June 30, 2016

Value Investor INSIGHT

The Leading Authority on Value Investing

On The Defensive

Four highly successful investors explain why they're sitting on so much cash, where they expect to use it when the time comes, and where – even in what they consider a pricey market – they see bargains of particular note.

Opinions vary among value investors over the extent to which portfolio cash is a valuable risk mitigator, or even a strategic asset. The "fully-invested" camp likens letting cash build in the absence of table-pounding investment options as thinly veiled market timing. As Carlo Cannell of Cannell Capital puts it: "By having a high cash balance, one is suggesting that he has some wisdom or knowledge about timing the market for which he should be compensated. I have none of that."

Others say they can typically find stocks that offer at least adequate returns, especially compared to cash that earns next to nothing. Vulcan Value Partners' C.T. Fitzpatrick put it this way in an interview: "People we greatly respect think about this differently, but if even in 2007 we could buy a company like Wrigley at 80 cents on the dollar, we think that's a lot more attractive than holding cash. Even at 80 cents on the dollar, we'd expect a rate of return in the mid-teens annually. And that was available in, across the board, the priciest market I've ever seen."

On the other hand, many equally accomplished investors are willing to let cash grow as a residual effect of not finding enough to buy. A high-profile proponent of this approach, Baupost Group's Seth Klarman, considers it a valuable way to mitigate downside risk: "Our willingness to hold cash during fallow periods has enabled us to maintain a strict sell discipline [and] has also enabled us to avoid the gun-to-the head mentality that pressures many investors to own less-than-stellar investments. The world doesn't end when we pass on a borderline investment that later works out; the danger we seek to avoid is the temptation or pressure to make too many borderline investments that later turn out badly." Bruce Berkowitz of Fairholme Capital trumpets a further beneficial aspect of having cash on hand: "The older I get, the more I see cash as a strategic asset. It allows us to take advantage of those great opportunities that come up from time to time. We're just behaving like the companies we like to invest in."

Seeking guidance from four of the best "defense-is-the-best-offense" investors in the business, we recently spoke with Charles de Vaulx of International Value Advisers, Zeke Ashton of Centaur Capital, First Eagle Investment's Kimball Brooker and Intrepid Capital's Jayme Wiggins about how they're positioning their portfolios today and why.

INVESTOR INSIGHT

Jayme Wiggins
Intrepid Capital

"We think valuations among smaller-cap stocks today make those we saw in the housing bubble look tepid."

Describe your buy discipline, which largely has you on the sidelines these days.

Jayme Wiggins: We focus on smaller-cap stocks, with understandable businesses and predictable cash flows. Our process is absolute-return oriented and to buy something we require at least a 20% discount to the intrinsic values we calculate using discounted-cash-flow models that include higher-than-average discount rates of 10-15% and lower-than-average growth rates. The entire process focuses on risk avoidance and minimizing downside.

We have a simple mission: to buy cheap stocks. If they don't exist, we don't lower our discount rates or increase our assumed growth rates in order to make the math work. If we sell something that hits our estimate of fair value and don't have anything to buy, we'll hold cash, which is now more than 70% of the portfolio.

To convince our clients we're right to be so conservative, we show them two

charts. The first shows the Russell 2000 index over the past 20 years. There have been three bubble periods: the tech bubble of the late 1990s, the housing bubble in the mid-2000s, and now what we consider the quantitative-easing bubble of today.

Then we show them a second chart, of the earnings of the Russell 2000 constituents. Today if you add up the earnings of all Russell 2000 members, they sum to just about zero. Nearly one-third of the index companies don't make money. People seem oblivious to how high the GAAP P/E multiple is for the smaller-company index – we think valuations there today make those we saw in the housing bubble look tepid. It's extremely difficult to find cheap stocks. As a result, my highest conviction idea is a pile of cash with a 0% return.

Is your sell discipline as absolute as your buy discipline?

JW: For the most part, as a stock approaches our estimate of intrinsic value we will be reducing the position, and when it reaches intrinsic value we're out. In this overheated market where ideas are scarce, we will make an exception for higher-quality, more-reliable holdings. An example would be Amdocs [DOX], which provides software and services primarily to communications-industry service providers. We've owned the stock successfully for about four years and it's now pushing the upper end of our cap range. It's probably fully valued, but not overvalued, so as long as we think it can compound value at around 10% per year, it makes sense to hold it rather than sell.

Something we did sell fairly recently that illustrates our process would be Ingram Micro [IM], the wholesale technology distributor. We had bought the stock at a 20% discount to tangible book value during the market swoon in the summer of 2011. Paying that price for a business that generates 12-13% returns on equity seemed to us a good opportunity, and the stock rose beyond our intrinsic-value estimate earlier this year, prompting us to sell on February 17th. In the sake of full disclosure, this proved to be comically bad timing as the company agreed later that same day to be bought out by a Chinese company for about 20% more than our sale price. It happens.

You describe the securities you do own as having less correlation to the broader market. What's a good example of that?

JW: The general idea is that when things get really silly from a valuation perspective, we should be positioned very differently from the broader market.

ON BUYING CHEAP:

If we can't buy cheap, we don't lower our discount rates or increase growth rates to make the math work.

One of our largest positions is in the convertible bonds of pawn-shop operator EZCorp. We first looked at the stock a few years ago, but were turned off by its reliance on rising gold prices to fuel scrapping profits and because corporate governance was terrible. We kept watching, though, as the company's results were impacted negatively by gold prices coming down, challenges in an ancillary payday-loan business and accounting issues at a division in Mexico. We established our convertible-bond position 18 months ago and grew it over the past year as the yield on the debt peaked at 18%, which we thought was far too high given the credit quality.

While the GAAP financials make the company look like it's in turmoil, when we adjust for businesses that are being closed or sold and debt that is non-recourse to the parent, we're left primarily with core pawn-shop businesses in the U.S. and Mexico that are healthy and generate strong, reliable EBITDA. We think the convertible bonds, which still yield about 10%, are very well covered by cash flows and the takeout value of the stores, and should trade at no more than the average 5.5% yield on BB-rated high-yield debt today. If we're right about the business, our returns here should be relatively immune to what happens in the overall market.

Describe a favorite equity idea today, Canada's Corus Entertainment [CJR/B:CN].

JW: After its acquisition in January of Shaw Media, Corus is now tied with Bell Media as the largest owner of TV networks in Canada and is the undisputed leader in channels targeting women and children. It also owns a number of radio stations and a production studio focused on kids' programming called Nelvana.

The stock price has suffered for much of the past two years due to investor concern over changing TV regulation in Canada and relatively weak advertising revenue. On the first point, regulators last year announced a set of rules requiring Canadian TV broadcasters to offer channels on an a la carte basis to viewers beginning in 2016. The fear is that as cable- and satellite-TV network offerings are unbundled, individual networks face falling subscription and advertising revenue.

While the impacts aren't yet fully clear, we think investor fears will prove overblown. People say they don't like to pay for channels that they don't watch, but the truth is that somebody else is probably helping to subsidize the channels they do watch. That to us means that as a la carte prices come in high, consumers will mostly stick with fairly large bundles of popular channels. That's good for Corus, because its leading channels – which produce the vast majority of its profits – are among the most-viewed networks and should be part of most bundles. At the same time, those channels should also command strong pricing on an a la carte basis.

The other big issue is that the company's advertising revenues are down around 10% over the past year. One reason is that the depreciation of the Canadian dollar has led U.S. firms operating there to cut back on advertising as their revenues in U.S. dollars shrink. The Canadian economy has also been negatively impacted by sharp declines in commodity prices. But the main factor for Corus, we think, has

INVESTMENT SNAPSHOT

Corus Entertainment
(Toronto: CJR/B:CN)

Business: Owns and operates radio stations and specialty and broadcast television stations in Canada, as well as a global media production business focused on animated content.

Share Information
(@6/29/16, Exchange Rate: $1 = C$1.295):

Price	**C$12.92**
52-Week Range	C$8.74 – C$17.42
Dividend Yield	8.8%
Market Cap	C$2.49 billion

Financials (6 mo. FY2016, annualized):

Revenue	C$852.0 million
Pretax Profit Margin	43.5%
Net Profit Margin	34.3%

Valuation Metrics
(@6/29/16):

	CJR/B	S&P 500
P/E (TTM)	6.7	24.2
Forward P/E (Est.)	11.7	17.9

CJR/B:CN PRICE HISTORY

THE BOTTOM LINE

With its stock trading at only 8x his estimate of normalized free cash flow, Jayme Wiggins believes the two key issues facing the company – a la carte pricing for television programming in Canada and weakness in advertising revenues – have been overly discounted by the market. His discounted-free-cash-flow analysis values the stock at C$20.

Sources: Company reports, other publicly available information

been its inability to match the advertising packages larger competitors could offer across multiple broadcast and cable channels. With the acquisition of Shaw Media doubling the size of the company, it will now be impossible for advertisers targeting women and kids to ignore Corus. We expect advertising results to improve now that the merger integration is under way. This recovery is crucial for the investment case. By the way, the company's increased heft won't hurt in negotiating with distributors over carriage fees as well.

At just under C$13, how inexpensive do you consider the shares?

JW: The stock has recovered some this year, but still trades at only about 8x our roughly C$300 million estimate of normalized annual free cash flow. Many investors and sell-side analysts simply value Corus based on an EBITDA multiple that is slightly discounted to the average multiple of large Canadian cable companies. We don't consider that fair given that Corus converts over 60% of its EBITDA to free cash flow, while for capital-intensive cable firms that's closer to 25%.

Based on our discounted-cash-flow model, we value the stock at about C$20 per share. That's a bit under 13x normalized free cash flow.

Is the current 9% dividend yield a draw?

JW: We'd actually be happier if they cut the dividend and directed more cash flow to de-leveraging after the Shaw acquisition. The cash flow is ample enough to do both, but we'd just prefer a faster pay down in debt than is currently planned. We don't think they'll do that, though. They take the dividend very seriously.

Your investing conservatism led to a change in your fund's name. Explain that.

JW: The SEC requires that if you call your fund a small-cap fund, you have to be 80% invested in small caps. Given all our cash, that hasn't been the case for some time. We have some leeway to take what they call a temporary defensive position, but it became harder over multiple years to call our level of cash temporary. No one made us do it, but rather than risk a regulatory tussle, a year ago we changed the name from the Intrepid Small Cap Fund to the Intrepid Endurance Fund.

One of the pillars of your investment strategy is what you call emotional discipline. Is that getting harder to maintain?

JW: It's our primary edge. It would be nice to consistently outperform, but we recognize that's not going to happen when you implement a consistent investment process through varied market environments. For us, that discipline has led to good long-term outcomes over the entirety of the past 18 years – we're hopeful that will be the case going forward as well. VII

Disclaimer

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The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectuses contain this and other important information about the investment company, and it may be obtained by calling 866-996-FUND or visiting www.intrepidcapitalfunds.com. Read it carefully before investing.

Past performance does not guarantee future results.

Mutual fund investing involves risk. Principle 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 may involve greater volatility and political, economic and currency risks and differences in accounting methods.

Cash Flow measures the cash generating capability of a company by adding non-cash charges and interest to pretax income. GAAP (Generally Accepted Accounting Principles) is a framework of accounting standards, rules and procedures defined by the professional accounting industry. P/E (Price-to-Earnings) is the market price per share divided by earnings per share. Tangible Book Value is the total net asset value of a company minus intangible assets and goodwill. Yield is the income return on an investment. It refers to the interest or dividends received from a security and is usually expressed as a percentage based on the investment's cost, its current market value or its face value. EBITDA is calculated as the company's Earnings Before Interest, Taxes, Depreciation and Amortization. Free Cash Flow measures the cash generating capability of a company by subtracting capital expenditures from operating cash flow. Dividend Yield is a dividend expressed as a percentage of a current share price. Return on Equity (ROE) is a measure of profitability that calculates how many dollars of a profit a company generates with each dollar of shareholders' equity. ROE is net income divided by shareholders' equity. Correlation is a measure of how investments move in relation to one another and when.

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. You cannot invest directly in an index.

As of 6/30/16, C$ = $0.776197

Intrepid Capital Management, Inc. is the advisor to the Intrepid Capital Funds. The Intrepid Capital Funds are distributed by Quasar Distributors, LLC.

TOP TEN HOLDINGS as of 6/30/2016	**(% of NET ASSETS)**
Ezcorp, Inc., 06/15/2019, 2.125%	5.7%
Pitney Bowes International Holdings, Inc., 6.125%	3.7%
Corus Entertainment, Inc. – Class B	3.6%
Silver Wheaton Corp.	2.3%
Dundee Corp.	2.1%
Tetra Tech, Inc.	2.0%
Amdocs Ltd.	1.9%
American Science & Engineering, Inc.	1.6%
Baldwin & Lyons, Inc.	1.6%
Cubic Corp.	1.5%

Fund holdings and sector allocations are subject to change and should not be considered a recommendation to buy or sell any security.

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