Intrepid Capital Funds

the constant pursuit of value

INTREPID SMALL CAP FUND

3rd QUARTER 2014 COMMENTARY

3Q2014

SEPTEMBER 30, 2014

PERFORMANCE

	Inception Date	Total Return Qtr.	Total Return YTD	Total Return 1 Year	Average Annualized Total Returns as of September 30, 2014 3 Year	5 Year	Since Inception
Intrepid Small Cap Fund - Inv.	10/03/05	-1.64%	2.21%	6.14%	10.63%	9.54%	10.81%
Intrepid Small Cap Fund - Inst.	11/03/09	-1.68%	2.31%	6.39%	10.88%	-	10.21%
Russell 2000 Index		-7.36%	-4.41%	3.93%	21.26%	14.29%	7.11%^

^Since Inception returns are as of the fund's Investor Class inception date. Since the inception date of the Institutional Class, the annualized return of the Russell 2000 Index is 15.90%.

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

Per the prospectus, the Fund's annual operating expenses (gross) for the Investor Share Class is 1.42% and for the Institutional Share Class is 1.17%. The Fund's Advisor has contractually agreed to waive a portion of its fees and/or reimburse expenses such that the total operating expense (net) is 1.40% and 1.15% through 1/31/15, respectively. Otherwise, performance shows would have been lower.

October 1, 2014

Dear Fellow Shareholders,

After eight consecutive quarterly gains, the Russell 2000 Index finally retreated in the third quarter of 2014. The benchmark's decline was 7.36%, which is a notable departure from the positive performance of larger capitalization stocks. As of September 30, 2014, the Russell's fully baked P/E based on GAAP earnings is 100x. The median constituent P/E in the index is 45x. The benchmark sits 8.8% below its all time high, but it's 28.7% above the previous cycle's July 2007 peak. The seepage in the prices of small cap stocks hasn't altered our view that the small cap market is prohibitively expensive. This condition is only likely to be cured by a sharp drop in stock prices.

Like the recent divergence in performance between large and small companies, we expect the next bear market to create a range of outcomes among small cap stocks. Higher quality, cash-generative companies should see their swollen valuation multiples contract. When this is paired with margin pressures, significant stock price declines are possible. However, for the fully invested money manager, this is the lesser of evils, since the intrinsic value growth inherent in owning good businesses eventually covers up poorly timed purchases. Just be prepared to wait. Long-term shareholders of Microsoft and Intel are still waiting to fully recover their tech bubble losses…over fourteen years later.

The small cap landscape is also littered with many companies of inferior quality. These range from the cyclically vulnerable to the structurally doomed to the hopelessly enamored. In many cases, these firms have been awarded substantial and rapidly growing market capitalizations well in advance of any signs of profitability. The endgame for the stocks of these weaker enterprises is potentially bleak (it might go something like this: http://www.youtube.com/watch?v=pkpglRZWEtU).

Currently, just over half of Russell 2000 index members are down more than 20% from their 52 week high prices. Given the Russell's negative year-to-date returns, it's not surprising that stocks belonging to higher beta industries are generally down more. Approximately 75% of Internet small caps and over 80% of biotechnology stocks are in a bear market (-20% or more). Three quarters of oil and gas drillers are in the same boat, as they have been impacted by declining commodity prices. On the other hand, financials have fared well. Only 14% of small cap banks and 10% of REITs have fallen by 20% or more.

For us, it's not a choice between owning overvalued high quality businesses or more overvalued low quality ones. Behind door number three is cash, which amounts to 73.4% of our portfolio. We don't view cash as our metaphorical bomb shelter—a place for us to hide until the battle is over. We're quite willing to tiptoe around investment landmines to dig up an 80 cent dollar, but we are unable to find meaningful value in this market. Sometimes there is an opportunity cost penalty for inaction, as the ongoing cash flow generated by companies leads to a gradual build in their values. The idea is that companies can grow into their stock prices, and some undoubtedly will. Nonetheless, over the past year, the membership of the Russell 2000, ex-financials, has produced aggregate free cash flow equal to 18 basis points of its collective market capitalization. The typical non-financial company's trailing free cash flow yield is 2%. We don't think time alone can fix this imbalance.

We present six signs of an increasingly hollow stock market:

- **Activism—the latest investment fad:** Don't get us wrong, management teams need to be held accountable, and activism has led to genuine improvements at many enterprises. However, we can't help but feel that there used to be a touch more substance behind activist positions. With corporate profit margins at record highs, the well has largely run dry for intelligent cost saving actions. The *activism du jour* is based on establishing a stake and then clamoring for management to borrow money to repurchase overvalued shares or explore "strategic alternatives." A specious 13D filing has been the surest ticket to a quick gain. Pardon our sanctimonious tone. To an extent, we are all investment mercenaries, so you can't blame activist investors for playing the game.
- **M&A at peak stock prices is viewed as a value creator:** How much value has been destroyed by companies overpaying for acquisitions? Promises of synergies now frequently lead to significant gains in the stock price of the *acquiring* company, which is a relatively new phenomenon. This summer the London Stock Exchange (LSE) agreed to buy Russell Investments, our favorite index compiler, for 19x EBITDA. LSE's stock rose 6% on the day of the announcement.
- **Earnings accretion and the 6 inch hurdle:** "Accretive to earnings" is perhaps the most abused phrase in the financial lexicon. An acquisition increases the acquirer's earnings per share (EPS) if the target's earnings yield (E/P ratio) is greater than the acquirer's after tax borrowing cost. Given that investment grade borrowing rates are approximately 3% today, creditworthy acquirers can pay around 50x earnings and still produce higher EPS. They can pay even higher multiples if using idle cash. Blessed are those management teams with the perspicacity to use their own overvalued stock when acquiring today.
- **Share repurchases are good for the goose, but not for the gander:** Over the last 7 years, S&P 500 stock buybacks troughed in the second quarter of 2009 and peaked in the first quarter of 2014. In terms of allocating shareholders' money, the timing is unbelievably awful. Yet, the ratio of insider buys to sells is near the lowest level since the tech bubble, according to Bloomberg.
- **Gaming the system through inversions:** A tax inversion is the relocation of a corporation's headquarters to a lower tax nation, while retaining the core of its operations in the original country. U.S. corporate tax rates are high in comparison to the rest of the developed world, and the system could use an overhaul. Nevertheless, most large companies have an effective tax rate well below the stated 35% Federal rate. In fact, during the last five years corporate tax receipts have been the lowest percentage of pre-tax profits going back to at least World War II. In 2013, that rate was 17.2%, according to data from the St. Louis Fed. Still, during 2014 corporate tax inversions caught on like wildfire as the newest variety of financial acrobatics to further enhance net income. Shares of Walgreens fell 14% on the day it disclosed it would not be moving its headquarters overseas upon closing the Alliance Boots acquisition. With recent anti-inversion rules, the Treasury department may have squashed the trend. Did anyone really think it could last?
- **More Central bank absurdity:** The Federal Reserve, through interest rate suppression, is the principal enabler of the colossal misallocation of capital we are witnessing. As U.S. Quantitative Easing supposedly comes to an end, Europe takes the baton. The European Central Bank has lowered its deposit rate deeper into negative territory and hopes it can stave off a recession through aggressive monetary policy. The Bank of Japan is directly purchasing Japanese equities. Central banks have become the clown car of the modern era—just when you think you've seen it all, out pops another silly idea.

Top Ten Holdings	(% of net assets)
Amdocs Ltd.	3.7%
Corus Entertainment, Inc. - Class B	3.1%
Tetra Tech, Inc.	3.0%
Bio-Rad Laboratories, Inc.	3.0%
Dundee Corp.	2.5%
IPSOS	2.0%
Aspen Insurance Holdings Ltd.	1.9%
Ingram Micro, Inc.	1.4%
Pitney Bowes International Holdings, Inc.	1.0%
CSG Systems International, Inc.	0.9%

Top ten holdings are as of September 30, 2014. Fund holdings and sector allocations are subject to change and are not recommendations to buy or sell any security.

For the three months ending September 30, 2014, the Intrepid Small Cap Fund (the "Fund") fell 1.64% compared to a 7.36% decline in the Russell 2000 benchmark. Year-to-date, the Fund has gained 2.21%, while the Russell is lower by 4.41%. For the Fund's trailing twelve month fiscal year ending September 30, 2014, the Fund increased 6.14% versus a 3.93% gain in the Russell 2000. The Fund's equity-only performance for the quarter, year-to-date, and trailing year was -6.09%, 9.96%, and 22.55%, respectively.

The Fund had no material gainers in the third quarter, which we define as equity positions adding more than 10 basis points to the Fund's overall return. Our Canadian dollar hedge was the largest gainer and offset foreign exchange losses on our Canadian-domiciled holdings, as the U.S. dollar strengthened. Other gainers were companies that we sold early in the quarter, before the small cap market fell. The primary detractors to the Fund's third quarter performance were Tetra Tech (ticker: TTEK), Pan American Silver (ticker: PAAS), and Ingram Micro (ticker: IM). The decreases in Tetra Tech and Ingram Micro were not dramatically different than the small cap market, and we have no insight to share. Pan American, a small position, fell significantly due to weakness in gold and silver prices.

During the third quarter, we bought shares of Ipsos (ticker: IPS FP), which is one of the world's leading market research organizations. By conducting surveys, Ipsos helps customers discover and dissect the attitudes and behaviors of consumers. The company is headquartered in France, but it has an extensive global reach and the official language of Ipsos is English. Approximately 60% of sales come from outside of Europe. Traditional players in the market research industry are being challenged by a shift toward digital forms of data collection and interpretation, driven by the proliferation of smartphones and social media. This has caused a significant slowdown in the growth rate of companies such as Ipsos.

On July 23, 2014, the company announced lower-than-expected organic growth, which led to a 22% single day drop in the share price. The trading multiple on Ipsos's stock fell to levels unseen since the credit crisis. While we do not discount the inroads being made by new digital players, we believe the stock's fall was an extreme overreaction. Like its peers, Ipsos is actively expanding its new business lines that fall under the digital umbrella. In fact, in a popular annual industry survey conducted by GreenBook of "The 10 Most Innovative Companies in Market Research," Ipsos is ranked third. Ipsos has longstanding relationships with blue chip customers, high emerging markets exposure, and it has delivered steady, expanding margins over time. We established a position at a free cash flow yield exceeding 10%.

We exited our remaining small positions in Aaron's (ticker: AAN), Royal Gold (ticker: RGLD), and WWE (ticker: WWE) in the third quarter. As the year progressed, we lost confidence in Aaron's management and have been surprised by the deterioration in its core rent-to-own business. We liquidated the majority of our Aaron's holding at favorable prices early in the third quarter and sold the remainder after the company reported second quarter earnings. Royal Gold exceeded our fair value appraisal as the precious metals royalty company outperformed underlying gold prices. We walked away with a nice gain.

WWE's stock rallied during the quarter both before and after it announced an improved outlook for 2015 due to $30 million of expense reductions. In our last quarterly letter to you, we speculated this cost cutting might occur. The stock exceeded our intrinsic value, and we sold it. U.S. subscriber growth at the WWE Network continues to stall. The Network has now been launched globally with more flexible pricing plans that have the potential to further cannibalize pay per view revenue. The company would be in a far stronger financial condition today if it never launched the WWE Network but instead nurtured its highly profitable television franchises. We expressed this view to them on more

than one occasion while we were WWE's largest public shareholder. Although it wouldn't be easy for the company to unwind its WWE Network, we think it's a long-term possibility if subscriber numbers remain underwhelming.

We do not know if the current weakness in small cap equity prices will stick. There have been two occasions this year when declines were followed by a quick rebound back toward all-time highs. It's our position that most small cap stocks need a substantial re-pricing downward in order to trade at fair value. A key pillar of our investment philosophy is that we measure our results over a full cycle, which includes both a bull and bear market. We believe that's the fairest way to appraise any investment manager. Those analyzing current 3 and 5 year relative returns for fund managers should understand that they are only judging half of the cycle. It's like a Tour de France without the mountain stages. Those who follow cycling know *the race is won in the uphill climb.*

Thank you for your investment.

Sincerely,

Jayme Wiggins, CFA
Intrepid Small Cap Fund Portfolio Manager

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

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

The Russell 2000 Index consists of the smallest 2,000 companies in a group of 3,000 U.S. Companies in the Russell 3000 Index, as ranked by market capitalization. The S&P 500 Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. The London Stock Exchange is the main stock exchange of the United Kingdom where stocks, bonds, and other financial instruments are sold on a day-to-day basis. You cannot invest directly in an index.

GAAP (Generally Accepted Accounting Principles) refers to the common set of accounting principles, standards and procedures that companies use to compile their financial statements. M&A is the abbreviation for Mergers & Acquisitions. Cash Flow measures the cash generating capability of a company by adding non-cash charges and interest to pretax income. Free Cash Flow measures the cash generating capability of a company by subtracting capital expenditures from cash flow from operations. Free Cash Flow Yield equals normalized free cash flow divided by the company's market capitalization. It measures how well a company generates cash from its current operations. EBITDA is calculated as the company's Earnings Before Interest, Taxes, Depreciation and Amortization. Price-to-Earnings Ratio (P/E Ratio) is an equity valuation multiple calculated as market price per share divided by annual earnings per share. Earnings Yield (E/P Ratio) is an equity valuation multiple calculated as earnings per share divided by market price per share. Basis Point is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. Beta measures the volatility or systemic risk compared to the market or the benchmark index. Earnings Per Share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock.

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

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