SOURCE CAPITAL INC /DE/
Form N-CSR
February 23, 2009

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, 2008

Item 1. Report to Stockholders

SOURCE CAPITAL, INC.

2008

ANNUAL REPORT

for the year ended December 31

SUMMARY FINANCIAL INFORMATION

	For the year ended December 31,			
	2008		2007	
	Total Net Assets	Per Common Share	Total Net Assets	Per Common Share
Beginning of year	$ 614,584,799	$ 64.75	$ 610,486,274	$ 64.81
Net realized and unrealized gain (loss) on investments	$ (230,124,114)	$ (26.58)	$ 33,936,693	$ 3.94
Net investment income	4,279,105	0.49	4,729,721	0.55
Distributions to Preferred shareholders	(4,726,109)	(0.55)	(4,726,109)	(0.55)
Distributions to Common shareholders	(30,293,340)	(3.50)	(34,481,934)	(4.00)
Proceeds from shares issued for distributions reinvested by shareholders			4,640,154	
Net changes during year	$ (260,864,458)	$ (30.14)	$ 4,098,525	$ (0.06)
End of year	$ 353,720,341	$ 34.61	$ 614,584,799	$ 64.75
Common market price per share	$ 28.29		$ 60.08	
Common market discount from net asset value	18.3%		7.2%	
Preferred asset coverage	653%		1,135%	
Preferred liquidation preference per share	$ 27.50		$ 27.50	
Preferred market price per share	$ 29.70		$ 32.25	

DESCRIPTION OF THE COMPANY

Source Capital, Inc., is a major diversified, publicly traded investment company with total net assets of approximately $354,000,000. 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 8,655,240 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, 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.

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:

2008 Investment Portfolio Returns

Total net assets of Source Capital amounted to $353,720,341 at December 31, 2008. After providing for Preferred Stock equity, Common equity amounted to $299,567,011 or $34.61 of net asset value per Common share. This compared with total net assets of $614,584,799, Common equity of $560,431,469, and net asset value per Common share of $64.75 one year ago. These changes reflect payments to Common and Preferred shareholders totaling $35,019,449. As a result, Source Capital recorded a negative total investment return during 2008 of (42.8)% on its Common net asset value, reflecting the reinvestment of 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.

The regular quarterly distribution was reduced to $0.50 a Common share for the distribution payable December 15, 2008, from the prior $1 rate. The reduction in the distribution rate reflected the dramatic decline in the overall stock market and the resulting drop in the value of the Company's portfolio and share price.

On February 2, 2009, the Board of Directors voted to continue the current distribution rate and declared a regular quarterly distribution of $0.50 a Common share, payable March 15, 2009.

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 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.

	Year-End				
	Premium/ (Discount)	**NAV**	**Market Price**	**Market Return**	**Net Asset Value Return**
2008	(18.3)%	$ 34.61	$ 28.29	(47.1)%	(42.8)%
2007	(7.2)%	$ 64.75	$ 60.08	(5.2)%	6.1%
2006	4.3%	$ 64.81	$ 67.59	(1.9)%	4.3%
2005	10.4%	$ 66.79	$ 73.75	10.7%	14.9%
2004	13.2%	$ 63.20	$ 71.54	27.2%	19.5%
2003	4.9%	$ 56.62	$ 59.38	19.0%	45.7%
2002	26.1%	$ 41.90	$ 52.85	(5.9)%	(17.1)%
2001	10.1%	$ 55.45	$ 61.02	24.5%	24.7%
2000	8.4%	$ 48.62	$ 52.69	22.5%	9.6%
1999	(4.8)%	$ 50.70	$ 48.25	14.4%	23.1%

The following table presents 2008 market returns for both Common and Preferred shareholders:

	Common Stock	**Preferred Stock**
Change in Market Value:		

NYSE Closing Price 12/31/2008	$ 28.29	$ 29.70
NYSE Closing Price 12/31/2007	60.08	32.25
Net change in 2008	$ (31.79)	$ (2.55)
Distributions in 2008	3.50	2.40
Total return Amount	$ (28.29)	$ (0.15)
Total return Percent	(47.1)%	(0.5)%

Common shareholders who participated in the Company's Automatic Reinvestment Plan experienced a negative return of (49.3)% during 2008. On a long-term basis, those shareholders who participated in the Automatic Reinvestment Plan during each of the 32 years since its inception experienced a positive annual compound rate of return of 13.3%.

Commentary

After a "mere" 15-20% decline in the first nine months, the market seriously swooned in the fourth quarter with losses of 20-25% for the major indexes. This brought the full year 2008 drop to 35-40%. If combined with the initial stages of the bear market during the last quarter of 2007, the total decline (so far) is roughly comparable to the 1973-74 market, which was arguably the worst since the Great Depression.

At this writing it is unclear whether the market bottomed during the fourth quarter, or this is still ahead of us. The S&P reached about 750 in late November, but closed the year 20% above this. January of 2009 has seen a market retreat however.

We believe that the market has concluded that the initial recapitalization of the banking system was inadequate given the increasing scope of its losses, now moving beyond exotic securities to more traditional assets like commercial real estate and leveraged buyout loans. Beyond financial concerns, the world economy appeared to be in free fall during the fourth quarter.

It is also an open question how effective the expected massive fiscal stimulus will be, given the offsetting dramatic increase in the personal savings rate a reaction to both economic uncertainty and to the very large capital losses suffered in household real estate and equity holdings.

Source's performance for 2008, a full-year decline of 43%, was the worst in its modern history (post-1976) as well as worse than the market averages. We were very disappointed by this result, both as managers and as fellow shareholders.

We can assure our shareholders that we have and will continue to adhere to the investment philosophy of owning high-quality businesses, which we expect will outperform their competitors over a multi-year time horizon. They have leading market shares, superior returns on capital, and strong balance sheets.

At year-end the portfolio's historical earnings per share (EPS) growth rate was 15%, its return on virtually unleveraged equity was 16%, and net debt as a percent of capital was 17%. All this for a PE of just 10x. In contrast, the market's returns, growth, and leverage are all inferior, but the PE is 14x. These extremely favorable metrics auger well for future performance. We continue to believe that owning much better than average companies at below market valuation is the key to strong portfolio performance over the long run.

Source was down about 33% in the fourth quarter. The best performers were companies perceived as beneficiaries of lower oil prices retailer O'Reilly Automotive (+15%), truckload carriers Heartland (+2%) and Knight (down 5%). Other stocks doing relatively well included Brown & Brown, Lincare, and CLARCOR.

On the negative side, the worst-performing portfolio companies were oil service companies Noble and Helix (down 50-70%) and firms providing products and services supporting life sciences research Charles River Labs, and Life Technologies which declined 40-50%. Unlike the oil service decline, which though overdone is understandable, the drop in the healthcare related companies appears to be unjustified by either actual or prospective business performance. Both are market leaders with extremely high operating margins and stable markets. At their November lows, each was selling at about 8x earnings. We added to positions in both oil service and life sciences research during the quarter.

For the year, the stock performance story is similar. The best performers were Heartland, Knight, and O'Reilly, while the worst were oil services and life sciences research support companies.

The table below shows performance for both Source and the benchmark Russell 2500, as well as leading large cap indexes. Returns for the longer 5- and 10-year periods have been more competitive than more recent periods. The investor who purchased equal amounts of Source, the S&P 500, and the Nasdaq ten years ago would find that his Source investment is worth twice the S&P and two and a half times the Nasdaq results.

	Fourth Quarter	**2008**	**3 Years***	**5 Years***	**10 Years***
Source	(33.0)%	(42.8)%	(14.1)%	(2.8)%	5.9%
Russell 2500	(26.3)%	(36.8)%	(9.4)%	(1.0)%	4.1%
S&P 500	(21.9)%	(37.0)%	(8.4)%	(2.2)%	(1.4)%
Nasdaq	(24.6)%	(40.5)%	(10.6)%	(4.7)%	(3.2)%

* Annualized Returns

Although we have had an occasional discussion of fixed-income investments and strategy in past shareholder letters, we have never, within memory, discussed the impact on performance of the fixed-income portion of the portfolio. We must depart from this practice now, however, because of the substantial negative effects which the extraordinary conditions in the bond market had on Source's fixed-income investments and, in turn, on Source's overall investment performance.

You may recall that Source's capital structure is modestly leveraged by the $54 million issue of Preferred stock, which pays a $2.40 annual dividend. Source's investment strategy has always been to neutralize this leverage by owning fixed-income securities roughly equal in value to its Preferred stock and yielding interest income which typically has covered the Preferred dividend and then some. Thus, fixed-income produced a modest enhancement to past Common stock investment returns.

In 2008, however, this was definitely not the case. Record high-yield spreads over Treasuries meant that bond prices declined and fixed-income contributed an absolute loss of about $6 million. When combined with the Preferred dividend, this had the effect of reducing equity returns by about 2.5 points, or nearly half of the 6 point difference between Source's full year return and that of the benchmark Russell 2500.

Steven Geist, whose responsibilities include managing Source's fixed-income investments, has contributed the following discussion of that portion of the portfolio.

For the fixed-income portion of Source Capital, 2008 was a difficult year. You may recall from our first quarter 2008 letter that we were adding bonds to the portfolio with a yield spread over an equivalent maturity Treasury bond of approximately 600 basis points. This translated into a yield-to-maturity of 9%, and we were quite satisfied with these purchases. Little did we know what the fourth quarter had in store for us. As can be seen in the following table, spreads on these bonds have considerably widened.

Company	Description	Spread over Treasury at Time of Purchase (bp)	Spread over Treasury at 12/31/08 (bp)
Brown Shoe	8.75% of 5/1/12	610	1900
Helix ESG	9.5% of 1/15/16	610	2200
Invacare	9.75% of 2/15/15	610	1200
Nova Chem.	6.5% of 1/15/12	650	4000
Rock-Tenn	9.25% of 3/15/16	610	900
Unisys	6.875% of 3/15/10	625	8500

Our bonds were not alone in this phenomenon, as the yield spread of a U.S. High Yield Master Index over Treasuries peaked at 2200 basis points and ended the year at a spread of close to 2000 basis points. Therefore, the question at hand is, why did the spreads change so significantly?

As you may know, prices of bonds move in the inverse direction to yields. As the yields on corporate bonds increased, indicated by the rise in spreads, the bond prices themselves took quite a tumble. This could be taken as a sign that investors had lost confidence in the ability of corporations to repay or refinance their debt. Thus, the greater perceived risk demanded a higher return.

Why the loss in investor confidence? During the fourth quarter, it became clear that the economy was in serious trouble. For the first time since 1952, consumers actually paid down some of their debt. While this is a positive in the long term, it means that over the short term consumers are buying fewer goods. Since consumer spending accounts for roughly 70% of gross domestic product, this serves as a nasty drag on the economy. Also, the number of industries lining up for a government bailout has continued to grow. Individual businesses were losing billions of dollars and warned of potential bankruptcy and the loss of tens of thousands of jobs. During 2008, 2.6 million jobs were lost with 2 million of those occurring in the fourth quarter alone. The unemployment rate ended the year at 7.2%, the highest rate in 16 years. Such data are not a bullish indicator for the 2009 economy.

Given this backdrop, it is not surprising that spreads would rise. Some investors may have felt that it became too risky to hold corporate bonds. If so, this may have caused some forced selling by hedge funds and asset management firms to raise cash needed to fund redemptions. Of course, in any market if an asset is deemed to be selling at a discount, at some point value investors will begin buying and the bond price will move back up. At the time of this writing, in January of 2009, this is in fact what we are seeing and the spreads have begun to tighten although not to the levels seen in early 2008.

Now, let us look at some specific bonds in the Source portfolio. We will discuss the two most egregious examples of spread widening, Nova Chemicals and Unisys.

Nova Chemicals is a leading producer of ethylene and polyethylene (most widely used plastic material in the world). The primary feedstock is ethane gas, which is sourced from and formula-priced based on natural gas. As energy prices peaked in mid-2008, the operating margins of Nova were severely tested. Even so, as of the end of the third quarter of 2008, Nova had $75 million of cash on the balance sheet, generated $165 million of year-to-date cash flow from operations, and has an untapped $500 million credit facility. In terms of its credit statistics, Nova covered interest expense by 4.5x after capital expenditures and had a leverage ratio (debt to earnings before interest, taxes, depreciation and amortization) of only 2.0x. These ratios are quite good for a cyclical company. The concern of the marketplace is the Nova debt which matures in April of 2009. This is a $250 million issue the company must retire. Considering that it too is selling at a discount to face value, we believe the company should purchase some of these bonds in the open market, prior to maturity, from the forced sellers mentioned above. When the company gets past the April maturity date, we expect the January 2012 bonds will recover in price.

Unisys, a provider of information technology services to corporations and government agencies for system integration, outsourcing, and infrastructure, is another example of a bond with an extremely wide spread. Unisys has annual sales of over $4.5 billion, just over $1 billion of debt on its balance sheet and over $400 million in cash. Over the last twelve months, the leverage ratio is less than 2.0x while its interest coverage ratio is approximately 5.0x. The company has three public debt issues outstanding, and the bond we own is the first to mature. Unisys produces hardware as well as software solutions. We feel the market is overly focused on softening hardware sales, which currently represent just 16% of sales. While these declining sales will continue to impact the company especially if the economy remains weak, we do believe Unisys has a sustainable business model. The credit ratios also indicate the company should have sufficient headroom in the event of a further loss of business.

Consequently, we have our reasons to continue to have confidence in these companies. We are also well aware of the inherent risks in the current economy and the impact it may have on any particular company. While we have typically used a buy-and-hold strategy in the bond portfolio, we will sell any company bond when we believe the repayment or refinance risk is working against us.

Returning to our discussion of the equity portfolio, we have responded to the previously noted price declines in energy companies by adding to our positions. But we have taken a focused, not a shotgun approach. Specifically we have emphasized oil service companies with a significant portion of their business in deep water offshore.

Although the modern oil industry dates back to the well drilled by Colonel Drake in Titusville, Pennsylvania in 1858, it is only much more recently, after World War II, that the industry first ventured offshore.

There are significant technical challenges associated with both exploring and developing discoveries offshore, and especially in deeper waters. It has been accomplished only with the help of an impressive stream of technical innovations, which continue to this day.

Initially offshore activity required that both drilling rigs and production platforms be attached to the sea floor. This limited drilling to about 400 feet of water. Permanent production platforms ultimately went deeper than this, but became uneconomic at water depths greater than 1,000 feet.

More recently, petroleum engineers have succeeded in developing techniques to drill commercially at ever increasing depths, currently exceeding two miles, as well as methods to develop and produce a successful discovery.

Operations in deep water have both significant barriers to entry as well as strong growth prospects. Because it is so technically demanding, only a small number of companies have the expertise to operate safely and efficiently in this environment. Very expensive equipment is required. On the drilling side, a semi-submersible or drill ship costs $500-750 million, and a fleet of several vessels currently is the minimum needed to be viewed as a credible operator.

Because the industry's ability to deal with deep-water challenges is extremely recent, much of the prospective geology in deep water is still relatively unexplored. Interest levels have been high, there have been numerous large discoveries, and current growth is being constrained by limited drilling capacity.

There has been considerable concern that depressed oil prices will reduce industry investment, including deep water. While there is no question that deep water is an expensive place to operate, and is not especially helped by current price levels, there are several mitigating factors.

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First, although deep-water activity is expensive, the basins are so lightly explored that discoveries tend to be very large; thus, cost per recoverable barrel is often not much different than in shallow water or on land.

Second, exploring and developing deep-water discoveries is a very long-term activity and the large national oil companies and super majors managing most of the projects have very long time horizons. They aim to prevent short-term oil price volatility from disrupting multi-decade projects.

In addition, we believe the recent profound decline in oil prices, driven by reduced levels of economic activity worldwide, is as unsustainable as the huge price spike that preceded it. Lower oil prices will be met by a supply response (lower investment and production), amplified by the natural decline curve of many aging fields. Eventually, when economic activity revives and boosts demand, prices will move to higher and more sustainable levels. As patient investors, we are quite prepared to wait for this return to market equilibrium.

And beyond this cyclically-driven medium-term improvement in the oil markets, secular longer-term trends remain very attractive. Demand, driven by developing nations like India and China, will grow faster than supply, which may in fact be close to a peak, boosting prices and supporting the technically challenging and more expensive exploration and development in deeper waters.

Source holds shares in four companies with a significant part of their business driven by deep-water activities. Combined they are about 9% of the portfolio, with Noble being the largest position. Average PE is under 6x, return on equity is 33%, and net debt as a percent of capital is a low 19%. The stock prices on December 31 represented an average 68% decline from the year 2008 highs.

Along with Transocean and Diamond Offshore, Noble is one of the leading offshore drilling contractors. Although it continues to operate jackups in relatively shallow waters (up to 400 feet), Noble's expansion focus has been on deep water, and the equipment it has been adding to the fleet is primarily semi-submersibles and drill ships capable of drilling at 10,000-foot depths.

Noble has historically earned better returns on capital than its peers through well-timed fleet additions, delivered on budget and on schedule, and by securing long-term contracts prior to committing to new orders.

Its operations are well diversified, avoiding the volatile shallow U.S. Gulf of Mexico, with a special focus on Brazil, West Africa, the North Sea, the Middle East and the deeper waters of the Gulf of Mexico. Noble has a relatively low cost structure, yet not at the expense of safety or operating efficiency.

Noble has a significant backlog of long-term contracts with financially strong customers, mostly national oil companies (Petrobras, Pemex, etc.) or large integrated majors (Shell, Exxon, Chevron, etc.). At $12 billion, its backlog alone is the equivalent of over three years of future revenue.

Our second deep-water company is **FMC Technologies**. FMC, along with Cameron International, is the leader in subsea production systems, consisting of trees, controls, manifolds, and related equipment. Placed at the well head on the sea floor, these components regulate oil and gas flows, control pressure, and permit safe access to the well for maintenance.

FMC is expanding its market through some new subsea technologies it has developed, including oil-water separation and water reinjection, as well as gas-liquids separation and gas compression. The key point is that these processes, which were traditionally performed on production platforms, can now be done on the sea floor. This reduces the need for expensive platform "real estate" and improves the economics of many offshore projects.

Helix Energy is primarily involved in deep water construction activities, including pipelay, equipment installation, diving, well intervention, and inspection and maintenance activities. Originally only a domestic operator, it has steadily increased its international activities.

Actuant, a relatively recent purchase, is a diversified industrial company with a substantial and increasing portion of its sales going to oil and gas markets. Historically most of its sales in this area have been high-force hydraulic tools for maintenance and repair applications, and joint integrity products, for pipeline maintenance. Actuant has moved more aggressively into offshore and deep-water markets with its recent Cortland acquisition, whose cables, rope, and umbilicals support exploration, development, and production applications. In total, we estimate that about $250 million or 15-20% of Actuant's annual sales is to oil and gas markets.

Despite the challenges posed by the world-wide economic slowdown and the accompanying dramatic decline in oil prices, we believe that our ownership of high-quality competitively-strong oil service companies will produce an attractive return to Source shareholders over the long term.

Respectfully submitted,

Eric S. Ende

President and
Chief Investment Officer

February 2, 2009

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.