Intrepid Capital MANAGEMENT INC.

2Q 2017

| Index Returns | |
|---|---|
| 4/1/2017 to 6/30/2017 | |
| Dow Jones | 3.95% |
| S&P 500 | 3.09% |
| NASDAQ | 4.16% |
| Russell 2000 | 2.46% |
| MSCI EAFE | 6.12% |

# QUARTERLY COMMENTARY

July 2017

*"The inherent irony of the efficient market theory is that the more people believe in it and correspondingly shun active management, the more inefficient the market is likely to become."*

— Seth Karman – The Baupost Group

**Dear Friends and Clients,**

About once every decade I lament the day in college when I finished reading "The Intelligent Investor" by Benjamin Graham, and it clicked as I became an investor devoted to seeking "value." Well, here I am again, feeling like momentum investors are having all the fun as my patience wears thin waiting for securities that we believe are both safe and cheap. Currently, most of the equity markets appear neither cheap nor safe to us. The momentum investors who are the current subject of my envy seem to only care that prices are going up, downside be damned, and pithy market aphorisms like "Don't fight the Fed" and "BTFD" (buy the – uh, friendly dip) have worked out swimmingly for the last several years. To me, much of what I am observing in the equity markets is indicative of this momentum mindset, and frankly, why trend-following can work so well at times.

I accuse most investors of "buying high and selling low" or, in the immortal words of the humorist Will Rogers, "Don't gamble; take all your savings and buy some good stock and hold it till it goes up, then sell it. If it don't go up, don't buy it." As a student of financial history, it interests me to look back over my lifetime and think about what preceded difficult equity conditions where prices were down 50% or more. In the early 1970s, we had the "Nifty 50" must-own growth stocks. This worked great until the oil embargo of 1973-1974. In the mid-1980s, as I was beginning my career at E.F. Hutton, the hot sale was "portfolio insurance," which allowed investors to stay completely invested without fear of loss. This "magic" was to happen by selling index futures into a falling market – a nice theory until "Black Monday" in October of 1987, when prices declined 22% in one day.

A decade later, after co-founding Intrepid Capital with my father Forrest in 1995, I watched clients leave to seek their "internet fortune." Three years after starting the firm, the Munder Net Net Fund and the Van Waggoner Emerging Growth Fund were the investors' favorites…R.I.P! The Nasdaq Index and the QQQ ETF were the only things to own in 1997, 1998, and 1999, until they weren't. Lest you have forgotten, the S&P 500 Index actually lost money in 2000, 2001, and 2002. Well, hardly a half decade later, the momentum trade was housing and particularly mortgage-related equities. Very few investors stopped to ask, "Are these mortgages being carelessly underwritten?" If they had, maybe the S&P 500 would not have suffered a 57% decline from October 2007 to March 2009 as the housing bubble burst.

So, where are we today? Anecdotally, I see excess everywhere I look. When I ride my bicycle around my neighborhood in Ponte Vedra Beach, Florida, I pass a different home being demolished every few days to make room for a new, bigger home in its place. When I have the radio on while working in my garage, I hear frequent ads to "come to our real estate seminar to learn how to flip properties." Snap, Inc. (ticker: SNAP) recently went public with egregious terms (no voting rights) for minority shareholders and no prospect of company profits, at least not any time soon. Last but not least, most money entering the stock market is going into some sort of indexed product, a trend accelerated in small part by government edict via the Department of Labor (DOL) ruling.

I suspect that like much of government regulation, we will see once again "the law of unintended consequences," particularly if there is a sharp contraction in equity prices similar to the ones I described earlier.

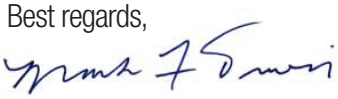
The Intrepid Balanced Portfolio (the "Portfolio") increased 0.75%, net-of-fees, for the second quarter ended June 30, 2017 compared to the BofA Merrill Lynch US High Yield Index and the S&P 500 Index, which returned 2.14% and 3.09%, respectively. Year-to-date through June 30, 2017, the Portfolio increased 3.33%, net-of-fees, compared with returns of 4.91% and 9.34% for the BofA Merrill Lynch US High Yield Index and the S&P 500 Index, respectively.

The Portfolio's five largest contributors during the quarter were Corus Entertainment (ticker: CJR/B CN), Western Digital (ticker: WDC), Hornbach Baumarkt AG (ticker: HBM GR), Stallergenes Greer (ticker: STAGR FP), and Metka Industrial (ticker: METTK GA). The Portfolio's five largest detractors for the quarter were Patterson UTI (ticker: PTEN), Express Scripts (ticker: ESRX), Dundee Corp. (ticker: DC/A CN), Verizon Communications (ticker: VZ), and Teradata (ticker: TDC). Cash in the Portfolio at the end of the quarter was 18.8%.

In this industry, there is career risk for managers who are "under-invested" in a rising market like the one we find ourselves in today. Not to worry – at this point, I am unemployable elsewhere! Please rest assured that I, along with the employees of Intrepid Capital, are invested alongside you. As you have heard from us many times, we are content to hold cash when we believe compelling opportunities are not present. We continue to seek businesses that can be valued with a high degree of confidence and those we believe to be selling at a discount to our fair value estimate. Our goal is to provide attractive absolute, risk-adjusted returns. We believe the cash present in various amounts in each of our portfolios to be a sea anchor in a rising market, and a life boat when many investors become fearful and decide to sell. Stay tuned, this could get interesting.

Thank you for entrusting us with your hard-earned capital. It is not a position we take lightly. If there is anything we can do to serve you better, please don't hesitate to call.

Best regards,



Mark F. Travis

President/CEO

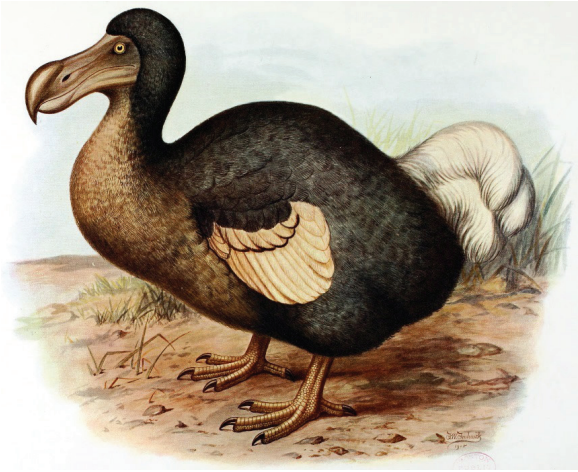
## SMALL CAP PORTFOLIO – COMMENTARY BY JAYME WIGGINS, CFA, CIO, PORTFOLIO MANAGER

The rise of passive investing is having a profound impact on the investment management industry. Index funds now own over 40% of U.S. stocks, according to the Investment Company Institute and Pictet Asset Management.[1] Passive funds in the U.S. collected over half a trillion dollars of net flows in 2016, while active funds shed $340 billion.[2] Efficient, low-cost investment vehicles are displacing undifferentiated, high-cost products. An index fund is a commodity. If an actively managed portfolio resembles an index, it probably deserves to get paid like one…or expire. Vanguard and Blackrock have become the apex predators.

The plight of active managers is mourned by few, but is the baby being thrown out with the bathwater? All funds are not created equal. Ironically, many high-active share managers, who by definition look very different from their benchmarks, are experiencing the same business pressures as their benchmark-hugging brethren. In fact, they may be suffering even more right now, since they are more likely to be underperforming and because their sales functions are often less evolved than their marketing-centered peers. High-active share managers believe that over time, their risk-adjusted performance will mostly sell itself. But the customers are shouting back, "What have you done for me lately?"

1 Petruno, Tom. "Small investors' move to 'passive' stock funds becomes a stampede." *Los Angeles Times*, 9 April 2017. Detrixhe, John. "Passive funds are on pace to eat the entire US stock market by 2030." *Quartz*, 5 June 2017.

2 Lauricella, Tom, and Alina Lamy. "U.S. Investors Favored Passive Funds Over Active by a Record Margin in 2016." *Morningstar Direct Asset Flows Commentary:* US, 11 January 2017.



The most endangered species among the active group is the absolute return investor, who appears to be headed to the same fate as the dodo bird. The plump, flightless dodo was rendered extinct by hungry sailors who arrived on the island of Mauritius. Likewise, the ranks of absolute return-oriented investment managers have withered after years of central bank intervention have sent capital markets in one direction: up. Wrapped in the cloak of intellectual honesty, the legendary value investor with the "permabear" moniker, Jeremy Grantham, is now wondering aloud, *maybe this time is different?*[3] Bruce Greenwald, the figurehead of Columbia Business School's Value Investing Program, says everyone thinks the market is expensive, but permanently higher profitability supports stock prices.[4] Capitulation?

Here's the quandary. Many professional investors may *think* the market is expensive, but few have modified their behavior.[5] The implied volatility of the stock market is at record lows, indicating that it has never been cheaper to hedge against negative outcomes.[6] By continuing to own stocks at ever-inflating multiples and bonds at diminishing yields, we believe investors are effectively capitulating. After all, actions speak louder than words.

An absolute return investor seeks to produce a positive return regardless of market conditions. They do not measure against a popular benchmark. This strategy is rarely employed inside of long-only equity funds. It is a more common goal for balanced products that include equity and debt or at hedge funds that short securities.

It can be difficult for a long-only equity fund to deliver on an absolute-return strategy without having the flexibility to hold cash. During some periods, stock markets are very overvalued. A price-conscious manager may realize that even just owning his or her best ideas is either: A) not enough to responsibly populate an entire portfolio, or B) likely suboptimal to the prospective returns he or she could possibly enjoy by waiting for a pullback to deploy capital. On the other hand, stocks can also trade below fair value (e.g. 2009), so the mere existence of a negative portfolio return does not revoke membership in the absolute return club. At least that's our view.

We think most equity fund managers would admit in their heart of hearts that they'd structure their funds differently if most of their life savings was invested in the product they run. Nevertheless, holding more than 10% of a portfolio in cash is not an option for the vast majority of them. Many advisors won't allocate to high cash managers because of the cost of enduring management fees during underinvested periods and, more importantly, because of the tracking error inherent in a cash-heavy portfolio. Therefore, it's usually a smart business decision for the investment manager to limit the amount of cash in a fund. They instantly broaden their addressable market. Why exacerbate the volatility of mutual fund inflows and outflows with another variable besides stock selection?

Career risk also comes into play in keeping cash minimized. If you underperform for long enough, you get fired. Most portfolio managers would like to avoid that outcome. Lastly, it can be mentally exhausting to adopt a contrarian posture for an extended period. Compare a career in investing to almost anything else. If you're a surgeon, a painter, or a car salesman, you probably know whether you succeeded or failed by the end of the day or that week. **For an absolute return investor, it can take *years* to determine whether you've done a good job.**

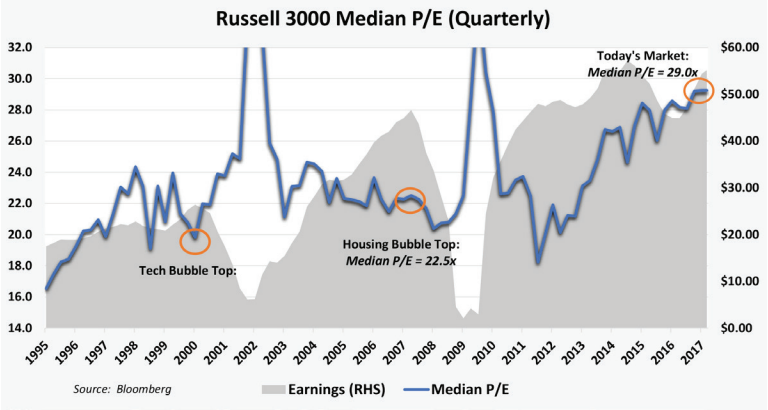
As a result of the potentially protracted payoff versus relative return strategies, an investment management firm must be totally committed to supporting an absolute return strategy for it to be successful—not just the investment team, but the entire organization including the marketing and client relations personnel, mutual fund trustees, board of directors, and all other

3 Grantham, Jeremy. "This Time Seems Very, Very Different." *GMO Quarterly Letter*, 2Q 2017, pp. 9-16.
4 Norton, Leslie P. "Bruce Greenwald: Channeling Graham and Dodd." *Barron's*, 13 May 2017.
5 Durden, Tyler. "A Record Number of Market Participants Says the Market is Overvalued, Surpassing 1999 Bubble Highs." *Zero Hedge,* 13 June 2017.
6 Johnson, Miles. "Cost of 'Black Swan' bet on falling markets hit pre-crisis low." *Financial Times*, 12 June 2017.

leadership. There is little room for self-doubt, since most outsiders won't get it until a bear market hits. Resisting outside influences is hard enough; resisting internal ones is nearly impossible.

There are not many small cap portfolios with an absolute return strategy. The Intrepid Small Cap Portfolio (the "Portfolio") is one of them. We won't (and haven't) avoided all losses, but we've done our best to minimize the downside and smooth out the ride by strictly adhering to our value discipline. We won't buy or hold stocks that exceed our fair value estimates. Instead, we will hold cash and Treasury bills. Our goal is to exceed the returns of small cap benchmarks and peers over a full market cycle, which is the combination of a bull and bear market.

Given today's market backdrop, it may be tougher than ever to be an absolute return investor, but it's possibly never been easier to know what we should do (minimize risk). Most commentators cite the tech bubble as the most expensive market of all time. That is true in narrow terms, as technology stocks and large cap blue chips sold then for the highest multiples in recorded history. However, this was not reflective of our opportunity set or the investable universe of most other professionals. We have thousands of companies to select from in creating our portfolio. At the peak of the tech bubble in March 2000, the median P/E of the members of the Russell 3000 Index was 20.0x. Today the figure is 29.0x (+45%).




With the full benefit of hindsight, how many homeowners would opt to buy a vacation property if you told them they would be paying a price-to-rent multiple that was 45% above the housing bubble peak?[7] Probably not many. Yet, investments in stocks are frequently treated like Monopoly money. It's far more difficult for us to find a bargain now than it has been since our firm was founded (and likely in generations), as the typical company has never traded so richly. The only time the average company's multiple has been higher was during recessions, when earnings fell sharply (e.g. 2002, 2009). Today's combination of high margins and high multiples should be a massive red flag for anyone managing money.

For those taking comfort in the argument that high margins/profits are protected by monopoly-like positions, we'd submit that this phenomenon, if it exists, is confined to the upper echelon of the technology segment. Think Google and Facebook, not company #1,500 on a descending list of Russell 3000 P/Es, which is what is driving the chart shown above. Google and Facebook posted 26% and 45% pre-tax operating margins, respectively, in 2016. They have a 20% market share of the global advertising pie and are responsible for all net advertising growth. We wonder if we will eventually see proposals for a windfall profits tax on Internet monopolies, since the returns on capital that some of them earn make most energy companies look like welfare recipients at $4 gas prices. Such a tax doesn't seem imminent because your average Joe sees the direct cost of filling up his tank but doesn't grasp the value to advertisers of his detailed Internet profile and search history. How much is your privacy worth to you?

Not even FANG royalty like Google and Facebook match the economics of the puppeteers of passive investing. We're not referring to Vanguard and Blackrock, which are in a race to the bottom with Charles Schwab and others of charging lower and lower expense ratios for commoditized index products. S&P Global, FTSE Russell, and MSCI are where the real dough is made. The index divisions of these public companies sported unbelievable operating margins between 56% and 64% last year on over half a billion dollars apiece in revenue. They have capitalized on the surge of passive investing by collecting fees from funds and ETFs that mimic their indexes.[8] There's not a tremendous amount of human involvement in the construction and maintenance of

7 According to Bloomberg, the current U.S. median housing price-to-rent ratio is approximately 32% below the 2007 peak of 25.3x.

8 FTSE Russell is owned by the London Stock Exchange Group.

9 "Russell U.S. Equity Indexes: Construction and Methodology." *FTSE Russell*, May 2017.

most benchmarks, which are typically configured using a rules-based methodology that often starts with market capitalization.[9] Earlier this year, after we ignored repeated sales inquiries from FTSE Russell, they informed us that we were violating their (undefined) reporting policy by citing Russell performance data in our quarterly letters without paying them a license fee. This data is widely available online.[10] We never imagined we and other managers would be targets in a shakedown by a benchmark provider that we all helped make popular and insanely profitable!

For the three months ending June 30, 2017, the Intrepid Small Cap Portfolio eked out a small positive return of 0.17%, net-of-fees. The Russell 2000 benchmark returned 2.46% for the quarter. Cash ended the quarter at 79.7% of the Portfolio's assets. There were no major new purchases or sales during the second quarter. The Portfolio slightly reduced its positions in Corus Entertainment (ticker: CJR/B CN) and Dominion Diamond (ticker: DDC) after the stocks appreciated. The Portfolio's top contributor in the quarter was Corus Entertainment and its leading detractors were Dundee Corp. (ticker: DC/A CN) and Syntel (ticker: SYNT).

Corus Entertainment's shares rose modestly at the end of June when the company reported its fiscal third quarter earnings. Corus delivered 14% EBITDA growth over the prior year's quarter, after adjusting for the impact of the Shaw Media acquisition. Television ad revenues were flat on a pro forma basis, which was a marked improvement from the 4% decline in fiscal Q2 and double-digit drops prior to that. Corus is finally outperforming its competitors on the advertising front. However, the overall ad climate in Canada remains challenging, with an ongoing share shift to digital players. We believed Corus's advertising results would be even better this quarter, since the company had higher price and volume commitments with all of the major ad agencies compared to last year. The structural pressures on television advertising in Canada are greater than we forecasted, but we believe that TV will remain a key advertising market and will be enhanced by more targeted ad delivery. Corus has the leading English-language TV market share in Canada. The stock is trading for less than 10x expected free cash flow. Corus continues to be an important holding for the Portfolio, but we trimmed our stake.

In our Dundee mea culpa in last quarter's letter, we wrote: *"We have urged management to sell Dundee's public investments to pay off bank debt and preferred stock, which would reduce cash burn by half. If the company then catches a break on one of its major private investments, it could mark a turning point for the company's fortunes."* On May 10th, Dundee announced that Delonex Energy will acquire United Hydrocarbon (UHIC), Dundee's Chad energy venture/money pit. Delonex offered $35 million at close, another $50 million when first oil is achieved, and ongoing royalties ranging from 5%-10% of production unless Brent prices fall below $45 per barrel. Dundee has been spending $12 million per year to maintain UHIC while seeking an investor, and this cash drain will disappear upon a sale. It's not a done deal, as Dundee is currently in negotiations with the Government of Chad to renew its Production Sharing Contract. On May 19th, Dundee sold its entire remaining stake in DREAM Unlimited for CAD $106 million. The proceeds will likely be used to pay down bank debt. The sales of UHIC and the DREAM shares were exactly the type of positive catalysts we were seeking. The market has clearly shrugged, since Dundee's shares are back down to all-time lows. Canadian small caps have traded weak this year, which could be a factor, but we think investors will need confirmation that the Delonex transaction closes before they bid up Dundee's shares.

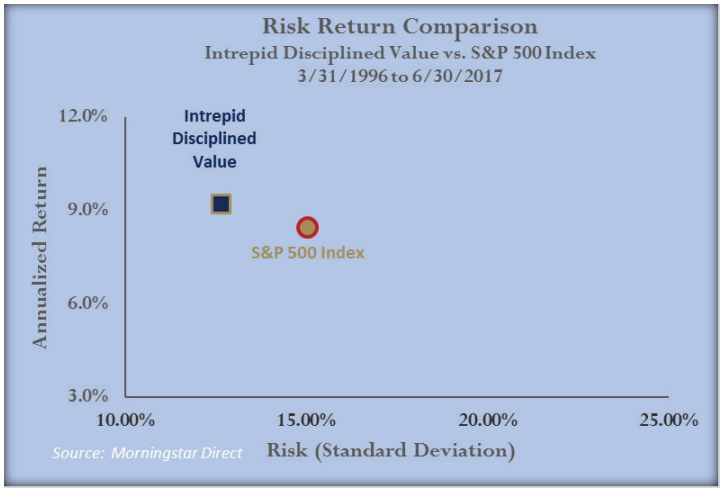
In late April, Syntel significantly reduced guidance for 2017 after receiving updated budgets from its major customers. Severe spending cuts by American Express appear to account for most of the reduction. Amex is Syntel's top customer and accounted for 22% of revenue in 2016, but Syntel's Amex revenue fell 24% in the first quarter, creating a 5.5% overall top line headwind. Amex is undergoing a material cost savings plan. Outside of American Express, Syntel is still exhibiting weaker trends than competitors, which management has partly blamed on subdued healthcare spending due to policy uncertainty. Indian IT outsourcers are collectively expected to grow revenue by a mid-single digit rate this year. Syntel's growth rates were squarely in line with peers until 2016, so it is not a chronic laggard. Based on comments from management, we expect it to take several quarters before the company's enhanced focus on marketing leads to better revenue trends.

10 "Russell U.S. Indexes." *FTSE.com/products/indices/Russell-us.*
"Russell 2000 PR USD." *Performance.morningstar.com/performance/index-c/performance-return.action?t=RUT.*
"Russell 2000 Index." *Money.cnn.com/data/markets/Russell/.*

The dodo bird was unable to adapt to the incursion of humans on its tranquil island. It went extinct. The population of absolute return investors has dwindled from value starvation. Some would say we have also failed to adapt to changing circumstances. We have been unwilling to partake in the force feeding of a nitroglycerin-laced diet from the Fed, which is now slowly tightening monetary policy. Will the wild animals that have been domesticated by central banks be able to forage for food on their own, since they have been conditioned to rely on a free meal for so many years? We'll see. Absolute return investors will never go extinct. All it takes to revive the species is a little knowledge of investment history and the clarity provided by a complete market cycle. Thank you for your investment.

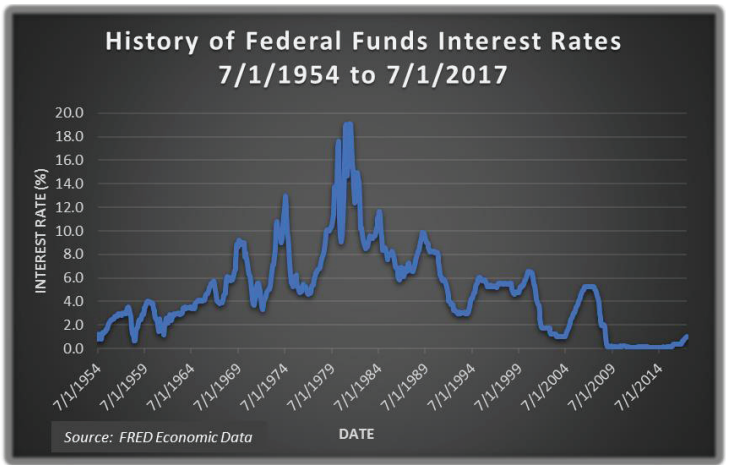
## DISCIPLINED VALUE PORTFOLIO – COMMENTARY BY MARK TRAVIS, CEO, PRESIDENT, PORTFOLIO MANAGER

I am pleased to report the performance of the Intrepid Disciplined Value Portfolio (the "Portfolio") for the quarter, year-to-date and trailing one-year periods ended June 30, 2017. For the quarter, the Portfolio increased 1.3%, net-of-fees, which brings the year-to-date return to 4.62%, net-of-fees, and the trailing one-year return to 8.20%, net-of-fees. The Portfolio's annualized return for the trailing five-year period is remarkably similar at 8.15%, net-of-fees. For comparison, the returns of the S&P 500 Index and the Russell 3000 Index for quarter ended June 30, 2017 were almost identical at 3.09% and 3.02%, respectively. For the year-to-date period, the S&P 500 Index and the Russell 3000 Index returned 9.34% and 8.93%, respectively. For the trailing one-year period, the S&P Index and the Russell 3000 Index increased 17.90% and 18.51%, respectively.




In our attempt to deliver a consistent process and exceptional risk-adjusted returns over a full market cycle, we are challenged in the current environment as we continue to confront high equity prices. As shareholders invested alongside our clients, our goal is to preserve your capital as well as our own. As shown in the chart to the left, the risk metrics of this Portfolio indicate we have taken materially less risk compared to the S&P 500 Index. We do this by focusing on our bottom-up valuation process and searching for high-quality businesses that we believe are mispriced using conservative valuation techniques. At this stage in the economic cycle, with a headwind of high equity prices – trailing price-to-earnings (P/E) ratio of 21 for the S&P 500 Index as of June 30, 2017 – cash in the Portfolio of 44.4% is reflective of the difficulty we are having in finding qualifying investments.

Prior to the financial crisis and the Fed's long-term suppression of interest rates (see chart to the right), we were in some instances able to deploy cash reserves and earn ~3-5% nominal returns on the balances. It has only been since December of 2016, with central bank rate suppression activity maybe, ever so slowly, coming to an end, that we believe investing these balances in Treasury bills has become a worthwhile endeavor again.




From our perspective, interest rates are a price, and frankly, one the marketplace could easily set without the

machinations of the Federal Reserve, European Central Bank, or the Bank of Japan. To use an analogy, just think of trying to diet by stepping on a scale every morning to help guide your dietary intake as well as your caloric output through exercise. Except every time you step on the scale, someone sneaks up behind you and presses their toe on the scale! I believe the distortions in the financial markets are much more widespread and consequential than a dieter becoming discouraged from a misreading of the bathroom scale. When the "Fed" and other central bankers take their "toe off the scale" and equity prices adjust to a more normalized interest rate environment, we anticipate utilizing the cash in the Portfolio to take advantage of buying opportunities.

The Portfolio's five largest contributors during the quarter were Western Digital (ticker: WDC), Corus Entertainment (ticker: CJR/B CN), Northern Trust (ticker: NTRS), Coach (ticker: COH), and Bank of New York Mellon (ticker: BK). The Portfolio's five largest detractors for the quarter were Dundee Corp. (ticker: DC/A CN), Verizon (ticker: VZ), Teradata (ticker: TDC), Alamos Gold (ticker: AGI), and Patterson UTI (ticker: PTEN).

Thank you for your continued support and investment in the Portfolio. If there is anything we can do to serve you better, please don't hesitate to contact us.

## INCOME PORTFOLIO – COMMENTARY BY JASON LAZARUS, CFA, PORTFOLIO MANAGER

Global markets continue to be influenced by many of the same themes we have discussed in these letters in recent periods. Namely, the incessant search for yield, persistently low energy prices, and the impact of e-commerce on a variety of industries – in particular, brick and mortar retailers. The culmination of yield-seeking behavior might have occurred in June, when Argentina was able to sell $2.75 billion of 100-year bonds. The country has defaulted on its debt five times in the last 100 years, most recently in 2014! Nevertheless, the issuer received orders totaling $9.75 billion. The search for yield was not restricted to just the western hemisphere. Across the Pacific, Australian bank Macquarie offered a $750 million bond that was oversubscribed by *16 times*, meaning $12 billion in total capital was chasing after the deal.

Energy and traditional retailing are two of the very few areas of broad concern to investors. The fears appear to be justified, so far. In our last letter, we highlighted several well-known retailers that were forced to declare bankruptcy, and we noted that more pain was on the horizon. The second quarter claimed more casualties, including Sears Canada, Payless Shoesource, rue21, and Gymboree. These operators plan to close stores and shed debt, but will attempt to continue operating after emerging from bankruptcy. Other management teams have concluded that liquidation is the only option. Gordman's and bebe are closing all of their stores, joining hhgregg, The Limited, and Wet Seal.

Markets mostly performed well outside of energy and retail. Fixed income securities generally provided positive returns in the second quarter despite the Federal Reserve's second rate hike this year. Longer maturity Treasury bond yields actually declined, which produced a tailwind to fixed income securities. The yield on the ten-year U.S. Treasury note declined slightly from 2.39% to 2.31%. The 2.25% Treasury note maturing on 2/15/2027 gained 0.74%. Investment-grade bonds, as measured by the Bloomberg Barclays Aggregate Bond Index, gained 1.45% in the quarter. Credit put in a very strong performance, with the BofA/ML US High Yield Index gaining 2.14% in the quarter ended June 30, 2017. High yield returns were bested by investment-grade credit. The BofA/ML US Corporate Index returned 2.42% in the second quarter.

The Intrepid Income Portfolio (the "Portfolio") rose 0.93%, net-of-fees. The Portfolio focuses on taking calculated credit risks while attempting to minimize credit risk, so our holdings did not benefit from lower rates in longer duration securities to the same extent as the indexes quoted above. Additionally, our holdings have typically been higher-quality, and therefore do not usually rise as much in a strong "risk-on" period. In the second quarter, short-term investment grade bonds averaged roughly 37% of the Portfolio's assets, and Treasury bills averaged another 13%. Less than half of the Portfolio is invested in high-yield or unrated securities.

The top contributors to the Portfolio's performance in the second calendar quarter were Corus Entertainment common stock (ticker: CJR/B CN), Consolidated-Tomoka Land Company convertible notes due in 2020 (ticker: CTO), and EZCORP convertible notes due in 2019 (ticker: EZPW). There were no material detractors in the quarter.

Corus's share price rose after the company reported earnings in June. The company's advertising revenues were flat compared to the prior year, which was a marked improvement over recent quarters. We believe the shares are still undervalued. Corus also pays an 8% dividend.

Consolidated-Tomoka is a Daytona Beach, Florida-based owner of office and retail income producing properties located across the United States. It also owns 8,200 acres of undeveloped land near I-95 in Daytona Beach. The company has been slowly monetizing its raw land and redeploying the proceeds into income-producing properties. The firm issued $75 million in convertible bonds in early 2015 that was partially used to fund purchases of income-producing properties. The notes pay a 4.5% coupon and mature in March 2020. We purchased the bonds late last year. While the equity does not appear significantly undervalued, we believe the yield on the bonds is relatively attractive.

We have been involved with several different pawn shop operators over the last few years. We recently added to our oldest pawn position, EZCORP's convertible notes due in 2019. Regular readers will recall that we substantially trimmed the position last year after the notes rallied from the low-60s to near par. The bonds performed very well after it became clear to the market that the value destruction occurring in a Mexican payday loan subsidiary could be isolated. Since then, the company was able to divest this subsidiary on favorable terms. Although much of the purchase price will be collected in future years (and will therefore be subject to the credit risk of the acquirer), the deal appears favorable. The notes declined in price recently as the stock sold off, and we were able to repurchase the notes at what we believe to be an attractive price. Last week, the company issued new convertible notes due in 2024 that pay a 2.875% coupon. EZCORP plans to use the proceeds to redeem a very high interest secured loan, and the remainder may be allocated to repurchase a portion of our convertible notes. While the stock fell substantially on the news of the equity dilution, the retiring of the secured loan is a positive event for creditors.

Three of the Portfolio's larger positions were called in the second quarter, including the bonds of Alamos Gold and FirstCash Inc.

The bonds of FirstCash (ticker: FCFS) were one of the Portfolio's largest positions for close to two years. We have discussed the company on several occasions, but to quickly recap, FirstCash is the product of the merger of two large pawn shop operators, First Cash and Cash America. We owned the bonds of both companies before the merger was completed. Our Cash America bonds were repurchased by the company last year. We maintained a large position in the FirstCash notes. We expected the notes to be called earlier this year so the issuer could eliminate some restrictive covenants, which occurred in the last quarter. The company issued new bonds that pay 5.375% and mature in 2024. We participated in new issue, but on a limited basis due to the longer duration.

Alamos Gold (ticker: AGI) unexpectedly issued equity and used the cash to retire our bonds. While we are disappointed that we are no longer a lender after being involved with the company for several years, we believe management made a good decision to issue stock, particularly with respect to the spot price of gold.

We exited the remainder of our position in PHI Inc (ticker: PHII) in the second quarter after several months of slowly trimming the name. PHI owns and operates helicopters for use in the energy and medical industries. The company transports workers to and from offshore oil and gas platforms and also performs medevac flights. The business's fundamentals have deteriorated significantly over the past six quarters and are likely to get worse. While we believed the company would be able to survive a period of low oil prices, the critical part of the thesis we got wrong is that we did not expect oil prices to remain so low for so long. This has resulted in customers negotiating hard to slash their operating costs, including helicopter transportation. In addition, we underestimated the profitability of a key contract that recently ended, which has further weighed on profitability. While we made money on the investment, we were partially bailed out by yield-hungry investors.

As we have complained for as long as we can remember, it has been very difficult to find suitable income-generating securities to replace our called bonds. We identified only one new core position in the quarter; Silgan Holdings' 5.5% notes due 2/01/2022. Silgan is a leading manufacturer of metal cans, plastic containers, and closure systems (tops for food and beverage containers).

The company was founded in 1987 to acquire the packaging plants of the large U.S. food manufacturers like Nestle, Campbell, and Del Monte. The company has durable competitive advantages in metal cans and closures. In the US, Silgan commands a 60% share of the metal can industry. This share has little risk of competition from current or new entrants, as it costs too much to transport empty cans more than 300 miles from the manufacturing location. Without the means to make the cans themselves, food manufacturers need certainty the containers will be available and correctly made, so 90% of Silgan's metal can sales are contracted for multiple years with input cost pass-through clauses.

Silgan is a classic Intrepid business: it is a market leader, the business is predictable, and it generates substantial free cash flow. We owned the stock and bonds close to a decade ago. Our own Ben Franklin (now Portfolio Manager of the Intrepid International Portfolio) was a young analyst when the idea was initially sourced in 2008. This is a good example of how we leverage our body of knowledge across the credit and equity teams. While our opportunity set remains quite limited, we are confident that our diligent searching will continue to unearth attractive investments for our shareholders. Thank you for your investment.

## INTERNATIONAL PORTFOLIO – COMMENTARY BY BEN FRANKLIN, CFA, PORTFOLIO MANAGER

*"Chasing what can't be done is madness. But the base person is unable to do anything else."*
— Marcus Aurelius, *Meditations, 5.17*

Attempting to outperform the index every quarter is a fool's game. Of course, it would be nice to do so but, in our view, any sound investment philosophy will require underperformance at times. For us, this quarter was one of those times. The MSCI EAFE Index (the "Index") returned 6.12% during the quarter, compared to the Intrepid International Portfolio's (the "Portfolio") return of 0.51%, net-of-fees. One of our primary tenets when we invest is to find securities that have a high probability of preserving capital, while also offering potential upside. During this period, we accomplished the first part but were unable to provide much of the latter. With one security, discussed in more detail below, we will no longer be able to achieve the upside we had hoped for.

International markets have had a good run recently as market participants appear focused entirely on the near-term outlook of the global economy, and not the price paid for securities or any expectation of long-term mean reversion in multiples. The VIX, a commonly quoted proxy for investor fear, hit the lowest level since 1993 during the quarter, and the VIX that tracks the EAFE ETF (VXEFA) hit an all-time low in March.[11] While Fear of Missing Out (FoMO) has caused many to remain fully invested, we believe Warren Buffett's advice to "Be Fearful When Others are Greedy" is sound, and appropriate at this stage in the cycle. In his book, *Black Swan*, Nassim Nicholas Taleb beautifully describes the struggle some people have with avoiding the greedy herd: "Psychologists distinguish between acts of commission (what we do) and acts of omission. Although these are economically equivalent for the bottom line (a dollar not lost is a dollar earned), they are not treated equally in our minds." It is very difficult for investors, as well as managers and CEOs of companies, to differentiate between these two acts. We believe we are treating each dollar the same, and thus have cash built into the portfolio when there is a dearth of opportunity.

We believe the EAFE index is more susceptible to herd mentality than the Portfolio due to the number of passive investment products tracking it. In fact, only one of our securities is in the EAFE index. We believe the remaining holdings are idiosyncratic and are trading more on their fundamentals than the general swings in the market. Thus, if the market continues its recent upwards march, we do not expect to keep up.

During the quarter, the top contributors to the Portfolio were Clere AG (ticker: CAG GR), Stallergenes Greer (ticker: STAGR FP), and KSB AG (ticker: KSB3 GR). Our largest detractors were Dundee Corporation (ticker: DC/A CN), Noranda Income Fund (ticker: NIF-U CN), and Coventry Group (ticker: CYG AU).

Despite Clere being the largest contributor to performance in the quarter, we are not happy with how this investment is progressing. Due to historically positioning this as our largest weight, we have discussed the investment in detail in previous

11 Mackintosh, James. "Should We Fear the Stock Market's Lack of Fear?" *The Wall Street Journal* 15 May 2017; Bloomberg.

commentaries. As a reminder, this German security is made up of approximately €25 per share in net cash and short-term securities, and the share price has recently traded in the mid- to high-teens. During the period, the company announced their decision to de-list from the Frankfurt Stock Exchange, which required a buyout offer from their largest shareholder, Elector. The minimum price Elector was required to offer was the weighted average trading price over the preceding six months, which was €16.33. At the time of the announcement, Elector held about 35% of the company. Prior to the delisting, we felt the downside was limited by the €25 per share in liquidity. The longer it would take to reach that price, the lower our annualized return, but the value was stable (even if the stock price wasn't!). The Supervisory Board and Management Board (similar to a Board of Directors in the United States) was required to offer an opinion on the buyout offer. Their conclusion about the consideration: nicht angemessen (not appropriate). Despite this, many holders accepted the offer and now Elector has over 50% of the shares outstanding.

One of our largest concerns about the delisting was whether we would still be able to own the security, and if we could still trade it. We scrambled to ask our German contacts whether the shares could trade on another exchange, which would eliminate this concern. We were comforted to know that the brokers expected them to trade, and we found out for sure on June 26th when the shares began trading on the Hamburg exchange. Historically, our thesis has been based on the limited downside, with the potential for upside. This wrinkle changed our thinking slightly, as there is now less liquidity, reduced regulatory oversight, lower visibility for a potential acquirer, and now there is a majority shareholder. Due to these concerns, we believe the downside is not as limited and trimmed the position.

Stallergenes Greer is an allergy immunotheraphy company that struggled with a recall and plant shutdown last year. They have been ramping up production and regaining lost market share. The company is known for their sublingual therapies in Europe, as well as their subcutaneous therapies here in the United States. If you or anyone you've known has received allergy shots, there is a good chance the allergen cocktail came from Stallergenes. The plant shutdown hurt the company's performance, but due to patients only needing to use allergy products for part of the year, it's easy to win back lost customers. In fact, their largest competitor ALK-Abello (ticker: ALKB DC) admitted so much in one of their recent conference calls:

*The market is a so-called fickle market which means actually that there will be a pause, you could say, during part of the year where patients will not take treatment when we talk about pollen products. And of course,* ***that is a moment where we had a risk to lose these patients again.***

*And of course, one-third of the market will be renewed every year. So, you could say that there will be a* ***complete wash of the entire market three years after this disruption.***

Stallergenes released earnings at the end of March, and the results appeared to give investors' confidence the company will regain most of the market share they lost. We took this time to reduce our position.

KSB Group is another German company. They manufacture pumps and valves and sell them across the world. The company has been in the process of restructuring, including cutting headcount and significantly reducing costs. They are controlled by the founding family, and financial reporting is not promotional to say the least. Many of their restructuring costs are not specifically called out. We believe this causes analysts to accept that their current earnings are reflective of their current earnings power. However, we think their true earnings power is being masked by these one-off charges that management chooses to bury. This is contrary to most public companies, which gladly point out the one-time costs and exclude them in their "underlying" performance. Additionally, the company has been making changes in their business structure to better position themselves for their target performance. These changes should help the business when economic conditions improve. In April, the company announced that their order intake was up 15%. We believe this increase, coupled with the improvements in the business, leaves the company in a good place to prosper. The market is finally recognizing this with the increased share price during the period.

Dundee has been a problem child for the Portfolio since we originally purchased it. We believe the Canadian holding company is making progress toward alleviating its cash burn, but the market is not giving them any credit and the stock price has suffered.

Noranda Income Fund's troubles, which were discussed in the first quarter's commentary, continued into the second quarter. The zinc smelter's unionized labor force is still on strike, although they are able to run at up to 50-60% of their normal levels. While a strike is never a good thing, it is better for it to occur at a time when the market treatment charges (i.e. prices) are at their lowest – they likely would not be making money even if running at full capacity. Treatment charges swing around frequently, with the economics for zinc shifting between the miner and smelter. With Noranda's low-cost plant and ideal location on the St. Lawrence river, we believe they are well positioned to prosper when the market recovers.

Coventry Group has robbed performance over several quarters now. This is another company where the net assets of the company are significantly above the market value, but the company is currently burning cash and narrowing that discount. In the first quarter, we discussed a letter we sent to the company's Board of Directors. Since that time, we have had a productive conversation with the Chairman of the Board. We believe he understands the urgency required, and we think he will take the necessary steps if the business does not quickly turn around.

The three detractors discussed have been detractors in the past. This may cause some to ask why we have not "cut our losses." Here we must distinguish between a loss in value and a decline in price. All of these securities have suffered both, in our opinion. However, the fall in price has outpaced the fall in value, and has done so by a large margin. The end result is a larger discount to our estimate of intrinsic value, even as our original value assessment proved too aggressive. In situations such as these, we are more likely to buy than sell. One factor that may sway our decision is if there is significant leverage, whereby a small change in one of our assumptions significantly reduces our opinion on the inherent value.

One of our largest contributors to performance this period was also one of our major disappointments. Metka (ticker: METTK GR) is a Greek engineering contractor and industrial company that was 50% owned by its parent company, Mytilineos (ticker: MYTIL GA). The company had nearly €11 per share in tangible book value, which was primarily cash and receivables from the parent company. Last December, Mytilineos announced it was merging with Metka. The merger was announced at a 1:1 exchange ratio; that is, 1 Mytilineos share for every Metka share. This was at a time when Mytilineos was trading around €6 per share, which could be used as a proxy for the value Mytilineos was offering. In fact, the offer price was *below* where Metka traded at the time resulting in a take**under.** As would be expected, we were not the only shareholders upset about this. In fact, we worked with several other shareholders, both larger and smaller, to fight for a better deal. The largest of the consortium was working with a Greek lawyer, and at one point we had a presentation ready to disburse to the Mytilineos Board, the sell side, and the press. However, the Greek lawyer recommended not submitting the presentation and giving up the fight. The family in charge of Mytilineos is a well-connected Greek family, and it was felt that they could countersue us for slander, despite us only releasing facts. Mytilineos had numerous related party transactions, conflicts of interests, and had given out conflicting information. All around, it was a shady deal. We knew this was a risk when investing in Greece (this would not have been legal in most of the developed world) but were surprised at the egregious mistreatment. Laws in the country often aren't followed; in fact, just this morning the Wall Street Journal wrote "Greeks believe rules are meant to be broken."[12] Not all was lost, however. Due to purchases at lower prices, we were still able to make a small profit on the investment. While sitting on my back porch reflecting on this investment, an appropriate Rolling Stones song began playing: "You Can't Always Get What You Want," which gave me some solace:

You can't always get what you want

But if you try sometimes well you might find

You get what you need

*12* Stamouli, Nektaria. "Greece's Antismoking Effort Has One Major Problem: Greeks." *The Wall Street Journal.* 11 July 2017.

While we didn't get what we wanted (€11 per share), we did get what we needed (preservation of capital). To quote Buffett again, we followed his two rules: "Rule No. 1: Never Lose Money. Rule No. 2: Never Forget Rule No. 1." The thesis with this investment was similar; we felt our downside was limited with the significant liquid assets, and there was potential for a large gain. Unfortunately, it was the majority holder that received the gain. We considered fighting it alone, but the time and money commitment would be too high.

There is plenty of talk about the prevalence of passive index funds and the risks of crowds rushing to buy these assets. At this point, we will say that if an investor wants run-of-the-mill international exposure, then an index ETF may be a good place to start. If, however, you want access to highly scrutinized investment ideas in the dusty corners of the globe, we're your manager. Thank you for your investment.

## SELECT PORTFOLIO – COMMENTARY BY JAYME WIGGINS, CFA, CIO, PORTFOLIO MANAGER

The Intrepid Select Portfolio (the "Portfolio") increased 2.02%, net-of-fees, for the first quarter ending June 30, 2017, while the Russell 2000 increased 2.46%. The S&P MidCap 400 rose 1.97% during Q2. Cash accounted for 10.5% of the Portfolio's assets as of June 30th.

The largest contributors to the Portfolio's performance in the second quarter were Corus Entertainment (ticker: CJR/B CN), Coach (ticker: COH), and Tetra Tech (ticker: TTEK).

Corus Entertainment's shares rose modestly at the end of June when the company reported its fiscal third quarter earnings. Corus delivered 14% EBITDA growth over the prior year's quarter, after adjusting for the impact of the Shaw Media acquisition. Television ad revenues were flat on a pro forma basis, which was a marked improvement from the 4% decline in fiscal Q2 and double-digit drops prior to that. Corus is finally outperforming its competitors on the advertising front. However, the overall ad climate in Canada remains challenging, with an ongoing share shift to digital players. We believed Corus's advertising results would be even better this quarter, since the company had higher price and volume commitments with all of the major ad agencies compared to last year. The structural pressures on television advertising in Canada are greater than we forecasted, but we believe that TV will remain a key advertising market and will be enhanced by more targeted ad delivery. Corus has the leading English-language TV market share in Canada. The stock is trading for less than 10x expected free cash flow. Corus continues to be an important holding for the Portfolio, but we trimmed our stake.

A return to positive same-store sales growth in North America favorably impacted the shares of Coach. The drawn-out restructuring is finally bearing fruit, and management has focused on bolstering the Coach brand by reducing promotions and consolidating the distribution footprint. The company has succeeded in lifting the average price point of handbags, after many in the investment community had been concerned Coach was going too far downmarket. While our investment in Coach was predicated on an operational turnaround, we are not forecasting a return to the company's former glory in our valuation. The market also warmly received the acquisition price Coach proposed for Kate Spade, a competitor. Management plans to adopt the same playbook it used for Coach to breathe new life into the Kate Spade brand, which is currently overexposed to promotional activity.

Tetra Tech posted solid growth from ongoing operations, excluding the drag from the intractable Remediation and Construction Management division that the company has nearly exited. The company's cash flow rebounded significantly from a depressed Q1. Management cited broad-based growth in U.S. state and local government project-related infrastructure, such as water collection in California and desalination in Texas. The U.S. federal business also increased due to more work for the Department of Defense, State Department, and USAID. Tetra Tech was the #2 USAID contractor in 2016. Management is bullish on the increase in the defense budget. However, the Trump administration has proposed draconian budget cuts to the State Department and USAID. We doubt the ultimate budgets for these departments will experience steep haircuts; nevertheless, we remain cognizant of the political pressure.

The top detractors from the Portfolio's performance in the quarter were Dundee Corp. (ticker: DC/A CN), Cubic Corp. (ticker: CUB), and Teradata (ticker: TDC).

In our Dundee mea culpa in last quarter's letter, we wrote: *"We have urged management to sell Dundee's public investments to pay off bank debt and preferred stock, which would reduce cash burn by half. If the company then catches a break on one of its major private investments, it could mark a turning point for the company's fortunes."* On May 10th, Dundee announced that Delonex Energy will acquire United Hydrocarbon (UHIC), Dundee's Chad energy venture/money pit. Delonex offered $35 million at close, another $50 million when first oil is achieved, and ongoing royalties ranging from 5%-10% of production unless Brent prices fall below $45 per barrel. Dundee has been spending $12 million per year to maintain UHIC while seeking an investor, and this cash drain will disappear upon a sale. It's not a done deal, as Dundee is currently in negotiations with the Government of Chad to renew its Production Sharing Contract. On May 19th, Dundee sold its entire remaining stake in DREAM Unlimited for CAD $106 million. The proceeds will likely be used to pay down bank debt. The sales of UHIC and the DREAM shares were exactly the type of positive catalysts we were seeking. The market has clearly shrugged, since Dundee's shares are back down to all-time lows. Canadian small caps have traded weak this year, which could be a factor, but we think investors will need confirmation that the Delonex transaction closes before they bid up Dundee's shares.

We like the transportation systems business inside of Cubic. The company is the world leader in fare collection systems for mass transit. However, Cubic's management lacks credibility. They cut guidance again after a deferral in the expected timing of contract awards for the firm's defense business. Cubic is one of the smaller weights in the Portfolio.

Teradata has endured a rough stretch over the past several years, with contracting revenue and profits. The firm is currently transitioning to a subscription-based revenue model, which is creating more turbulence for reported earnings but hopefully moving the company closer to stabilization. Teradata embraced the cloud more slowly than many other IT companies, but it is making progress in converting customers to a recurring revenue model. The stock is clearly out of favor, and we envision a return to growth as management executes the business shift.

We purchased two new securities for the Select Portfolio in the second quarter: Hallmark Financial Services (ticker: HALL) and Scripps Networks Interactive (ticker: SNI).

Hallmark Financial Services is a specialty property and casualty insurance company that focuses on transportation-related niche commercial markets with a concentration of business in Texas. Hallmark will underwrite accounts ignored by larger carriers due to the insured's loss history, years in business, minimum premium size, or type of business. The firm derives a significant portion of premiums from trucking companies, which Hallmark has in common with Baldwin & Lyons (ticker: BWINB), another Select Portfolio holding. Hallmark has a solid long-term track record of compounding book value, but underwriting losses and unfavorable reserve adjustments have saddled returns over the past few years. Management has worked to address problem areas by raising rates and exiting markets like personal automobile insurance where Hallmark has failed to make money. The company is well-capitalized, and Hallmark's bond portfolio carries a weighted-average credit rating of BBB+ with a three-year duration.[13] This should help protect the balance sheet under a scenario of rising interest rates. We bought the stock at 0.9x tangible book value.

Late in the quarter we established a small position in Scripps Networks Interactive, the U.S. owner and operator of HGTV, Food Network, and the Travel Channel. We simultaneously reduced our weighting in Corus Entertainment by an amount equal in size to our new position in Scripps. We have followed Scripps for many years and know its assets well, not only because of the company's relationship with Corus (the Canadian operator of Scripps' brands), but also because the company's networks are frequently on display in the living rooms of our homes! Scripps owns powerhouse brands and its networks' core viewers have extremely attractive demographics. As a result, Scripps' advertising slots are considered

*13* Company investor presentation

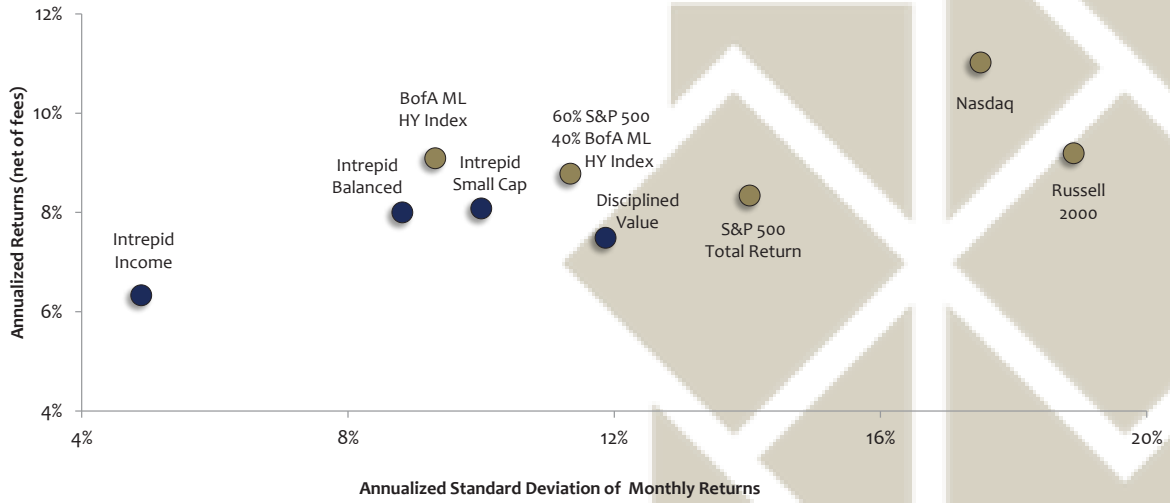
premium inventory compared to most other U.S. media companies. Advertising accounted for 71% of Scripps' revenue in 2016. On the other hand, Scripps punches below its weight in regards to the affiliate fee revenue Scripps earns from cable and satellite providers. HGTV receives monthly affiliate revenue per subscriber per month that is less than half the level of other cable networks like USA and Discovery, in spite of the superior ratings of HGTV. Correcting this imbalance over time could significantly enhance the company's profitability and should, at a minimum, help insulate Scripps from cord-cutting pressure, the negative drag from advertising in the event of a recession, or continued advertising share shifts to digital venues.

# Risk Adjusted Returns

Intrepid Capital

## Trailing 15 Year risk/return

*June 30, 2002 to June 30, 2017*



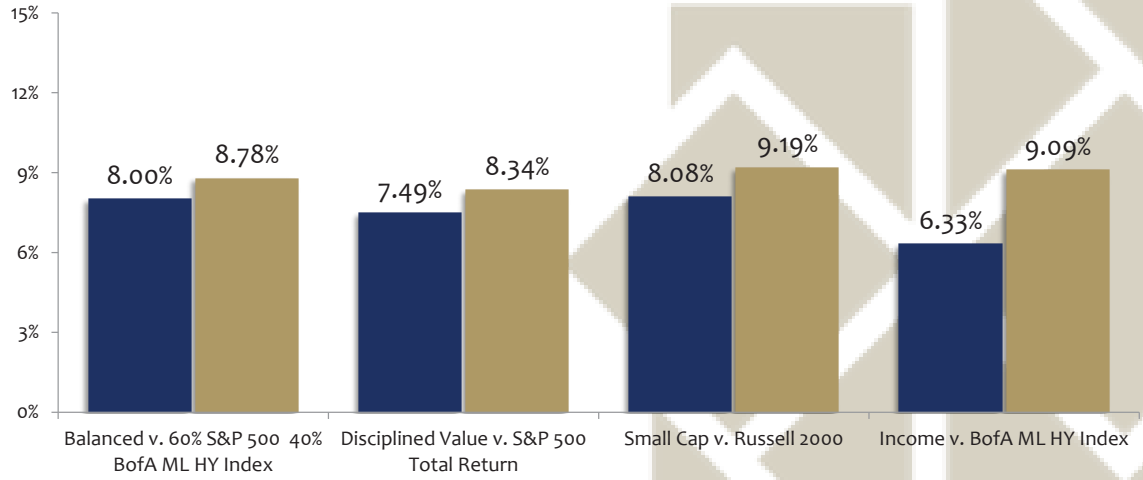

- Past performance is no guarantee of future results. Intrepid composite returns are presented net of investment advisory fees and all returns are presented annualized for the 15-year period ending June 30, 2017. Returns reflect the reinvestment of dividends and other earnings. The volatility of the listed benchmarks may differ materially from the volatility of any 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 which, in 2016, had a name change to the BofA Merrill Lynch High Yield Index.

# Annualized Performance

Intrepid Capital

## Trailing 15 Year risk/return

*June 30, 2002 to June 30, 2017*




- Past performance is no guarantee of future results. Intrepid composite returns are presented net of investment advisory fees and all returns are presented annualized for the 15-year period ending June 30, 2017. Returns reflect the reinvestment of dividends and other earnings. The volatility of the listed benchmarks may differ materially from the volatility of any 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 which, in 2016, had a name change to the BofA Merrill Lynch High Yield Index.