

SOURCE CAPITAL INC /DE/
Form N-CSR
March 03, 2015

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)

11601 WILSHIRE BLVD., SUITE 1200, LOS ANGELES, CALIFORNIA
(Address of principal executive offices)

90025
(Zip code)

J. RICHARD ATWOOD,

11601 WILSHIRE BLVD., SUITE 1200, LOS ANGELES, CALIFORNIA 90025
(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,
2014

Item 1. Report to Stockholders

SOURCE CAPITAL, INC.

2014

ANNUAL REPORT

for the year ended December 31

SOURCE CAPITAL, INC.
SUMMARY FINANCIAL INFORMATION

	For the year ended December 31,			
	2014	Per	2013	Per
	Total Net Assets	Common Share	Total Net Assets	Common Share
Beginning of year	\$639,974,092	\$ 73.94	\$511,150,166	\$ 59.06
Net realized and unrealized gain on investments	\$ 91,376,630	\$ 10.56	\$153,710,062	\$ 17.76
Net investment income	1,239,865	0.14	1,079,584	0.12
Distributions to Common shareholders	(36,352,008)	(4.20)	(25,965,720)	(3.00)
Net changes during year	\$ 56,264,487	\$ 6.50	\$128,823,926	\$ 14.88
End of year	\$696,238,579	\$ 80.44	\$639,974,092	\$ 73.94
Common market price per share	\$ 72.13		\$ 67.10	
Common market discount from net asset value	10.33%		9.14%	

DESCRIPTION OF THE COMPANY

Source Capital, Inc. is a diversified, publicly traded investment company. Its investment portfolio includes a wide range of securities with primary emphasis on common stock.

Source Capital's Common Stock is listed and traded on the New York Stock Exchange, and there are currently 8,655,240 shares 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.

Source Capital is not a mutual fund. Thus, the Company 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 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 investments in seeking to achieve its growth objective for its Common shareholders. The desirability of equity in contrast with fixed-income investments has been increasingly debated in recent years. Source Capital's position is that without assuming undue risk, 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 are 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 is 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.

SOURCE CAPITAL, INC.
LETTER TO SHAREHOLDERS

TO OUR SHAREHOLDERS:**2014 Investment Portfolio Returns**

Total net assets of Source Capital amounted to \$696,238,579 at December 31, 2014, or \$80.44 of net asset value per Common share. This compared with Common equity of \$639,974,092, and net asset value per Common share of \$73.94 one year ago. These changes reflect payments to shareholders totaling \$36,352,008. Source Capital recorded a positive total investment return during 2014 of 14.9% on its Common net asset value, reflecting the reinvestment of dividends and distributions.

Distributions to Common Shareholders

Source Capital's flexible distribution policy allows the Board of Directors to consider changes in net asset value when establishing the quarterly distribution rate. But this policy also provides for the flexibility to consider such other factors 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, but not in excess of cumulative earnings.

A quarterly distribution on the Common shares of \$1.80 per share was paid on December 15, 2014, to shareholders of record on November 21, 2014. This distribution, comprised of the regular quarterly distribution of \$0.80 per share plus a special distribution of \$1.00 per share (for a total of \$1.80 per share), was paid as a result of substantial capital gains realized during the year.

On February 9, 2015, the Board of Directors voted to increase the current distribution rate by \$0.05 a Common share and declared a regular quarterly distribution of \$0.85 a Common share, payable March 15, 2015. Consistent with Source Capital's flexible distribution policy, this increase primarily reflects the rise in net asset value for the year ended December 31, 2014.

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.

The following table presents 2014 market return for Common shareholders:

Change in Market Value:		
NYSE Closing Price		
12/31/2014		\$ 72.13
NYSE Closing Price		
12/31/2013		67.10
Net change in 2014		\$ 5.03
Distributions in 2014		4.20
Total return Amount		\$ 9.23
Total return Percent		13.8%

Common shareholders who participated in the Company's Automatic Reinvestment Plan experienced a positive return of 14.2% during 2014. On a long-term basis, those shareholders who participated in the Automatic Reinvestment Plan during each of the 38 years since its inception experienced a positive annual compound rate of return of 14.9%.

Commentary

Performance

As shown on the following table, Source's portfolio was up about 12% during the fourth quarter, well above to the benchmarks, and also demonstrating excellent long-term results as can be seen in the following table.

Periods Ended December 31, 2014

Fund/Index	QTR	1 Year	3 Years**	5 Years**	10 Years**	15 Years**	20 Years**
Source Capital (NAV)	12.33%	14.93%	20.23%	15.72%	8.72%	10.63%	12.70%
Russell 2500	6.77%	7.07%	19.97%	16.36%	8.72%	8.59%	11.21%
S&P 500	4.93%	13.69%	20.41%	15.45%	7.67%	4.24%	9.85%
NASDAQ	5.70%	14.75%	23.60%	17.19%	9.15%	1.80%	N/A

** Annualized.

Ranking individual portfolio positions by performance contribution, the top five were as follows:

	Positive Contribution
CarMax	2.9%
O'Reilly	2.6%
HNI	1.5%
Signet	1.3%
Knight	1.2%
	9.5%

The bottom five contributors were:

	Negative Contribution
FMC	(0.5)%
Noble	(0.4)%
Maxim	(0.3)%
Microchip	(0.2)%
Aggreko	(0.1)%
	(1.5)%

Overall, the best performers were retailers. The worst were found in oil and gas and technology.

The table below shows Source's returns over the last five years.

Fund/Index	2010	2011	2012	2013	2014
Source Capital (NAV)	30.75%	-6.04%	15.55%	30.87%	14.93%
Russell 2500	26.70%	-2.50%	17.88%	36.80%	7.07%
S&P 500	15.06%	2.11%	16.00%	32.39%	13.69%

While we have no way to predict future performance, we would suggest that returns of a similar magnitude over the next five years are unlikely.

One of the tactics we try to employ in managing the Company's portfolio is minimizing shareholder tax liability. A benefit of our long-term holding periods is that it keeps as much as possible of our shareholders capital working for them with no premature "sharing" with federal and state income tax collectors.

Portfolio company managements need to be closely monitored, because from time to time they take actions with which we disagree. For example, last year Zebra Technologies management announced some major changes to its business, which would, in our opinion, undermine its balance sheet, negatively transform its business model, and force management to operate parts of the business in which they lacked experience.

We felt the risk for Zebra shareholders was changing and not in a favorable direction. We met with management and made our views known, but to no avail.

When this decline in the fundamentals of the business was combined with a volatile stock price we seized on the opportunity to sell out our entire position. While not the ideal outcome, we felt it was a lot better than potential alternatives under their new model.

We'd like to comment this quarter on **Nordson**, a company in the portfolio for the past year, and which now sits at about a 2% holding. Nordson manufactures and markets products and systems used for dispensing adhesives, coatings and sealants. Markets served include consumer packaging, non-wovens, electronics, medical, appliances, energy, transportation and construction.

It is most useful to look at Nordson through the windows of its three global operating segments. First and most important is adhesives, characterized by high margins, attractive growth, and a strong competitive position. Typical applications are non-wovens for products like baby diapers and adult incontinence, sold to companies like Kimberly-Clark and Proctor & Gamble. Segment operating margin is about 25%

The next important segment in Nordson's business model is technology, driven by advances in circuit board design as well as inspection and test. As might be expected, these markets are dynamic, often rapidly growing, and include electronics, medical, and diverse industrial markets

Operating margin in this advanced technology segment has been improving and is now between 20 and 25%.

Finally, Nordson has an industrial coating segment. This is the application of paint and other coatings, mostly in a factory environment. Most significant markets and applications include appliances, lawn and garden, wood working and construction. Operating margins in this segment are at best an unexciting 15%.

It is notable that segment profitability varies a good deal and what is only a decent return at coatings (about 15%), is vastly improved at the other two segments (close to 25%). Other of the more dynamic aspects of the business which also need to be noted.

- Sales growth has been steady in the more attractive segments.
- Overall company operating margins have nearly doubled over the past ten years.
- Coatings represent only about 15% of total sales, and are a declining percent.

- Merger and acquisition capital has been directed toward the more attractive segments. The plan is that improved profitability at existing operations and judicious reinvestment of cash flows should yield a steady improvement of rates of return throughout the business.

It might be of some value to compare Nordson to another similar portfolio company, owned for a longer period, specifically **Graco**.

- Graco was first purchased for the Source portfolio in 1996 and held continuously to the present.
- Its most important business segment is industrial coatings, where it typically earns operating margins of 30-35%, compared to 15% at Nordson.
- Graco's business model currently overlaps Nordson's in several respects.
- Another key Graco business is selling paint sprayers to painting contractors, mostly through retailers like Home Depot and Sherwin-Williams. This business is economically sensitive, but does earn attractive margins and is showing good growth in Europe and Asia, as the merits of spray vs roller and brush are gradually better understood.
- Both companies have strong historical M & A performance and have deployed cash flow resources judiciously.

Nordson and Graco

Three different though similar business lines

Overall excellent margins

Barriers to entry

Re-investment opportunities

Long track records

We are pleased to receive reader feedback to shareholder letters at the email address, source@fpafunds.com.

Thank you for your continued support and trust.

Eric S. Ende

President and
Chief Investment Officer

February 9, 2015

SOURCE CAPITAL, INC.

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 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 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 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.

**SOURCE CAPITAL, INC.
PORTFOLIO SUMMARY**

December 31, 2014
(Unaudited)

Common Stocks	97.0%
Retailing	31.8%
Producer Durable Goods	23.9%
Business Services & Supplies	17.6%
Transportation	9.6%
Healthcare	5.6%