc.*               | 95,000    |
| Black Box Corporation                     | 260,800   |
| HNI Corporation                           | 321,400   |
| Manpower Inc.                             | 300,000   |
| Office Depot, Inc.*                       | 900,000   |
| ScanSource, Inc.*                         | 284,000   |
| <br>                                      |           |
| HEALTHCARE -- 10.7%                       |           |
| Health Management Associates, Inc.        | 410,000   |
| Landauer, Inc.                            | 14,300    |
| Lincare Holdings Inc.*                    | 450,000   |
| Ocular Sciences, Inc.*                    | 390,000   |
| Renal Care Group, Inc.*                   | 600,000   |
| <br>                                      |           |
| ENERGY -- 10.1%                           |           |
| Cal Dive International, Inc.*             | 725,000   |
| Noble Corporation*                        | 460,000   |
| Tidewater Inc.                            | 540,000   |
| <br>                                      |           |
| TECHNOLOGY -- 10.0%                       |           |
| Advanced Fibre Communications, Inc.*      | 710,000   |
| KEMET Corporation*                        | 200,000   |
| Plantronics, Inc.*                        | 380,000   |
| SanDisk Corporation*                      | 740,000   |
| TriQuint Semiconductor, Inc.*             | 1,143,029 |
| <br>                                      |           |
| FINANCIAL -- 8.7%                         |           |
| Brown & Brown, Inc.                       | 251,000   |
| Arthur J. Gallagher & Co.                 | 215,000   |

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|   |         |
|---|---------|
| National Commerce Financial Corporation | 415,000 |
| North Fork Bancorporation, Inc.         | 455,000 |

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| COMMON STOCKS (CONTINUED)  | SHARES OR<br>FACE<br>AMOUNT |
|--|-----------------------------|
| -----  |                             |
| RETAILING -- 7.8%  |                             |
| CarMax, Inc.*  | 625,006                     |
| O'Reilly Automotive, Inc.*   | 652,500                     |
| ENTERTAINMENT -- 4.6%  |                             |
| Carnival Corporation   | 536,600                     |
| MATERIALS -- 2.7%  |                             |
| Engelhard Corporation  | 465,000                     |
| TRANSPORTATION -- 0.5%   |                             |
| Heartland Express, Inc.  | 105,000                     |
| TOTAL COMMON STOCKS -- 86.0% (Cost \$288,800,191)                    |                             |
| PREFERRED STOCKS   |                             |
| REAL ESTATE INVESTMENT TRUST   |                             |
| CBL & Associates Properties, Inc.                                    | 100,000                     |
| Duke-Weeks Realty Corp. (Series B)                                   | 40,000                      |
| Pennsylvania Real Estate Investment Trust (Series A)                 | 59,000                      |
| ProLogis (Series G)  | 120,000                     |
| TOTAL PREFERRED STOCKS -- 2.0% (Cost \$10,179,446)                   |                             |
| CONVERTIBLE BONDS AND DEBENTURES                                     |                             |
| TECHNOLOGY -- 0.7%   |                             |
| BEA Systems, Inc. -- 4% 2006   | \$ 2,000,000                |
| LSI Logic Corporation -- 4% 2006                                     | 2,000,000                   |
| PRODUCER DURABLE GOODS -- 0.1%                                       |                             |
| Checkpoint Systems, Inc. -- 5.25% 2005                               | \$ 781,000                  |
| TOTAL CONVERTIBLE BONDS<br>AND DEBENTURES -- 0.8% (Cost \$4,355,460) |                             |

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| NON-CONVERTIBLE BONDS AND DEBENTURES                                     | FACE<br>AMOUNT |
|--|----------------|
| -----  |                |
| CORPORATE -- 6.8%  |                |
| Actuant Corporation -- 13% 2009  | \$ 2,275,000   |
| Avaya Inc. -- 11.125% 2009   | 1,300,000      |
| Central Garden & Pet Company -- 9.125% 2013                              | 2,000,000      |
| Host Marriott Corporation -- 9.25% 2007                                  | 2,000,000      |
| Lear Corporation -- 7.96% 2005   | 2,000,000      |
| Manitowoc Company, Inc., The -- 10.5% 2012                               | 2,000,000      |
| Metaldyne Corporation -- 11% 2012  | 2,000,000      |
| OM Group, Inc. -- 9.25% 2011   | 4,000,000      |
| Orbital Sciences Corporation -- 9% 2011                                  | 3,000,000      |
| PolyOne Corporation -- 10.625% 2010                                      | 950,000        |
| Realty Income Corporation -- 8.25% 2008                                  | 2,000,000      |
| SpectraSite, Inc. -- 8.25% 2010  | 2,000,000      |
| Unisys Corporation   |                |
| -- 7.875% 2008   | 1,500,000      |
| -- 8.125% 2006   | 2,000,000      |
| Vicar Operating Inc. -- 9.875% 2009                                      | 3,000,000      |
| Windmere Durable Holdings Inc. -- 10% 2008                               | 3,000,000      |
| <br>   |                |
| U.S. GOVERNMENT AND AGENCIES -- 0.2%                                     |                |
| Federal Home Loan Mortgage Corporation                                   |                |
| -- 6.5% 2023 (Interest Only)   | \$ 120,413     |
| -- 10.15% 2006 (REMIC)   | 1,044          |
| Federal National Mortgage Association -- 6% 2029 (Interest Only)         | 2,225,432      |
| Government National Mortgage Association (Mobile Home)                   |                |
| -- 9.75% 2010  | 417,951        |
| <br>   |                |
| TOTAL NON-COVERTIBLE BONDS<br>AND DEBENTURES -- 7.0% (Cost \$37,083,020) |                |
| <br>   |                |
| TOTAL INVESTMENT SECURITIES -- 95.8% (Cost \$340,418,117)                |                |
| <br>   |                |
| SHORT TERM INVESTMENTS   |                |
| Short-term Corporate Notes:  |                |
| General Electric Capital Corporation                                     |                |
| -- 1.30% 7/1/04  | \$ 8,623,000   |
| General Electric Capital Services, Inc.                                  |                |
| -- 1.22% 7/20/04   | 15,000,000     |
| <br>   |                |
| TOTAL SHORT-TERM INVESTMENTS -- 4.3% (Cost \$23,613,342)                 |                |
| <br>   |                |
| TOTAL INVESTMENTS -- 100.1% (Cost \$364,031,459)                         |                |
| Other assets and liabilities, net -- (0.1%)                              |                |
| <br>   |                |
| TOTAL NET ASSETS -- 100%   |                |

\* Non-income producing securities

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See notes to financial statements.

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## MAJOR PORTFOLIO CHANGES Quarter Ended June 30, 2004

|  | SHARES OR<br>FACE AMOUNT<br>----- |
|--|-----------------------------------|
| <b>NET PURCHASES</b>                     |                                   |
| <b>COMMON STOCKS</b>                     |                                   |
| Bio-Rad Laboratories, Inc.               | 55,000 s                          |
| CarMax, Inc.                             | 180,000 s                         |
| Arthur J. Gallagher & Co.(1)             | 215,000 s                         |
| Health Management Associates, Inc.       | 101,300 s                         |
| North Fork Bancorporation, Inc.          | 70,000 s                          |
| Oshkosh Truck Corporation(1)             | 110,500 s                         |
| SanDisk Corporation                      | 140,000 s                         |
| <b>CONVERTIBLE SECURITY</b>              |                                   |
| BEA Systems, Inc. -- 4% 2006(1)          | \$ 2,000,000                      |
| <b>NON-CONVERTIBLE SECURITIES</b>        |                                   |
| Orbital Sciences Corporation -- 9% 2011  | \$ 2,000,000                      |
| PolyOne Corporation -- 10.625% 2010(1)   | \$ 950,000                        |
| SpectraSite, Inc. -- 8.25% 2010(1)       | \$ 2,000,000                      |
| <b>NET SALES</b>                         |                                   |
| <b>COMMON STOCKS</b>                     |                                   |
| Checkpoint Systems, Inc.                 | 40,000 s                          |
| National Commerce Financial Corporation  | 130,000 s                         |
| Ocular Sciences, Inc.                    | 310,000 s                         |
| Zebra Technologies Corporation (Class A) | 24,000 s                          |
| <b>CONVERTIBLE SECURITY</b>              |                                   |
| IVAX Corporation -- 5.5% 2007(2)         | \$ 3,000,000                      |

(1) Indicates new commitment to portfolio

(2) Indicates elimination from portfolio

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## STATEMENT OF ASSETS AND LIABILITIES

### ASSETS

Investments at value:

Investment securities -- at market value

JUNE 30, 2004  
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|  |                |
|--|----------------|
| (cost \$340,418,117) -- Note A   | \$ 529,009,800 |
| Short-term investments -- at cost plus interest earned<br>(maturities 60 days or less) -- Note A                                     | 23,613,342     |
|  | -----          |
| Cash   |                |
| Receivable for:  |                |
| Investment securities sold   | \$ 3,541,553   |
| Accrued interest and dividends   | 874,007        |
|  | -----          |
| <b>LIABILITIES</b>   |                |
| Payable for:   |                |
| Investment securities purchased  | \$ 4,300,510   |
| Advisory fees  | 317,034        |
| Accrued dividends -- Preferred Stock   | 196,921        |
| Accrued expenses   | 53,314         |
|  | -----          |
| <b>TOTAL NET ASSETS -- June 30, 2004</b>   |                |
| Assets applicable to Preferred Stock at a liquidation preference of<br>\$27.50 per share (asset coverage 1,020%) -- Note B           |                |
| Net assets applicable to Common Stock -- \$60.01 per share   |                |
| <b>SUMMARY OF SHAREHOLDERS' EQUITY</b>   |                |
| \$2.40 Cumulative Preferred Stock -- par value \$3 per share;<br>authorized 3,000,000 shares; outstanding 1,969,212 shares -- Note B |                |
| Common Stock -- par value \$1 per share; authorized 12,000,000 shares;<br>outstanding 8,299,387 shares -- Note B                     |                |
| Additional Paid-in Capital   |                |
| Undistributed net realized gain on investments   |                |
| Unrealized appreciation of investments   |                |
| <b>TOTAL NET ASSETS -- June 30, 2004</b>   |                |

See notes to financial statements.

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### STATEMENT OF OPERATIONS For the six months ended June 30, 2004

|                                  |              |
|----------------------------------|--------------|
| <b>INVESTMENT INCOME</b>         |              |
| Income:                          |              |
| Interest                         |              |
| Dividends                        |              |
| Expenses -- Note C:              |              |
| Advisory fees                    | \$ 1,850,237 |
| Transfer agent fees and expenses | 169,352      |
| Reports to shareholders          | 111,822      |
| Registration and filing fees     | 53,451       |
| Directors' fees and expenses     | 50,121       |

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|                                      |        |
|--------------------------------------|--------|
| Taxes, other than federal income tax | 38,300 |
| Legal and auditing fees              | 27,704 |
| Insurance                            | 26,506 |
| Custodian fees and expenses          | 25,937 |
| Other expenses                       | 10,260 |

Net investment income -- Note A

REALIZED AND UNREALIZED GAIN ON INVESTMENTS

Realized gain on investments:

|  |               |
|--|---------------|
| Proceeds from sale of investment securities<br>(Excluding short-term investments with maturities of 60 days or less) | \$ 51,206,976 |
| Cost of investment securities sold   | 35,466,668    |

Net realized gain on investments -- Notes A and D

Unrealized appreciation of investments:

|  |                |
|--|----------------|
| Unrealized appreciation at beginning of period | \$ 159,709,723 |
| Unrealized appreciation at end of period       | 188,591,683    |

Increase in unrealized appreciation of investments

Net realized and unrealized gain on investments

NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS

See notes to financial statements.

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STATEMENT OF CHANGES IN TOTAL NET ASSETS

|   | FOR THE SIX MONTHS ENDED<br>JUNE 30, 2004 |               |
|---|---|---------------|
| INCREASE IN TOTAL NET ASSETS  |   |               |
| Operations:   |   |               |
| Net investment income   | \$ 2,099,774                              | \$ 3,         |
| Net realized gain on investments --<br>Notes A and D                                  | 15,740,308                                | 35,           |
| Increase in unrealized<br>appreciation of investments                                 | 28,881,960                                | 115,          |
| Increase in total net assets resulting from<br>operations                             |   | \$ 46,722,042 |
| Distributions to Preferred shareholders:  |   |               |
| From net investment income  | \$ (2,099,774)                            | \$ (4,        |
| From net realized capital gains   | (263,280)                                 | (2,363,054)   |
| Distributions to Common shareholders from net realized<br>capital gains -- Note A     |   | (16,523,005)  |
| Proceeds from shares issued for distributions<br>reinvested by shareholders -- Note B |   | 3,087,002     |

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|                              |                |
|------------------------------|----------------|
| Increase in total net assets | \$ 30,922,985  |
| TOTAL NET ASSETS             |                |
| Beginning of period          | 521,248,726    |
| End of period                | \$ 552,171,711 |

See notes to financial statements.

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FINANCIAL HIGHLIGHTS

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

|   | Six<br>months<br>ended<br>June 30,<br>2004 | -----<br>2003<br>----- | -----<br>2002<br>----- | -----<br>2001<br>----- |
|---|--|------------------------|------------------------|------------------------|
| <b>PER SHARE OPERATING PERFORMANCE:</b>                                 |  |                        |                        |                        |
| Net asset value at beginning of period                                  | \$ 56.62                                   | \$ 41.90               | \$ 55.45               | \$                     |
| Income from investment operations:                                      |  |                        |                        |                        |
| Net investment income   | \$ 0.25                                    | \$ 0.41                | \$ 0.49                | \$                     |
| Net realized and unrealized gain (loss)<br>on investment securities     | 5.40                                       | 18.36                  | (8.97)                 |                        |
| Total from investment operations  | \$ 5.65                                    | \$ 18.77               | \$ (8.48)              | \$                     |
| Distributions to Preferred shareholders:                                |  |                        |                        |                        |
| From net investment income  | \$ (0.26)                                  | \$ (0.51)              | \$ (0.49)              | \$                     |
| From net realized gains   | (0.03)                                     | (0.06)                 | (0.10)                 |                        |
| Distributions to Common shareholders:                                   |  |                        |                        |                        |
| From net investment income  | --   | --                     | --                     |                        |
| From net realized gains   | (2.00)                                     | (3.50)                 | (4.60)                 |                        |
| Total distributions   | \$ (2.29)                                  | \$ (4.07)              | \$ (5.19)              | \$                     |
| Effect of shares issued for distributions<br>reinvested by shareholders | \$ 0.03                                    | \$ 0.02                | \$ 0.12                | \$                     |
| Net asset value at end of period  | \$ 60.01                                   | \$ 56.62               | \$ 41.90               | \$                     |
| Per share market price at end of period                                 | \$ 65.02                                   | \$ 59.38               | \$ 52.85               | \$                     |
| Total investment return(1)  | 13.1%                                      | 20.6%                  | (6.2)%                 |                        |
| Net asset value total return(2)   | 9.7%                                       | 45.7%                  | (17.1)%                |                        |

SUPPLEMENTAL DATA:

Total net assets at end of period

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|  |    |            |    |           |    |           |    |
|--|----|------------|----|-----------|----|-----------|----|
| (in thousands)   | \$ | 552,172    | \$ | 521,249   | \$ | 395,176   | \$ |
| Ratios based on average net assets applicable to Common Stock: |    |            |    |           |    |           |    |
| Expenses   |    | 0.98% (3)  |    | 0.99%     |    | 0.99%     |    |
| Net income   |    | 0.87% (3)  |    | 0.85%     |    | 0.99%     |    |
| Ratios based on average total net assets:                      |    |            |    |           |    |           |    |
| Expenses   |    | 0.88% (3)  |    | 0.87%     |    | 0.87%     |    |
| Net income   |    | 0.78% (3)  |    | 0.75%     |    | 0.87%     |    |
| Portfolio turnover rate  |    | 20.50% (3) |    | 18.43%    |    | 16.62%    |    |
| <b>PREFERRED STOCK:</b>  |    |            |    |           |    |           |    |
| Total shares outstanding (4)                                   |    | 1,969,212  |    | 1,969,212 |    | 1,969,212 | 1, |
| Asset coverage per share (4)                                   | \$ | 280.40     | \$ | 264.70    | \$ | 200.68    | \$ |
| Involuntary liquidation preference per share                   | \$ | 27.50      | \$ | 27.50     | \$ | 27.50     | \$ |
| Average market price per share (5)                             | \$ | 33.54      | \$ | 31.87     | \$ | 31.15     | \$ |

(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) Annualized

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

(5) The average of all month-end market prices during each period

See notes to financial statements.

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### NOTES TO FINANCIAL STATEMENTS

June 30, 2004

#### NOTE A--SIGNIFICANT ACCOUNTING POLICIES

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 investments with maturities of 60 days or less are valued at cost plus interest earned, which approximates market value. Restricted securities and 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. **FEDERAL INCOME TAX**--No provision for federal taxes is considered necessary because the Company has elected to be taxed as a "regulated investment

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company" under the Internal Revenue Code and intends to maintain this qualification and to distribute each year all of its taxable net investment income and taxable net realized gain on investments to its shareholders in accordance with the minimum distribution requirements of the Code.

3. 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.

4. OTHER--Securities transactions are accounted for on the date 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 distribution allocation at June 30, 2004, is preliminary and may be revised based on operating results for the entire year. The ratios of expenses and net income to average net assets do not reflect the effect of 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. At June 30, 2004, the asset coverage of the Preferred Stock was 1,020%.

The Company issued 50,188 shares of Common Stock under its Reinvestment Plan for Common and Preferred shareholders during the six months ended June 30, 2004.

### 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 six months ended June 30, 2004, the Company paid aggregate fees of \$50,000 to all Directors who are not affiliated persons of the Investment Adviser. During the six months ended June 30, 2004, the Company incurred legal fees of \$1,704 payable to O'Melveny & Myers LLP, counsel for the Company. A Director of the Company is a retired partner and a retired of counsel employee of that firm. The Officers of the Company are also officers of the Investment Adviser.

### NOTE D--PURCHASES AND SALES OF SECURITIES

Cost of purchases of investment securities (excluding short-term corporate notes with maturities of 60 days or less) aggregated \$58,167,302 for the six months ended June 30, 2004. Cost of investment securities owned at June 30, 2004, was the same for federal income tax and financial reporting purposes. Gains and losses are based on the specific certificate identification method.

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Gross unrealized appreciation and depreciation for all investments at June 30, 2004, for federal income tax purposes was \$203,193,860 and \$14,602,177, respectively.

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### DIRECTORS AND OFFICERS

| NAME, AGE &<br>ADDRESS<br>-----   | POSITION(S)<br>WITH COMPANY<br>-----                      | TERM OF OFFICE AND<br>LENGTH OF<br>TIME SERVED<br>----- | PRINCIPAL OCCUPATION(S)<br>DURING THE PAST 5 YEAR<br>-----  |
|---|---|---|---|
| Willard H. Altman, Jr. - (68)*<br>11400 W. Olympic Blvd.<br>Los Angeles, CA 90064 | Director  | Term: 1 Year<br>Time Served: 6 Years                    | Retired. Formerly, until 1995, Partner of Ernst & Young LLP, a public accounting firm.  |
| Wesley E. Bellwood - (80)*<br>11400 W. Olympic Blvd.<br>Los Angeles, CA 90064     | Director  | Term: 1 Year<br>Time Served: 24 Years                   | Retired. Formerly, until 1999, Chairman Emeritus director of Wynn's International, Inc.   |
| David Rees - (80)*<br>11400 W. Olympic Blvd.<br>Los Angeles, CA 90064             | Director  | Term: 1 Year<br>Time Served: 36 Years                   | Private investor. Former President and Chief Executive Officer of the International Institute Los Angeles. Formerly, until 1995, the Senior Editor of Los Angeles Business Journal. |
| Paul G. Schloemer - (76)*<br>11400 W. Olympic Blvd.<br>Los Angeles, CA 90064      | Director  | Term: 1 Year<br>Time Served: 5 Years                    | Retired. Formerly President and Chief Executive Officer (1984-1993) of Parker Hannifin Corporation.   |
| Lawrence J. Sheehan - (72)<br>11400 W. Olympic Blvd.<br>Los Angeles, CA 90064     | Director  | Term: 1 Year<br>Time Served: 13 Years                   | Retired. Formerly partner (1969 to 1994) and of counsel employee (1994 to 2002) of the firm of O'Melveny & Myers LLP, legal counsel to the Company.                                 |
| Eric S. Ende - (59)<br>11400 W. Olympic Blvd.<br>Los Angeles, CA 90064            | Director<br>President &<br>Chief<br>Investment<br>Officer | Term: 1 Year<br>Time Served: 4 Years                    | Senior Vice President of the Adviser.   |
| Steven R. Geist - (50)<br>11400 W. Olympic Blvd.<br>Los Angeles, CA 90064         | Senior Vice<br>President &<br>Fixed-Income<br>Manager     | Time Served: 8 Years                                    | Vice President of the Adviser.  |
| J. Richard Atwood - (44)  | Treasurer   | Time Served: 7 Years                                    | Principal and Chief   |



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11400 W. Olympic Blvd.  
Los Angeles, CA 90064

Operating Officer of the  
Adviser. President of  
FPA Fund Distributors,  
Inc.

Sherry Sasaki - (49)  
11400 W. Olympic Blvd.  
Los Angeles, CA 90064

Secretary

Time Served: 22 Years

Assistant Vice President  
and Secretary of the  
Adviser and Secretary of  
FPA Fund Distributors, I

Christopher H. Thomas - (47)  
11400 W. Olympic Blvd.  
Los Angeles, CA 90064

Assistant  
Treasurer

Time Served: 9 Years

Vice President and  
Controller of the Advise  
and of FPA Fund  
Distributors, Inc.

\* Audit committee member

RESULTS OF ANNUAL MEETING

Following is a list of matters voted upon and the results of those votes  
cast at the annual meeting of shareholders held May 3, 2004:

1. With respect to the election of four directors by the holders of Common  
Stock, \$1.00 par value, and election of two directors by the holders of  
\$2.40 Cumulative Preferred Stock, \$3.00 par value:

|                       | VOTES FOR<br>----- | VOTES W<br>----- |
|-----------------------|--------------------|------------------|
| COMMON                |                    |                  |
| Wesley E. Bellwood    | 6,840,953          |                  |
| Eric S. Ende          | 6,863,101          |                  |
| David Rees            | 6,850,637          |                  |
| Lawrence J. Sheehan   | 6,856,785          |                  |
| PREFERRED             |                    |                  |
| Willard H. Altman, Jr | 1,724,262          |                  |
| Paul G. Schloemer     | 1,723,530          |                  |

2. With respect to continuation of the Investment Advisory Agreement, a  
total of 8,480,473 shares voted for, 63,873 shares voted against, and  
127,558 shares abstained.

No broker non-votes were received with respect to any of the matters voted  
upon above.

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SOURCE CAPITAL, INC.

11400 West Olympic Boulevard, Suite 1200  
Los Angeles, California 90064-1550

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Item 2. Code of Ethics. N/A.

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- Item 3. Audit Committee Financial Expert. N/A.
- Item 4. Principal Accountant Fees and Services. N/A.
- Item 5. Audit Committee of Listed Registrants. N/A.
- Item 6. Schedule of Investments. N/A.
- Item 7. Disclosure of Proxy Voting Policies and Procedures for Closed-End Management Investment Companies. N/A.
- Item 8. Purchases of Equity Securities by Closed-End Management Investment Company and Affiliated Purchasers. N/A.
- Item 9. Submission of Matters to a Vote of Security Holders. There has been no material changes to the procedures by which shareholders may recommend nominees to the registrant's board of directors.
- Item 10. Controls and Procedures.
  - (a) The Principal Executive Officer and Principal Financial Officer of Source Capital, Inc. ("Company") have concluded that the Company'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 Fund's internal controls over financial reporting (as defined in Rule 30a-3(d) under the Investment Company Act) that occurred during the registrant's last fiscal half-year that has materially affected, or is reasonably likely to materially affect, the registrant's internal controls over financial reporting.
- Item 11. Exhibits.
  - (a) Code of ethics as applies to the registrant's officers and directors, as required to be disclosed under Item 2 of Form N-CSR. N/A.
  - (b) 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.

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, President

Date: September 3, 2004

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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: September 3, 2004