

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

Item 1. Report to Stockholders

SOURCE CAPITAL, INC.

2005

ANNUAL REPORT

for the year ended December 31

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 |
|---|-----------|---------------|
| BUSINESS SERVICES & SUPPLIES 15.7% | | |
| 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 |
| PRODUCER DURABLE GOODS 13.7% | | |
| 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 |
| ENERGY 12.5% | | |
| 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 |
| TECHNOLOGY 10.6% | | |
| 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 |
| FINANCIAL 9.2% | | |
| 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 |
| RETAILING 8.5% | | |
| CarMax, Inc.* | 750,006 | \$ 20,760,166 |
| O'Reilly Automotive, Inc.* | 1,000,000 | 32,010,000 |
| | | \$ 52,770,166 |
| HEALTHCARE 8.1% | | |
| 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 |
| ENTERTAINMENT 4.6% | | |

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

PORTFOLIO OF INVESTMENTS

December 31, 2005

| | Shares or Face Amount | Value |
|---|-----------------------------|----------------|
| PREFERRED STOCKS | | |
| REAL ESTATE INVESTMENT TRUST | | |
| 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 |
| TOTAL PREFERRED STOCKS 1.7% (Cost \$10,179,446) | | \$ 10,794,600 |
| CONVERTIBLE BONDS AND DEBENTURES | | |
| TECHNOLOGY 1.0% | | |
| 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 |
| BUSINESS SERVICES & SUPPLIES 0.3% | | |
| Pegasus Solutions, Inc. 3.875% 2023 | \$ 2,000,000 | \$ 1,920,000 |
| TOTAL CONVERTIBLE BONDS AND DEBENTURES 1.3% (Cost \$7,690,000) | | \$ 7,822,500 |
| NON-COVERTIBLE BONDS AND DEBENTURES | | |
| CORPORATE 3.8% | | |
| 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 |
| U.S. GOVERNMENT AND AGENCIES 0.0% | | |
| 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 |
| TOTAL NON-COVERTIBLE BONDS AND DEBENTURES 3.8% (Cost \$23,553,165) | | |
| TOTAL INVESTMENT SECURITIES 98.5% (Cost \$384,101,612) | | \$ 23,649,932 |
| SHORT TERM INVESTMENT 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 |
| TOTAL INVESTMENTS 100.0% (Cost \$393,028,568) | | \$ 619,725,688 |

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| | | |
|-----------------------------------|---------------|-----------------------|
| Other assets and liabilities, net | 0.0% | 247,343 |
| TOTAL NET ASSETS | 100.0% | \$ 619,973,031 |

* Non-income producing securities

See notes to financial statements.

PORTFOLIO SUMMARY

December 31, 2005

| | |
|---|---------------|
| Common Stocks | 91.7% |
| 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% |
| Preferred Stocks | 1.7% |
| Convertible Bonds and Debentures | 1.3% |
| Non-Convertible Bonds and Debentures | 3.8% |
| Short-Term Investments | 1.5% |
| Total Net Assets | 100.0% |

MAJOR PORTFOLIO CHANGES

Quarter Ended December 31, 2005
(Unaudited)

| | Shares |
|--|---------|
| NET PURCHASES | |
| Common Stocks | |
| 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 |
| NET SALES | |
| Common Stocks | |
| SanDisk Corporation | 210,000 |

FEDERAL INCOME TAX INFORMATION

Calendar 2005

Cash Dividends and Distributions:

| Date Paid | Amount Paid Per Share | (1) Ordinary Income Dividends | (2) Long-Term Capital Gain Distributions |
|-------------------------------|------------------------------|--------------------------------------|---|
| PREFERRED STOCK: | | | |
| 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 |
| TOTAL | \$ 2.40 | \$ 2.1548 | \$ 0.2452 |
| COMMON STOCK: | | | |
| 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 |
| TOTAL | \$ 5.47 | | \$ 5.4700 |

(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

| | | |
|--|----------------|----------------|
| ASSETS | | |
| 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 |
| LIABILITIES | | |
| Payable for: | | |
| Advisory fees | \$ 355,185 | |
| Accrued dividends Preferred Stock | 196,921 | |
| Accrued expenses | 57,113 | 609,219 |
| TOTAL NET ASSETS 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 |
| SUMMARY OF SHAREHOLDERS' EQUITY | | |
| \$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 |
| TOTAL NET ASSETS December 31, 2005 | | \$ 619,973,031 |

See notes to financial statements.

STATEMENT OF OPERATIONS

For the year ended December 31, 2005

| | | |
|--|----------------|----------------------|
| INVESTMENT INCOME | | |
| 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 |
| NET REALIZED AND UNREALIZED GAIN ON INVESTMENTS | | |
| 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 |
| NET INCREASE IN TOTAL NET ASSETS RESULTING FROM OPERATIONS | | |
| | | \$ 80,366,616 |

See notes to financial statements.

STATEMENT OF CHANGES IN TOTAL NET ASSETS

For the year ended December 31,

| | 2005 | | 2004 |
|--|----------------|--------------|----------------|
| INCREASE IN TOTAL NET ASSETS | | | |
| 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 |
| TOTAL NET ASSETS | | | |
| 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 |
| Common Stock: | | | | | |
| 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 | | |