Dear Shareholders:

Performance

During the fourth quarter of 2019, the net asset value per share of Source Capital, Inc. (the “Fund,” or the “Company”) increased 5.91% for the quarter and 20.89% for the calendar year (both percentages including the reinvestment of the distributions paid during the period). These changes compare with returns of 9.07% for the quarter and 31.49% for the calendar year for the S&P 500 Index, 0.18% for the quarter and 8.72% for the calendar year for the Bloomberg Barclays U.S. Aggregate Bond Index, and 5.46% for the quarter and 22.18% for the calendar year for the 60/40 blended S&P 500/Bloomberg Barclays U.S. Aggregate Bond benchmark during the same period.

Contributors to and detractors from the Fund’s trailing 12-month returns are listed in the following table.

<table>
<thead>
<tr>
<th>Contributors</th>
<th>Performance Contribution</th>
<th>Percent of Portfolio</th>
<th>Detractors</th>
<th>Performance Contribution</th>
<th>Percent of Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arconic</td>
<td>2.25%</td>
<td>4.1%</td>
<td>Baidu</td>
<td>-0.55%</td>
<td>1.3%</td>
</tr>
<tr>
<td>Charter Comm.</td>
<td>1.32%</td>
<td>2.4%</td>
<td>Mylan</td>
<td>-0.48%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Citigroup</td>
<td>1.31%</td>
<td>2.8%</td>
<td>PHI (combined)</td>
<td>-0.18%</td>
<td>0.4%</td>
</tr>
<tr>
<td>AIG</td>
<td>1.23%</td>
<td>4.0%</td>
<td>Glencore</td>
<td>-0.13%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Alphabet</td>
<td>1.21%</td>
<td>5.1%</td>
<td>McDermott (combined)</td>
<td>-0.10%</td>
<td>1.3%</td>
</tr>
<tr>
<td></td>
<td><strong>7.32%</strong></td>
<td><strong>18.4%</strong></td>
<td></td>
<td><strong>-1.44%</strong></td>
<td><strong>4.2%</strong></td>
</tr>
</tbody>
</table>

Equities

We continue to focus on companies that have at least a small breeze at their backs and avoid those businesses with wind in their faces. Over time, we generally expect the companies we own to sell an increasing number of units as well as have at least enough pricing power to offset cost inflation.

The Fund’s investment in the cable industry via Charter Communications (up approximately 70%) along with Comcast (up approximately 34%) were two notable contributors in 2019. We made these investments in mid-2018, when many investors were concerned that subscribers would cut the cord in favor of streaming and when wireless 5G threatened to damage these companies’ dominant broadband franchise. Our belief remains that while video will continue to shrink, video is less profitable on a cash basis than many believe it to be. Thus, we think broadband should remain vibrant, as it is likely to take many years and many billions of dollars before the potential impact of the competitive threats is known. The market has sidled over to our thinking on this, at least for the time being.

1 Reflects the top five contributors and detractors to the Fund’s performance based on contribution to return for the trailing twelve months (“TTM”). Contribution is presented gross of investment management fees, transactions costs, and Fund operating expenses, which if included, would reduce the returns presented. The information provided does not reflect all positions purchased, sold or recommended by FPA during the quarter. A copy of the methodology used and a list of every holding’s contribution to the overall Fund’s performance during the TTM is available by contacting FPA Client Service at crm@fpa.com. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities listed.

2 Percentage change reflects total return including the reinvestment of dividends and interest. The total return of the security may not equate with the performance of the holding in the Fund.

Past performance is no guarantee, nor is it indicative, of future results. Comparison to any index is for illustrative purposes only. The Fund does not include outperformance of any index or benchmark in its investment objectives. Please see end of Commentary for important disclosures and definitions.
American International Group’s (AIG) stock lost 32% in 2018, including dividends, negatively impacting the Fund’s performance in that year. In 2019, however, it delivered a total return of 34%. The company’s multi-year turnaround efforts are finally bearing fruit, and the market has begun to take notice. The Fund further benefited by increasing its stake to take advantage of price weakness in late 2018. If AIG’s return on capital continues to improve, as we expect, the company should trade at a similar price-to-tangible book value multiple as its peers. Were that to be the case, we can see its stock trading at $70 to $80 in the next couple of years, a healthy premium to its closing price of $51.33 at the end of 2019. As value investors, AIG is emblematic of so many of our investments that underperform on their way to outperforming.

The Fund’s two largest detractors for 2019 were Baidu (BIDU) and Mylan (MYL). BIDU has lost market share in the Chinese online advertising market, with particular weakness seen in key verticals including healthcare and online gaming. Lower than expected revenue, combined with increased investments in ventures that are expected to produce profits only over the long term, has resulted in a demonstrable decline in profitability and led to a severe sell-off of the shares, resulting in what we believe to be a very inexpensive valuation applied to its core search business.

MYL continues to face multiple headwinds including a challenging regulatory environment, pricing pressure on generic drugs in the U.S., and slower than expected regulatory approval of new products. We used the recent merger announcement between Mylan and the Upjohn division of Pfizer as an opportunity to trim into strength.

Fixed Income

In 2019 (and also in the past quarter), bonds of all sorts became more expensive. Chart 1 shows that yields on high-quality 2- to 4-year maturity bonds declined by 90 to 100 basis points (bps) during the year. Chart 2 shows that yields on high-yield bonds declined by over 275 basis points, ending the year at a not-so-high-yield of 5.2%! In the leveraged loan market, spreads compressed by nearly 80 basis points at one point before finishing the year approximately 30 basis points lower than where it started at the beginning of the year. What is an absolute value investor to do in a market like this? We wait and preserve capital for better investment opportunities.

3 FPA defines ‘high quality bonds’ as those rated single-A or higher.
Chart 1: High Quality Opportunity Set

Source: Bloomberg Barclays; Chart data covers the period 1/1/2019 through 12/31/2019.

Chart 2: Credit Opportunity Set

Source: High Yield data Bloomberg Barclays, Loan data Credit Suisse; Chart data covers the period 1/1/2019 through 12/31/2019.
Despite expensive credit markets, we periodically find investments that satisfy our absolute return criteria, though these investments are few and far between. These days, those investments are often tied to industries or businesses that are experiencing some degree of stress, either secular and/or business-specific. One example is the Fund’s investment in the first-in, last-out (“FILO”) term loan of Sears, formerly one of the largest retailers in the United States. This loan is secured by the working capital (accounts receivable and inventory) of Sears. The success of this investment is not predicated on the survival of Sears. Rather, we think that the liquidation value of the working capital is sufficient to cover the balance of the FILO loan. This is not a new position, but we did increase the Fund’s holdings during the fourth quarter. Another example is a new term loan we added during the fourth quarter to the Fund’s existing investments in PHI, Inc., an energy and health care-related helicopter transportation services company. This new term loan is secured by a first lien on the Company’s assets, including its fleet of owned helicopters. Based on the liquidation value of the Company’s assets, the loan has a loan-to-value of less than 30%.

We have recently been increasing the Fund’s exposure to private credit, both individual loans and co-mingled vehicles, and continue to see opportunity. These higher-yielding investments fit nicely in Source’s closed-end fund structure. We will have a more robust discussion of these opportunities in future commentaries.

Thank you for your continued trust and support.

Respectfully submitted,

Source Capital Portfolio Management Team
January 2020

Important Disclosures

This Commentary is for informational and discussion purposes only and does not constitute, and should not be construed as, an offer or solicitation for the purchase or sale with respect to any securities, products or services discussed, and neither does it provide investment advice. This Commentary does not constitute an investment management agreement or offering circular.

On December 1, 2015, a new portfolio management team assumed management of the Fund and the Fund transitioned to a balanced strategy. Performance prior to December 1, 2015 reflects the performance of the prior portfolio manager and investment strategy and is not indicative of performance for any subsequent periods.

Current performance information is updated monthly and is available by calling 1-800-982-4372 or by visiting www.fpa.com. Performance data quoted represents past performance, which is no guarantee of future results. Current performance may vary from the performance quoted. The returns shown for Source Capital are calculated at net asset value per share, including reinvestment of all distributions. Returns do not reflect the deduction of taxes that a shareholder would pay on Fund distributions, which would lower these figures. Since Source Capital is a closed-end investment company and its shares are bought and sold on the New York Stock Exchange, your performance may also vary based upon the market price of the common stock.

The Fund is managed according to its investment strategy which may differ significantly in terms of security holdings, industry weightings, and asset allocation from those of the indices noted. Overall Fund performance, characteristics and volatility may differ from the benchmark(s) shown.

There is no guarantee the Fund’s investment objectives will be achieved. You should consider the Fund’s investment objectives, risks, and charges and expenses carefully before you invest. You can obtain additional information by visiting the website at www.fpa.com, by email at crm@fpa.com, toll free by calling 1-800-279-1241 (option 1), or by contacting the Fund in writing.
The views expressed herein and any forward-looking statements are as of the date of this publication and are those of the portfolio management team. Future events or results may vary significantly from those expressed and are subject to change at any time in response to changing circumstances and industry developments. This information and data has been prepared from sources believed reliable, but the accuracy and completeness of the information cannot be guaranteed and is not a complete summary or statement of all available data.

Portfolio composition will change due to ongoing management of the Fund. References to individual securities are for informational purposes only and should not be construed as recommendations by the Fund, FPA, or the portfolio managers. It should not be assumed that future investments will be profitable or will equal the performance of the security examples discussed. Please visit our website, https://fpa.com/funds/portfolio-characteristics/source-capital, for a complete list of portfolio holdings.

Investing in closed-end funds involves risk, including loss of principal. Closed-end fund shares may frequently trade at a discount or premium to their net asset value. Capital markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. It is important to remember that there are risks inherent in any investment and there is no assurance that any investment or asset class will provide positive performance over time.

The Fund may purchase foreign securities, including American Depository Receipts (ADRs) and other depository receipts, which are subject to interest rate, currency exchange rate, economic and political risks; these risks may be heightened when investing in emerging markets. Non-U.S. investing presents additional risks, such as the potential for adverse political, currency, economic, social or regulatory developments in a country, including lack of liquidity, excessive taxation, and differing legal and accounting standards. Non-U.S. securities, including American Depository Receipts (ADRs) and other depository receipts, are also subject to interest rate and currency exchange rate risks.

The return of principal in a fund that invests in fixed income securities is not guaranteed. The Fund’s investments in fixed income securities have the same issuer, interest rate, inflation and credit risks that are associated with underlying bonds owned by the Fund. Lower rated bonds, convertible securities and other types of debt obligations involve greater risks than higher rated bonds.

When interest rates go up, the value of fixed income securities, such as bonds, typically go down and investors may lose principal value. Credit risk is the risk of loss of principle due to the issuer’s failure to repay a loan. Generally, the lower the quality rating of a security, the greater the risk that the issuer will fail to pay interest fully and return principal in a timely manner. If an issuer defaults, the security may lose some or all its value.

Mortgage securities and collateralized mortgage obligations (CMOs) are subject to prepayment risk and the risk of default on the underlying mortgages or other assets; such derivatives may increase volatility. Convertible securities are generally not investment grade and are subject to greater credit risk than higher-rated investments. High yield securities can be volatile and subject to much higher instances of default. The Fund may experience increased costs, losses and delays in liquidating underlying securities should the seller of a repurchase agreement declare bankruptcy or default.

The ratings agencies that provide ratings are Standard and Poor’s, Moody’s, and Fitch. Credit ratings range from AAA (highest) to D (lowest). Bonds rated BBB or above are considered investment grade. Credit ratings of BB and below are lower-rated securities (junk bonds). High-yielding, non-investment grade bonds (junk bonds) involve higher risks than investment grade bonds. Bonds with credit ratings of CCC or below have high default risk.

Value style investing presents the risk that the holdings or securities may never reach their full market value because the market fails to recognize what the portfolio management team considers the true business value or because the portfolio management team has misjudged those values. In addition, value style investing may fall out of favor and underperform growth or other styles of investing during given periods.
Index Definitions

Comparison to any index is for illustrative purposes only and should not be relied upon as a fully accurate measure of comparison. The Fund will be less diversified than the indices noted herein, and may hold non-index securities or securities that are not comparable to those contained in an index. Indices will hold positions that are not within the Fund’s investment strategy. Indices are unmanaged and do not reflect any commissions or fees which would be incurred by an investor purchasing the underlying securities. An investor cannot invest directly in an index. The Fund does not include outperformance of any index or benchmark in its investment objectives.

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

The Bloomberg Barclays U.S. Aggregate Bond Index provides a measure of the performance of the U.S. investment grade bonds market, which includes investment grade U.S. Government bonds, investment grade corporate bonds, mortgage pass-through securities and asset-backed securities that are publicly offered for sale in the United States. The securities in the Index must have at least 1-year remaining in maturity. In addition, the securities must be denominated in U.S. dollars and must be fixed rate, nonconvertible, and taxable.

60% S&P 500/40% Bloomberg Barclays U.S. Aggregate Bond Index is a hypothetical combination of unmanaged indices comprised of 60% S&P 500 Index and 40% Bloomberg Barclays U.S. Aggregate Bond Index, representing the Fund’s neutral mix of 60% stocks and 40% bonds.

You can obtain additional information by visiting the website at www.fpa.com, by email at crm@fpa.com, toll free by calling 1-800-279-1241 (option 1), or by contacting the Fund in writing.