SOURCE CAPITAL INC /DE/
Form N-CSR
February 17, 2012

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) | (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 end: DECEMBER 31

Date of reporting period: DECEMBER 31, 2011

Item 1. Report to Stockholders

SOURCE CAPITAL, INC.

2011

ANNUAL REPORT

for the year ended December 31

SUMMARY FINANCIAL INFORMATION

	For the year ended December 31,			
	2011		2010	
	Total Net Assets	Per Common Share	Total Net Assets	Per Common Share
Beginning of year	$ 577,534,615	$ 60.47	$ 490,042,573	$ 50.36
Net realized and unrealized gain on investments	$ (24,569,211)	$ (2.84)	$ 108,827,915	$ 12.58
Net investment income	1,900,091	0.22	4,162,812	0.48
Distributions to Preferred shareholders	(4,726,109)	(0.55)	(4,726,109)	(0.55)
Distributions to Common shareholders	(25,965,720)	(3.00)	(20,772,576)	(2.40)
Net changes during year	$ (53,360,949)	$ (6.17)	$ 87,492,042	$ 10.11
End of year	$ 524,173,666	$ 54.30	$ 577,534,615	$ 60.47
Common market price per share	$ 46.98		$ 53.20	
Common market discount from net asset value	13.5%		12.0%	
Preferred asset coverage	968%		1,066%	
Preferred liquidation preference per share	$ 27.50		$ 27.50	
Preferred market price per share	$ 34.71		$ 34.53	

DESCRIPTION OF THE COMPANY

Source Capital, Inc., is a major diversified, publicly traded investment company with total net assets of approximately $524,000,000. Its investment portfolio includes a wide range of securities with primary emphasis on common stock.

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 remainder of the Company's assets and income are available to the 8,655,240 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, 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 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 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 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.

LETTER TO SHAREHOLDERS

TO OUR SHAREHOLDERS:

2011 Investment Portfolio Returns

Total net assets of Source Capital amounted to $524,173,666 at December 31, 2011. After providing for Preferred Stock equity, Common equity amounted to $470,020,336 or $54.30 of net asset value per Common share. This compared with total net assets of $577,534,615, Common equity of $523,381,285, and net asset value per Common share of $60.47 one year ago. These changes reflect payments to Common and Preferred shareholders totaling $30,691,829. Source Capital recorded a negative total investment return during 2011 of 5.2% 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.

The regular quarterly distribution on the Common shares of $0.75 per share was paid on December 15, 2011, to shareholders of record on November 25, 2011.

On February 6, 2012, the Board of Directors voted to reduce the current distribution rate by $0.05 a Common share and declared a regular quarterly distribution of $0.70 a Common share, payable March 15, 2012. Consistent with Source Capital's flexible distribution policy, this reduction primarily reflects the decline in net asset value for the year ended December 31, 2011, as well as our current assessment of, and expectations for, the market in 2012.

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 2011 market returns for both Common and Preferred shareholders:

	Common Stock	Preferred Stock
Change in Market Value:		
NYSE Closing Price 12/31/2011	$ 46.98	$ 34.71
NYSE Closing Price 12/31/2010	53.20	34.53
Net change in 2011	$ (6.22)	$ 0.18
Distributions in 2011	3.00	2.40
Total return Amount	$ (3.22)	$ 2.58

Total return	Percent	(6.1)%	7.5%

Common shareholders who participated in the Company's Automatic Reinvestment Plan experienced a negative return of 6.3% during 2011. On a long-term basis, those shareholders who participated in the Automatic Reinvestment Plan during each of the 35 years since its inception experienced a positive annual compound rate of return of 14.3%.

Commentary

"Politics in the Driver's Seat"

At the start of 2012, the investment backdrop is little changed. Developed-country consumers, financial companies and governments over the last decade accumulated too much debt. The reduction of those borrowings is underway by the first two groups, but government debt continues to expand in most developed countries as economic growth and the accompanying tax receipts remain below trend. Significant challenges await in Europe and the U.S. in the year ahead. The outcome is largely in the hands of the politicians and central bankers. It would be an understatement to say their past records provide little comfort. We view the quality of the businesses in our portfolio as a form of protection against these uncertainties.

EU Reckoning Postponed, but Not Forgotten

Europe's leaders sought to deal with the crisis in 2011 by pushing for greater fiscal (tax and spending) integration and oversight. They believe that countries overseen by a proposed EU fiscal authority would be unable to undertake excess borrowing, which they think should provide comfort to the markets about future deficits. From our perspective, this idea offers no such assurance. Provisions in the Maastricht Treaty clearly limited government debt accumulation. Germany and France both violated them, and most of the other countries followed. No matter what enforcement mechanism is offered this time, we see no reason to expect a different outcome.

On top of failing to convince us that sovereign (government) debt problems cannot recur in the future, this anticipated EU fiscal compact will introduce the first major political hurdle of 2012, for its ratification will require popular votes in some countries. Practically, the voters in Ireland and potentially several other countries will face a referendum on the EU and the concept of further integration.[1] EU history is littered with public rejections of initiatives increasing central authority at the expense of national sovereignty. A 'no' vote this time would likely cause markets to question the viability of the EU.

In the near term, pressure on EU politicians was eased by the European Central Bank's (ECB) extension of credit to Europe's banks in December and again in February 2012. These three-year loans served two purposes. First, they signaled that the ECB would not permit the undercapitalized banking system to collapse.[2] Second, the capital infusion allowed the banks to buy short-dated government bonds, reducing interest rates and thereby market concerns about the cost of government financing. The ECB's actions postponed the reckoning for EU banks and governments yet did not resolve Europe's fundamental issue.[3] Beyond these loan facilities, it is unclear what additional actions the ECB will take in 2012.

In addition to popular votes specifically held on the fiscal treaty change, the first round of French Presidential elections is scheduled for April. This will provide voters an indirect way of expressing their views on this proposal. A vote for Sarkozy will be seen as support for the plan. If another candidate is favored, the markets might question France's commitment to the plan's existing terms.

Attention Will Eventually Return to the U.S.

The U.S. has its own debt overhang issues. At the end of 2011, the gross government debt was 100% of GDP. We've written many times in the past that the practice of annually running outsized deficits that cause ballooning government debt levels has reached a critical stage. The European experience of 2011 clearly shows what happens when the markets will not lend money to governments on affordable terms. Once that point is reached, efforts to cut spending and raise taxes slow the economy, which makes the debt seem even less affordable. We are in very dangerous territory and need an immediate correction in course in order not to repeat Europe's recent experience on these shores.

Unfortunately, few in Washington, D.C., seem willing to act for the long-term good of the country. The election year makes it less likely that substantive reforms will occur. That means the choices made in the 2012 elections will have a significant impact on whether the necessary actions are taken. Negative market reaction is a real possibility if candidates opposed to improving our fiscal position are winners.

Against a backdrop of too much debt in the developed world, politics takes center stage in 2012. We cannot predict all the actions of politicians, central bankers and voters. But the combination of excess borrowings and their decisions is likely to produce significant market volatility.

Our Portfolio

As it is every year, our mantra is company quality. In ebullient markets we hope our companies' leadership positions are recognized, but when market sentiment darkens, we count on their high levels of profitability and modestly levered balance sheets to hold up better than most. As we begin 2012, these quality characteristics are evident when compared to the portfolio's Russell 2500 (R2500) benchmark. According to data from BNY Mellon, at the end of 2011, the Source equity portfolio had an ROE (return on equity) of 17.5% (compared to 12.5% for the R2500), gross debt (not including cash) of 58% of equity (94% for the R2500) and sold at a trailing P/E (price/earnings) ratio of 17x (compared to 20x for the R2500). We believe this combination of better quality at lower prices is a recipe for potential continued long-term outperformance versus the index.

Performance

For the fourth quarter Source increased 18%, a dramatic reversal of its 24% decline in the third quarter, but a continuation of the volatile environment we have seen for some time. The Source gain exceeded the benchmark Russell 2500 by almost four points and the S&P 500 by six and a half points.

For the full year 2011, relative performance was more of a challenge. Source was down a little over 5%, about three points worse than the two and a half point decline in the benchmark Russell 2500. The leaders during the year were definitely larger-cap companies. The S&P 500 was up 2%, six points ahead of the small-cap Russell 2000. The Dow Jones Industrials, an index long deserted by sophisticated investors, and dominated by big companies paying healthy dividends, provided a return of over 8%, almost 13 points better than the Russell 2000.

The table below shows performance for both Source and the benchmark Russell 2500 as well as leading large-cap indexes.

[1] An Irish popular referendum is legally required for any change to the constitution. There will be pressure in France also to offer a referendum. In Germany, the 2011 constitutional court ruling will force parliamentary action or a public referendum. The Netherlands has a history of voting against EU expansion and will likely face popular demands for a vote.

[2] To assist banks further, the ECB has continued to increase the range of acceptable assets that banks can pledge as collateral. From just under 30,000 in early December, the number of eligible assets was recently increased to over 37,000.

[3] This issue is the enormous amount of variation in competitiveness among Europe's economies, which leads to large trade surpluses (Germany) and deficits (southern Europe). Without the possibility of currency adjustment, it will be nearly impossible for a deficit country to balance its budget when its banks and consumers are reducing their financial leverage. Markets have already signaled that government debt levels in Portugal, Italy and Spain are not acceptable in the long run. Until the deficits of these countries are structurally reduced, Europe's fundamental issue will be unresolved.

Source return comparisons measured over longer periods remain strong.

	Periods Ending December 31, 2011					
	Fourth Quarter	One Year	Three Years	Five Years	Ten Years	Fifteen Years
Source	18.3%	(5.2)%	22.2%	2.1%	6.7%	10.2%
Russell 2500	14.5%	(2.5)%	18.4%	1.2%	6.6%	7.8%
S & P 500	11.8%	2.1%	14.1%	(0.2)%	2.9%	5.5%
Nasdaq	8.2%	(0.8)%	19.4%	2.4%	3.7%	5.4%

Company Discussion

We believe it useful to look at the portfolio's full year 2011 best and worst performers in greater-than-usual detail, both as a way of better understanding how we did last year as well as providing insight into the portfolio management process.

Starting with the winners, the following portfolio companies had the greatest percentage gains over the course of the year.

O'Reilly Automotive	+32%
Aggreko	32
Copart	28
Clarcor	17
FMC Technologies	17
Scan Source	13
Franklin Electric	12
Maxim Integrated Products	10

Looking at the big picture, what themes were most successful in 2011? Several ideas stand out.

- First, size. Bigger was better, as we might have concluded from the strong performance of the Dow Jones average noted above. Three of the year's biggest winners (O'Reilly, Aggreko, and FMC) where among the four biggest market cap companies in the portfolio.

- Next, relatively low exposure to the economic cycle was often rewarded, as the market continued to worry about the extent and speed of the recovery. Of the five biggest portfolio price increases, three companies have minimal cyclical exposure (O'Reilly, Copart, and FMC) while Aggreko and Clarcor were only moderately exposed to the cycle.

O'Reilly Automotive is one of the country's three leading auto parts retailers, along with Auto Zone and Advanced Auto.

O'Reilly was up 32% last year, and is Source's largest portfolio position at 9%. Most of the stock was purchased over a decade ago at an average price of $7.50 a share. The price at year end was $80.

From a fundamental business standpoint O'Reilly is a relatively low risk investment, with only modest exposure to the economic cycle. Although car usage occasionally declines, driven by either recession or high fuel prices, past impacts

have not been severe. People need to use their cars, and they need to maintain them, to O'Reilly's benefit.

In addition to its nominal economic risk, as well as zero exposure to Europe, O'Reilly benefited from several company-specific factors. One, it continued to see sales and margin gains driven by its highly successful acquisition of CSK three years ago. And two, it has had significant increases in cash flow, driven by modestly slower store expansion, steadily improving working capital management, and modified store leasing practices, with the funds used for share repurchase.

We have sold O'Reilly shares periodically, mostly to trim position size. Mid-teens returns on equity and excellent reinvestment opportunities within the business have supported past earnings growth of close to 20%.

Aggreko operates two closely related businesses. First is short-term rental of power generating equipment, generally to meet temporary industrial needs. Second is the sale of power to supplement inadequate supply. This sometimes results from natural disasters (hurricane, earthquake) or special events (Olympics, World Cup), or, most important, endemic shortages in developing countries, the consequence of underinvestment in generating capacity.

Aggreko was first purchased about a year ago, at prices 30% lower than now. Though we are quite comfortable with our current 1% position, we will patiently await opportunities to increase it at lower price levels.

Although Aggreko's short-term rental business, generally located in economically developed regions, certainly has some cyclical risk, it has become the less important of the two businesses, while International Power Projects (IPP) is now dominant.

IPP is highly unusual in its tilt toward the poor but developing world for most of its business. Typical customers are in South Asia, Latin America, and Africa. In many of these countries relatively small but steady increases in demand for electric power (for cell phones, lighting, TV, refrigeration) meet with static supply, generally the result of inadequate investment. The root cause is selling power at prices that are too low or in diverting whatever cash flows there are to alternative uses.

Unfilled demand for alternative power has grown significantly over time, with ability to pay the true constraint on the market. Despite this, Aggreko has steadily increased its generating capacity and has grown earnings at rates approaching 20% annually for many years. Returns on capital have been very high.

We expect future investment opportunities for Aggreko to continue to be relatively unrestrained by the economic cycle.

Copart is one of the two leading operators of auctions for salvage vehicles those crash-damaged beyond the point of economic repair.

Copart's stock price was up 28% last year. Over time, with both rising earnings and a modestly higher multiple, Copart's position, purchased in 2006, has grown to about 4% of the portfolio.

Our view of Copart's secure competitive position, improving reinvestment opportunities, and its relative imperviousness to the economic cycle, keeps us comfortable with its sizeable portfolio position.

The key aspect of the Copart story is the improving reinvestment opportunities the company is seeing in its business. It has increased the flow of vehicles going to its auctions, both by winning an exclusive contract with Allstate, and by convincing

dealers, car lessors, etc., to send their high mileage but drivable vehicles to Copart, supplementing its normal diet of salvage vehicles.

Entering the U.K. market a few years ago with an acquisition, Copart added some additional assets and now is the market leader. This raises the hope that Copart could eventually expand to markets on the European continent as well, potentially doubling the size of its U.S.-only business.

Copart did a very large and highly accretive share repurchase about a year ago, reducing shares outstanding by 20% though at the cost of some balance sheet leverage. We take a positive view of this more aggressive balance sheet management.

FMC Technologies is the leading worldwide manufacturer of subsea trees, equipment that controls the flow of oil and gas from offshore wells.

FMC's stock price was up 17% last year and is currently about a 4% portfolio position. Our initial purchase was in 2008 at about $12 per share (current price = $50).

The company has improved its market share to over 50% in recent years, in part from its success in developing equipment that can perform tasks underwater, mostly oil-water and oil-gas separations, which previously could only be done at the surface. These technology advances have greatly improved the economics of many offshore projects.

The oil and gas industry has seen a steady increase in subsea activity over past decades, driven by worldwide economic growth and improving technology, permitting oil companies to develop resources not economically accessible in the past.

Although oil and gas exploration and production are influenced strongly by economic activity, in the short and medium term there may be little linkage, as large multi-year projects will often continue regardless of current oil prices or level of demand.

Turning now to the down stocks, the following portfolio companies had the largest percentage stock price declines over the course of the year.

Dolby	(54)%
Manpower	(43)
Life Technologies	(30)
Wabco	(29)
Carnival	(29)
L'Occitane	(27)
Bio Merieux	(25)
Sonova	(19)

In the case of four of these companies, (Dolby, L'Occitane, Bio Merieux and Sonova) our first purchase was during the course of 2011. Despite the very broad price decline these companies had during the year, by patiently waiting for buying opportunities at attractive prices, we were able to initiate and enlarge our positions in two of the four companies at lower average costs than year-end prices.

Moving to some of the larger positions, **Life Technologies** is a major provider of supplies and equipment for biotech research. At year-end 2011 it was Source's eighth largest position, at 4% of the equity portfolio. It declined 30% last

year. Because of our already full position we did not add to our shares post decline.

The lower stock price was driven largely by concern about pressures on government-funded spending for life science research. In addition, the fiscal stimulus program was winding down, and the long-term malaise in new drug development continued.

We held a more sanguine view. Life's core business has been high margin and very stable. It has substantial cash flows and a low correlation with overall economic activity. Finally, it has demonstrated the ability to profit from research breakthroughs.

These positives became more evident in January. Early in the month it announced some very aggressive new products in its next-generation sequencing business. This improved its market position relative to its major competitor, Illumina. Then a few weeks later, Illumina became the target of a hostile tender offer from Roche, demonstrating the value of a next-generation franchise. The consequence of this improvement in sentiment was a strong gain in Life's stock price, up 10 points, or 24%, for the month of January and erasing 60% of its year 2011 decline.

Wabco is a worldwide leader in heavy truck components with an emphasis on safer braking systems. At year-end 2011, Wabco was Source's fifth largest position at 4.1%. It declined 29% last year. As was the case with Life Technologies, our relatively full position made us reluctant to add to our shares.

The market's concern was centered on Europe, Wabco's largest market. Also at issue was a possible slowing in the growth rate in some rapidly growing truck markets, especially China, India, and Brazil.

We continue to be enthusiastic about Wabco and its prospects. It has the leading market share in an oligopolistic industry. It combines both cyclical (U.S., Europe) and secular growth opportunities (BRIC countries Brazil, Russia, India and China). Wabco strongly benefits from tighter government regulations, especially in safety. And finally, the company has been dramatically improving its operating margins.

Sentiment has improved in January, as Europe now appears likely to avoid a worst case outcome (at least for now). Wabco's stock is up about eight points or 20% for the month, erasing half of its year 2011 decline.

In the past, reader feedback to shareholder letters came in written form or over the telephone. While those methods are still welcome, we are now pleased to also receive comments at the email address, source@firstpacad.com.

Thank you for your continued support and trust.

Eric S. Ende

President and
Chief Investment Officer

February 6, 2012

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 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 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 SUMMARY

December 31, 2011
(Unaudited)

Common Stocks		**92.7%**
Producer Durable Goods	20.6%	
Retailing	19.0%	
Business Services & Supplies	18.3%	
Healthcare	14.2%	
Energy	7.1%	
Technology	5.6%	