Intrepid Capital

MANAGEMENT INC.

the constant pursuit of value

1Q'12	01/01/12 – 03/31/12	
▲	Dow Jones	8.84%
▲	S&P 500	12.59%
▲	NASDAQ	18.98%
▲	Russell 2000	12.44%
▲	E.A.F.E.	11.00%

QUARTERLY MARKET LETTER — April 2012

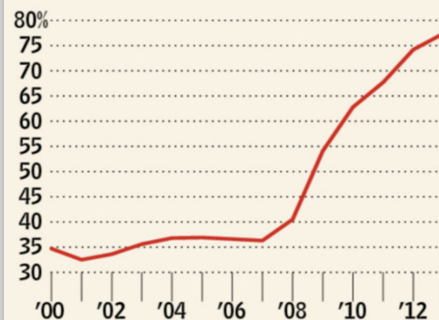
> "Debt is the slavery of the free"
>
> — *Publilius Syrus*

Dear Friends & Clients,

For the moment, the financial markets have overlooked the monumental amount of U.S. Treasury debt outstanding. This debt, held in large part by the American public and China, has expanded to $11 trillion, including $5 trillion accumulated in the last four years alone (see chart at right).

The Debt Boom

Federal debt held by the public as a share of GDP, 2000-2013*



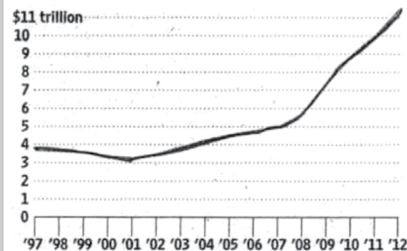
*2012 and 2013 Estimates
Source: Office of Management and Budget

If it weren't for two pertinent facts, there might be tear gas in a street near your home. First, the U.S., unlike certain members of the European Union (e.g. Greece), prints its own currency. Ironically the dollar is imprinted with "In God We Trust," but the Lord knows there is nothing to back our currency other than hollow political promises. Second, our external debt interest costs are financed at the short end of the yield curve. If you recall, a few years back homeowners got in trouble with financing long-term assets – their homes – with short-term liabilities – adjustable rate mortgages (ARMs). From what I can tell, that didn't work out so well.

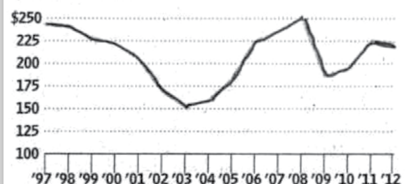
Our elected officials in Washington have scheduled $5 trillion of the $11 trillion outstanding to mature in the next three years. I should point out that any public company with a financing need and a CFO worth his salt has extended its maturities as far out into the future as possible.

Washington's Low-Rate Windfall

Federal debt held by the public



Net federal interest payments on debt held by the public, in billions



Note: 2012 estimates
Sources: Congressional Budget Office, Office of Management and Budget

This Treasury debt currently costs roughly 2.2% per annum, or the princely sum of about $225 billion in interest expense. If rates were to "normalize," say at 5 to 6%, our interest costs would exceed the annual cost of Medicaid or Medicare. The icing on the debt cake is that there is $550 trillion in notional value of interest rate derivatives outstanding, all held by five banks. To put this in perspective, world GDP this year will be $70 trillion.

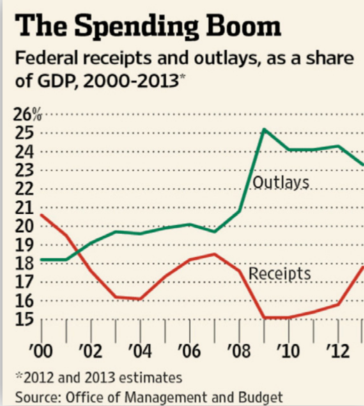
I bring all of this up because interest rates have tended to move up or down over generational time periods. From 1946 to 1981, interest rates went up. From 1981 until just recently, rates have moved down. One of the key variables in valuing a business is the interest rate used to discount cash flows back to present value. Rising "risk free" rates could prove to be a headwind for higher equity prices.

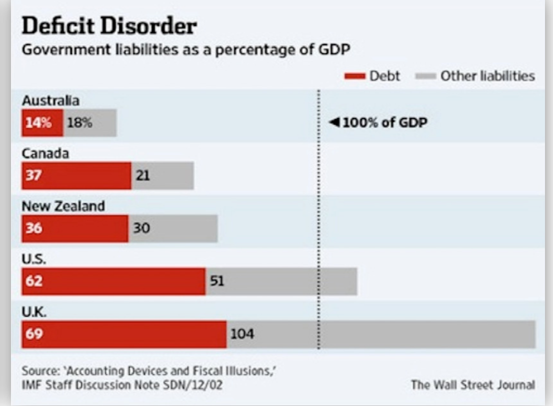
continued on page 2

The debt issued will either be resolved by higher growth that enables the country to service these debts more easily or through the inflationary effects of currency depreciation, much like what Argentina has done.

In this election year, I am hopeful that we bring forth policies that promote savings, investment and risk taking. The "recovery" since the official end of the recession in June 2009 has been subpar. Throughout our history the more harsh the recession, the more rapid the recovery has been. Not this time. Over the last 50+ years, the economy has grown at 3.2% annually. This recovery has averaged 1.6% per annum.

The crowding out effect may have something to do with the lackluster growth. The government is spending 24% of GDP and only bringing in 16% of GDP in tax receipts, compared to a more "normal" sized government spending 20% and collecting 18%. As you can see from the above example, we need both faster growth (tax receipts) and smaller government (back to 20% of GDP) to get our fiscal house in order.



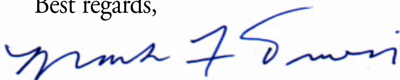


The equity markets have enjoyed this governmental largesse of "free money" brought about by market manipulations courtesy of the Federal Reserve, but I think elected officials have put them in a tough position. Returns for the equity indexes are up more than 30% since early October and low double digits since January 1st of this year. If the equity markets were a high school dance, we would be the girl standing alone in the corner while everyone else was out on the dance floor. As I would expect in an environment marked by an almost parabolic increase in equity prices, we look like an unattractive dance partner, a step slow if you will -- at the moment!

Our bottom up, internally generated research process seeks high quality, lightly levered, cash generative businesses. Once found, we look to purchase at a discount, or a price below fair value. When we are unable to find appropriate mispricings, we default to cash or very short term Treasury bills. Our cash levels tend to be countercyclical in that when security prices are high (by our estimation), then our cash is high. When volatility is high and prices are low (by our estimation), we may be fully invested.

For the last three years, the S&P 500 and Russell 2000 equity indices have compounded annualized returns slightly above 23% and 26%, respectively. This broad increase in prices has made our preference to be fully invested nearly impossible. Stay tuned as opportunities often present themselves when they are least expected.

Best regards,



Mark F. Travis,
President and CEO

"Will this count against my carbon footprint?"

Intrepid Capital
MANAGEMENT INC.

SMALL CAP PORTFOLIO

Like a tired dog, Wall Street is accustomed to walking around in circles. Instead of writing this letter, we almost re-posted the commentary from last year's first quarter. Little has changed since then, even though the market has bounced around quite a bit. Through the first three months of 2012, the Intrepid Small Cap Portfolio (the "Portfolio") gained 5.35%, net-of-fees, versus a 12.44% increase for the Russell 2000 Index. We have trailed small cap benchmarks during this upswing, much like we did in last year's early ramp. The reasons are basically the same. Small caps are back to all-time highs and undervalued securities are scarce. As a result, our portfolio consists of lower beta holdings and a large amount of cash.

Cash and equivalents equaled 47% of Portfolio assets at March 31, 2012. According to the Investment Company Institute, the average equity mutual fund has 3.6% of assets in cash, which is close to a historical low. A record high level of cash for the fund industry of almost 6% was reached in early 2009. Interestingly, that was the last time the Intrepid Small Cap Portfolio held less cash than our peers. Our cash has returned to 2007 levels because the small cap opportunity set is similarly constrained. Unlike then, when we earned 5% in Treasury bills, the Federal Reserve has eliminated the returns from owning risk-free investments. By punishing savers and promoting higher stock prices, the Fed hopes to create a virtuous circle of consumer and corporate confidence. Why own a risk-free Treasury that pays nothing if an investment grade bond yields 3%? Why accept a high grade coupon of only 3% if junk bonds yield 7%? Why settle for below investment grade debt at 7% if stocks have increased 9% annually over the "long run"? The logic of the slope of relative returns is very slippery. Pitfalls abound.

Although certain European economies are worse off than the U.S. is today, America isn't an economic oasis. Unfortunately, the short-term impact of doing the right thing by reducing spending is politically unpalatable. Today, the front page headline on *The Wall Street Journal* reads, "Markets Fear End of Stimulus." Investors shouldn't be trading on hopes of unsustainable government intervention, but it has existed for so long now that it's difficult to discern how our economy would look standing on its own two feet. What would happen to the collective top line of Corporate America if our government had a balanced budget? To what extent has the decades-long decline in interest rates given a tailwind to borrowers?

There were rumblings of margin pressure in the fourth quarter, but corporate profitability remains near peak levels. Some market participants claim that small cap margins, in contrast to large caps, are not yet back to the record highs of 2006. Based on our internal analysis, this is false. The median operating margin for non-financial companies in the Russell 2000 was 6.8% in 2011 and 7% in 2006. The market cap weighted average margin was 10.2% and 10.1% in 2011 and 2006, respectively, excluding outliers. Larger companies in the small cap index have higher profitability. Financials were excluded from the data because interest is a component of their operating profit. The margins of financial companies, namely banks, have fallen significantly since the housing bubble.

Some in the investment community claim that there have been structural changes in the economy (e.g. technology, globalization) that permit higher margins than were historically attainable. The economy has shifted from manufacturing toward services over the years. One can make the case that since service businesses generally require fewer assets than manufacturing businesses, the economy's steady state margin should actually be lower, not higher. Competition drives down returns toward the cost of capital. The return on capital is the product of unlevered after-tax margins and invested capital turnover (operating margin * [1 – tax rate] * [sales/invested capital]). Therefore, if the economy becomes more asset light (i.e. invested capital declines), margins for companies without a sustainable competitive advantage should be competed downward. We believe small company margins are as high as they've been in a long time and expect them to eventually contract.

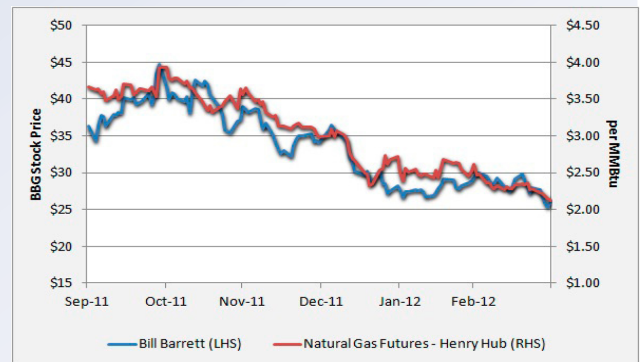
The Portfolio's largest contributors

during the first quarter included many of the same companies that fell furthest in the preceding quarter. The three stocks adding the most to the portfolio's return were Federated Investors (ticker: FII), Computer Sciences (ticker: CSC), and CoreLogic (ticker: CLGX). Federated's stock previously suffered from the specter of SEC regulation of money market funds, as well as the Fed's pledge to keep interest rates near zero through 2014. Speculation has grown that the SEC committee charged with proposing money fund reforms is leaning in the direction of less harsh regulation. Additionally, the market has started to doubt that interest rates will remain at zero for another two years. These developments helped drive Federated's shares up 48% in the quarter, adding 1% to the Portfolio's overall return.

We opined in last quarter's letter that Computer Sciences was "broadly hated" and believed the shares were attractive. The stock received a nice bounce in early February as the firm simultaneously announced earnings and the appointment of Mike Lawrie as CEO. Lawrie has a successful track record of turning around troubled firms, and the resignations of CSC's former CEO and CFO could help restore credibility to the management team. The company's earnings report was weak, but bookings were strong. CSC also is making progress in its negotiations with the U.K. National Health System. This contract has dogged the firm for years and clarity would be welcomed by investors.

CoreLogic was the Portfolio's third largest gainer in the first quarter. The stock has been highly volatile over the past year, and we have taken advantage of these movements to resize our position. For example, CoreLogic was briefly a 4% weighting and the Portfolio's largest holding last August, before the company announced it was examining strategic alternatives. In Q1, CoreLogic said its strategic review was complete and the firm plans to remain independent. To the surprise of many, the stock rallied on this news, which was accompanied by solid guidance for 2012. As CoreLogic, Federated, and CSC have approached their intrinsic values, we have reduced the positions.

Bill Barrett (ticker: BBG) was the Portfolio's only major detractor in the quarter. This position negatively impacted the Portfolio's return by 61 basis points. Bill Barrett's stock has been hammered by the lowest natural gas prices in ten years. *The Wall Street Journal* even speculated recently that natural gas prices will turn negative this summer (March 28, 2012: "Why Natural Gas Prices Could Fade to Red"). There's no denying that natural gas inventories are bloated and prices are in the gutter. We do not expect natural gas prices to stay at existing low levels. There is no incentive for E&P companies to drill for new gas today, and we are fast approaching the point when operators will take a loss producing already developed reserves. We expect supply to fall and demand to gradually increase. Nevertheless, our investment thesis for Bill Barrett does not depend on a sharp rebound in natural gas prices back to the averages of recent years. While Bill Barrett is clearly perceived as a natural gas company (see chart below), approximately half of its revenue comes from oil and natural gas liquids, which are priced at a premium to dry gas. Ultimately, we believe that investors will recognize that Bill Barrett has substantial "wet" assets that are more highly valued in today's market. We more than doubled our ownership in Bill Barrett's stock during the quarter as the shares fell 23%.



Per MMBtu = per 1 million Btus Source: Intrepid

New purchase activity was limited in the first quarter. We bought small positions in Amdocs (ticker: DOX) and Pan American Silver (ticker: PAAS). Amdocs is the world's leading provider of billing and customer care solutions to the communications industry. It is a high-quality business that generates substantial free cash flow and possesses a pristine balance sheet.

Pan American is a silver miner that we have previously owned. Over the past two years, the price of silver has doubled while Pan American's stock has slightly declined. The stock trades for 5x operating income. Shares have fallen because of reduced expectations for another round of money printing by the Fed. In theory, no more quantitative easing should lower inflation expectations. In our opinion, the Fed's money printing antics are not over. Pan American Silver provides a small hedge against the possibility of increased inflation. We will not claim to know the fair value for an ounce of silver, but our Pan American valuation assumes a normalized silver price that is well below recent levels.

During the quarter, we sold our holdings of ICU Medical (ticker: ICUI), Oshkosh (ticker: OSK), Scholastic (ticker: SCHL), and Total Systems Services (ticker: TSS). Each of these stocks crossed fair value. Scholastic's rise was more company-specific than the others, as the success of *The Hunger Games* gave a temporary boost to earnings.

Lower-quality stocks have outperformed this year. We don't believe that increasing portfolio risk is prudent at current market valuations. We have a long shopping list of companies we want to own at the right price. While bargains are limited today, the sentiment of the market can change rapidly. We are well-positioned to capitalize when this occurs.

ALL CAP EQUITY PORTFOLIO

For the first calendar quarter ended March 31, 2012, the Intrepid All Cap Equity Portfolio (the "Portfolio") returned 8.97%, net-of-fees. During the same period, the Standard & Poor's 500 Index returned 12.59% and the Russell 3000 Index rose 12.87%. In this environment, in which the broad market increases so steeply, we believe our results will typically underperform compared to benchmark indices. We believe this because we strive to maintain a consistent investment process in all environments. Because we do not shift from our disciplined value investment process to a more growth-oriented or momentum-driven approach, we may sometimes encounter periods of underperformance, as we did in this quarter.

One result of our investment process was an increase in the Portfolio's cash position. A rising market has usually resulted in fewer discounted investments available for purchase and more sales of existing holdings that reached our estimated intrinsic value. The Portfolio's cash level has risen from 18.7% in the previous quarter to nearly 35% at the end of the most recent quarter. Naturally, this has a dampening effect on performance in current rising market conditions. On the other hand, there is a method to our madness. Our cash levels have typically been inversely related to our investment opportunities available. In times like these, where discounts are harder to find, cash will be high. Should the market pull back, we have cash to deploy in purchasing new opportunities. Our cash position has two purposes. First, we think that it should help hedge against potential losses in the event of a market correction. Second, it affords us the flexibility to buy new positions without having to sell other positions. In doing this, we believe that we can provide a lower-volatility experience for Portfolio investors.

When we write about our cash positions, the first question on most investors' minds has to do with our expectations for future market performance. Given the Portfolio's high level of cash, are we implying that we believe that the market will decline in the future? We respond by saying that we do not attempt to time the market. However, our cash position is evidence of our perception of the overall risk of the market. To us, risk and volatility are not synonymous. Volatility is short-term movement in market prices; risk is the potential for long-term loss of principal. Can we say with certainty that the market will decline? Of course we cannot. We know of many value investors who point to the S&P 500 Index's P/E multiple (Price to Earnings ratio) and say that it looks reasonable. In our view, that number, currently 14.59 times, does look reasonable, but only if one assumes that the earnings in the statistic are maintained or grow. Statistics such as P/E only look at the trailing twelve month period, which in this case has seen growth in overall corporate profits. We do not consider future growth in profits to be a given.

As a matter of fact, we are concerned that overall corporate profit margins (defined as trailing twelve month net income divided by trailing twelve month net sales) are at or near peak values. Profit margin is a sign of a firm's efficiency in generating profits, or viewed more simply, how well a firm is performing. They can fluctuate. In the case of the S&P 500 Index, the current profit margin is 13.81%. Over the past ten years, it has fluctuated, going as low as 8.30% in September 2009 and as high as 14.53% in January 2007. Likewise, the Russell 3000 Index's profit margin is currently 13.41%, with a ten-year high of 17.62% in July 2011 and a low of 7.53% in September 2009. It is amazing to see how rapidly these margins re-inflated from their floors in September 2009. We believe that corporate profit margins have benefitted from aggressive cost cutting activities over the past two years. Going forward, we believe there is much less room for increasing efficiency through continued cost-cutting measures, and some of the measures currently benefiting margins may even be unsustainable.

For the quarter, there were not many holdings which performed poorly. Of the two which detracted from performance, one was a new addition and another was a position to which we are adding. The former is Bill Barrett Corporation (ticker: BBG), which is widely known as a natural gas driller. The stock has been hurt by the massive decline in natural gas prices. What is less obvious to casual observers is that Bill Barrett also has liquid production, both in petroleum and natural gas liquids. We think that the market is pricing Bill Barrett at trough natural gas prices instead of long-term normalized prices. The net result of our investment was a detraction of 44 basis points from the Portfolio's quarterly return. You can read more about Bill Barrett in the Intrepid Small Cap Portfolio section. Our second underperformer, World Wrestling Entertainment (ticker: WWE), took away only approximately 3 basis points from the Portfolio's quarterly return. Continued uncertainty over the launch of WWE's television network has been weighing on the stock. We will continue adding to the position as the stock price permits.

The Portfolio's performance benefitted from its flexibility to invest across all market capitalizations. Specifically, the Portfolio's investment in select large cap equities added to overall quarterly performance. At the end of 2011, four of the Portfolio's top five holdings were large caps: Gilead Sciences (ticker: GILD), Dell, Inc. (ticker: DELL), Microsoft Corp. (ticker: MSFT), and Bank of New York Mellon Corp. (ticker: BK). These four securities accounted for more than one third of the total return in the quarter. We were compelled to sell Gilead when it reached intrinsic value, and we are closely monitoring the discounts in the other stocks mentioned. The best performer in the quarter was Federated Investors (ticker: FII), which added 99 basis points to the Portfolio's total return in the quarter. Prior to the first quarter, the uncertainty of money market regulation had weighed down FII's share price. As the quarter progressed, the market seemed to grow more confident that: 1) added regulation is less certain than originally thought, and 2) if regulation is added, it will not happen anytime soon. Given the increase in FII's share price and corresponding decrease in discount, we cut the position in half.

As we have stated before, sustained increases in stock prices have led to smaller discounts in our holdings, which means we will likely be selling more than we are buying. That was the case in this quarter. At the start of the quarter, the Portfolio comprised 34 equities. It ended the quarter with 30 holdings. We added two new positions in the quarter: Bill Barrett, mentioned above, and Cott Corp. (ticker: COT), a market leading private-label soft drink and juice manufacturer and distributor. Of the eight positions we exited completely, all were due to their stock prices reaching our corresponding intrinsic value estimates.

We end this letter by examining the discount within the Portfolio. Each security we own has a discount to its intrinsic value which is based upon its market price and our calculated intrinsic values. At the end of the quarter, that average discount was 12%. Bear in mind that this metric is a snapshot taken at the end of the quarter. We exited those positions whose discounts evaporated as their stock prices rose, so

they are not included in the Portfolio's discount calculation. Selling positions which have a small discount or a premium to our calculated intrinsic values while keeping those equities with larger discounts has a net effect of maintaining a larger average discount than if we had simply held a static portfolio over the quarter.

BALANCED PORTFOLIO

For the period ended March 31, 2012, the Intrepid Balanced Portfolio (the "Portfolio") returned 6.10%, net-of-fees, in the first calendar quarter. Taking a step back, the Portfolio has produced annualized returns, net-of-fees, of 17.70%, 6.38%, and 9.72% over the last three years, five years, and since inception, respectively.

At this point in all of my letters, our lawyers force us to remind you that "past performance is no guarantee of future results." With that out of the way, we do tend to agree with the lawyers on past performance, but we also think well designed strategies with a rigorous, disciplined process should continue to attain attractive risk-adjusted results over the long run.

Prospective investment returns depend on what an investor is willing to pay today for a stream of expected future cash flows, whether those cash flows are delivered by a stock, bond, or other type of investment vehicle. In an environment where broad equity indices such as the S&P 500 have annualized three-year returns exceeding 20%, finding strong businesses trading at attractive prices has become quite challenging. The same can be said of corporate debt securities, whose prices remain artificially inflated by the lowest interest rate environment in years.

The easy way to think of the investment process we deploy at Intrepid Capital is that when security prices are depressed and offer attractive prospective returns, our cash levels tend to be low. Conversely, when prices are high and your brother-in-law is bragging about his stock market winnings, our cash levels tend to be high.

I have often lamented over the last 17 years as a portfolio manager about how much easier my life would be if I were a "closet indexer," holding a basket of securities that closely resembled market benchmarks and floating with the tide, whichever way it may be going. Easier for me, yes, but much harder for you, since I would be able to blame losses of your capital on "the market" and avoid accepting any culpability.

At Intrepid Capital, our value-sensitive, contrarian-tilted investment process can be "painful" as we try to grow your capital base and ours, with an ever-watchful eye on risk. Risk is the evil twin sister of return that is often ignored when markets march upward, but will quickly find its way to the front of investors' minds when asset values begin to fall.

For the quarter, the three biggest contributors to positive performance were: Computer Sciences (ticker: CSC), CoreLogic (ticker: CLGX), and Microsoft (ticker: MSFT). To be "fair and balanced" in our reporting, our largest detractors for the same period were: Newmont Mining (ticker: NEM) and Bill Barrett Corp. (ticker: BBG). Interestingly, these last two are what we refer to as "asset valuations," where we think there is a material disconnect between the current market price of a business and the long-term value of its asset base net of liabilities. The recent decline in share prices has only increased our conviction, and we have taken the opportunity to increase our weights in these holdings.

HIGH YIELD PORTFOLIO

The high-yield market extended the gains booked at the end of 2011, rising 5.15% in the first quarter ended March 31, 2012, as measured by the the Bank of America Merrill Lynch High Yield Master II Index (the "Index"). In contrast, the Intrepid High Yield Portfolio (the "Portfolio") gained 2.46% in the quarter, net-of-fees. As discussed in previous quarterly commentaries, our short-duration, high-quality bias tends to underperform in periods of rapidly rising prices.

The largest contributor to the Portfolio's first quarter performance was Computer Science Corporation 6.500% due 3/15/2018. We entered this position early in the quarter as the bond sold off. Our thesis is described in more detail later in the commentary. Rounding out the top contributors, Central Garden & Pet

8.250% due 3/01/2018 and Gibraltar Industries 8.000% due 12/01/2015 both added materially to the Portfolio's performance. These businesses are long-term holdings of the Portfolio and represent large positions.

Due to the significant gains in the bond and equity markets, the Portfolio had only one detractor in the first quarter. Our newly entered Quality Distribution position, which is discussed below, fell less than 1% after purchase and detracted an immaterial amount from the Portfolio's performance.

The first quarter was fairly active from a trading perspective. We initiated three new positions, primarily in ideas where we had completed our research but could not immediately find a willing seller. These positions include Computer Sciences 6.500% due 3/15/2018, Energy Partners 8.250% due 2/15/2018, and Quality Distribution 9.875% due 11/01/2018. We also added to our holdings of Intertape Polymer 8.500% due 8/01/2014 and PetroQuest Energy 10.000% due 9/01/2017.

The equity team is responsible for sourcing our newly entered Computer Sciences bond. Early in the year, the market became concerned that the possible loss of a large contract with the United Kingdom's National Health Service would result in a downgrade of the company's credit rating. While this concern was not unfounded, we believed CSC's credit quality would not be materially impaired if the contract were lost. CSC's 6.5% issue is an investment grade bond. Because the Portfolio is not constrained to only the high-yield bond asset class, our flexibility allowed us to capitalize on this unique opportunity, acquiring an investment-grade credit offering a junk-bond yield.

Another new position, Quality Distribution, operates the largest chemical tank truck network in North America. The logistics company transports everything from the raw materials that go into Tide laundry detergent to herbicides for Monsanto. The growth in "fracking," which requires massive amounts of water to be pumped into rock layer to extract oil and natural gas, has been an avenue of growth for Quality, which entered the space as a transporter of water in the fourth quarter of 2010. Recently, the company has been shifting to an asset-light business model that runs with less operating leverage. The new model utilizes independent affiliates to provide the physical transportation of chemicals. This can be thought of as a franchise model, and the new strategy requires capital expenditures of only about 1% of revenue, compared to industry-wide percentages of around 10%. This reduction in spending allows the company to use cash for other purposes, such as paying down debt.

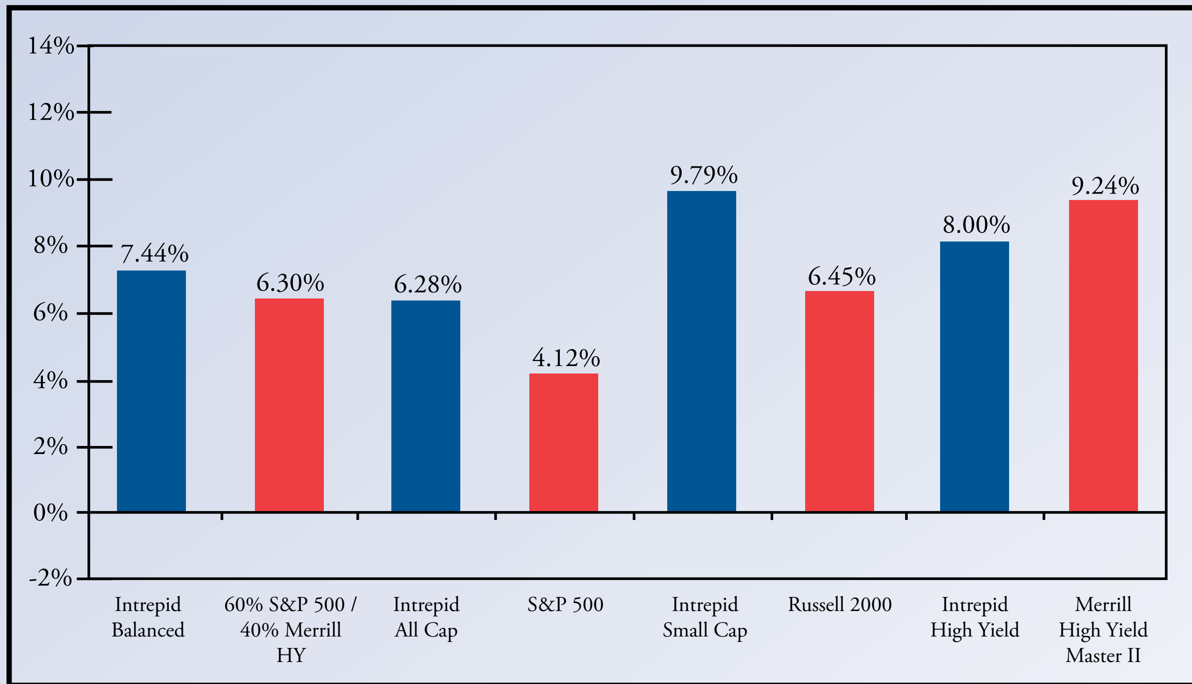
Only one of our holdings was called by its issuer in the first quarter. Mac-Gray (ticker: TUC) repurchased its 7.625% notes. Our purchase activity more than offset the cash influx. It is important to note that we expect several of our holdings to be called through the summer. As a reminder, our cash levels do not reflect any attempt to time the market. Cash will fluctuate purely as a function of the available opportunities. As such, we expect the Portfolio's cash level to grow over the next few quarters in the absence of a market sell-off.

The rise in high-yield bond prices has compressed the Index's yield-to-worst down to 7.13%. This is a historically low level of potential return offered by the asset class. On only a handful of occasions over the last decade have yields been this low, first in 2004/2005 then again in early 2011. We believe the Portfolio is positioned defensively to insulate our clients from adverse credit events and higher risk-free rates. The Portfolio's modified duration remains significantly shorter than the Index's. While the opportunity set looks to be fairly limited, persistence and patience are still allowing us to find attractive high-yield issues.

Intrepid Capital Management

Trailing 10-Year Annualized Performance*

March 31, 2002 to March 31, 2012



*Past performance is no guarantee of future results. Intrepid composite returns are presented net of investment advisory fees for the 10-year period ending March 31, 2012. Returns reflect the reinvestment of dividends and other earnings. The volatility of the listed benchmarks may be materially different from the volatility of an Intrepid composite. As of December 31, 2004, the firm changed its fixed income benchmark from the Salomon High Yield Short-Term Index to the Merrill Lynch High Yield Master II Index.