Intrepid Capital Funds

the constant pursuit of value

INTREPID SMALL CAP FUND

1Q2015

1st QUARTER 2015 COMMENTARY

MARCH 31, 2015

PERFORMANCE

	Inception Date	Total Return: Qtr.	YTD	1 Year	Average Annualized Total Returns as of March 31, 2015: 3 Year	5 Year	Since Inception
Intrepid Small Cap Fund - Inv.	10/03/05	-0.28%	-0.28%	-1.47%	5.32%	6.98%	10.08%
Intrepid Small Cap Fund - Inst.	11/03/09	-0.27%	-0.27%	-1.26%	5.58%	7.23%	9.02%
S&P 500 Index		0.95%	0.95%	12.73%	16.11%	14.47%	7.92%^
Russell 2000 Index		4.32%	4.32%	8.21%	16.27%	14.57%	8.25%^

^Since Inception returns are as of the fund's Investor Class inception date. Since the inception date of the Institutional Class, the annualized return of the S&P 500 Index is 15.88% and the Russell 2000 Index is 17.23%.

Performance data quoted represents past performance and does not guarantee future results. *Investment returns and principal value will fluctuate, and when sold, may be worth more or less than their original cost. Performance current to the most recent month-end may be lower or higher than the performance quoted and can be obtained by calling 866-996-FUND. The Fund imposes a 2% redemption fee on shares held for 30 days or less. Performance data does not reflect the redemption fee. If it had, returns would be reduced.*

Per the prospectus, the Fund's annual operating expenses (gross) for the Investor Share Class is 1.40% and for the Institutional Share Class is 1.15%.

April 1, 2015

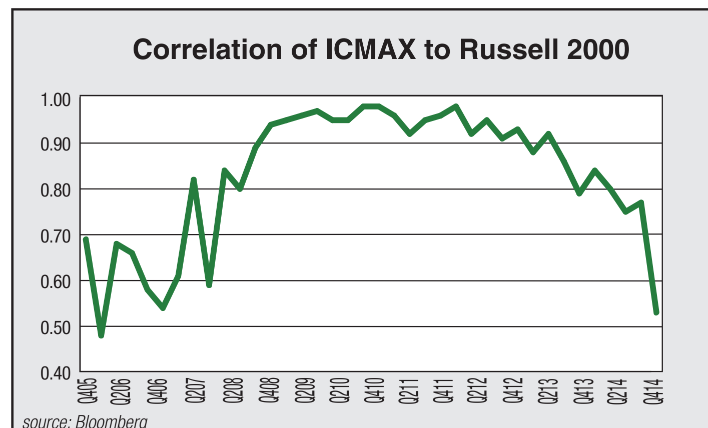
Dear Fellow Shareholders,

Have you seen those movies where a guy is alone in the desert, dying of thirst under the 110 degree sun? With only a few breaths to spare, he struggles over a sandy dune. Through blurred vision, he sees a sparkling lake in the distance. He slowly crawls toward this refuge, but the oasis disintegrates. It was a mirage.

That's what it feels like to be a value investor today. When you are desperate for an investment idea, you may start to see things that don't exist. You ignore what could go wrong and focus on what could go right. You imagine a solution to any corporate conundrum. As far as earnings, Non-GAAP is the new black. You take your analysis sunny side up.

In a state of investment fatigue, survival depends on how you respond. Do you correctly recognize a mirage as an illusion and live to fight another day? Or do you dive in headfirst anyway, potentially choking on a mouthful of sand? With small cap stocks at record highs and multiples at nosebleed levels, we believe discretion is the better part of valor.

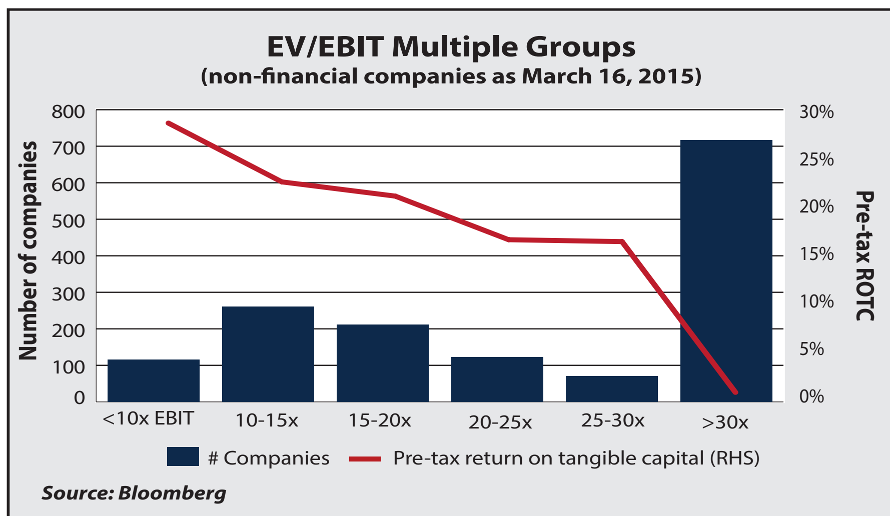
The Intrepid Small Cap Fund's (the "Fund") correlation of daily returns to the Russell 2000 benchmark is the lowest it has been since shortly after the Fund's launch, when it had less than $3 million in assets. The correlation was relatively high when we thought small cap stocks were cheap or reasonably priced (2008-2011), and it has fallen precipitously in recent years as our perception of market risk has mushroomed. According to Morningstar, most mutual funds have correlations to their benchmarks of 0.95 or greater. Ours was 0.53 over the past three months.



The correlation is not necessarily influenced by cash, as a fund that always returned exactly half of its benchmark would have a perfect 1.0 correlation. Rather, our low correlation is the byproduct of deliberate actions to invest in things that aren't popular and don't move along with the benchmark. Today, that includes energy stocks, precious metals, foreign companies, a convertible bond, and preferred shares. Configuring the Fund to look different than the Russell 2000 hasn't paid off yet, but we strongly believe this is the right course of action.

In mid-March, we calculated updated statistics for the Russell 2000 Index. **As of March 16, 2015, the Russell 2000's P/E ratio was 56x. Excluding financials, the P/E was 131x. In the aggregate, the Index has no free cash flow.** The median non-financial EV/EBIT multiple was 27x and the *pre-tax* return on *tangible* capital (excluding Goodwill) was approximately 10%--not exactly "the stuff that dreams are made of." Some might point out that younger, less profitable companies drag down the statistics. There are 821 "seasoned" non-financial companies in the Russell Index which were publicly traded in mid-2007, which was immediately before the last recession. The cumulative change in operating income for this group, over the past 7 years is...drumroll…less than zero (-4%). The cumulative change in market capitalization for this batch is +25%. This change in price is from July 13, 2007—the day of last market peak. Thus, a group of 821 small cap companies with lower earnings today than 7 years ago is collectively trading for more than 25% above prior *peak* levels. We don't believe the prior Russell 2000 peak is a sound valuation reference point, but this example illustrates the extremes we currently face.

We typically purchase stocks trading at single digit multiples of normalized operating income (EBIT). When we ran our analysis two weeks ago, there were 116 non-financial stocks in the Russell 2000 that sold for an EV/EBIT multiple below 10x, compared to over 700 names with multiples exceeding 30x. In a slap in the face to logic, returns on invested capital decline as multiples increase. The sub-10x, lowest multiple group contains many melting ice cubes and firms with imploding business models, like Eastman Kodak and Weight Watchers, as well as a host of oil and oil services companies where trailing earnings are unlikely to represent the future. It's not pretty. Nevertheless, this is the landfill that we rummage through on a daily basis, hoping to uncover something interesting.



During the first quarter, the Intrepid Small Cap Fund returned -0.28%, while the Russell 2000 benchmark gained 4.32%. The S&P 500's year-to-date return is 0.95%. Small cap stocks have outperformed large caps year-to-date as investors rush toward businesses with less currency risk. Biotech and pharmaceutical companies were star performers during the quarter. The Russell 2000 Biotechnology (ticker: RGUSHSBT) and Pharmaceutical (ticker: RGUSHSPH) Indexes rose 16.71% and 16.56%, respectively, in the three months ending March 31, 2015. Collectively, these companies sport a market capitalization of $231 billion and reported a combined trailing twelve month net loss of $8.7 billion. Needless to say, we don't own any of these firms, and it cost us on a relative performance basis. The equities within the Fund were basically flat in local currency terms in the first quarter (the Fund's foreign stock positions were fully hedged). Collectively, commodity stocks did not move the needle much, as solid gains on some positions (SM Energy and Newfield Exploration) were offset by losses on others (Contango Oil & Gas, Unit Corp. and Dundee Corp.).

Over the past few years, many people look at the relative performance gap of our Fund compared to the benchmark and think

we are idiots for holding so much cash. We are simply adhering to our mandate to not own stocks we deem to be overvalued. In our mind, stuffing a portfolio full of stocks trading at 50x or 100x earnings is setting oneself up for a catastrophe. The Fund ended the first quarter with 73.9% cash. We wrote this to you in our third quarter 2012 letter:

Any fund with the words "Small Cap" in its name must have an investment objective to normally invest 80% of the Fund's assets in small capitalization companies. Funds that invest in small caps but do not have Small Cap in their title are exempt from this rule. The Intrepid Small Cap Fund has not met the 80% objective for the past two years because we have not found enough undervalued small caps to fill the portfolio. Funds like ours are permitted to take a "temporary defensive position" and hold more than 20% cash in response to "adverse market or economic conditions." Please review our prospectus for this disclosure. From our perspective, an adverse market is not when stocks are falling sharply but when they have risen beyond what normalized earnings can justify.

We do not know when the Fund will be 80% invested again, since it depends on the external opportunity set. We approached the 20% cash level last August, but the market quickly resumed an upward path. Our cash is not a market call, but it is a byproduct of how many undervalued businesses we discover through our bottom-up analysis. While the Fund could become more invested without a change in market levels, we think that small caps will need to experience a selloff before we find enough ideas to reduce cash meaningfully.

Top Ten Holdings	(% of net assets)
Amdocs Ltd.	3.1%
Tetra Tech, Inc.	3.0%
Corus Entertainment, Inc. - Class B	2.8%
Ezcorp Inc. 06/15/2019, 2.125%	2.3%
Dundee Corp. - Class A	2.2%
Pitney Bowes Intl Pfd Stock	2.2%
Bio-Rad Laboratories, Inc.	2.2%
Unit Corp.	1.8%
Sandstorm Gold Ltd.	1.6%
Ingram Micro, Inc.	1.5%

Top ten holdings are as of March 31, 2015. Fund holdings and sector allocations are subject to change and are not recommendations to buy or sell any security.

Our cash stake has remained elevated far longer than we anticipated, due to small cap stocks becoming increasingly overvalued, in our opinion. It has been a bull market run for the ages on the back of a feeble economic recovery. Despite our strong convictions that most small caps are exceedingly expensive, we don't know when things will change. As a result, **we expect that at some point during 2015 we will change the name of the Intrepid Small Cap Fund. There will be no change in the Fund's approach.** We will continue to seek out undervalued small cap stocks, and any change in cash levels will be contingent on finding undervalued securities.

This change is solely being made to address our interpretation of SEC rule 35d-1, which states that Funds with descriptive names should strive to invest 80% or more of assets in a manner consistent with the name (in our case, small cap stocks) "under normal circumstances."[1] We believe the investment climate has been anything but normal, as central banks have inspired a rally of epic proportions. We expected a correction long ago, and it could still happen at any time. We are overdue by any historical comparisons. However, the Fund's last significant cash drawdown was in the summer of 2011, which was the last time stocks sold off appreciably. Our "temporary defensive position" is becoming more permanent than we ever predicted. By changing the Fund's name to a less descriptive label today, we can continue implementing the same investment philosophy (ironic, isn't it?), which we believe will result in the best shareholder outcomes, while living within the spirit of the Commission's naming rule.

We didn't purchase anything new in the Small Cap Fund in the first quarter, although we sold a few names. We exited our positions in Ipsos (ticker: IPS FP), SM Energy (ticker: SM), Newfield Exploration (ticker: NFX) and Northern Oil & Gas (ticker: NOG). Ipsos reached our fair value target as European equities have performed well in 2015. SM Energy and Newfield Exploration also hit our intrinsic value estimates after the stocks popped due to end of year reports. We sold Northern Oil & Gas after the shares outperformed the peer group early in the year, potentially over enthusiasm related to an activist's 13D filing. We rotated most of the proceeds into Unit Corp. (ticker: UNT), one of our existing energy holdings, which has a stronger balance sheet than Northern.

The Fund's largest contributors in the first quarter were Amdocs (ticker: DOX), SM Energy, and Bio-Rad (ticker: BIO). Both Amdocs and Bio-Rad have long been among the Fund's biggest holdings. Amdocs has continued to be a reliable cash flow generator, steadily building intrinsic value each quarter. Bio-Rad's shares rallied after the firm delivered better currency-neutral revenue performance than investors may have been expecting. Although Bio-Rad still trades far more cheaply than other life sciences companies, management has lost credibility with past projections about the cost and impact of a corporate ERP (Enterprise Resource Planning) system. We partially reduced the position. While our holding period for SM Energy was short, we realized a significant gain. We remain disciplined in selling energy positions when they factor in more favorable outcomes for oil prices than we are anticipating.

[1] https://www.sec.gov/rules/final/ic-24828.htm

The positions detracting most from the Fund's first quarter performance were Corus Entertainment (ticker: CJR/B CN), Tetra Tech (ticker: TTEK), and Contango Oil & Gas (ticker: MCF). Tetra Tech has struggled to meet guidance as it deals with the winding down of its fixed price construction segment in order to focus on its higher-margin consulting work. Tetra Tech is the nation's leader in consulting on water projects, but it has also aggressively grown its oil & gas business (~one third of operating profit). Some investors may be concerned that oil & gas-related revenue will be pressured, although Tetra Tech is primarily exposed to more stable midstream projects.

Investors reacted negatively to Contango's end of year production and reserve report and guidance for 2015. Production fell as the company curtailed drilling in response to cratering oil prices. Management axed planned 2015 capital spending by 73% versus 2014, pledging to only drill what is necessary to meet short term lease expirations, and in limited cases, exploratory well tests. Additionally, after analyzing new well data, Contango lowered its proved reserves due to a negative revision in a large offshore gas field. The company has a nasty habit of haircutting offshore reserves, although it's admittedly difficult to know ahead of time what the decline rate will be for a massive offshore field. While the reserve adjustment was unwelcome, we believe the market's reaction was more tied to production and capex guidance. On this front, we think management is acting rationally. Contango has an excellent balance sheet, but its assets are not as robust to lower oil prices as some other domestic E&Ps. They are wise to defer drilling. Contango may trade at the lowest multiple to NAV of any unlevered small cap E&P. We believe investors give the company little credit for undeveloped reserves or a highly profitable gas joint venture. For those seeking E&P exposure who don't mind owning a cigar butt, we think Contango is a good bet.

We typically devote more space in the letter to discussing our underperforming names, and Corus Entertainment was one of the Fund's top detractors for the second quarter in a row. In March, the Canadian Radio-television and Telecommunications Commission (CRTC) announced a set of rules requiring TV broadcasters to offer channels on an a la carte basis ("pick-and-pay") in Canada in order to "maximize choice." Ironically, the CRTC's decisions should ultimately lead to less viewer choice, with smaller channels dying and consumers paying significantly higher prices per channel for survivors. The policy decisions were more stringent than we predicted a few months ago, since we thought regulators would view the new U.S. over-the-top offerings of *HBO, Showtime, CBS*, and others as evidence that strict regulatory involvement was not necessary for the TV bundle to evolve. We were wrong and shouldn't have underestimated the tendency for bureaucrats to cave to political pressures.

With that said, we believe we understand Corus's pick-and-pay predicament better than most investors and sell side analysts. First, under an a la carte regime, we think both broadcasters (at the wholesale level) and cable and satellite providers (at the retail level) will meaningfully raise prices for popular channels to offset lost volumes. Many consumers will opt to remain in the bundle. Although Corus will face headwinds from TV unbundling, we believe investors are ignoring the aspects of the company's portfolio that are more resilient to pick-and-pay, including Corus's radio business, pay networks (e.g. *HBO Canada*), French channels, and merchandising and distribution revenues. These categories account for an estimated 40%+ of EBITDA and are either unrelated to network penetration (radio, merchandise) or already largely distributed on an a la carte basis (pay, French).

That still leaves almost 60% of cash flow that is directly exposed to the effects of pick-and-pay, including both subscriber fees and advertising revenue. Corus's top 3 networks deliver the lion's share of profitability, and these are each ranked by ratings as top 10 specialty networks in Canada. We do not expect them to go away, and we think that through shrewd pricing calculus the firm can withstand large losses to subscriber revenues even as household penetration falls. On the advertising side, ratings primarily drive revenues, and in theory, most of those households who have been watching the networks will still watch them after pick-and-pay is implemented. We believe that some of Corus's smaller networks will not survive, but these account for a minor share of profitability.

Pick-and-pay pricing is not Corus's only issue. In spite of robust television ratings, the company has stumbled recently with shortfalls in advertising from U.S.-based consumer packaged goods manufacturers, partially due to the depreciating Canadian dollar. Also, cord-cutting trends remain an overhang on the whole industry as over-the-top solutions proliferate and strengthen. On the other hand, now that pick-and-pay decisions have been publicized, there may be a higher likelihood of Corus merging with Shaw. The Shaw family controls Corus, and economically it makes sense to combine Corus with Shaw Media, the broadcast division. The merged business would dominate the kids and women's TV spaces in Canada. Corus's stock is selling for 9.5x this fiscal year's guided free cash flow. In our judgment, this multiple is too low and assumes more severe earnings pressure than we are forecasting.

When we think about the small cap market, it reminds us a lot of the rip currents you can find on the Florida beaches less than a mile from our offices. A riptide is a narrow current of water that flows strongly directly away from the shore. The leading cause of ocean deaths are rip currents, as swimmers try in vain to swim against the pull of water. If you are caught in a rip current, you're

supposed to keep calm and swim sideways, parallel to the beach, until you are past the current. If that doesn't work, try to float until the current loses strength further offshore. In recent years, short sellers have been swimming against the world's greatest artificial rip current—a central bank-driven bull market. The strong shorts could survive, exhausted, while the weak have already succumbed. At the Intrepid Small Cap Fund, we've been swimming sideways, paring positions and holding cash, and finding that this rip current has unimaginable breadth, with edges that continue to expand. It's not a freak of nature, but a freak of the Fed. Most investors have been swimming *with* the current. We're sure the rush has felt great, as they reach swimming speeds on par with Olympic athletes and exchange high-fives with Flipper in between strokes. Yet, we wonder if at some point in the future, these folks will pause for air, look around, and realize they are miles from shore with no way to make it back safely.

Thank you for your investment.

Sincerely,

Jayme Wiggins, CFA
Intrepid Small Cap Fund Portfolio Manager

Mutual fund investing involves risk. Principal loss is possible. The Fund is subject to special risks including volatility due to investments in smaller companies, which involve additional risks such as limited liquidity and greater volatility. The Fund is considered non-diversified as a result of limiting its holdings to a relatively small number of positions and may be more exposed to individual stock volatility than a diversified fund. The Fund may invest in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods.

The Advisor believes that current market conditions warrant a defensive position from the requirement to invest at least 80% of its net assets in equity securities of small capitalization companies.

The Russell 2000 Index consists of the smallest 2,000 companies in a group of 3,000 U.S. Companies in the Russell 3000 Index, as ranked by market capitalization. The S&P 500 Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. The Russell 2000 Biotechnology Index and the Russell 2000 Pharmaceutical Index are sectors of the Russell 2000 Index. You cannot invest directly in an index.

Cash Flow measures the cash generating capability of a company by adding non-cash charges and interest to pretax income. Free Cash Flow measures the cash generating capability of a company by subtracting capital expenditures from cash flow from operations. Free Cash Flow Yield equals normalized free cash flow divided by the company's market capitalization. It measures how well a company generates cash from its current operations. EBITDA is calculated as the company's Earnings Before Interest, Taxes, Depreciation and Amortization. Net Debt to EBITDA is a measurement of leverage, calculated as a company's interest-bearing liabilities minus cash or cash equivalents, divided by its EBITDA. EV/EBIT is the ratio of a company's enterprise value (EV) to its earnings before interest and taxes (EBIT). Enterprise Value equals market capitalization plus debt minus cash. Non-GAAP (Generally Accepted Accounting Principles) is an alternative earnings measure of the performance of a company. E&P (Exploration and Production) is a type of company in the oil and gas industry focused on discovering and extracting crude oil and natural gas from underground reserves. Capital Expenditure (CAPEX) is money invested by a company to acquire or upgrade fixed, physical, non-consumable assets, such as buildings and equipment or a new business. Correlation is a statistical measure of how securities move in relation to one another. Price to Earnings (P/E) Ratio is calculated by dividing the current price of a company's stock by its trailing 12 months' earnings per share. Pre-tax Return on Tangible Capital is calculated as Earnings Before Interest and Taxes (Operating Income) divided by Shareholders Equity plus Debt minus Cash, Goodwill and Other Intangible Assets.

Opinions expressed are subject to change, are not guaranteed and should not be considered investment advice or recommendations to buy or sell any security.

The Intrepid Capital Funds are distributed by Quasar Distributors, LLC.