To Our Shareholders

Net asset value at March 31, 2001 was $226,608,613, equivalent to $59.40 per share after deducting an allowance of $20.79 per share for deferred taxes on net unrealized appreciation of investments. Assuming reinvestment of all dividends and tax credits on retained long-term capital gains, the March 31, 2001 net asset value of $59.40 was 3.3% below the March 31, 2000 net asset value of $62.09 per share and 16.9% below the peak March 31, 1998 net asset value of $78.15 per share. Assuming the same reinvestment of dividends and tax credits, the March 30, 2001 closing market price of $65.00 was 20.1% above the March 31, 2000 market price of $54.75 and 27.7% below the March 31, 1998 market price of $94.00.

Our investment concentration in the manufactured housing industry was a major factor in the decline in Capital Southwest's net asset value during the past three years. As industry shipments dropped from a 25-year high of 373,000 homes in 1998 to 251,000 homes in 2000 and an estimated 205,000 homes in 2001, the value of our investment in Palm Harbor Homes, Inc. (Nasdaq: PHHM) dropped by $59,699,000, which (after reversal of deferred taxes) represented 55.9% of the decline in our Company's net asset value during the three years ended March 31, 2001. During the same period, the value of our investment in American Homestar Corporation (Nasdaq: HSTRQ) dropped by $16,992,710, which represented 15.9% of the three-year decline in our net asset value. Fortunately, Palm Harbor Homes has emerged from the storm as one of the strongest companies in the industry and our investment, which has a cost of $10,931,955 and is now valued at $78,551,000 is believed to have strong potential. Unfortunately, American Homestar did not weather the storm, and our investment, which had a cost of $3,405,824, was written off after the company's recent Chapter 11 bankruptcy petition.

Other significant decreases in net asset value during the three years ended March 31, 2001 were caused by major reductions in the values of our investments in Encore Wire Corporation (Nasdaq: WIRE) and Mail-Well, Inc. (NYSE: MWL). The March 31, 2001 value of our $5,800,000 Encore investment was $13,623,000, reflecting a three-year decline of $20,037,000 and corresponding to 18.8% of the decrease in our net assets during the three-year period. Although Encore's earnings per share declined by 61% during this period, the company is still the most profitable business in the intensely competitive building wire industry. During the three years ended March 31, 2001, the value of our $2,986,870 investment in Mail-Well decreased to $7,338,000, reflecting a decline of $17,648,000 and corresponding to 16.5% of the decrease in our net assets during the three-year period. Mail-Well's earnings have declined with the complexity of managing its growing collection of envelope, printing and label businesses and the management is now engaged in a strategic review of the company's holdings.

Another source of losses was our small portfolio of technology investments. As we answered the call of the wild over the past four years, we invested $14,521,723 in embryonic technology ventures, which proved to have more risk than reward. Today, these investments are valued at $4,000,227. In the future, we believe it will be more efficient and profitable to send each stockholder a cash dividend and a ticket to Las Vegas.

Our performance during the past year was also penalized by the marked decline in the value of our portfolio of unrestricted marketable securities. During the year ended March 31, 2001, the $49,671,701 value of such securities held for the entire year (excluding American Homestar) declined by $21,332,702 to $28,338,999.

Three of our holdings registered major increases in value totaling $28,850,000 during the three years ended March 31, 2001. Our ownership of RectorSeal Corporation, cost of $52,600 and value of $47,500,000, achieved a $9,000,000 increase in value during the past three years as its specialty chemicals and lubricants businesses grew internally and by acquisitions. The other two investments, Media Recovery, Inc. and All Components, Inc., are described on page 4 of this report. During the past three years, our investment in Media Recovery, having a cost of $5,415,000 and a value of $18,000,000, grew in value by $13,200,000. During the same period, our investment in All Components, with a cost of $150,000 and a value of $8,750,000, grew in value by $6,650,000.

Measures of Performance and Value

As illustrated by the bar graph on the inside cover, Capital Southwest's net asset value per share increased from $8.64 at March 31, 1981 to $78.15 at March 31, 1998, then declined for three years to $59.40 at March 31, 2001. The growth in net asset value over the past 20 years corresponded to a compound annual rate of 13.9%, assuming shareholders reinvested all dividends and tax credits on long-term capital gains retained by the Company. On the same basis, the growth over the 10-year period ended March 31, 2001 was equivalent to a compound annual rate of 12.1%. Although our long-term investment results exceeded the S&P 500 Index for many years, the following table shows the extent to which our Company's performance is now below the performance of this benchmark:

	Investment Returns	
Period Ended March 31, 2001	*Capital Southwest	**S&P 500 Stock Index
10 years	12.1%	14.4%
20 years	13.9	14.9

* Compound annual return for Capital Southwest based on net asset value per share assuming reinvestment of dividends and tax credits.

** Compound annual return for the S&P 500 Stock Index assuming reinvestment of dividends. Comparison of our performance with this Index is provided, not because of similarity between our investments and the stocks in the Index, but because the S&P 500 is a widely-followed benchmark which represents a large majority of the market value of all publicly-owned companies.

Capital Southwest, unlike most investment companies, reports its net asset value after deducting deferred taxes on unrealized appreciation of investments. Because of our long-term investment perspective, it is probable that a large proportion of our successful investments will be retained for many years. Meanwhile, the amount of the deferred tax liability is represented by assets which are working for the benefit of our shareholders. If net assets were increased by the amount of this deferred tax liability, the pro forma March 31, 2001 net asset value would be $80.19 per share. On this basis, the 20-year return percentage shown in the preceding table would increase to 14.4%.

The following analysis of a share of Capital Southwest stock shows the composition of the assets and liabilities underlying each share:

	Value Per Share	
Major investments:		
Palm Harbor Homes, Inc.	$20.59	
The RectorSeal Corporation	12.45	
Skylawn Corporation	9.96	
Alamo Group Inc.	7.40	$ 50.40
Other investments:		
Restricted securities	24.32	
Marketable securities	8.09	32.41
Cash and other assets		1.77
Total assets		84.58
Deferred taxes		(20.43)
Long-term debenture and other liabilities		(4.75)
Net assets at March 31, 2001		$ 59.40

In addition to a complete list of our investments, this report includes detailed information on our twelve largest holdings. These twelve investments had a combined cost of $50,379,546 and a combined value of $274,620,768, representing 86.9% of the value of our investment portfolio at March 31, 2001.

Building Blocks

Convential investment company reporting focuses primarily on the amounts and trends of net asset value, obscuring the fundamental importance of the real businesses owned indirectly by Capital Southwest shareholders.

Capital Southwest is generally classified as a venture capital company, although a more accurate term is a business development company in view of our concentration on developing the fundamental values of our holdings over many years. As our Company evolves and we retain many of our successful ventures, our investments fall into one of three categories: 1) holding company type assets including the four major investments referred to in the following section and other 25% to 100% owned long-term investments, 2) venture capital assets and 3) marketable (unrestricted) securities. As of March 31, 2001, we classify our portfolio as follows:

	Cost	Value	%
Holding company assets (mainly Palm Harbor, RectorSeal, Skylawn, Alamo and Whitmore)	$19,810,922	$201,943,760	63.9
Venture capital assets	55,240,497	83,115,331	26.3
Marketable securities	12,550,227	30,858,418	9.8
Total investments	$87,601,646	$315,917,509	100.0

Investment Activity

An aggregate of $15,922,079 was invested during the year, including $6,822,073 in additions to existing investments and $9,100,006 in the following new investments:

- $5,000,006 in Texas Capital Bancshares, Inc. of Dallas, Texas, which owns both Texas Capital Bank, NA, a locally operated bank serving middle market clients in Texas metropolitan areas, and Bank Direct, an Internet bank.
- $2,700,000 (currently $2,400,000) in Heeling, Inc. of Carrollton, Texas, which introduced Heelys, a unique athletic shoe with a removable skate-type roller mounted in the heel.
- $1,300,000 in Sprockets.com, Inc. of Boston, Massachusetts, provider of web-based file transfer and collaboration platforms to facilitate the creation of visual media from multiple locations.
- $100,000 of a $1,000,000 commitment to First Capital Group of Texas III, L.P., a San Antonio/Austin based venture capital investment company, which has previously co-invested with Capital Southwest.

Four Major Investments

Four of our major holdings - Palm Harbor Homes, Inc., The RectorSeal Corporation, Skylawn Corporation and Alamo Group Inc. – represent 60.9% of the value of our investment portfolio. At March 31, 2001, investments in these companies had an aggregate cost of $17,560,002 and a value of $192,264,000 ($50.40 per Capital Southwest share). Our Company's equity in their earnings for the most recently completed fiscal years was $19,559,000 ($5.13 per Capital Southwest share). At $50.40 per share, the aggregate value of our investments in these companies is equivalent to a price/earnings ratio of 9.8 - far below the March 31, 2001 ratios of 19.9 for the Dow Jones Industrials, 22.8 for the Standard & Poor's 500 and 288.6 for the Nasdaq Composite Index.

Four Up and Coming Investments

The four companies described on the following page – Media Recovery, Inc., Encore Wire Corporation, Concert Industries Ltd. and All Components, Inc. – are viewed as Up and Coming Investments. Collectively, they represent 16.3% of the value of our investment portfolio. At March 31, 2001, investments in these companies had an aggregate cost of $22,232,649 and a value of $51,535,000 ($13.51 per Capital Southwest share). Our Company's equity in their earnings for the most recently completed fiscal years (plus interest on debt securities owned by CSWC) was $5,462,000 ($1.43 per Capital Southwest share). At $13.51 per share, the aggregate value of our investments in these companies is equivalent to a price/earnings ratio of 9.4.

Unlike the Four Major Investments profiled in last year's report, these companies have yet to generate dramatic gains. However, their excellent results clearly reflect the competence of their managements and the potential rewards to investors who are committed to creating value by building businesses.

Media Recovery, Inc., founded in 1974 and based in Graham, Texas, was acquired in 1997 in a management buyout with equity financing provided by Capital Southwest and another venture capital firm. Media Recovery operates three divisions: Computer Supply, Shockwatch and Damage Prevention. The Computer Supply division distributes computer and office automation supplies and accessories to corporate customers through its direct sales force, with 25 offices and four distribution centers in 18 states. It accounted for 83.9% of Media Recovery's revenue in its most recent fiscal year. Shockwatch, with a plant in Graham, Texas, manufactures impact and tilt monitoring devices used to detect mishandled shipments. While providing only 9.2% of Media Recovery's revenue, Shockwatch's patented products accounted for 24.2% of total EBITDA during the most recent fiscal year. The Damage Prevention Company, Denver, Colorado, which was acquired by Media Recovery in 1999, manufactures corrugated dunnage products used to brace truck, railcar and export container shipments. Since 1989, Al Myers, a proven leader and seasoned manager, has served as Media Recovery's chief executive officer. Media Recovery, with approximately 285 employees, has grown internally and through acquisitions. For the year ended September 30, 2000, revenue was $92,705,000 and net income was $3,139,000. Capital Southwest owns a 68.2% fully-diluted equity interest in Media Recovery at a cost of $5,415,000 and a value of $18,000,000 – 8.4 times our $2,141,000 equity in its earnings. During the three years since the buyout, Media Recovery's sales grew by 64.2%.

Encore Wire Corporation (Nasdaq: WIRE), McKinney, Texas, was financed by Capital Southwest when it was founded in 1989 by its chairman, Vincent Rego, the dean of the building wire industry, who has built a 50-year success record. Encore Wire is the low cost manufacturer of copper electrical building wire and cable and is a significant supplier of wire for homes and apartments and for electrical distribution in commercial and industrial buildings. The company's estimated shares of the residential and commercial building wire markets are 15% and 11%, respectively. With 475 employees, Encore operates a single vertically-integrated, highly automated manufacturing facility from which its products are shipped throughout the country. Encore markets its products primarily through wholesale electrical distributors in the lower 48 United States. Its strategy is to expand its share of the residential and commercial wire markets by continuing to emphasize a high level of customer service and low-cost production and the addition of new products, such as color coded wire, to complement its product lines. Encore maintains inventory levels sufficient to meet customer demand and believes that the speed and completeness with which it fills orders are key competitive advantages critical to marketing its products. For the year ended December 31, 2000, Encore reported net sales of $283,689,000 and earnings of $8,050,000 ($0.52 per share). The closing market bid price on March 30 was $7.813. Capital Southwest owns 2,724,500 shares (a 17.1% fully-diluted equity interest) at a cost of $5,800,000 and a value (at $5.00 per share) of $13,623,000 – 9.6 times our $1,417,000 equity in Encore's earnings. During the past five years, Encore's sales grew by 87.5%, while copper unit volume grew by 146.5%.

Concert Industries Ltd (Toronto Stock Exchange: CNG.TO), Vancouver, British Columbia, manufactures pulp based air-laid nonwoven fabrics used as absorbent cores in a wide range of personal care products including feminine hygiene, specialty diapers and adult incontinence products and in a variety of other applications. Concert's major customers are multi-national companies which produce and market personal care products. The company entered the air-laid business in 1993 by building the Thurso, Quebec plant, which was expanded in 1997 to a capacity of 7,000 tonnes (metric tons) per year. In 1998, Concert opened its 55% owned plant in Falkenhagen, Germany and, in 1999, a second line was installed, bringing that plant's capacity to 28,000 tonnes. In June 2000, Concert acquired Airformed Composites, Inc. of Charleston, South Carolina, which has a new 10,000 tonne facility and had been financed by Capital Southwest. Construction of a major plant in Gatineau, Quebec, which is nearing completion, will increase Concert's capacity by 38,000 tonnes to 83,000 tonnes per annum, enabling the company to participate in the accelerating demand for air-laid fabrics. The architect of Concert's growth is CEO and founder, Dieter Peter. During the past three years, Concert's sales increased over tenfold to C$86,606,000 in 2000. Net income in 2000 was C$7,375,000 (C$0.31 per share). The closing market price on March 30 was C$6.30. Capital Southwest's investment has a cost of US$10,867,649 and a value of US$11,162,000, including a 10% junior secured note, 8% exchangeable subordinated debentures, a warrant and common stock, which correspond collectively to 2,917,128 shares at a cost of US$9,686,078 (C$5.23 per share) and represent 9.8% of Concert's fully-diluted shares.

All Components, Inc., Farmers Branch, Texas, was acquired in September 1994 in a buyout organized by the company's president, Robert Cooper, and financed by Capital Southwest and two other venture capital funds. All Components is a comprehensive supplier of products and services in the memory module segment of the electronics industry. The company delivers engineering and design services, contract manufacturing, test and repair services and independent distribution of memory assemblies through three operating divisions that collectively make All Components a "memory solutions provider" to a wide range of electronics entities. All Components' products are used in a variety of electronic devices, such as personal computers, servers, storage devices, routers, hubs, switches and specialty industrial devices. With a growing workforce of over 250 employees, the company operates manufacturing facilities in Austin, Texas, and Boise, Idaho, and a major sales and distribution facility in the Dallas metropolitan area. The company grew from $72 million in revenues in the fiscal year ended August 31, 1995 to $221 million in the fiscal year ended August 31, 2000, while memory prices dropped from $27.00 per megabyte to $0.30 per megabyte over the same five-year period. During this period, EBITDA increased from $2 million in fiscal 1995 to $9.6 million in fiscal 2000. For the year ended August 31, 2000, All Components reported net sales of $220,835,000 and net income of $4,025,000. Capital Southwest's $150,000 investment has a value of $8,750,000 – 7.5 times the $1,167,000 value of our 29.0% fully-diluted equity interest in the company's earnings. During the past five years, All Components sales grew by 206%.

Heeling Along the Road to Riches

Our investments are consistently boring – except for Heelys, the revolutionary stealth skate shoe which has generated shipments and orders to ship totaling over 300,000 pair since this unique form of transportation was introduced in late December 2000. If you have not sighted a Heeler, you soon will as the Heeling devotees embrace this *cool* product sponsored by a decidedly *uncool* investment company and now sold at Heelys.com and in hundreds of retail stores. Will *cool* trendsetters make Heelys the next big alternative sport? Try them yourself. I have.

Venture Capital or Ponzi Scheme

Two years ago, my letter dated June 1, 1999 pointed to the excess supply of venture capital, stating:

> *There will be a day of reckoning and an eventual collapse of the irrational market prices that have little or no fundamental support. This collapse will inevitably curtail the supply of venture capital which is being invested in anticipation of a continuing new issue market which places outrageous values on questionable concepts rather than realizable earnings.*

Nevertheless, the venture capital Ponzi Scheme raged on, reporting high double digit and even triple digit returns that lured new capital commitments of $60.0 billion to U.S. venture funds in 1999 and $92.9 billion in 2000. Ten years earlier - in 1990 - capital commitments to venture funds had been $3.1 billion, an amount commensurate with the market's opportunities and equivalent to only 1/30th of the $92.9 billion committed in 2000 by misguided fiduciaries and other lemmings. Except for the rewards reaped by those venture capitalists, investment bankers and other opportunists who dumped their cash-devouring enterprises on the public, how much real value was created?

Business Development or Capital Paralysis

Our Company's generic classification as a venture capital company fails to convey the importance of our emphasis on business development. Our aim is to provide patient capital, management assistance and philosophical support to foster the growth of real businesses which will have enduring value. When our long-term perspective causes us to overstay the market, as it sometimes does, we compromise our gains and paralyze our capital. But, when our Methuselah-like holding periods are appropriate, we achieve major returns – not measured in the percentage calculations which are enhanced by early exits, but in the more important annual earnings progressions which may each year exceed the cost of a successful investment. For example, our Company's equity in the most recent annual earnings of our Four Major Investments (held an average of 31 years) was $19,559,000, equivalent to 1.1 times the $17,560,002 cost of these investments. To fast-exit venture capitalists, this may be an embarrassingly low return, but to our long-term value-oriented shareholders, it is a growing annuity that reflects their continued ownership of real businesses.

William R. Thomas

June 8, 2001

President and Chairman