Intrepid Capital MANAGEMENT INC.

the constant pursuit of value

3Q'12 7/1/12 – 9/30/12

DOW JONES	5.02%
S&P 500	6.35%
NASDAQ	6.54%
RUSSELL 2000	5.25%
E.A.F.E.	7.00%

QUARTERLY MARKET LETTER | September 2012

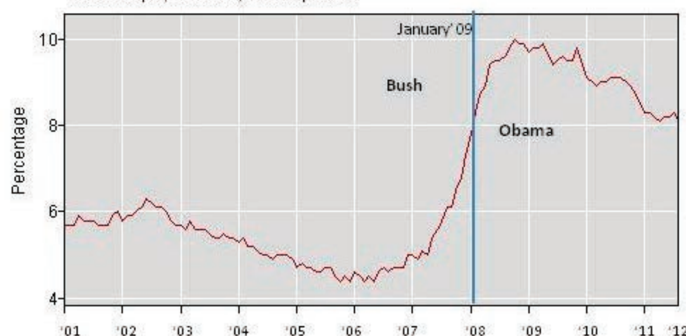
Dear Friends & Clients,

"The power of holding two contradictory beliefs in one's mind simultaneously, and accepting both of them to tell deliberate lies while genuinely believing in them, to forget any fact that has become inconvenient and then, when it becomes necessary again, to draw it back from oblivion for just as long as it is needed, to deny the existence of objective reality and all the while take account of the reality which one denies"

— Doublethink
George Orwell "1984"

We are living in strange times; where up is down and down is up. Poverty is growing, incomes are falling, the economy's growth is slowing to a snail's pace, joblessness is growing in more than half the country, and the President is talking to us in Orwellian "doublethink" (see definition to the left). My apologies in advance, looking at the current polls as I am likely to aggravate a majority of you. I will declare my interests front and center. I believe, like Larry Kudlow on CNBC, that free market capitalism is the path to prosperity for all of us.

The Obama campaign tag line is "Forward." Well, I sure would hate to see backward! The level of employment in this country in January of 2009 was roughly 133 million; today it is no greater. In fact, in August of 2012, more people went onto food stamps (175,000) than found a private sector job (96,000). The Obama campaign uses the counterfactual arguments that the economy would have been much worse without the massive stimulus, or that the administration's decisive action "saved" GM, etc. etc. The perennial favorite is that everything is George W. Bush's fault – a valid argument to a point, but not four years later (see Not His Fault chart below).



To add to the toxic financial brew, Ben Bernanke announced a third round of quantitative easing (QE3), which caused a spike in financial assets. Early in his career, he was given the moniker "Helicopter Ben" when he publically stated that the Fed could print money and drop it from a helicopter if conditions were dire enough. With the Fed's recent decision to print money and expand its balance sheet indefinitely (leading many to refer to QE3 as "QEternity"), I have christened him "Buzz Lightyear" from the animated classic, Toy Story. In this movie, Buzz, a plastic toy with wings, jumps out of a window with his wings extended, shouting "to infinity and beyond" right before landing in the shrubs below the window.

The "free" interest rate Mr. Bernanke is offering to the market is doing two things that I view negatively. First, short-term interest rates in theory represent the price, or opportunity cost, of borrowing money and should be set by the market. The suppression of this rate over time contributes to a misallocation of capital, as everything looks viable from an investment standpoint (e.g. Tech Bubble, Housing Crash) when borrowed capital is virtually free. Second, this low-cost borrowing enables our government's financial profligacy to continue unchecked. When – not if – the Fed has to shrink its balance sheet and short-term rates rise, the Federal government's budgetary problems will explode like those of Greece, Spain, and Portugal (see "What We Pay" chart below right).

Let's hope our politicians can come up with a reasonable resolution to what I view to being a spending problem. The period between November 6th and December 31st will be filled with high political drama.

Thank you for entrusting your hard earned capital to us. It is not a position we take lightly. With the exception of Berkshire Hathaway shares that I have held for years, all of my immediate family's investment and retirement accounts are invested in the Intrepid Capital portfolios.

Best regards,

Mark F. Travis
President and CEO

What We pay…

	Net Interest Rate %	Net Interest Expense/Total Receipts %
1940s	1.8	9.3
1950s	2.3	7.8
1960s	3.4	7.2
1970s	5.7	8.2
1980s	8.6	15.2
1990s	6.7	16.4
2000s	4.7	9.4
2010	2.4	9.1
2011	2.4	10
2012e	2.1	9.1

and would pay if…

2012 @ 3%		13
2012 @ 4%		18
2012 @ 5%		22
2012 @ 6%		26

source: Office of Management and Budget

SMALL CAP PORTFOLIO

Like many others in this business, we often bring our work home with us. Intrepid Capital is the largest institutional shareholder of WWE. Much to my wife's chagrin, I now watch wrestling on TV. While I was viewing an episode of *Monday Night RAW* a few weeks ago, the intro music for the wrestler "Ryback" began to blare. "*Feed. Me. More. Feed. Me. More…*" According to Wikipedia, Ryan Reeves was nicknamed "Silverback" as a teenager after a childhood friend joked that he resembled a silverback gorilla. I concur. The muscled 6'3", 291 pounder's signature move is performing a fireman carry and backwards body slam on two men at the same time. Rather than watching Ryback destroy his opponent, I began to daydream. As the fans chanted, "*Feed. Me. More,*" I thought of the investing masses pleading for more quantitative easing (QE) from the Fed later that week. "*Feed. Me. More.*" Instead of Ryback lifting 400 pounds onto his shoulders, I saw Ben Bernanke, a modern-day Atlas, hoisting stock markets to all-time highs. "*Feed. Me. More.*" The crowd goes wild! I know how this scene ends: a face plant into the mat.

For the quarter ending September 30, 2012, the Intrepid Small Cap Portfolio (the "Portfolio") returned 3.83%, net-of-fees, versus a 5.25% gain for the Russell 2000 Index. Year-to-date, the Portfolio is up 6.94%, net-of-fees, compared to 14.23% for the Russell 2000. Stocks have run up again despite a barrage of negative economic signals and the fast-approaching fiscal cliff. We have taken advantage of the market's strength to sell holdings that have crossed our fair value estimates. At quarter end, cash was 50.1% of Portfolio assets. Cash has accounted for the majority of the Portfolio's underperformance versus the benchmark. Our high cash position reflects our opinion that small cap discounts are very difficult to find today. How could we be wrong? Here are three possible explanations. *Our portfolio positioning may be incorrect if:*

1) Debt doesn't matter anymore. When borrowing costs are zero, there is no difference between one dollar of debt and infinity dollars of debt.

2) Profit margins are at a "permanently high plateau." Earnings multiples for large caps aren't that high today (small caps are a different story), so if the current record level of profitability is sustainable, the broader market may be fairly valued.

3) The risk premium for owning equities has shrunk permanently. High grade fixed income investors can reach out and touch the lower bound for bond yields, and they realize there is scant upside. If investors are now willing to accept a 7% long-run nominal return for stocks instead of 10%, then they are willing to pay a much higher price for the same earnings.

In our opinion, a defensive stance is warranted today. At least two of the theories listed above would be debunked if interest rates were at normal levels. Debt matters, margins mean-revert, and stocks only seem safe until they go down. We don't stretch our valuations in order to stay invested or generate portfolio activity. As a result, the Portfolio's cash has grown significantly over the past two years.

During the third quarter, the Portfolio's largest contributors were CSG Systems (ticker: CSGS), Bill Barrett (ticker: BBG), and Pan American Silver (ticker: PAAS), which collectively added 1.69% to the Portfolio's return. CSG may have benefited from reduced fears of customer losses, as management has expressed considerable optimism about its key relationships. CSG, which had long been one of the Portfolio's largest positions, was significantly reduced as it neared fair value. Bill Barrett and Pan American had been portfolio underperformers until this quarter. As commodity names, they participated in the QE hype of the third quarter. Even after the recent run up, we believe that Bill Barrett's stock price has not caught up to the improved sentiment toward natural gas. Pan American was purchased as a QE-hedge. It is an imperfect hedge, since inflation also affects the cost structure of precious metals miners. Nonetheless, it offers us some protection.

The only holdings that adversely affected the Portfolio's performance by more than 10 basis points in the third quarter were Ingram Micro (ticker: IM) and Speedway Motorsports (ticker: TRK), which collectively cost the Portfolio 31 basis points. There was no significant news on Speedway Motorsports.

Ingram is the world's largest distributor of technology products. At the beginning of the quarter, Ingram announced the acquisition of BrightPoint (ticker: CELL), which is a provider of supply chain services to the wireless industry. The acquisition makes strategic sense. We suspect that investors were not happy with the large premium offered to BrightPoint shareholders, but the offer price was only 12x BrightPoint's five year average free cash flow. Ingram is a market leader that has consistently generated cash, and it is trading below tangible book value today. We doubled our share ownership in Q3.

We only purchased one new holding in Q3: Big Lots (ticker: BIG). Big Lots is the nation's largest broadline closeout retailer. A majority of shoppers visit Big Lots to look for steep discounts in a "treasure hunt" environment, but 30% of the company's merchandise is consumables. The stock plummeted after second quarter earnings, which were impacted by poor merchandising decisions. Although the company is exposed to consumer spending, Big Lots' value-orientation and consumables mix helped sustain the company during the last recession. We bought the stock at a multiple of approximately 6x operating income (EBIT).

In addition to the Big Lots purchase, we significantly increased our positions in FTI Consulting (ticker: FCN) and Global Payments (ticker: GPN). FTI's shares fell to a multi-year low after second quarter earnings. In our opinion, the company should perform above-average in a hairy economy due to FTI's leading restructuring practice and its consulting on high-profile litigation. Global Payments is a major payments processor that helps small and medium-sized merchants process electronic transactions. The firm experienced a security breach earlier this year, but the damage appears limited. Global Payments has recurring revenue and competes in an attractive industry. We have owned other payments names like Total Systems Services (ticker: TSS), and we continue to explore undervalued opportunities in this space.

We exited several positions that reached valuation in the past three months, including Computer Sciences (ticker: CSC), Convergys (ticker: CVG), ICON plc (ticker: ICLR), and Regis (ticker: RGS). We also sold Tellabs (ticker: TLAB). Tellabs' fundamentals have deteriorated over time, but we were comforted by the cash-rich balance sheet. After Tellabs' CEO died of pancreatic cancer this quarter, we thought the new leaders might chart a different strategic direction for the company. This does not appear to be in the cards, and we lacked confidence that management would deploy the company's cash in an intelligent fashion. We sold Tellabs at a loss. We significantly reduced our Teleflex (ticker: TFX) holding as the stock neared intrinsic value. Lastly, we sold our entire Federated Investors (ticker: FII) stake. Although the money market industry experienced a small victory in late August when the SEC lacked the votes to push through more reform, financial authorities are hell-bent on altering the industry structure. The regulatory uncertainty was too substantial for us to maintain our position in light of the stock's appreciation year-to-date.

Regardless of the market's direction, we will continue to implement the Intrepid Capital investment process to uncover overlooked opportunities. While much of the investing world treats performance like an NFL game measured in quarters, we view investing as a marathon of emotional discipline encompassing years of investment returns in favorable and unfavorable climates. We look forward to the day when Ben Bernanke is not the focal point of investing decisions. As we enter October, our Fed fatigue has never been greater. Store your investment acorns; it could be a cold winter. Thank you for your investment.

ALL CAP EQUITY PORTFOLIO

With a slight turn of phrase, we can best encapsulate the policy of the Federal Reserve, "The easings will continue until morale improves." First, we should give the reader a quick review of the Fed's efforts. We have already experienced two previous rounds of quantitative easing – mass purchases of securities by the Fed from banks and other private institutions to increase the money supply. QE1 began in late 2008 and ended in early 2009. The Fed bought $500 billion in mortgage-backed securities, eventually topping out at $750 billion. The federal funds rate was cut to nearly zero. The Fed also purchased $100 billion in Fannie Mae and Freddie Mac debt as well as $300 billion in longer-term Treasuries. All in, the Fed bought $1.25 trillion in mortgage-backed securities

and $175 billion in agency debt. When that did not work, the Fed initiated QE2 from the fourth quarter of 2010 to June 2011. It bought back $600 billion in longer-term Treasuries in monthly, $75 billion lots. The net effect of this easing is an extremely low rate environment with little economic recovery. Stocks have benefitted not from underlying improving fundamentals so much as the act of pushing trillions of dollars into the equity market in the mother of all risk-on trades. Including the years 2009, 2010, 2011 and the past nine months of 2012, the S&P 500 is up 73.03% cumulatively, or 15.77% on an annual basis. That's quite a run for an economy that has seen high unemployment since January 2009.

In light of the history of failed monetary easing policy, what is the Fed to do in an effort to boost the economy? Meet the new boss, same as the old boss. Announced in September, the new Bernanke-led program, dubbed QE3 (Quantitative Easing Part 3), will purchase $40 billion of mortgage-backed securities each month. Concurrent with QE3 is the continuing phase of Operation Twist, in which the Federal Reserve is buying longer-term Treasuries while selling short-term Treasuries it holds. This phase of the program started in June and runs through December and encompasses about $267 billion in securities. The idea is to lower long-term interest rates by creating artificial demand and putting upward price pressure on long-term Treasuries, thereby giving the economy a boost. There is one difference between QE3 and all of the previous programs, and it ties back in to the first line of this letter. This time, the Fed has indicated it will continue buying until it is satisfied that there is economic recovery. There are serious problems with engaging in this behavior. The Fed's balance sheet will continue to balloon. Once it stops, it will have an extremely difficult time unloading all of the longer-term assets. In addition, and more specific to our concerns, it pushes more dollars indiscriminately into the stock market because there is little other place for the dollars to go. It is this type of environment in which asset bubbles form.

For the quarter ended September 30, 2012, the Intrepid All Cap Equity Portfolio (the "Portfolio") returned 3.94%, net-of-fees, trailing both the Standard & Poor's 500 Index and the Russell 3000 Index returns of 6.35% and 6.23%, respectively. Our underperformance is largely caused by our sustained high cash level. Simply put, we do not believe that the current market environment is moving up due to fundamental improvements in businesses. Rather, it is being pushed up by a calculated policy of asset inflation which is forcing too many dollars into the equity market. We refuse to buy businesses which have been bid above and beyond what we believe that they are worth. This has hurt our relative performance over the past year and the past quarter, but we do not believe our approach should or will change.

Among our biggest underperformers for the quarter was Dell (Ticker: DELL), which continued to post disappointing quarterly numbers and, in the latest release, cut its estimates for the full year. Dell is a business that is attempting to shift from the commodity business of low margin, low-end consumer PCs to higher-margin, business-centric offerings – not only PCs, but also servers and networking hardware and software. That shift is not happening fast enough. With the heavy sell-off in the quarter, we partially sold our position to realize tax losses. The second underperformer in the quarter was Speedway Motorsports (ticker: TRK), which cited lower admissions as race fans continue to be impacted by the weak economy. The third underperformer was our cash position, which, based upon our reasoning at the beginning of this letter, was 26.6% at quarter-end.

CSG Systems (ticker: CSGS) led the top performers in the quarter with a decent quarterly earnings release and a full year earnings guidance increase. The second best performer was Telephone & Data Systems (ticker: TDS), which was oversold in the second calendar quarter and was most likely experiencing share price recovery. Finally, Pan American Silver (ticker: PAAS) participated in the strong showing which most commodity-related stocks experienced in the quarter. Case in point – rounding out the Portfolio's top five contributors were oil & gas company Bill Barrett (ticker: BBG) and timber company Potlatch (ticker: PCH).

Given the rising market, we have not been afforded the opportunity to purchase many new names. During the quarter, we were able to add two new businesses to the Portfolio. First, we added Big Lots (ticker: BIG), a small cap discount retailer. For more information, please refer to the Intrepid Small Cap Portfolio section. We also bought Staples, Inc. (ticker: SPLS), the leading office supply retailer in the country. It is also the second largest Internet retailer in the world. It is a business which has many of the characteristics that we are attracted to: low capital needs, high cash generation, not overly leveraged, and market leadership. Unlike many other attractive businesses, Staples was trading at a discount to its intrinsic value. Of course, given the current market climate, there is usually a reason for that, and this case is no exception. Staples' one-time industry-leading operating margins were 7% to 8% for its North American

retail and North American Delivery segments. With mounting weakness in business and home office spending, those margins have fallen. In addition, the smaller International segment's operating margin has gone negative due to global weakness and lack of scale. Overall margins are down from 6.5% at the end of fiscal 2012 to 4% at present. However, we believe that the stock is oversold, and that management will implement a restructuring plan to improve margins by rationalizing underperforming stores.

Other activity in the Portfolio involved trimming down positions which approached intrinsic values or, in a couple of cases, realizing capital losses. CoreLogic (ticker: CLGX) and ICON plc (Ticker: ICLR) were examples of stocks which crossed intrinsic value. In the case of ManTech International (ticker: MANT), we took the opportunity to harvest capital losses in the position. Tellabs (ticker: TLAB) was trimmed back significantly for a capital loss. The operational environment for the telecommunications equipment industry is poor, but Tellabs has almost $1 billion in cash – a significant amount for a stock with a market capitalization of $1.28 billion. Unfortunately, new management has given no indication that it will take steps to maximize shareholder value with respect to its balance sheet. It is currently holding much more cash than necessary to fund its operations, which are currently at break-even. Although the company trades below its book value, we believe that the time horizon for such an investment to pay off no longer justifies a significant weight in the Portfolio.

At the end of the quarter, the average discount in the Portfolio was 14%. Every security held in the Portfolio can be compared against our corresponding calculated intrinsic value estimate. We mention this metric every quarter because it gives us some idea about the availability of discounts in the equity market. When the market is dear - that is, when the market is perceived to be expensive as a whole - the average discount tends to be low; when the market is selling off, the average discount tends to increase. It is anecdotal, but we find it to be a useful number to compare against itself over time. Like our investors, we understand that times like these can be the most difficult: to exercise caution in the face of market exuberance, to be patient and wait for good businesses at good prices. We thank you for your confidence in our process.

BALANCED PORTFOLIO

The Intrepid Balanced Portfolio (the "Portfolio") is the most flexible product that we offer. As of September 30, 2012, the allocation of the Portfolio was 60.1% in equities, 21.2% in corporate debt, and 18.6% in cash. The Portfolio can invest in stocks of any market capitalization and debt of any credit quality. Historically, the firm has focused on less popular corners of the capital markets, which include small cap stocks and high yield bonds. Despite the Portfolio's allocation to these "riskier" asset classes, the Portfolio generally exhibits no more volatility than portfolios constructed of large cap stocks and investment grade bonds. We attribute our risk control to our cash flexibility as well as our preference for basic, boring businesses with predictable cash flow streams and below-investment-grade debt with better credit quality and shorter duration.

We are occasionally asked about the overlap across our products. Nearly all of the Intrepid Balanced Portfolio's ideas are sourced from our other strategies (Berkshire Hathaway, Newmont Mining, and Royal Gold are current exceptions), the All Cap Equity, Small Cap, and High Yield Portfolios. The Portfolio is blessed because it has the broadest contribution of ideas from our investment team, but our other funds also benefit from analytical synergies. We are fortunate that many high yield issuers are small cap companies. Since we consider the entire capital structure when we analyze a company, ideas that first pique our interest from a credit perspective may become an equity holding, and vice versa. For example, in 2007 we first bought the bonds of Rent-A-Center, which had a maturity under three years but were paying a 10% yield at the time—several hundred basis points in excess of the high yield index. Within a month, we bought Rent-A-Center's (ticker: RCII) stock after a temporary drop in price, and we also bought the equity of competitor Aaron's (ticker: AAN). All of these investments were fruitful for the Portfolio, and we have owned both stocks more than once.

In a few cases, the Portfolio owns the stock and bonds of the same company simultaneously, such as is currently the case with Speedway Motorsports (ticker: TRK), FTI Consulting (ticker: FCN), Bio-Rad Labs (ticker: BIO), and Bill Barrett (ticker: BBG). None of these individual companies' securities represent more than 5% of assets on a combined basis. Many of the bond names in the Intrepid Balanced Portfolio at the end of the third quarter have also been equity holdings at some point in the past. We hope it's clear that we derive maximum benefit from our analytical resources through sharing ideas across products.

For the quarter ended September 30, 2012, the Portfolio increased 5.39%, net-of-fees. This brings the Portfolio's year-to-date performance to a gain of 9.77%, net-of-fees, and a gain for the trailing year of 17.48%, net-of-fees. The markets have delivered above-average returns over the last three years. Through September 30, 2012, the S&P 500 has a three-year annualized return of 13.22% and the Bank of America Merrill Lynch High Yield Master II index posted a return of 12.61%, compared to the Portfolio's return of 11.42%, net-of-fees. These strong returns have made it harder to find investment candidates that meet our criteria, although our sizable cash balance will allow us to act quickly when the analyst team at Intrepid Capital detects a disconnect between price and value. Thank you for entrusting your hard earned capital to us.

HIGH YIELD PORTFOLIO

Investors continue to push funds into the high-yield asset class in search for yield. With the Fed pledging to keep short-term rates low for an additional year into 2015 and announcing another round of quantitative easing targeted at deploying $40 billion per month into mortgage-backed securities, high-yield is essentially the only fixed-income asset class offering even a sliver of income. Since most managers are forced to put new cash to work, the current environment seems to be the result of supply and demand imbalances. There is simply too much cash chasing too few bonds. In our conversations with bond dealers, the most common phrase we hear is "there is just so much cash out there." The high demand has served as a major tailwind for returns this year, while further limiting future potential returns. On September 19, 2012, the yield-to-worst on the Bank of America Merrill Lynch High Yield Master II Index (the "Index") reached an all-time low of 6.2%.

In the quarter ended September 30, 2012, the Index rose 4.61%, while the Intrepid High Yield Portfolio (the "Portfolio") returned 1.79%, net-of-fees. Our underperformance is primarily due to the Portfolio's large cash position, which increased through the quarter as noted in our previous commentary. Additionally, our portfolio is composed of higher-quality, shorter-duration credits that generally underperformed riskier, longer-dated bonds in the risk-on environment.

The Portfolio was not particularly active in quarter, but we did increase our position in Energy Partners Ltd 8.25% due 2/15/2018 by 50%.

We remarked in our previous letter that we expected several holdings to be called through the summer. Six holdings were called in part or entirely in the quarter, the largest of which were Amscan Holdings 8.750% due 5/01/2014, and HSN Inc 11.250% due 8/01/2016. We exited one position, which was an opportunistic idea that increased in price. The price of our Computer Sciences Corp 6.5% bonds due 3/15/2018 rose to the point where we believed the yield was unattractive.

The two largest contributors to the Portfolio's performance in the quarter were Central Garden 8.25% due in 2018 and PetroQuest 10% due in 2017. There were no detractors in the quarter.

At Intrepid, we aren't creating portfolios that hold hundreds of bonds. That approach is largely based on technical factors such as anticipated flows into the asset class and expected default rates. Managers of these products expect to have defaults but believe gains elsewhere will offset these losses. Our strategy differs significantly. Instead, we carefully select 25-40 individuals holdings that we believe offer the best returns for the risk taken. The primary goal, as with all Intrepid products, is to minimize the risk of permanent capital impairment. The most common type of permanent capital loss occurs in a bankruptcy or restructuring, where various claims to a company's assets often receive a fraction of what they were owed.

We also believe interest rate risk can lead to "permanent" capital loss, but this is a much less common concern among the investment community. The price of a 30-year bond will exhibit extreme volatility with only minor changes in interest rates. In the current environment of near record low rates, even a return to "normalized," or historical average, rates would trigger a material decline in the price of long-dated bonds. We used quotation marks above with "permanent" because if the investor's holding period is long enough and the bond is held to maturity, the loss will only be temporary. However, we think many of our investors would agree that they don't want to wait 30 years to recoup this "temporary" loss.

In our quest to limit the risk of permanent loss, we will only invest in securities that we believe offer attractive potential returns for the risk taken. We are not required to invest excess cash as many other managers are. When opportunities are limited, as they are now, our cash position will naturally be higher than normal. Cash and Treasury bills account

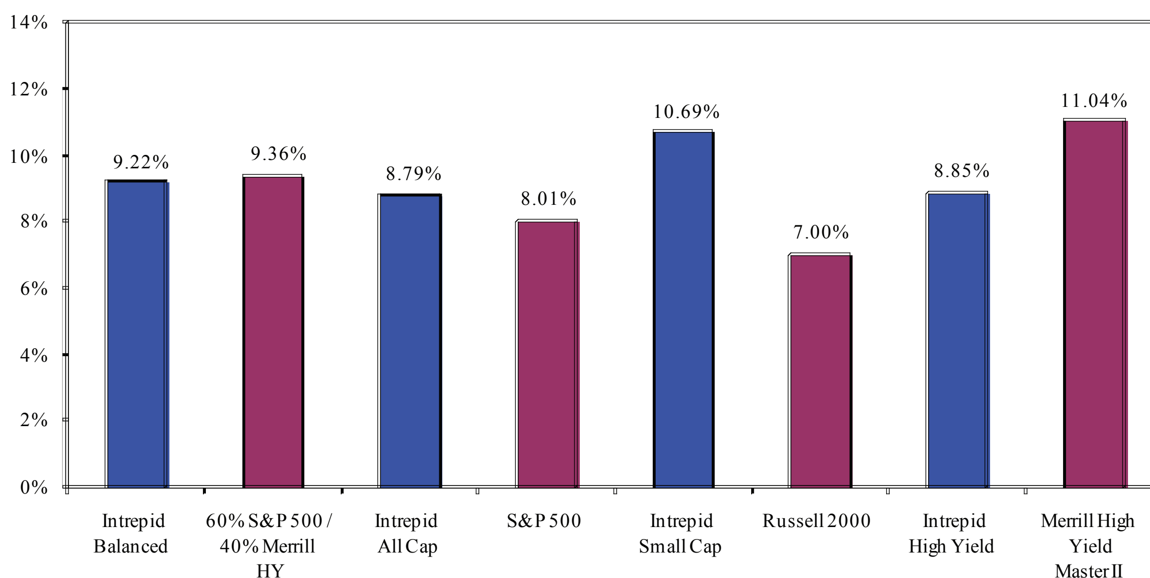
for about 19% of the Portfolio's assets. As we have stated in prior letters, the cash allocation is not an attempt to time the market.

While we don't spend as much time analyzing the market from a 50,000 foot view, there are signs that the current high-yield environment is overheated. Recent flows into the asset class have slowed considerably. Newly issued bonds have terms similar to those seen in the mid- to late-2000's, with loose covenants and the ability to defer cash interest payments. Further, those pesky collateralized loan obligations (CLOs) and collateralized debt obligations (CDOs) that were the talk of the financial press just four short years ago (and had largely been extinct post-2008) are coming back into vogue as investors continue the yield search outside of traditional asset classes. While it may seem like eons ago to many investors, the credit crisis is still fresh in our minds, and we will continue to manage your capital with a keen focus on minimizing downside risk. Thank you for your investment.

Intrepid Capital Management

Trailing 10-Year Annualized Performance

September 30, 2002 to September 30, 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 September 30, 2012. Returns reflect the reinvestment of dividends and other earnings. The volatility of the listed benchmarks may be materially different 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.