Intrepid Capital MANAGEMENT INC.

the constant pursuit of value

4Q'12 10/1/12–12/31/12

DOW JONES	-1.74%
S&P 500	-0.38%
NASDAQ	-2.47%
RUSSELL 2000	1.85%
E.A.F.E.	6.63%

QUARTERLY MARKET LETTER COMMENTARY | December 2012

SMALL CAP PORTFOLIO

The fourth quarter of 2012 unfolded like a Sylvester Stallone highlight reel. The first half of Q4 was *Rocky*, with the Russell 2000 Index down 8% through mid-November. Next, we were faced with an economic *Cliffhanger*, as citizens were bombarded with media coverage that we risked going *Over the Top*. The denouement of the ordeal was an advertised *Victory* engineered by our political leaders, who decided that our nation's balance sheet fell into the pile of *The Expendables*. The only way the fiscal cliff negotiations could have been more of a circus is if Howie Mandel himself was reporting the play-by-play on the steps of the Capitol. Deal or No Deal?

The result of the Great Compromise is a projected reduction in the deficit of 6%. Color us unimpressed. Speaking of coloring, politicians' understanding of the concept of a budget apparently never made it past a first grade level. Here's

our message to a childish Congress, in language they can comprehend: *Your failure to show proper discipline with Fiscal Clifford leaves us with a Big Red Deficit. Instead of the ear-to-ear grins you sported during New Year's press conferences, you should have been crying in a corner.*

In the fourth quarter of 2012, the Intrepid Small Cap Portfolio (the "Portfolio") gained 1.00%, net-of-fees, versus a 1.85% increase in the Russell 2000 benchmark. The Portfolio outperformed during the first half of the quarter, when stocks were declining, and underperformed over the second half, when stocks were rising. Cash was 50.6% of Portfolio assets at December 31st. For all of 2012, the Intrepid Small Cap Portfolio rose 8.01%, net-of-fees, compared to a 16.35% gain for the Russell Index. Our high cash levels accounted for the Portfolio's underperformance, since the Portfolio's equity holdings returned 17.8% for the year.

While the Russell 2000 has been the official benchmark for the Portfolio since inception, that index does not define our investment universe well. Over one quarter of companies in the Russell 2000 posted net losses during the past twelve months. More than one fifth reported negative operating income before restructuring charges, interest, and other expenses. We do not purchase companies that have a history of losing money. Between these stocks, microcaps that are too small for us to buy, and a handful of industries that we don't spend much time on, only around half of the Russell 2000 constituents are regularly evaluated for purchase. We have several holdings that can be found in the Russell 1000 index, where about half of the members have market capitalizations below $5 billion. Lastly, we have a few holdings that aren't in either index because they are headquartered outside of the United States (Canada, Sweden).

The median Enterprise Value to EBIT ratio for non-financial companies in the Russell 2000 was nearly 16x at the end of the quarter. The median free cash flow multiple was 29x. These ratios are lofty, especially when one considers that earnings growth in the coming years could be hampered by slower economic growth and a lack of margin expansion. As usual, the Russell 1000 Index is not priced as dearly and is trading at a median 13x EBIT and 20x free cash flow. However, these multiples are not cheap either. We typically pay 9-13x normalized free cash flow for new purchases in the Portfolio. Better valuations are the primary reason that several of our largest positions today have market capitalizations in the $2 to $3 billion range. The Intrepid

Small Cap Portfolio's median market capitalization is $1.5 billion. Our smallest company is WWE with an investable float of $235 million ($600 million market cap), and our largest is Amdocs which currently has a $5.5 billion capitalization.

The Portfolio's three top gainers during the fourth quarter were FTI Consulting (ticker: FCN), Securitas (ticker: SECUB SS), and Patterson-UTI Energy (ticker: PTEN). FTI Consulting was the Portfolio's largest position and had the highest percentage gain of all but one other holding. We like FTI's hedged business model and believe there is additional upside. We had not made money on Securitas, the security services provider, before this quarter, but we are fond of its predictable service business and current large dividend. Patterson-UTI was purchased earlier in 2012. It is a major operator of land-based drilling rigs, and our internal valuation was supported both by cash flows and asset values.

The three positions most negatively impacting the Portfolio in Q4 were Bill Barrett (ticker: BBG), Pan American Silver (ticker: PAAS), and CSG Systems International (ticker: CSGS). These were the top three gainers last quarter. Following CSG's strong gains in Q3, we meaningfully reduced our position, and the stock fell back in Q4. Bill Barrett and Pan American are two of the Portfolio's more volatile holdings, when judged by the standard deviation of daily stock returns over the past year. The average volatility of an individual holding in the Intrepid Small Cap Portfolio is 35% compared to 49% for the Russell 2000 Index. The Portfolio's overall monthly volatility was 6.38% in 2012 compared to 12.39% for the Russell 2000.

Bill Barrett was the worst performer in the portfolio for the quarter and year. The stock struggled from negative sentiment toward natural gas producers, in particular those with high or increasing leverage. Bill Barrett went from having a clean balance sheet two years ago to 2.7x Debt/EBITDAX today. The company increased leverage to fund a transition in its portfolio from dry gas to oil. Several other operators are taking the same path, but their balance sheets are more stretched. Over half of Bill Barrett's revenue now comes from liquids production, and the percentage will grow this year while debt should not increase further. The company cites IRRs of up to 50% on its oil projects, where drilling is focused. If they can achieve anywhere close to this level of return on capital spending, then the recent increase in borrowings will have been worthwhile. At the stock's current price, we think an acquirer could buy Bill Barrett and fully develop its remaining reserves for less than what an average firm would spend to find and develop reserves internally.

Once in a blue moon, we receive hate mail from clients. One recent letter offering some friendly advice caught our attention. Sent on December 17th, it pointed out the Portfolio's "paltry" year-to-date return and "really miserable" three year number (9.87% annualized through 12/31/12). It continued, "You are being overly cautious, which is not warranted…Sometimes in life you have to take risks. This past year was a decent year to take a risk with equities…. I hope you will do better in 2013. As long as the market stays up, equity funds, as well as bond funds, [should] do well."

We have to agree on his last point (the logic is unassailable), and no, Yogi Berra did not pen the letter. We'll use this as another opportunity to clarify our investment philosophy to our shareholders. Unlike some other investment managers we don't view risk as trailing our benchmark in an up market—risk to us is losing money. In rising markets, it's understandable to lament about money left on the table, especially regarding a Portfolio that is almost half in cash. Our significant cash directly reflects the challenges we are experiencing in identifying undervalued small capitalization securities. Other investment managers may not be having this issue because most of them use a different investment process. We expect to utilize our cash to purchase attractively priced equities when they materialize. Patience is of paramount importance in this business and is fundamental to our approach to investing. Thank you for your investment.

ALL CAP EQUITY PORTFOLIO

As we write this letter, there is word that an agreement will be struck in Congress to avoid the so-called "Fiscal Cliff." This gave equity markets a bounce on the final day of the year. For the quarter ended December 31, 2012, the S&P 500 was down -0.38%, while the Russell 3000 Index was up 0.25%.

But for all the ink spilled over the fiscal cliff, the solution is actually quite small and does not go very far in addressing the federal deficit, which is in the vicinity of $1 trillion per year, and the National Debt, which is over $16 trillion. The agreed upon bill will raise revenues by $620 billion *over the next ten years*, which is but a drop in the bucket compared to the level of overspending. Currently, deficit spending accounts for about 7% of GDP (Gross Domestic Product). Imagine if the government eliminated the deficit immediately. That 7% chunk of GDP would be gone, which would lead to a painful economic contraction. We believe that there is no easy way out of the current deficit and debt problem, but we as a nation must take the medicine of fiscal responsibility. From our point of view, the bottom line is this: whether more revenues are raised or spending cuts are enacted, we will be in for some economic pain, and in our view, this is not being properly factored into the market's analysis. Both the S&P 500 and the Russell 3000 are within 8% and 5%, respectively, of their all-time highs back in the fourth quarter of 2007. To us, that does not look like a market that is at all concerned about a potential contraction.

Although it appears less in the news, we also have the backdrop of the Federal Reserve's continuing quantitative easing program, which has been providing a continual flow of dollars into the market. Indeed, for the year, the S&P 500 Index was up 16.00%, while the Russell 3000 Index gained 16.42%. In comparison, the Intrepid All Cap Equity Portfolio (the "Portfolio") gained 10.69%, net-of-fees. A primary cause for this disparity between the Portfolio and market indices is our cash level, which ended the year at 33.5% and remained elevated through most of the year. Our cash level is high due to our concern for the dearth of cheaply priced, quality investment opportunities.

We believe that our firm is unique because our value investment process does not change. Allow us to digress momentarily to discuss the core of our valuation approach, in which we view a business as a perpetual free cash flow generator. The basic formula to discount such a free cash flow stream is as follows:

$$\text{Firm Value} = \frac{FCF\,(N)}{(k - g)}$$

In this formula, the value of the firm is simply the discounted stream of future free cash flow, which we attempt to normalize to adjust for the business cycle. Think of it this way: a firm in a recession may be producing free cash flow which is below its normalized level, just as a firm at the end of an economic expansion may be producing free cash flow much higher than its normalized level. We attempt to remove that cyclicality from our estimate. We divide this normalized free cash flow [FCF(N)] by the difference between the required rate of return, denoted as "*k*," and the growth rate of free cash flows, "*g*." In our valuations, we use required rates of return (also called discount rates) typically between 10% and 15%. Keep in mind that we are dealing with businesses, not Treasury Bills. Since there is risk inherent in any business, we believe that a relatively high discount rate is necessary. We use conservative growth rates- usually no more than 5% growth of free cash flows. The final result of this equation gives us what we believe is the intrinsic value of a firm.

If our intrinsic estimate is higher than the market's value of the firm, then that would be something of interest to us. Today, however, most of the ideas that we see are priced higher than our intrinsic value estimates, which leads us to avoid purchasing them. We attempt to use this process consistently, whether in periods of economic decline or boom, and it explains why we currently cannot find many investments that we consider attractive. In markets such as the one we have been experiencing for the past three years, we think one of two things could be occurring. The first possibility is that we have indeed reached a new paradigm in which risk premiums are permanently lower, which would mean discounting cash flows by a smaller *k*, which would in turn increase valuations of *all* firms. We reject this line of thinking. We do not believe that it is any less risky to operate a business today than it was five, ten, or thirty years ago. As a matter of fact, it might be *riskier* due to increased regulation. What we do have, however, is a Federal Reserve that is artificially attempting to lower risk premiums by forcing short-term rates to near-zero levels. This maneuver, however, is not permanent, and when it unwinds, we think it may cause many investors to sell their investments as their perceived required rates of return increase. Rising rates may make it seem to market investors that many ideas which at one time appeared to be cheaply priced are, as a matter of fact, expensive. A second possibility is that the market is using higher normalized free cash flows than we use. We think this is indeed happening. If cash flows are at a cyclical peak, we do not believe it makes sense to project growth from those lofty levels. If the market is doing this, it could explain why it sees so many stocks as values when we do not.

While most holdings in the Portfolio contributed positively to the total return for the year, there were a couple that hampered Portfolio performance. Bill Barrett (ticker: BBG), a natural gas and oil company, has seen its share price decline as free cash flows were further impacted due to higher capital expenditures. We think this capex may produce fruit in the future. In addition, we think the market unduly ties Bill Barrett solely to natural gas and overlooks the company's increasing amount of oil production. Please refer to the Intrepid Small Cap Portfolio section for further analysis.

In the case of Dell (ticker: DELL), the market appears to have abandoned the company. The PC cycle, in which corporations "refresh" their machines, has been extended due to continued economic uncertainty. This has caused weakness in desktop and laptop sales. Combine this with the growing voices of those who think that the marketplace will abandon PCs for tablets, and you get the extreme selloff that we have seen in shares of DELL. The latter claim is, we believe, one of the most overplayed stories of 2012. Yes, tablets are a technological innovation, but no, we do not believe that they will supplant laptops/desktops (as we write this from our trusty desktop). While tablets have great portability, they are, in our opinion, far less useful for productive purposes than for entertainment. Furthermore, consider that Dell is focused on corporate customers over retail consumers. As a matter of fact, less than 5% of Dell's operating income comes from consumers. The rest comes from businesses and the public sector. The business cycle for IT companies is at a trough, and PC sales have been impacted by it. We think that the market is incorrectly projecting that trough well into the future. Conversely, we believe that a likely catalyst for Dell in the coming quarters will be the release of Microsoft's new operating software, Windows 8. Dell is expected to generate more than $3.5 billion in operating income in fiscal 2013 on a market capitalization of $18.5 billion. We consider that a very attractive pre-tax yield.

The top two contributors to Portfolio performance for the year were financial firms: Bank of New York Mellon (ticker: BK) and Federated Investors (ticker: FII). For BK, a few things happened during 2012 that were viewed as positives. First, it settled legal action related to how it handles foreign currency trading. Second, the company has done a good job controlling expenses, which has led to an increase in operating margins. Finally, we have yet to see an increase in net interest margin, which is the spread the company earns between what it earns on its assets less what it pays for its deposits. That spread is at an all-time low due to the Fed's action to set rates near zero. We believe rates will eventually move up, leading to an increase in the company's net interest margin. Our second contributor, Federated Investors, has seen its share price increase as the SEC became deadlocked over further money market fund regulation. In addition, the company paid a special dividend of $1.51 per share in November, which is a significant yield for a stock that traded in a range between $18.28 and $21.86 in the final three months of 2012.

At the end of the quarter, the average discount in the Portfolio was 12%. Every security held in the Portfolio can be compared against our corresponding calculated intrinsic value estimate. We mention this every quarter because it gives us some idea about the availability of discounts in the equity market. In long bull market periods, the number and scope of discounts becomes smaller. Conversely, in bear market periods, discounts may increase. This average discount is not of course a comprehensive gauge of the market, since it only shows what we think our investments are worth compared to their market prices. But we do like to compare our average discount today to where it has been historically to get a sense of how close to 'fair value' the Portfolio may be. Today, the average discount is closer to fair value than it has been in several years, which explains, in part, why our cash levels have remained elevated. We thank you for your confidence in our process, and we wish you a prosperous 2013.

BALANCED PORTFOLIO

The Intrepid Balanced Portfolio (the "Portfolio") completed the quarter and calendar year ended December 31, 2012 with a gain of 0.07% and 9.85%, net-of-fees, respectively. The Portfolio performed favorably relative to the large-cap S&P 500 index, which fell 0.38% in the quarter, but was bested by the Russell 2000's gain of 1.85%. The Portfolio exhibited significantly less volatility than these equity indices due to our relatively high cash position (averaged about 21% in the quarter) and allocation to high-yield bonds, which performed well in the quarter.

For the year ending December 31, 2012, the Portfolio trailed the Morningstar Moderate Allocation category by 1.87%. We attribute the underperformance to our conservative nature and strong desire to preserve that which has been entrusted to us. Common stock and high-yield bond indices have produced double digit annualized returns over the past three years, which has resulted in considerably less attractive opportunities for us to deploy capital to. In these generally rising markets, we have been net sellers as many of our holdings have reached our estimates of intrinsic value. In such an environment, the portfolio naturally becomes more defensively positioned through the increase in our cash position, which is a direct result of the lack of opportunities. Additionally, while many of our peers in the Moderate Allocation category may be taking greater interest rate risk by extending the maturity profile of their funds' fixed income allocation, we do not view the incremental yield as adequate compensation for the increase in risk. With 10-year U.S. Treasury bonds offering a measly 1.7% yield until maturity, bounded by zero, we don't believe now is the time to reach for yield by extending maturities for a few basis points. Investment writer Raymond DeVoe, Jr. said it best; "More money has been lost reaching for yield than at the point of a gun." At Intrepid Capital, given the choices of interest, credit, or liquidity risk in our fixed income selection, we prefer credit and liquidity.

The top three contributors to the Portfolio's return for the fourth quarter were: FTI Consulting (ticker: FCN), Bank of New York Mellon (ticker: BNY) and Securitas AB (ticker: SECUB SS). FTI Consulting (ticker: FCN) is discussed in further detail in the Small Cap Portfolio commentary.

Bill Barrett (ticker: BBG), Newmont Mining (ticker: NEM), and CSG Systems (ticker: CSGS) were the top detractors from the Portfolio's quarterly performance. The Small Cap Portfolio commentary discusses Bill Barrett, and the holding has been mentioned in prior letters. Newmont's share price has been pressured by the recent decline in gold prices and slower than expected growth in production. Management has stated it will focus on reducing all-in costs in lieu of financing faster growth. While this may have disappointed the market, we believe shares of Newmont are trading at less than a conservative valuation of its reserves. In this case we believe we may be paid to be patient: Newmont is currently paying a decent dividend of over 3%.

Despite persistently high equity prices and low yields on fixed income securities, we had some success sourcing new ideas in the quarter. We initiated an equity position in Big Lots (ticker: BIG) common stock. In addition, several new high-yields bonds entered the portfolio, which can be reviewed in further detail in the Intrepid High Yield Portfolio commentary. The fixed income allocation of the Portfolio will closely mimic that of the Intrepid High Yield Portfolio. Accordingly, the bonds redeemed by their issuers from the High Yield Portfolio were also called away from the Balanced Portfolio.

Big Lots is the nation's largest broadline closeout retailer. 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 were able to purchase BIG for a single-digit multiple of operating income.

While bargains do not abound, we can assure you that we will continue to diligently search for undervalued securities on your behalf, while maintaining tight controls on risk. Thank you for trusting us with your hard-earned capital; it is not a position we take lightly.

HIGH YIELD PORTFOLIO

The high-yield market concluded 2012 with a bang. The Bank of America/Merrill Lynch High Yield Master II Index, which is comprised of more than 2,100 individual issues, tacked on an additional 3.18% in the quarter ending December 31, 2012. The asset class outperformed most equity indexes in the quarter and nearly matched equity performances in the full year. High-yield bonds have been one of the best performing asset classes of the last decade as the Federal Reserve's mission to bludgeon savers has forced investors to reach for yield in securities with higher credit and interest rate risk. However, the strong performance is an acclaim which we believe will not be repeated. Average prices recently topped $105 on $100 in par value, and yields on high-yield bonds are near all-time lows at around 6%. In general, we believe investors are not being compensated for the risks inherent in the asset class. As such, the Intrepid High Yield Portfolio (the "Portfolio") is more defensively positioned than at any other time in its history. We have been increasing the credit quality of the portfolio through security selection and higher cash balances. Additionally, we have elected to keep the Portfolio's duration short to help protect against adverse changes in interest rates. We simply do not believe the small incremental return offered by extending further out the yield curve is worth the increased interest rate risk. While this short-duration posturing may seem like we are making a macro call, the result is actually more a function of our process. It has been difficult to find high-yield securities that we believe are offering attractive absolute returns. As a result, the Portfolio's cash position has increased, which contributes significantly to the shorter maturity profile. As a reminder, we do not take a top-down approach when managing our cash position. The Portfolio's cash balance will always be a reflection of the opportunities we see available in the marketplace.

The top three bond contributors were Spartan Stores 3.375% convertible notes due 5/15/2027, EPL Oil and Gas 8.250% due 2/15/2018 (formerly known as Energy Partners Ltd.), and PetroQuest Energy 10.000% due 9/01/2017. Spartan surprised investors by announcing it would redeem the notes in early 2013 at a premium to par, rather than waiting for holders to utilize the put option that would require the company to repurchase the notes at par on 5/15/2014. The EPL and PetroQuest bonds performed similarly to the high-yield market as a whole, and constitute two of our larger positions, hence the positive contribution to the overall performance. There were no material detractors in the quarter.

Those that have read our past letters are acutely aware of the ongoing redemption of our portfolio's bonds. The flood of funds into the asset class has resulted in an extremely favorable environment from the corporate treasurer's point of view. In the quarter ending December 31, 2012, four of our credits were called in their entirety, and one was partially called. These credits include several long-term holdings which we had large positions in, including Pep Boys 7.500%, Collective Brands 8.250%, and FTI Consulting 7.750%. We expect redemptions to continue absent a negative shift in the credit markets. We sold our Oshkosh 8.250% bonds due 3/01/2017 after activist investor Carl Icahn announced a tender offer for the common stock. In our view, the range of potential outcomes included situations that could have materially impaired the credit quality. The notes did not immediately sell off and we were able to exit the position. While Icahn did not win over Oshkosh stockholders, we believe the sale of the bonds is consistent with our goal, to limit the possibility of permanent capital impairment.

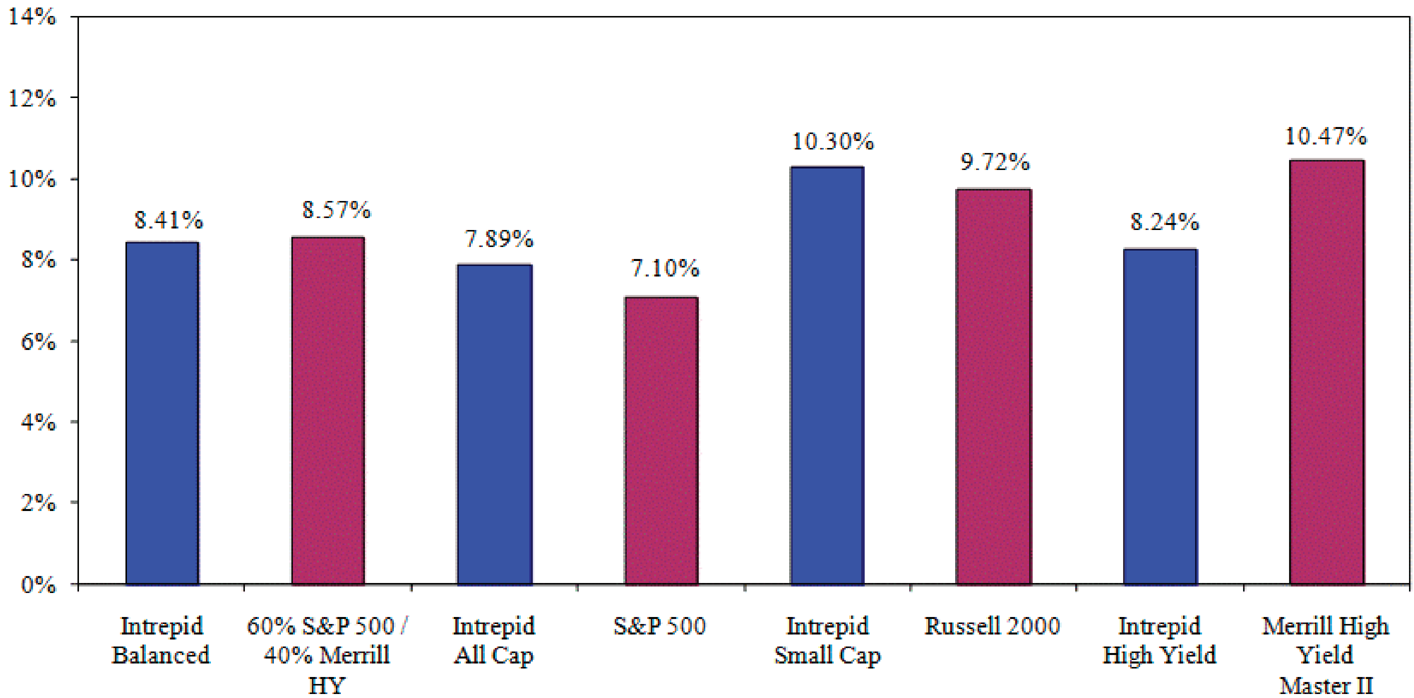
The Intrepid High Yield Portfolio's flexible investment mandate allows us to selectively reinvest the cash from these bond redemptions. We are not forced to put capital to work in overvalued securities. We will only commit capital when we believe the returns are compensating us well for the risks being borne. We had some success in finding such securities even among the current unfavorable environment, although our cash balance grew and now accounts for 24% of the Portfolio's assets, up from 19% at the end of September. We added four new credits to the Portfolio in the quarter, including Cott Beverages 8.125% due 9/01/2018 and Scotts Miracle-Gro 7.250% due 1/15/2018.

Cott Beverages is the world's largest producer of private label beverages. The company has a 60% market share in U.S. store-brand carbonated soft drinks and shelf-stable juices. Cott's operating history has been volatile in the face of rising raw material costs, since it takes considerable time to pass through input costs. However, we believe the company will continue to generate significant free cash flow and will manage the capital structure in a conservative manner. Cott's debt service ratios will likely improve when it retires the higher-cost 9.375% notes later this year. We expect our 8.125% notes due 9/01/2018 to be called in September of 2014, which should result in an attractive return for short-dated paper. The potential return increases with each longer call date.

Our purchase of Scotts Miracle-Gro bonds follows a similar thesis to the Cott purchase, where we put capital to work in a higher-quality business and expect the notes to be called within the next couple years. Scotts is a leading manufacturer of garden products including fertilizers, grass seed, potting soils and plant foods, and chemicals. The company controls a significant portion of most of the markets it participates in, up to 75% of total retail dollars in some product lines. Poor weather conditions and weak consumer spending have pressured the company's financials recently, but Scotts's credit quality is still very solid with leverage around 3.0x. Additionally, management has committed to reducing debt in the near term. We expect our 7.25% notes due 1/15/2018 to be retired in early 2014.

We conclude this letter with a new year's quote attributed to Michael Josephson, speaker and author on the topic of ethics. The author urges readers to *"Approach the New Year with resolve to find the opportunities hidden in each day."* While uncovering hidden investment opportunities was probably not the author's intent when he penned the quote, we believe it is synonymous with what we do here every day at Intrepid. We are working as diligently as ever to find undervalued securities on your behalf.

Intrepid Capital Management
Trailing 10-Year Annualized Performance
December 31, 2002 to December 31, 2012



*Past performance is no guarantee of future results. Intrepid composite returns are presented net of investment advisory fees for the 10-year period ending December 31, 2012. Returns reflect the reinvestment of dividends and other earnings. The volatility of the listed benchmarks may be materially different from the volatility of 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.