

Index Returns	
10/1/2016 to 12/31/2016	
Dow Jones:	8.62%
S&P 500:	3.82%
NASDAQ:	1.66%
Russell 2000:	8.83%
MSCI EAFE:	-0.71%

PRESIDENT'S LETTER

January 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.

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

¹ <http://corporate.morningstar.com/US/documents/AssetFlows/AssetFlowsDec2016.pdf>

Passive-Fund Flows Continue to Dominate

Estimated Net Flows* \$Mil	Active			Passive		
	Nov 2016	1 Year	Assets \$Bil	Nov 2016	1 Year	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.

volatility and moving up, it appears almost free and easy to implement an index strategy. It is neither.

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 portfolio’s holdings and those of its benchmark. This is an academic response to the question, “Am I getting what I am paying for?” Our strategies have active share metrics between 97.5% and 99.9%.

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.

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

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?

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 Balanced	0.64
S&P 500 Index	0.49

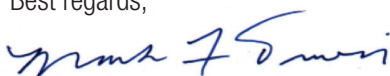
As shown in the table to the left, the Sharpe Ratio for the Intrepid Balanced (the "Portfolio") is 0.64 compared to the S&P 500 Index of 0.49 for the period of January 3, 2005 to December 31, 2016. Using this risk-adjusted return

measure, I am pleased to say the Portfolio has 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 Portfolio increased 2.51%, net-of-fees, for the quarter and 15.33%, net-of-fees, for the year, compared with the S&P 500 Index, which returned 3.82% and 11.96%, and the Blended benchmark, which returned 3.07% and 14.22% for the respective periods. The Portfolio ended the quarter with 19.1% in cash. The Portfolio'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 Portfolio'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).

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

Best regards,

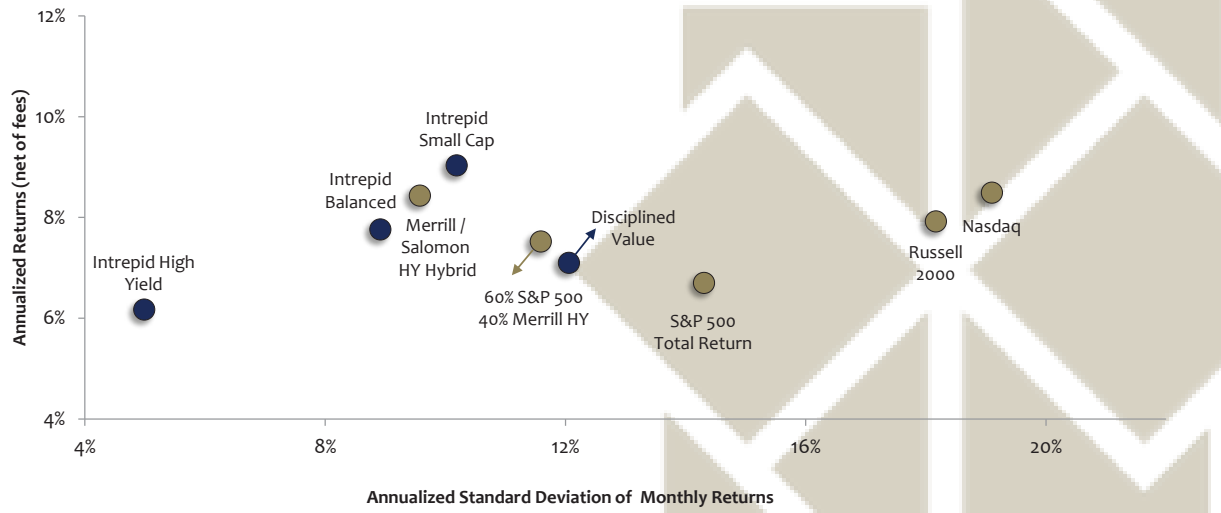


Mark F. Travis

President/CEO

Risk Adjusted Returns

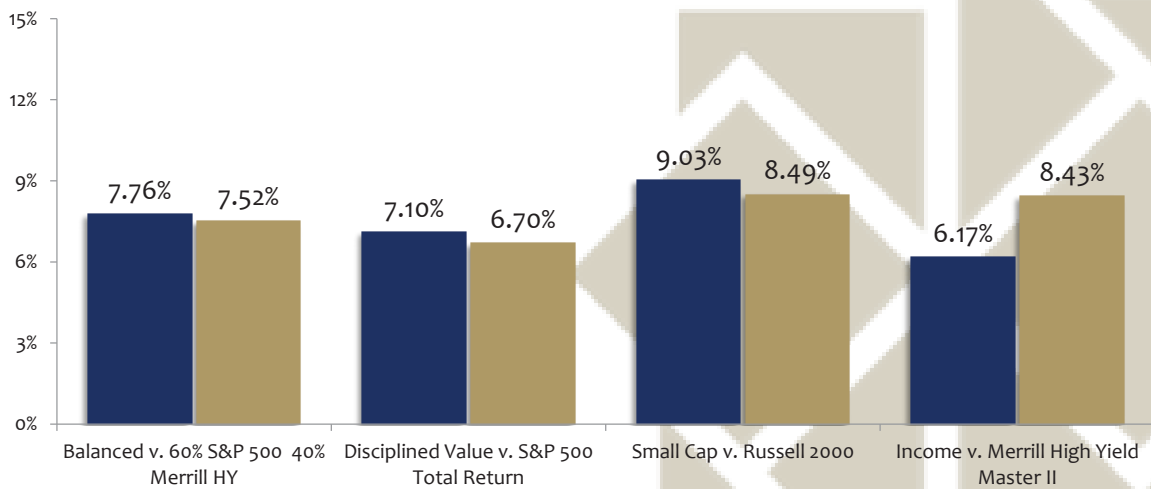
Trailing 15 Year risk/return
December 31, 2001 to December 31, 2016



- Past performance is no guarantee of future results. Intrepid composite returns are presented net of investment advisory fees and all returns are presented annualized for the 15-year period ending December 31, 2016. Returns reflect the reinvestment of dividends and other earnings. The volatility of the listed benchmarks may differ materially from the volatility of any Intrepid composite. As of December 31, 2004, the firm changed its fixed income benchmark from the Salomon High Yield Short-Term Index to the Merrill Lynch High Yield Master II Index.

Annualized Performance

Trailing 15 Year risk/return
December 31, 2001 to December 31, 2016



- Past performance is no guarantee of future results. Intrepid composite returns are presented net of investment advisory fees and all returns are presented annualized for the 15-year period ending December 31, 2016. Returns reflect the reinvestment of dividends and other earnings. The volatility of the listed benchmarks may differ materially from the volatility of any Intrepid composite. As of December 31, 2004, the firm changed its fixed income benchmark from the Salomon High Yield Short-Term Index to the Merrill Lynch High Yield Master II Index.