

Overview

Investment Objective and Strategy

The primary objective of the FPA Small/Mid-Cap Absolute Value (“SMAV”) investment strategy, including the FPA Capital Fund, is long-term growth of capital. Current income is a secondary consideration. FPA Capital Fund seeks to fulfill this objective through investing primarily in small and medium-sized public companies.

Investment Philosophy

In order to find securities that we believe meet our objective we employ a disciplined and patient approach to identify:

- Market leading companies with a history of profitability
- Strong balance sheets
- Successful management teams
- Companies with a potential for profitability improvement
- Absolute, not relative, value

We believe that a concentrated portfolio of our best ideas, rather than a diversified basket that mimics benchmark weightings, better allows us to accomplish our objective.

Investment Process

- Identify candidates that fit within our SMAV investment philosophy utilizing multiple proven methodologies.
- Run potential investments through a rigorous fundamental investment analysis process, which includes both quantitative and qualitative metrics.
- Apply a comprehensive set of valuation and business quality measures to the few remaining securities to determine intrinsic value and gauge the attractiveness of the reward-to-risk ratio embedded in the underlying security’s price.
- Construct and monitor portfolio of securities that have passed prior three steps.

The SMAV investment philosophy and strategy are simple to articulate, but difficult to execute. Many investors lack patience and are ill-equipped emotionally to handle the sometimes extreme volatility of the equity markets. The success we have achieved since 1984 is due to patience and discipline in the execution of this investment strategy.

INVESTMENT OBJECTIVE AND STRATEGY

The primary objective of the FPA Small/Mid-Cap Absolute Value (“SMAV”) investment strategy, including the FPA Capital Fund, is long-term growth of capital. Current income is a secondary consideration. FPA Capital Fund seeks to fulfill this objective through investing primarily in small and medium-sized public companies.

We believe the combination of discipline, patience, long-term focus and remaining loyal to our valuation criteria increases the odds that our objectives can be achieved. We endeavor to attract clients who share the same principles. to invest in small and medium-sized public companies and produce superior long-term investment returns. Some may have a different understanding of “long-term” and “superior returns.” Let us clarify:

Long-term. What does long-term mean today when the average holding period for an NYSE-listed stock is just six months? To us, long-term means three, five, maybe even ten years and we consider our investment time horizon accordingly. When merited, we have often held securities for ten years or longer. This long-term holding period has allowed us to develop a deeper understanding of our holdings as well as to significantly reduce taxes and transaction costs.

Average Annual Returns as of September 30, 2016:

Fund/Index	QTR	YTD	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years	25 Years	Since 8/1/84*
FPA Capital Fund, Inc.	3.66 %	12.28 %	8.49 %	-1.14 %	7.01 %	4.96 %	9.18 %	9.05 %	11.83 %	13.39 %
Russell 2500	0.48 %	10.80 %	14.44 %	7.77 %	16.30 %	7.95 %	10.07 %	9.43 %	10.81 %	11.65 %

Periods over one year annualized.

Inception for FPA Management was July 11, 1984. Inception for FPA Management was July 11, 1984. A benchmark comparison is not available based on the Fund's inception date therefore a comparison using August 1, 1984 is used. Expense ratio calculated as of most recent prospectus is 0.73%. **Past performance is no guarantee of future results and current performance may be higher or lower than the performance shown. This data represents past performance and investors should understand that investment returns and principal values fluctuate, so that when you redeem your investment it may be worth more or less than its original cost. Current month-end performance data may be obtained by calling toll-free, 1-800-982-4372. A redemption fee of 2.00% will be imposed on redemptions of certain shares within 90 days.*

Superior returns. We strive for top decile returns in the universe of long only, diversified, unleveraged investment managers. We do not seek to have the best results over the short term. In fact, we often have lagged (and will lag) other managers over a three-year time horizon, or longer. But, over ten, fifteen, and twenty years our investment strategy has produced top decile returns.

PHILOSOPHY

The Small/Mid-Cap Absolute Value team believes that the best way to produce superior absolute returns, while protecting capital, is to build a portfolio of companies with the following characteristics:

- I. Leadership positions and a history of profitability. Companies with such characteristics have a lower probability of business failure than firms with secondary or tertiary positions, or businesses with unproven operating histories and a lack of profitability. When economic recessions occur, customers and vendors naturally gravitate toward larger and financially solid companies. This is because customers and vendors have greater confidence in market leaders and their ability to remain solvent.
- II. Balance sheets with little leverage. A strong financial position helps to protect against the cyclical changes in profitability that are inherent in business cycles and that can bankrupt firms with too much leverage. Strong balance sheets not only protect a company against bankruptcy, but also allow shrewd managers to buy good assets when there is distress in the economy, enhancing the long-term enterprise value of such entities.
- III. Management teams of high quality. Effective management maximizes business and capital allocation opportunities in both good times and bad. For example, attention to a low cost structure protects margins and cash flows during recessions. A focus on improved volumes, mix and pricing also provides owners with better upside during times of growth. While a successful past is no guarantee to future outperformance, we make investments in companies that have a management

team with a proven track record of achievement and an effective capital allocation philosophy and where there is a true alignment of interest with their shareholders.

- IV. Potential for profitability improvement. We seek those companies that have the ability to expand margins, for those that do will, in general, have more stock price appreciation. An example would be a company operating under recessionary conditions that we are able to buy at a depressed valuation and where the upside in earnings accrues entirely to us, the shareholders. It also can be companies and industries undergoing a change for the better, but the stock price is not accounting for the prospective improvement. Additionally, we occasionally will find companies that are misunderstood and where we believe the profit potential is substantially greater than the market believes.
- V. Prices that provide at least a 3:1 reward-to-risk ratio. We seek to earn at a minimum three dollars of upside for every dollar of initial capital that we potentially have at risk, should our downside scenario materialize. For instance, if a stock is trading at \$20, meets all of our strict investment criteria, and we believe the most likely downside to the stock is \$14, we require that the conservative upside scenario entail the stock nearly doubling before allocating any capital to the investment. It is important to note that our 3:1 reward-to-risk ratio does not apply to binary outcomes, where there is some modest probability that the investment could go to zero. We are not home-run hitters who have a penchant for striking out. Price is the great equalizer and we are willing to wait for the right price to come our way. *This concept of absolute valuation is what distinguishes us from “relative” value managers, and is among the prime factors for our long-term excess returns.* Discipline keeps us from paying too much, a cardinal sin of investing.

These five tenets help protect our investments against both business and market risk, and help guard against a permanent impairment of capital. Permanent loss of capital can result from buying a fundamentally flawed business, investing in a business whose balance sheet doesn't allow them to survive inevitable downturns, partnering with managements who unwisely commit capital or who just cannot manage well, or paying too much.

PROCESS

We search for dominant businesses that, for reasons we understand, might sell at a bargain price. Our team begins by identifying companies that meet certain quantifiable metrics. We screen for companies within a range of market capitalizations usually between \$1 billion and \$4 billion. We have valuation metrics, such as price/earnings and price/cash flow ratios¹, for which we screen potential investments. Other methods to generate new ideas include reviewing stocks trading at their 52-week low, attending investment conferences and trade shows, and reading industry trade journals and newsletters.

We then engage in a thorough fundamental analysis that often quickly weeds out many companies that passed the initial identification stage. The analysis includes a rigorous review of a company's financial statements, often extending back a decade or longer. This step also includes assessing the company's management team, operations and its competitive position. We conduct site visits, talk with customers and suppliers, and visit or talk with competitors to better assess the business risks of a company. The fundamental analysis can take many months to complete, and sometimes ends because we cannot sufficiently understand the risks posed by owning equity in a complex or challenging business. This type of deep research aids us in avoiding the value traps.

Finally, we put all of the companies through a valuation analysis. We analyze a company's valuation based on its sales, earnings, cash flow, and book value. The team employs absolute value metrics, not relative value measures to identify really cheap stocks. That is, if a security is trading above a certain multiple of

¹ Price/Earnings ratio is a valuation ratio of a company's current share price compared to its per-share earnings. Price/Cash Flow is a measure of the market's expectations of a firm's future financial health. Because this measure deals with cash flow, the effects of depreciation and other non-cash factors are removed. Similar to the price-earnings ratio, this measure provides an indication of relative value.

normalized profits and cash flow, we will not invest the capital that has been entrusted to us. Finally, the companies that pass all three steps are then candidates for inclusion in our clients' portfolios. At this point we typically end up with between 20-40 companies for the portfolios that we manage.

STRATEGY

We maximize the strengths of our philosophy and process by i) focusing on the long-term when investing, ii) concentrating our investments in our best and most attractive ideas and sectors, and iii) being aggressive in deploying capital when opportunities are abundant and patient when there is a lack of prospects.

Our long-term strategy embraces an "ownership" mentality rather than Wall Street's commonly held view today that stocks should be "rented." Our long-term view allows us to increase the odds of compounding our clients' assets at attractive returns, and not be seduced into selling a holding because of short-term perception changes by other investors or traders.

We like to invest in the "land of tall trees," – one of our favorite phrases. We don't want a bunch of small saplings cluttering both the portfolio and our minds, but rather a few strong trees that will continue to grow as their market dominance hopefully translates into larger profits. Typically, each portfolio will have investments in 20-40 securities, with the top ten securities and the largest three sectors generally constituting more than 50% of the portfolio. Owning a concentrated portfolio allows us to get the maximum benefit from our best ideas and to gain a deeper understanding of a business and the industry in which it operates. When there is a lack of investments that satisfy our criteria for absolute valuation and return possibility, cash will build as we await better opportunities. Cash, or liquidity, is just the residual of investment opportunity. We do not set out on our investment journey with a particular cash level in mind. When an opportunity that meets our criteria presents itself, it is generally under a cloud of some sort. The industry may be out of favor or in a recession, or the company may be doing poorly for a number of reasons. It is paramount during these occasions, that if the opportunities meet our criteria, that we take advantage of them to the fullest extent possible, despite what negative sentiment may weigh on the stock or industry. On the other hand, if there are few attractive opportunities available, it is equally important that we do not deploy capital in marginally attractive investments. We would rather sit in cash until something meets our criteria and presents itself as an opportunity.

The important factor to remember is that we have been executing this strategy everyday for the past two decades at FPA. We do not expect any changes to this fairly simple investment strategy, but the key is to execute it when the valuations warrant either a buy or sell decision.

SUMMARY

The SMAV investment philosophy and strategy are neither complex nor ephemeral; rather, grounded in a timeless, simple, and proven approach that has culminated in superior returns on invested capital.

A clear philosophy and its disciplined and patient execution form the foundation for our success. When security prices are collapsing and valuations are depressed, it can be daunting to commit capital in the face of an uncertain payoff. On the other hand, selling overpriced securities takes discipline. It is a large challenge to stand alone and look inside the window as other investors are enjoying a booming stock market, but one that demonstrates little value for the investor who thinks about owning the entire business and not just a piece of paper. We recognize these volatile conditions and know they will continue over the cycles to come. Rather than hide during volatile times our training and knowledge allow our absolute value philosophy to embrace opportunities when they arise.

We recognize our fallibility. We can make (and have made) bad decisions and we expect that there will be future discrete disappointment. However, we expect that the portfolio should withstand such challenges over time, not upsetting *long-term* investment returns.

We would like to extend our sincere appreciation to all of our clients who have been with us over these many years, and we look forward to earning the trust of other investors in the future, as we continue to execute per this policy statement, as we have in the past.

The SMAV Team

The Russell 2500 Index consists of the 2,500 smallest companies in the Russell 3000 total capitalization universe. The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization. This index is considered a measure of small to medium capitalization stock performance. This index does not reflect any commissions or fees which would be incurred by an investor purchasing the stocks they represent. The performance of the Fund and of the Averages is computed on a total return basis which includes reinvestment of all distributions.

You should consider the Fund's investment objectives, risks, and charges and expenses carefully before you invest. The Prospectus details the Fund's objective and policies, sales charges, and other matters of interest to the prospective investor. Please read this Prospectus carefully before investing. The Prospectus may be obtained by visiting the website at www.fpafunds.com, by email at crm@fpafunds.com, toll-free by calling 1-800-982-4372 or by contacting the Fund in writing.

Fund Risks

Investments in mutual funds carry risks and investors may lose principal value. Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. The Fund may purchase foreign securities, including American Depositary Receipts (ADRs) and other depository receipts, which are subject to interest rate, currency exchange rate, economic and political risks; this may be enhanced when investing in emerging markets. Small and mid-cap stocks involve greater risks and they can fluctuate in price more than larger company stocks. Groups of stocks, such as value and growth, go in and out of favor which may cause certain funds to underperform other equity funds.

The FPA Funds are distributed by UMB Distribution Services, LLC. 235 W Galena Avenue, Milwaukee, WI 53212