Intrepid Capital MANAGEMENT INC.

2Q 2019

Index Returns	
4/1/2019 to 6/30/2019	
Dow Jones:	3.21%
S&P 500:	4.30%
NASDAQ:	3.87%
Russell 2000:	2.10%
MSCI EAFE:	3.68%

QUARTERLY COMMENTARY

July 2019

"Mistakes are part of the dues one pays for a full life."

— Sophia Loren

Dear Friends and Clients,

I often reflect on the different perspectives that clients hold of real estate investments versus those in the capital markets (stocks and bonds). The beauty – or peril, depending on your perspective – of a direct real estate investment is once you are "in," you are really in! The illiquidity of a building or piece of property gives the illusion of stability due to the lack of a daily tradeable market. On the other hand, most individual stocks and bonds we hold for clients can be liquidated with a push of a button or a brief phone call. The ability to price one's liquid net worth over a morning cup of Joe is not a plus, in my humble opinion.

As I have said often and continue to believe, most investors' worst enemy is themselves. People are inclined to "buy high and sell low," and Wall Street generally helps facilitate these poor decisions with the promise – usually implied but sometimes explicit – that "with our proprietary trading tools, you too can get rich trading stocks!" If only it were so easy!

My reflection on this real estate versus capital markets dilemma stems from recent developments involving a handful of large landowners a few miles west of our Jacksonville Beach office. By all appearances, heirs of the various families appear to be getting fabulously wealthy now that there is ample market demand and liquidity to monetize the family heirloom land holdings – acquired by the hundreds of acres, often 50-100 years earlier, and now priced by the square foot. The perception is that the only requirement was to buy land at $X per acre, sit on it for a few decades, then decide on a whim to sell it, and voilà, you've made 50x or 100x your money with no pesky volatility to speak of.

The reality is that there have been numerous periods – think the Great Depression, Cuban Missile Crisis, Arab Oil Embargo, the Resolution Trust Takeover of S&Ls, the 2008 financial crisis, and so on – where there was no market for these landowners to sell into, whether they wanted to or not. For better (in this case) or worse, the lack of liquidity kept them from selling in unfavorable conditions and forced them to hold for the long run.

The same principle of illiquidity applies to private equity (PE). The absence of a daily exchange-quoted market value doesn't eliminate risk or volatility, it only makes them less easy to quantify. PE investors enter an investment knowing their capital will be tied up for 5-10 years, but with that commitment comes an expectation of higher returns. There's no magic, just no daily liquid market that would allow a quick sale after a short-term decline from the initial value.

I think the true "magic" in all of this, if there is any, is patience. There are striking similarities between a long-term landowner and our attempts to create what we consider a "durable product" by carefully underwriting each security we buy as if we are going to be a co-owner in the equity of a business or a lender to a business. After careful assessment of a business we believe to be undervalued, we invest as if it was a direct real estate investment we planned to hold for five years or more. The difference, and the maddening part, is that the landowner is under no obligation to sell and no pressure to show price appreciation on a daily, monthly, or quarterly basis, while we operate in the hyper-short-term world of no-load mutual funds.

As an aside, we do own actual real estate in our portfolio indirectly through a mix of equity and debt investments in FRP Holdings (ticker: FRPH), Consolidated Tomoka Land Co. (ticker: CTO) and PotlatchDeltic Corp. (ticker: PCH). FRP owns and develops apartment and retail space and holds royalty-producing mining properties; Consolidated Tomoka owns and develops land around Daytona Beach, FL; PotlatchDeltic owns and develops timber around the US.

These securities have been trading for less than our current estimates of value. FRP Holdings was our largest contributor to the Intrepid Balanced Portfolio (the "Portfolio") in the second quarter ended June 30, 2019. FRP Holdings had a return of over 17%, which contributed 0.50% to the Portfolio's return for the period. PotlatchDeltic and Consolidated Tomoka were smaller contributors and had returns of 4.24% and 1.27% for the quarter. These securities range in market cap from $300 million (CTO) to $2.6 billion (PCH).

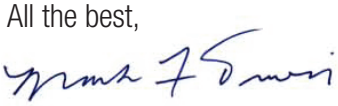
I bring all of this up for two reasons. First, it is possible to own an equity stake in high-quality real estate, either inside a publicly traded C corporation or a REIT (Real Estate Investment Trust). Second, we believe our shareholders can benefit if they are willing to be patient; a request we have made repeatedly over the last few years. If several years is too long for the potential value to accrue to your benefit, maybe the bond market would be a better alternative for your investment portfolio. On the other hand, if you could wait multiple decades to liquidate as the landowners near our office have, the returns offered by the equity market have historically been quite handsome over such long holding periods.

Year-to-date ending June 30, 2019, the Portfolio has performed reasonably well with an increase of 5.29%, net-of-fees, for the period, but it still lags the sexier equity-only indexes such as the S&P 500, which increased 18.54% for the same period. The blended benchmark, which is more representative of our intended balanced strategy, consisting of 60% S&P 500 and 40% Bloomberg Barclays Government/Credit 1-5 Year Index, increased 12.53% for the six-month period. Please keep in mind that the Portfolio typically holds about 65% in equity securities, which we believe has allowed us to participate on the upside in rising market environments and, historically, has generally made the downside market periods less severe.

Besides FRP Holdings, the Portfolio's other highest contributors for the quarter were Gattaca PLC (ticker: GATC), AmerisourceBergen (ticker: ABC), Hallmark Financial Services (ticker: HALL), and Berkshire Hathaway Class B (ticker: BRK.B). The largest detractors for the period were Greenhill & Co. (ticker: GHL), Vistra Energy (ticker: VST), Cabot Oil & Gas (ticker: COG), Teradata (ticker: TDC), and Bank of New York Mellon (ticker: BK).

Thank you for your continued support. If there is anything we can do to serve you better, please don't hesitate to call.

All the best,



Mark F. Travis
President/CEO

SMALL CAP PORTFOLIO – COMMENTARY BY JOE VAN CAVAGE, CFA, CO-PORTFOLIO MANAGER AND MATT PARKER, CFA, CO-PORTFOLIO MANAGER

The small cap market's return of 2.21% (represented by the Morningstar Small Cap benchmark) during calendar Q2 2019 probably seems like an unexciting or "as expected" result. However, it was not a pedestrian journey, as investors were subjected to some noteworthy volatility in the middle of the quarter – small cap stocks were down 8% in May before rebounding in June. The news flow was even more wild, with concerns and rumors about trade policy, slowing growth fundamentals, geopolitics (Iran), and Federal Reserve expectations trending in many directions.

We are aware of and follow all these issues but are not in the business of predicting how they might turn out. We find it much more productive to focus on what is most important: finding opportunities to put capital to work in quality small cap

stocks at attractive valuations. By focusing on both quality and valuation, we believe we can generate returns for our clients over reasonable holding periods that over-compensate them for the risks inherent in small cap stocks – whether they be the macroeconomic risks listed above or the industry and company-specific risks related to each individual holding.

The Intrepid Small Cap Portfolio ("the Portfolio") returned 0.82%, net-of-fees, during calendar Q2 2019 compared to 2.21% for the Morningstar Small Cap Index benchmark. The underperformance is partly due to the firm's large cash position relative to the index, but also because we continue to allocate to undervalued – but out of favor – small cap value stocks. We think this latter point is worth further discussion to provide context to the Portfolio's positioning and recent results.

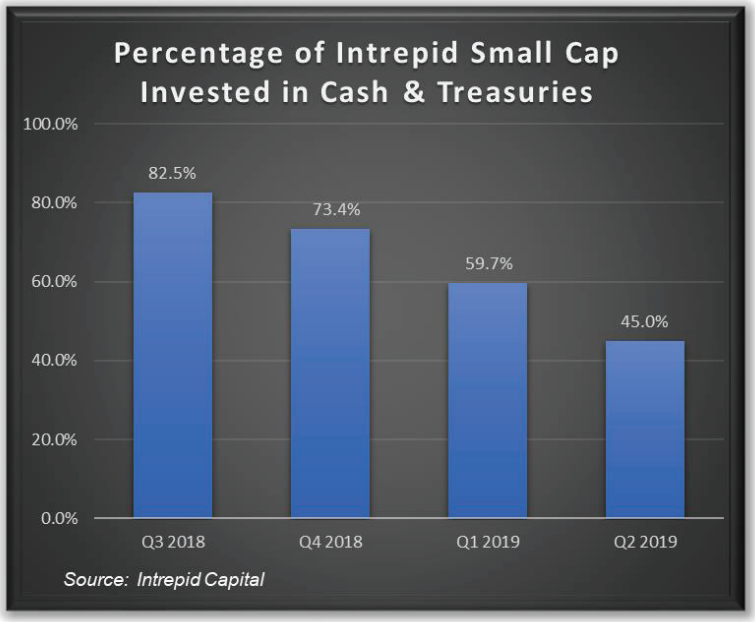
Stocks with value-oriented characteristics have underperformed growth-oriented stocks for some time. Much has been written about this divergence in the financial press – we have little unique insight to add to the debate. What we do find interesting and rarely discussed, however, is the underperformance of *small cap value* in particular.

According to market research firm Dalbar, the average investor holds an equity mutual fund for about four years. Unfortunately, the past four years has not been a good relative stretch for small cap value stocks, as investors have favored larger and more growth-oriented stocks. The Morningstar Large Cap Value Index has outperformed its small cap value peer index by over 24% during the four-year period ended June 30, 2019 – the second largest ever discrepancy in the 21-year history of monthly return data for these indices.

Similarly, mid cap value has outperformed small cap value by over 20% using the same Morningstar indices and performance periods, which is one of only a handful of periods in which this has occurred. Since value stocks have underperformed growth stocks over this four-year stretch, small cap value has suffered the double-whammy of being the loneliest subgroup within an unloved category.

History suggests this underperformance will not persist. In fact, small cap value has been one of the best performing asset classes over multi-decade periods, and numerous academic studies have provided reasons for this.[1] Unsurprisingly, periods in which small value has underperformed significantly relative to other equity categories have often set the stage for significant future outperformance, as this data has tended to show strong mean reversion over time.

Some in the investment community have suggested (not for the first time) that value is dead, and that established businesses cannot compete with new-age disruptors in a winner-take-all digital economy. Consider us skeptics. We are confident that buying stable, cash-generative businesses at reasonable multiples will inevitably come back into favor.



In that sense, we view the unpopularity of small cap value stocks as a good thing, as it has provided an opportunity to prudently deploy more of the Portfolio's cash in high-quality businesses that we believe are priced to generate attractive returns looking forward. The Portfolio's cash level ended calendar Q2 at 45.0% – down from 59.7% at the end of Q1, 73.4% at the end of Q4 2018, and 82.5% at the end of Q3 2018.

Specifically, we purchased six new holdings during Q2. They are listed and briefly described below.

- **Silicom (SILC)** – A technology company that is a leading manufacturer of equipment to enhance networking speeds for businesses. We think this small company is overlooked (it has almost no sell

1 Several studies have examined this issue over the years and our conclusions drew off the work included in the 30-year return data from the study *Periodic Tables*, *Long Term Investing*, and *Illusions of Randomness* by Stephen J. Huxley, Ph.D. and Brent Burns, President, Asset Dedication, LLC.

side coverage) and that investors are not giving Silicom enough credit for its growing exposure to cloud and SD-WAN applications.

- **Garrett Motion (GTX)** – A spin-off from Honeywell in 2018, Garrett Motion is the market-leading turbocharger manufacturer worldwide. Auto manufacturers are increasingly installing turbochargers in newer car models, as they improve engine efficiency and are a cost-effective solution for compliance with increasingly stringent environmental regulations. The company has a unique supply chain model that allows it to earn returns on capital over 100%. However, due to its small size relative to its former parent, we believe it is generally undiscovered – and meaningfully mispriced – by investors.
- **Greensky (GSKY)** – A fast-growing financial technology business that brokers home improvement loans to customers through a network of contractor partners. We think the company has carved out an interesting niche within the consumer finance space, and that its key bank partnerships and strong results validate the business model.
- **Take-Two Interactive Software (TTWO)** – One of the largest video game developers that owns the rights to successful game franchises such as Grand Theft Auto, NBA 2K, and Red Dead Redemption. We think the company's intellectual property is extremely valuable and that future game releases and overall industry growth should continue to compound the company's intrinsic value.
- **Jefferies (JEF)** – A financial holding company that owns the Jefferies investment bank and a collection of other assets. We have followed the company for a long time and believe the stock trades at an unfairly large discount to the sum of its parts. JEF's value-oriented management team also recognizes the discount and has been taking steps to realize value, including buying back significant amounts of stock.
- **IAA Inc. (IAA)** – Another spin-off, IAA is one of two players in the duopoly salvage auction industry that provides a marketplace to connect buyers and sellers of damaged or "total loss" vehicles. IAA's auction-based business model generates high returns on capital and has growth tailwinds as vehicles become more complex and expensive to repair.

These stocks add to the list of new holdings we have purchased since the end of Q3 2018 – which now totals sixteen (we divested one stock during this period as well). This "buying spree" over the last nine months was first triggered by the enormous volatility that emerged in Q4 2018 (small caps were down 20% that quarter), but the underperformance of small cap value stocks since then has provided additional attractive opportunities despite a rising stock market.

Our top three contributors to performance during calendar Q2 were:

- **Hallmark (HALL)** – Hallmark reported a great first quarter which featured improved underwriting profitability, strong top line growth, and an attractive outlook on future results. Initially, investors didn't seem to notice, but the stock rallied sharply in June. We reduced the position size as the stock neared our valuation estimate.
- **Amdocs (DOX)** – Amdocs also reported a strong quarter to start the year. DOX was a top detractor in the prior quarter, as it fell victim to a short seller report in January. Although Amdocs management addressed many of the short seller's allegations in the company's Q4 earnings call, we think the solid Q1 earnings report was the proof that some investors wanted to see, as the results included improvements in certain areas that were alleged to be red flags.
- **Crawford (CRD/A)** – Although we didn't think the company's Q1 earnings report was noteworthy, Crawford's stock rallied sharply in June. Perhaps other investors are beginning to notice the improving fundamental picture for this small, underfollowed company.

Our three worst detractors on performance during calendar Q2 were:

- **Garrett Motion (GTX)** – Garrett's stock suffered along with a host of other auto suppliers, as slowing global auto production data weighed on these companies shortly after we established our position. At less than five times forward earnings, we think the risk of continued slowing auto production is more than priced into this stock.
- **Skechers (SKX)** – A large winner last quarter, we think the pullback in SKX during calendar Q2 was mostly related to the trade war with China. Although we believe the trade war only has a minor impact on Skechers' manufacturing capabilities, a significant portion of their sales come from China, and investors are concerned that tariff-related weakness in China's economy could slow consumer spending on footwear.
- **Cabot Oil & Gas (COG)** – Cabot reported a very strong Q1 2019 result that proved out its commitment to low costs, accelerated growth, free cash flow generation, and returning capital to shareholders. However, the price of natural gas fell 13% during the quarter, dragging the stock down with it.

Finally, it is important to continue to assess the Portfolio's performance and actions relative to the three strategic objectives we laid out last quarter. We are pleased with our performance against the first two objectives but have fallen short with the third:

i) **Avoiding large drawdowns on your capital** – The Portfolio performed very well in the two recent small cap market drawdowns, including Q4 2018 when the Morningstar Small Cap Index was down -19.51% (Portfolio -3.46%, net-of-fees), and in May of this year, when the benchmark fell -7.89% (Portfolio -3.32%, net-of-fees).

ii) **Taking advantage during periods of volatility** – The Portfolio has purchased 16 new positions in the nine months of this fiscal year, and cash has fallen from 82.5% to 45.0% in response to increased volatility and the general underperformance of small cap value stocks.

iii) **Generate attractive positive absolute returns** – The Portfolio has a -0.73%, net-of-fees, return over the trailing twelve-month period ended June 30, 2019, compared to the -1.50% return of the benchmark Morningstar Small Cap Index and the -7.86% compared to the Morningstar Small Value Index. Based on these results, it would be fair to say that the Portfolio managed the value-related headwinds over the last year well. However, we are not thrilled with this outcome as it falls short of our objective of generating positive absolute returns.

With that said, we believe the Portfolio is positioned well to bounce back from the slightly negative absolute returns over the last twelve months. Recent actions – highlighted by the sixteen new holdings established during the past three quarters – position the Portfolio for more potential upside than it has had in years. While still remaining defensive and flexible (cash is at 45.0%), the Portfolio now has over 3x the equity exposure it had nine months ago as we have exploited several dislocations in our value universe. While we don't have pre-determined plans to continue allocating cash to new opportunities at this rate – that will depend on how our opportunity set is priced at any given time – we will not hesitate to act should volatility spike again or our core universe of small cap value continue to offer an increasing number of attractive opportunities.

In closing, we are very optimistic about the future performance of the Portfolio. We expect the multitude of new purchases and higher equity exposure to provide attractive future absolute returns within a category that may be poised for a mean-reverting outperformance on a relative basis. Meanwhile, our significant cash position provides an overall defensiveness while maintaining the ability to deploy additional cash as further opportunities appear. We believe this simple, flexible, and opportunistic approach should continue to add value over the benchmark, over reasonable holding periods, and provide attractive positive absolute returns that are worth the risk assumed. We thank you for your investment.

DISCIPLINED VALUE PORTFOLIO – COMMENTARY BY CLAY KIRKLAND, CFA, PORTFOLIO MANAGER

Looking back over the first half of 2019, there continues to be a wide and still growing disparity between the returns of different investment styles – a divide that is not captured by simply looking at the most popular indices. As has been the case for the

last 3-4 years, investors again favored growth stocks over value stocks in the second quarter. The same phenomenon applied to the other axis of the commonly recognized Morningstar style box grid, as large cap outperformed both mid and small cap. Combining style and size shows the greatest discrepancy, as large cap growth has dramatically outperformed small cap value over the last several years. I would encourage you to read the Small Cap Portfolio's commentary for a more detailed historical analysis of growth vs value.

The Intrepid Disciplined Value Portfolio ("the Portfolio") generated a modest return of 0.92%, net-of-fees, during the quarter ended June 30, 2019. The S&P MidCap 400 returned 3.05%, the S&P 500 was up 4.30%, and the Russell 2000 was up 2.10%. The value-oriented sub-indices for each of these returned less.

The drawdown during the month of May was just over 5% for the Portfolio. Losing any amount of money is hard to digest, but when you consider that an index like the S&P MidCap 400 was off about 8% over that time, we were pleased to see our portfolio of undervalued securities begin to separate itself in what was a volatile month. However, since the sell-off in the market was short-lived, we did not entirely make up lost ground from earlier in the quarter.

We aimed to upgrade the quality of businesses in the Portfolio throughout the first half of 2019 and are pleased with the composition of the current portfolio. Cash levels hovered around 10% for much of the quarter before increasing in June as we exited a few positions entirely and trimmed others.

The top three contributors to performance for the quarter were Amdocs (ticker: DOX), Take-Two Interactive Software (ticker: TTWO), and Laboratory Corp of America (ticker: LH). In fact, we wrote about all three of these companies in our first quarter letter.

Amdocs reversed course in the second quarter after coming under pressure earlier in the year when a short seller published a report questioning its business practices. The company reported solid earnings results in May which included steady revenue growth and EPS that exceeded expectations. The results helped answer concerns raised by the short seller by showing a decrease in days sales outstanding (DSO) and strong cash flow generation. We believe that most of Amdocs' business is doing quite well but recognize the challenges posed by sluggishness in its AT&T business. We trimmed the position during the quarter and still hold a meaningful weight in the company.

Take-Two is a position we initially purchased during the first quarter when most of the video game publishers were near 52-week lows. There wasn't a particular catalyst that helped shares rebound in the months since, rather many small data points that were favorable for the sector and Take-Two in particular. Take-Two is not a typical investment for us as the cash flow and earnings tend to be lumpy due to title release cycles. However, the company has a growing revenue base that is recurring in nature, which should help smooth financials in the future.

Viewed over a longer period of time or in a year when one of its franchise titles is released, a company like Take-Two is actually quite cheap. Grand Theft Auto 5 was released in 2013 and earned $800 million in its first day and $1 billion within three days of its release, becoming the fastest-selling entertainment product in history. While a release date has yet to be confirmed, we expect Grand Theft Auto 6 will hit the market shortly after the new generation of gaming consoles are released, which is likely a late 2020 or early 2021 event. We remain bullish on the gaming sector and believe there is a long runway of growth ahead. We view this as an attractive opportunity to own an asset-light business with high margins and growing end markets with a potential for a low double-digit free cash flow multiple.

LabCorp continues to rebound from the rocky fourth quarter of 2018. Headwinds remain in its core diagnostics business, which accounts for about 60% of revenue, due to both reimbursement cuts and share losses associated with the opening of a large managed care contract to Quest. Its Covance business has turned the corner after a long period of disappointing results following the acquisition a few years ago. Now Covance is helping to drive growth at LabCorp. Furthermore, Covance sports operating margins that are far below peers, so we expect to see improvement as the company remains committed to attaining similar margins to its peers. We trimmed the position during the quarter to right size the weight, and it remains one of our top holdings.

The top three detractors to performance in the quarter were Vistra Energy (ticker: VST), Teradata (ticker: TDC), and Bank of New York Mellon (ticker: BK).

Vistra Energy is a position we initiated in the first quarter that has unfortunately been a major drag on performance. While the company has already hedged 100% of its natural gas and power price exposure for this year, the market does not seem to care. Weather trends in Texas have been mild, causing a sharp selloff in 2019 and 2020 peak prices.

Aside from the movement in the stock price, Vistra Energy as a business is doing quite well. It refinanced existing debt at more favorable interest rates, repurchased over $1 billion worth of stock in the past year, and recently initiated a dividend, all while keeping leverage at less than 3x EBITDA. The company is committed to generating stable cash flows, and we remain confident in its prospects as a long-term investment.

Teradata has been mentioned in many past commentaries at Intrepid as both a contributor and detractor. With this in mind, we have tried to adjust the position size accordingly to both capture moves higher and limit the damage when it moves lower. We materially trimmed our position during the first quarter after shares appreciated substantially without much change in the outlook for the business. The earnings report in May was accompanied by a disappointing outlook and served as a painful reminder that the transition to a subscription-based business model still has a long way to go.

We continue to believe that we are at or near an inflection point in that transition, where free cash flow will begin to rebound to levels historically seen. Until then, the shares may be range bound. We added to the position after it fell back near the 52-week low and it is now one of our larger weights.

Bank of New York Mellon has been under pressure this year primarily due to lower interest rates. It faces other headwinds like muted client activity, low exchange rate volatility, continued pressure on deposits, and secular pressures in asset management. The valuation remains compelling, but the business is not growing, and it carries both cyclical and market risk. Non-interest-bearing deposits at trust banks have fallen to levels last seen in 2011-2013. While a recent boost to the dividend and continued share buybacks are nice, they are not reason enough to own the stock. Despite these mostly short-term pressures, the company has recently won some significant new business and continues to invest in technology which we expect will improve long-term results. We have owned Bank of New York Mellon for many years and will continue to keep a watchful eye out for any sign that the outlook is eroding further.

We continue to find undervalued ideas despite major indices being at or near all-time highs. We purchased a few new positions in the quarter, including Shutterfly (ticker: SFLY). The company sells customized greeting cards, stationary, photo albums, and many other personalized items. We began looking at Shutterfly early this year after it provided disappointing guidance and lowered its synergy estimates due to difficulties with the integration of its Lifetouch acquisition. Lifetouch is the national leader in school photography and was Shutterfly's largest acquisition in its history.

At the same time, management disclosed that it had been approached by a 3rd party (but had not received a formal offer) that was interested in acquiring Shutterfly. As a result, it formed a committee to review strategic alternatives. The share price eventually retraced back to its lows over the next few months before rumors began to swirl in the media about advanced deal talks.

We decided to purchase a small weight. There is a lot to like about Shutterfly's business—it has the largest market share, high customer retention, generates strong free cash flow, and is vertically integrated. However, the company has struggled to grow in its core business recently. We viewed the Lifetouch acquisition favorably, just not to the extent that investors did when the stock nearly doubled in price shortly after the acquisition was first announced.

When we bought Shutterfly, we believed that if a deal were to happen, a fair price would be $55, and a strategic acquirer could potentially pay as much as $60. If a deal did not occur, we were happy owning the business longer term, as we expected organic growth to resume and financials to improve. Shortly after we established our position, Apollo Global announced that it would purchase Shutterfly for $51. We are disappointed in the price, since in conjunction Apollo is also acquiring Snapfish, which makes this a quasi-strategic acquisition. Nonetheless, we are happy to have made a profit on the investment and decided to sell out of the position as it approached deal price.

Our wish list of securities that we would like to own if the share price were to drop continues to build. While we would welcome downside volatility in the market in the hopes of acquiring these names at great prices, we are optimistic about the Portfolio's current positioning should the market continue to appreciate. Thank you for your investment.

INCOME PORTFOLIO – COMMENTARY BY HUNTER HAYES, CO-PORTFOLIO MANAGER AND MARK TRAVIS, PRESIDENT/CEO, CO-PORTFOLIO MANAGER

Would you ever pay for the privilege to lend someone money? We sure wouldn't. The idea of lending someone $100 to get paid back even $99.99 sometime in the future seems so absurd to us that it's hard to believe it's a reality. Not only does lending at a guaranteed loss violate basic tenets of finance, like the time value of money, but it also goes against common sense. Nonetheless, across the world nearly one quarter of global debt carries a negative yield, according to Bloomberg.

So why do people buy bonds that will lose them money? There are very few plausible reasons:

- Fixed income assets are often seen as the safest assets in the market, especially during times of elevated market stress. That drives investors to plow cash into them at any price, even to the ludicrous extreme of negative rates. For these investors, locking in a slightly negative return on a bond is their way of saying *I'll lose some money, but probably not as much as I would in another asset class.* For many of these investors, owning cash is not an option.
- Some mandates require investors to track government bond indexes or invest in certain securities, regardless of price or yield.
- Portfolio managers believe negative yields on the debt they own will become even more negative, driving prices up - a glorified example of the greater fool theory.

None of these reasons for owning negative yielding debt strike us as particularly compelling. However, the consequences of negative yielding debt on investor behavior are alarming. We wrote last quarter about the hunt for yield driving investors into riskier debt securities to compensate for the lack of yield in investment grade and sovereign debt securities. Astonishingly, according to The *Wall Street Journal* over a dozen "high yield" bonds in Europe now also trade with a negative yield. It seems that negative rates have coursed their way through debt markets in Europe like a shockwave, first pushing many investment grade debt issues into negative territory, and now some junk bonds into the land of guaranteed loss as investors scramble to find ways to generate return.

Over the long term, we don't see this return-with-any-level-of-risk dynamic playing out well. The reason high yield bonds have higher interest rates in the first place is to compensate investors for the elevated credit risk. The idea of getting compensated next to nothing (or less than nothing) to underwrite these risky bonds is hard to fathom, yet it probably won't be long before a bond is issued in the high yield primary market with a negative coupon.

We wonder where it ends. It seems like until there's a substantial shock to the global financial system, yield-starved investors will continue moving further out on the risk spectrum in search of adequate return. Many European and Japanese investors have already flocked to the U.S. debt markets, expanding the negative interest rate shockwave and pushing rates down here as well. We also continue to see banks and private equity shops take advantage of the frenzy for yield by squeezing through looser

covenants and fewer protections for debtholders on new deals.

With the prospect of one or more rate cuts on the table this year despite all-time highs in the stock market and a seemingly healthy economy, will the U.S. also end up with negative rates at some point? If we can't raise rates in such a sanguine environment, when will we ever be able to do so?

In light of all this uncertainty, we continue to feel good about the way the Intrepid Income Portfolio (the "Portfolio") is positioned. We believe our short duration profile has the potential to keep us insulated from any interest rate surprises and agile enough to take advantage of dislocations in the market when it is warranted.

Despite a volatile month of May, corporate bond yields continued to tighten in the second quarter after a strong start to the year. The ICE BofAML High Yield Index (the "HY Index") returned 2.57%, composed of a 0.98% increase in price and a 1.59% gain from interest income, in the quarter ended June 30, 2019. The shorter-duration Bloomberg Barclays US Govt/Credit 1-5 Year Total Return USD Index (the "1-5 Year TR Index") gained 1.92% over the same period.

Longer-duration investment grade securities meaningfully outperformed in the quarter following increased speculation that the Fed will lower rates. The Bloomberg Barclays US Aggregate Index (the "Barclays Aggregate Index") returned 3.08% for the quarter and the ICE BofAML US Corporate Index (the "Corporate Index") recorded a 4.35% gain over the same period. The Intrepid Income Portfolio gained 0.84%, net-of-fees, in the quarter ended June 30, 2019.

We are happy with our results over the past three months. We believe that the main difference between our return and the indices was related to duration. Our emphasis remains on finding creditworthy companies with attractive fundamentals that we can underwrite. We continue to find value in the neglected corners of the fixed income market, including broken convertibles, small issues, and unrated issues.

The Portfolio's top contributors for the three-month period ending June 30, 2019 were Central Garden 5.125% notes due 2/01/2028, Coach Inc. 4.125% notes due 07/15/2027, and Nathan's Famous Inc. 6.625% notes due 11/01/2025. It's no coincidence that these securities were also some of the longest duration names in the portfolio. The same effect from declining rates that drove the longer duration indices up also pushed these credits higher. Although we are happy to participate in this upside with a small percentage of our holdings, we remain committed to keeping the overall duration of the Portfolio low.

The Portfolio only had one material detractor for the quarter, LSC Communications Inc. 8.75% 1st lien notes. As we detailed in our last commentary, LSC is being purchased by Quad/Graphics, Inc. and were the deal to close, we should receive a favorable call price or even a make-whole premium. In late June, however, the Department of Justice sued to block the merger on antitrust grounds. The bonds sold off several points and we used the opportunity to purchase more. We believe that whether the merger occurs or not, LSC is creditworthy and that we are being more than adequately compensated for the risk.

The Income Portfolio had seven corporate bond positions that were called or matured in the second calendar quarter. We also rebalanced several positions. The proceeds from the bonds that matured or were called were redeployed into short-term paper of investment grade issuers that we believe offer attractive yields in excess of government securities. Additionally, we purchased five new holdings during Q2. They are listed and briefly described below.

- Activision Blizzard – A premium video game company that generates robust free cash flow, has twice as much cash as debt, and carries investment grade ratings. We purchased the 3.4% notes due 6/15/2027. We like Activision for its strong brands and returns on invested capital.
- Air Canada – Canada's leading airline, serving around 180 destinations, primarily in Canada and the US but also in the Asia/Pacific region. Together with a regional affiliate (jazz) the company operates a fleet of about 330 aircraft from hubs in Calgary, Montreal, Toronto, and Vancouver. It also hauls cargo and offers ground handling and travel arrangement services. We bought various enhanced equipment trust certificates (EETCs) in the wake of the 737 Max 8 aircraft tragedy

earlier this year. These notes are all fully secured by aircraft other than the 737 Max 8. Additionally, Air Canada is growing on the top and bottom line and generating a lot of free cash flow.

- Choice Hotels – One of the world's largest global hotel franchisors with brands that include Comfort Inn and Suites, Sleep Inn, and Econo Lodge. The company has low net leverage of 2.0x, investment grade ratings, and a large equity cushion. We purchased the 5.7% notes due 8/28/2020 as we believe they presented good value for such short duration.
- Ensign Drilling – We purchased Ensign's 9.25% notes due 4/15/2024 when they were issued in the primary market. Ensign is one of the largest global providers of onshore contract drilling to the upstream oil and natural gas industry. The company was a first-time high yield issuer which we believe led to the relatively high coupon. The 9.25% notes helped fund Ensign's acquisition of Trinidad Drilling and we believe the combined company will be able to deleverage quickly.
- Great Western Petroleum – A private, independent oil and natural gas company active in the DJ basin in Colorado. Great Western has a $300 million bond issue that traded down because of oil prices and political risk in Colorado earlier this year. We purchased these 9% bonds due 9/30/2021 in May at what we view as an attractive yield. We believe the political risk has largely been mitigated and expect the bonds to trade back up over the next few quarters. We also think there's a chance the company could refinance these notes later this year which could result in substantial upside for our position.

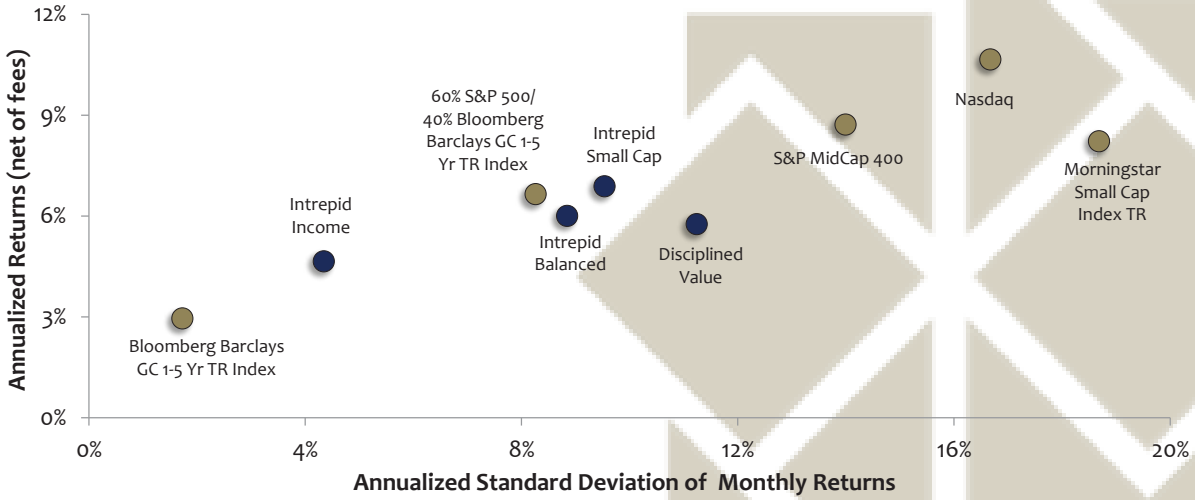
Portfolio activity was otherwise subdued. We continue to diligently search for attractive opportunities to take credit risk while limiting the Portfolio's duration, which was 1.36 as of June 30th. Thank you for your investment.

Risk Adjusted Returns

Intrepid Capital

Trailing 15 Year risk/return

June 30, 2004 to June 30, 2019



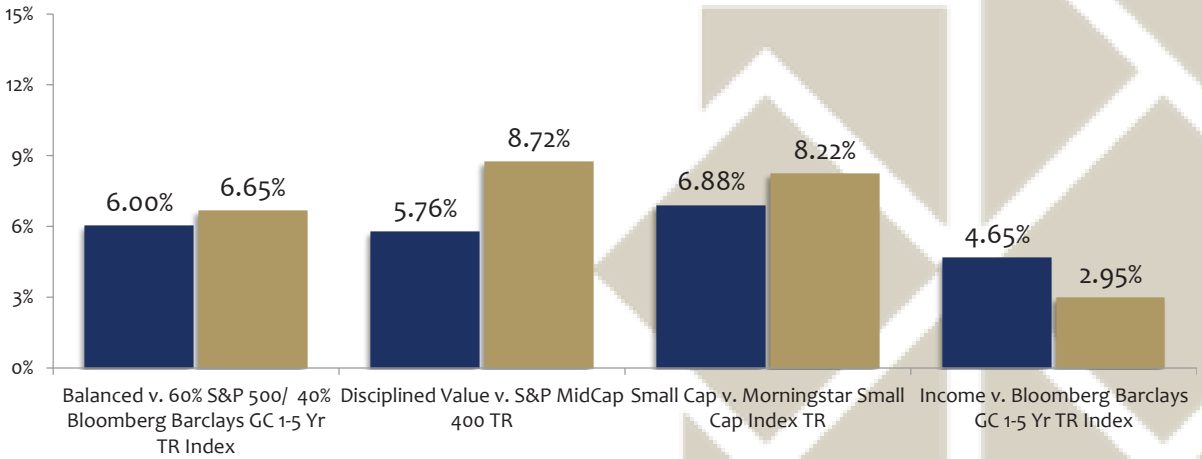
Past performance is no guarantee of future results. Intrepid composite returns are presented net of investment advisory fees and all returns are presented annualized for the 15-year period ending June 30, 2019. Returns reflect the reinvestment of dividends and other earnings. The volatility of the listed benchmarks may differ materially from the volatility of any Intrepid composite. As of January 1, 2019, the Intrepid Small Cap changed its benchmark from the Russell 2000 Index to the Morningstar Small Cap Index. As of January 1, 2019, the Intrepid Disciplined Value changed its benchmark from the S&P 500 Index to the S&P MidCap 400 Index. As of January 1, 2019, the Intrepid Balanced and Intrepid Income changed their fixed income benchmarks from the ICE BofAML US High Yield Index to the Bloomberg Barclays Gov/Credit 1-5 Year TR Index. The benchmarks for the Intrepid Small Cap and the Intrepid Disciplined Value have not been changed retroactively. The benchmarks for the Intrepid Balanced and the Intrepid Income have been changed retroactively.

Annualized Performance

Intrepid Capital

Trailing 15 Year Performance Returns

June 30, 2004 to June 30, 2019



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