Intrepid Capital Funds
*the constant pursuit of value*

# INTREPID CAPITAL FUND

## 4Q 2016

4TH QUARTER 2016 COMMENTARY

DECEMBER 31, 2016

## PERFORMANCE

| | Inception Date | Total Return Qtr. | YTD | 1 Year | Average Annualized Total Returns as of December 31, 2016 3 Year | 5 Year | 10 Year | Since Inception |
|---|---|---|---|---|---|---|---|---|
| Intrepid Capital Fund - Inv. | 1/03/05 | 2.34% | 14.88% | 14.88% | 4.14% | 7.51% | 6.91% | 6.84% |
| Intrepid Capital Fund - Inst. | 4/30/10 | 2.49% | 15.27% | 15.27% | 4.44% | 7.78% | - | 7.09% |
| S&P 500 Index | | 3.82% | 11.96% | 11.96% | 8.87% | 14.66% | 6.95% | 7.56%^ |
| BofA Merrill Lynch US High Yield Index | | 1.88% | 17.49% | 17.49% | 4.72% | 7.35% | 7.34% | 7.30%^ |
| Russell 2000 Index | | 8.83% | 21.31% | 21.31% | 6.74% | 14.46% | 7.07% | 7.91%^ |

^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 S&P 500 Index is 12.35%, BofA Merrill Lynch US High Yield Index is 7.30% and Russell 2000 Index is 11.57%.

**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 1/31/17, respectively. Otherwise, performance shown would have been lower.

January 6, 2017

*"In America, you can go on the air and kid the politicians and the politicians can go on the air and kid the people."*

— Groucho Marx

Dear Friends and Clients,

About this time 20 years ago (December 1996), Alan Greenspan, then chairman of the Federal Reserve, uttered the words "irrational exuberance" in reference to what he saw as expensive market conditions. In hindsight, the market was still in the early stages of the tech bubble, and took a little over three more years (March of 2000 to be more exact) before correcting - a grinding affair that took equity indices down more than 50% over another three-year period (calendar years 2000-2002). I begin this letter with the Greenspan phrase and history because I think the increase of over 14% in the Russell 2000 Index since the surprise election of Donald Trump on November 8, 2016 may just be "irrational exuberance."

I could rationalize a higher price for a business **if** corporate tax rates were to drop from 35% to 15% **and** much of the recent regulatory burden were to be rolled back. But then again, if I were 6'3" and 220 pounds, I would have played in the NFL! All kidding aside, as most of you know by now, I am a libertarian free market capitalist and would love to see government represent a smaller percentage of the economy, but I believe prices were already high prior to the November election and they have continued to increase into 2017.

In order to justify a world of low market volatility (as evidenced by the CBOE Volatility Index (VIX) near historic lows), high equity prices (based on the S&P 500's P/E ratio greater than 22 on a trailing basis), rising U.S. interest rates (the 10-Year Treasury now yields around 2.4%, up from a low of 1.4% six months ago), and low high-yield bond spreads (425 basis points vs. 600 basis points historically), everything on Donald Trump's Christmas list to Santa needs to be delivered on time. I believe the road will get steeper for him after he is inaugurated on January 20th.

**Top Ten Holdings** (% OF NET ASSETS)

| Holding | % of Net Assets |
|---|---|
| Berkshire Hathaway, Inc. - Class B | 3.7% |
| Royal Mail PLC | 3.3% |
| Leucadia National Corp. | 3.1% |
| Corus Entertainment, Inc. - Class B | 3.0% |
| Patterson-UTI Energy, Inc. | 3.0% |
| Teradata Corp. | 2.8% |
| Western Digital Corp. | 2.7% |
| Nathan's Famous, 03/15/2020, 10.000% | 2.2% |
| Tech Data, 09/21/2017, 3.750% | 2.2% |
| Fenner PLC | 2.1% |

Top ten holdings are as of December 31, 2016. Fund holdings are subject to change and are not recommendations to buy or sell any security.

## Department of Labor (DOL) Ruling and the Effect on Active vs. Passive Management

A recent decision that has roiled the asset management industry is the DOL's new fiduciary rule, which legally requires brokers and advisors to act in their clients' best interest when giving advice related to retirement plans governed by the Employee Retirement Income Security Act of 1974, known as ERISA (think IRA, profit sharing plan, 401(k), etc.). While its intention is good, like many government edicts, I believe this ruling will have unintended consequences as it takes effect. The fiduciary rule was published last April and doesn't take effect until this April, but because brokers and advisors will have a harder time justifying recommending products with high fees, the ongoing flight from actively managed to passively managed investment vehicles has only accelerated, which has benefited lower-cost index funds and Exchange-Traded Funds (ETFs). In its latest fund flows report for the month of November, Morningstar reported that $359 billion of assets have left actively managed funds over the last year, and most of those dollars have contributed to the $480 billion in net inflows to passive strategies over the same time period.[1]

**Passive-Fund Flows Continue to Dominate**

| Estimated Net Flows* $Mil | Active Nov 2016 | Active 1 Year | Active Assets $Bil | Passive Nov 2016 | Passive 1 Year | Passive Assets $Bil |
|---|---|---|---|---|---|---|
| U.S. Equity | (21,177) | (257,486) | 3,569 | 41,911 | 217,157 | 2,883 |
| Sector Equity | (5,461) | (31,187) | 374 | 18,999 | 29,934 | 395 |
| International Equity | (8,377) | (63,630) | 1,436 | 7,845 | 64,889 | 887 |
| Allocation | (6,595) | (60,167) | 1,149 | 206 | 4,217 | 63 |
| Taxable Bond | (11,569) | 9,089 | 2,286 | 8,693 | 140,967 | 898 |
| Municipal Bond | (10,223) | 47,918 | 622 | (239) | 5,704 | 26 |
| Alternative | (2,143) | (6,028) | 166 | (2,835) | 3,289 | 46 |
| Commodities | 38 | 2,733 | 25 | (3,977) | 13,610 | 66 |
| **All Long Term** | **(65,506)** | **(358,804)** | **9,627** | **70,603** | **479,768** | **5,264** |
| Money Market | 66,026 | (6,565) | 2,688 | | | |

*Includes liquidated and merged funds.

Source: Morningstar Direct Asset Flows.

On the surface, all else being equal, cheaper is better. But from my perspective, few investors actually pay just the reported fee of a passive fund, because few no-load funds are bought directly from the manager. Most are likely purchased through an intermediary (a broker or advisor) who charges their own fees. This immediately reduces the savings from using low-fee funds; once advisory fees are included, an index fund charging 10-20 basis points may cost the holder as much as 100 to 150 basis points per year. In addition, poor timing can ding the returns of passive portfolios even more than fees and taxes if the investor and/or advisor don't have the emotional discipline to sit still during volatile markets. As you've heard me say before, when the market is exhibiting low volatility and moving up, it appears almost free and easy to implement an index strategy. It is neither.

1 http://corporate.morningstar.com/US/documents/AssetFlows/AssetFlowsDec2016.pdf (Numbers in parenthesis and red red font represent negative numbers.)

My fear for the public is two-fold. First, out of concern to be compliant with the new DOL ruling, many financial intermediaries feel compelled to sell "mom and pop" an index or ETF in their IRA accounts, which could be terrible timing since we are at all time highs in the market. Keep in mind that equity indexes fell about 50% peak-to-trough in 2000-2002 (tech bubble) and in 2007-2009 (housing crash). Second, the number of fund share classes available to smaller investors, which tend to have higher expense ratios and are thus subject to greater scrutiny under the new rule, is likely to contract, potentially cutting off those with $250,000 or less of investable retirement assets from access to entire swaths of the investment industry.

I truly wish there was a "free lunch," as I would certainly partake of it and deliver it to you; our clients and shareholders. Thankfully, due to your unwavering support, the industrywide exodus from active managers was not a detriment to our business this year, as we had net inflows for 2016!

Most of this industry shift, in my opinion, is from what I consider "high-cost passive" to "low-cost passive." What I mean is that unfortunately, many in our industry are content to paraphrase John Meynard Keynes: *"Worldly wisdom teaches that it is better to fail conventionally than to succeed unconventionally."* They do this by marketing themselves as active managers, while very closely aligning their portfolio with the index they are benchmarked against.

At Intrepid Capital, we could not be more different. Most of our holdings are not in an index we happen to be benchmarked against. This suits us just fine! In fact, we have been cited in prominent financial publications for having high "active share," which measures the amount of overlap between a fund's holdings and those of its benchmark.[2] This is an academic response to the question, "Am I getting what I am paying for?" The "active share" calculations below, show how very dissimilar we are to an index (hint, very!).

| INTREPID CAPITAL FUNDS – ACTIVE SHARES AS OF 12/31/16 | | | | |
|---|---|---|---|---|
| **ICMAX** | **ICMBX** | **ICMCX** | **ICMIX** | **ICMTX** |
| 99.72% | 97.85% | 97.50% | 99.98% | 99.88% |

*Note: Active shares relative to Russell 2000, S&P 500, S&P 500, MSCI EAFE Net, and Russell 2000 holdings, respectively. Active share is calculated on equity holdings only.*

In the heady equity environment that we have been in for at least the last five years (I hate to keep bringing this up), you might want to consider how much risk you are taking as we start 2017. Unfortunately, I have found that investors only consider risk when they are doing a post-mortem on an investment that falls into the category I politely call "seemed like a good idea at the time!"

For me, as one of your portfolio managers at Intrepid Capital, I am on the constant lookout for what we consider good businesses at good prices, and bonds with relatively short maturity, generally less than 5 years, that offer a compelling yield over and above the comparable maturity Treasury note. These companies should also have the free cash flow, or assets, to help repay the bonds at maturity. The cash levels in the Intrepid Capital portfolios are indicative of how many qualifying equity or debt securities we can find. In other words: cash high, prices high; cash low, prices low.

We also attempt to mitigate risk for the overall portfolio in several ways. First, position sizes are carefully managed. Second, the financial leverage and the potential volatility of the respective companies' cash flows are taken into consideration. Third, we try to obtain the best interest rate spread possible with the fixed income portion. Simply, can we earn better than "risk-free" interest rates, such as Treasury bills, by lending to a creditworthy business over a short period of time?

2 Light, Joe. "And the Next Star Fund Manager Is..." Wall Street Journal. January 17, 2014.

**Sharpe Ratio**

One of the industry standard financial risk management tools is called the "Sharpe Ratio". Dr. William Sharpe was granted a Nobel prize for his work in this area. The Sharpe Ratio is a measure for calculating risk-adjusted return. More technically defined, it is the average return earned in excess of the risk-free rate, per unit of volatility or total risk. This is all very logical to me, particularly when I meet someone in public crowing about their 25% returns on ______ (fill in the blank - stocks, ETFs, land speculation, private equity). Often, due to the tremendous leverage, lack of liquidity and other inherent risks, my retort is often, "25% should be the minimum return you expect given the risks you just incurred!"

| | Sharpe Ratio |
|---|---|
| Intrepid Capital Fund - ICMBX | 0.64 |
| S&P 500 Index | 0.49 |

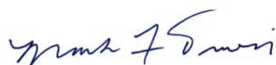
As shown in the table to the left, the Sharpe Ratio for the Intrepid Capital Fund (ICMBX, the "Fund") is 0.64 compared to the S&P 500 Index of 0.49 for the period of January 3, 2005 (inception of the Fund) to December 31, 2016. Using this risk-adjusted return measure, I am pleased to say the Intrepid Capital (balanced) portfolios have a more attractive risk/return profile than the most commonly followed equity index, the S&P 500 Index. For the period ending December 31, 2016, the Fund increased 2.34% for the quarter and 14.88% for the year, compared with the S&P 500 Index, which returned 3.82% and 11.96%, respectively.

The Fund ended the quarter with 18.4% in cash. The Fund's five largest contributors during the quarter were Tetra Tech (ticker: TTEK), Leucadia National (ticker: LUK), Patterson-UTI Energy (ticker: PTEN), Berkshire Hathaway CL B (ticker: BRK.B), and Western Digital (ticker: WDC). The Fund's five largest detractors for the quarter were Teradata (ticker: TDC), Royal Mail PLC (ticker: RMG), Oaktree Capital (ticker: OAK), Dundee Corp. (ticker: DC/A CN), and METKA Industrial (ticker: METTK GA).

The Intrepid Capital Fund (ICMBX) achieved an overall 4-star Morningstar Rating out of 710 Moderate Allocation 50%-70% Equity funds for the period ending December 31, 2016 (derived from a weighted average of the fund's three-, five-, and ten-year risk-adjusted return measures). Included in this weighted average rating is a 5-Star Morningstar Rating out of 419 Moderate Allocation 50%-70% Equity funds, based on risk-adjusted returns for the 10-year period ending December 31, 2016.

We are pleased to report that over the same 10-year period, the Intrepid Capital Fund (ICMBX) has outperformed 95% of the 419 funds in the Morningstar Moderate Allocation 50%-70% Equity peer group, based on total returns. Morningstar ranked the Fund in the 5th, 45th, 66th, and 5th percentile out of 810, 710, 606, and 419 Moderate Allocation 50%-70% Equity funds for one-, three-, five-, and ten-year periods ending December 31, 2016, respectively. 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
Intrepid Capital 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. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments by the Fund in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. The Fund may invest in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods.**

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 BofA Merrill Lynch US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million. The CBOE Volatility Index (VIX) reflects a market estimate of future volatility, based on the weighted average of the implied volatilities for a wide range of strikes. It is used to gauge the market's anxiety level. The MSCI EAFE Net Index is recognized as the pre-eminent benchmark in the United States to measure international equity performance. You cannot invest directly in an index.

Basis Point is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. Price-to-Earnings (P/E) Ratio is calculated by dividing the current price of the stock by the company's trailing 12 months' earnings per share. Standard Deviation is a statistical measure of portfolio risk used to measure variability of total return around an average, over a specified time. The greater the standard deviation over the period, the wider the variability or range of returns and hence, the greater the fund's volatility. Sharpe Ratio is a measure that indicates the average return minus the risk-free return divided by the standard deviation of return on an investment. 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.

The Morningstar RatingTM for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, excluding the effects of sales charges and loads, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar RatingTM for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar RatingTM metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods. The Intrepid Capital Fund-Investor received 3-Stars among 710 for the three-year, 3-Stars among 606 for the five-year, and 5-Stars among 419 Moderate Allocation – 50% to 70% Equity Funds for the ten-year period ending 12/31/16. The rating is specific to the Investor Share Class and does not apply to other share classes, which have different ratings.

Morningstar Rankings represent a fund's total-return percentile rank relative to all funds that have the same Morningstar Category. The highest percentile rank is 1 and the lowest is 100. It is based on Morningstar total return, which includes both income and capital gains or losses and is not adjusted for sales charges or redemption fees. The ranking is specific to the Investor Share Class and does not apply to the other share class, which as different rankings.

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Active investing has higher management fees because of the manager's increased level of involvement while passive investing has lower management and operating fees. Investing in both actively and passively managed mutual funds involves risk and principal loss is possible. Both actively and passively managed mutual funds generally have daily liquidity. There are no guarantees regarding the performance of actively and passively managed mutual funds. Actively managed mutual funds may have higher portfolio turnover than passively managed funds. Excessive turnover can limit returns and can incur capital gains.

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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