Intrepid Capital MANAGEMENT INC.

3Q 2019

Index Returns	
7/1/2019 to 9/30/2019	
Dow Jones:	1.83%
S&P 500:	1.70%
NASDAQ:	0.18%
Russell 2000:	-2.40%

QUARTERLY COMMENTARY

October 2019

"The times they are a changin'."

— Bob Dylan

Dear Friends and Clients,

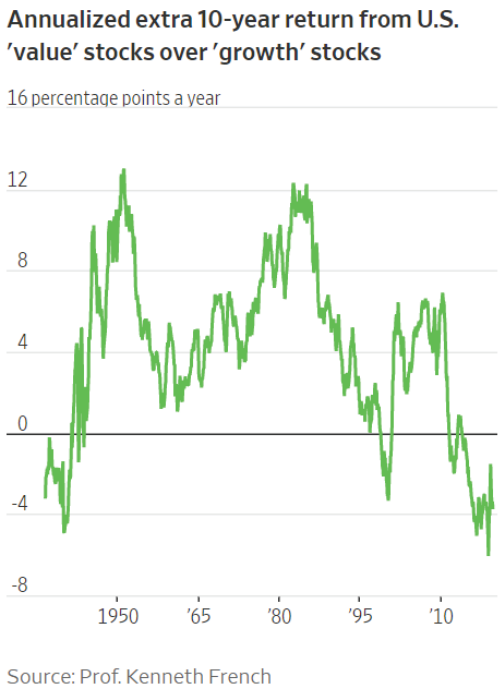
As a lifetime participant in the financial services business, I have heard more times than I care to count the often repeated and almost never heeded disclaimer, *"Past performance is no guarantee of future results."* Unfortunately, many, if not most, market participants use recent performance (1-5 years) as the basis for choosing how to allocate their capital. The reality, with tongue in cheek, is that most investors *buy high* and *sell low* by extrapolating recent performance – good or bad – into the distant future when making investment decisions.

Study after study has shown that investors pour their money into strategies and companies that have done well recently, whether in terms of absolute performance or relative performance vs. peers, and pull money out of short-term underperformers, kneecapping their own long-term returns in the process.

Consider the past year. For the twelve months ending September 30, 2019, the S&P 500 (US large cap companies) was up 4.25% and the Russell 2000 (US small cap companies) was down 8.89%. US large caps have been one of the best performing asset classes globally for the last several years, so it should come as no surprise that over roughly the same twelve-month period (Morningstar data is only available through August) an estimated $93.2 billion of net asset flows have gone *into* passive US large cap funds, chasing better relative performance, while a net $131 million has come *out of* US small cap index funds.

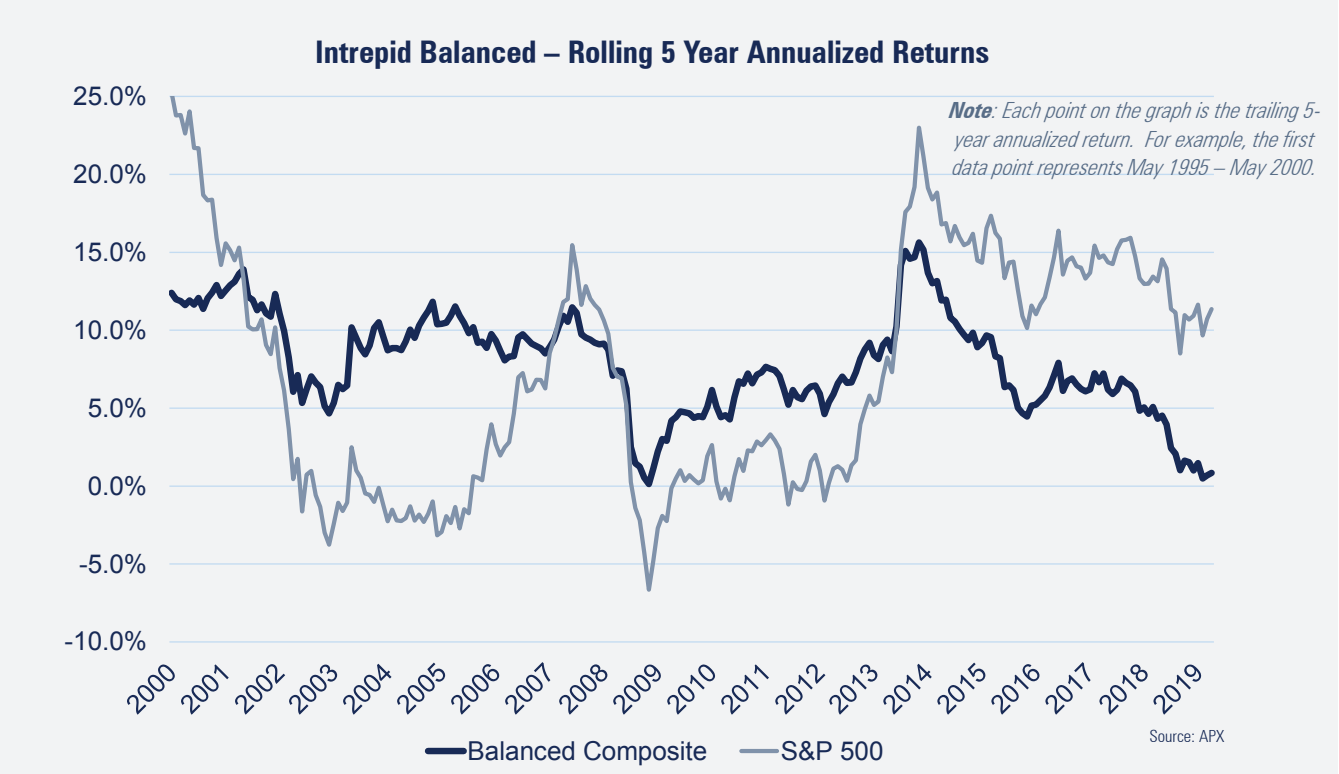
But what about long-term performance? If you expand the investment horizon to 20 years (Sept. '99 – Sept. '19), which encompasses both two bear markets and two bull markets, the results are quite different. Annualized returns over the full 20 years were 6.33% for the S&P 500 and 7.99% for the Russell 2000. 164 basis points may not seem like much, but if you were to put $1 million in funds tracking each index in 1999, you'd have $4.6 million today in the Russell and $3.4 million in the S&P – a $1.2 million difference!

I bring this up because we at Intrepid Capital have concentrated the majority of our research efforts on the smaller end of the US market, typically in the $500 million to $10 billion range. We further narrow our playing field to profitable businesses trading at a discount to their reasonable private market fair value, which puts our sweet spot squarely in what Morningstar considers a small cap value or mid cap value style box. That our niche lies in this less efficient, less competitive corner of the capital markets is no accident. We believe it is partly because of these traits that small stocks have historically outperformed their larger brethren and value has beaten growth over most decade-plus periods.



The accompanying graph from the *Wall Street Journal*[1] going back to 1936 shows that over most 10-year historical periods, a preference for stocks with lower valuations has produced significant outperformance over stocks with higher growth but also more demanding valuations. However, value as an investing style is currently in a historic 10-year slump relative to growth, the likes of which we haven't seen since the late '30s. The underlying factors that have favored growth stocks over the last decade – Fed-induced low interest rates, loose monetary policy, and unrestrained corporate borrowing, among others – I have bemoaned at length in past letters and will not repeat here. The bottom line, in the *Journal's* words, is that a "value bounce [is] overdue."

Keen observers will point out that with higher return comes higher risk. This has generally been the case with small caps, but as value investors, we try to hunt in what we regard as a less efficient part of the stock market for high-quality and hopefully mispriced shares. Our goal is to generate high returns with less volatility than the broad market indexes.

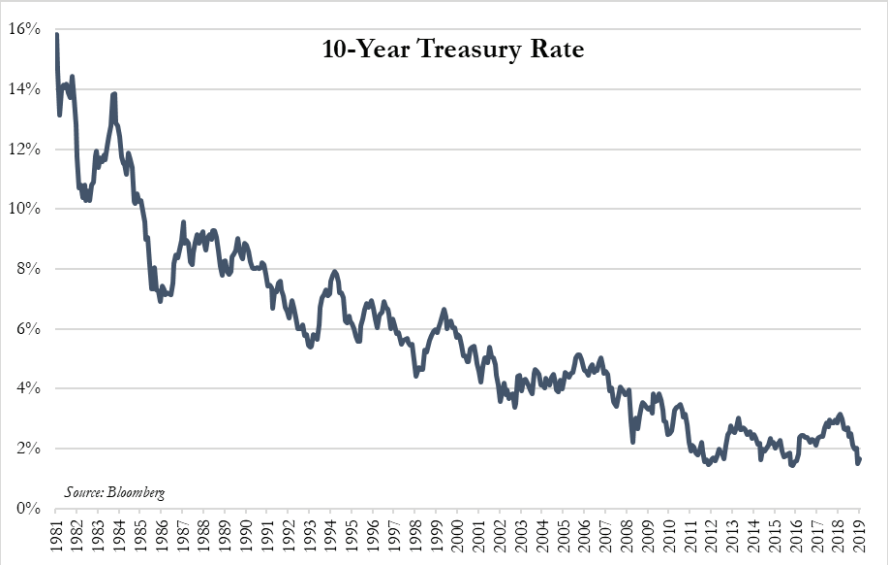


This has admittedly been a difficult period for the Intrepid Balanced Portfolio (the "Portfolio"). Frankly, a stretch of 60 months with barely visible returns will try the patience of any investor, present company included. In reviewing the 24-year audited track record of the Portfolio, there has been one other brief "flat spell" with a negligible 5-year return (early 2009), as well as two multi-year periods (2002-2006 and 2009-2013) where the S&P 500 (the "Index"), the equity portion of the Portfolio's benchmark, hadn't made any money over the trailing five years.

1 Mackintosh, James. "Value's Rebounding, but Don't Get Your Hopes Up." *WSJ.com.* 14 Sept 2019. Web. Accessed 3 Oct 2019.

But just as we wouldn't expect periods with high double-digit performance to last indefinitely, whether it be the Portfolio or indexes, neither do we expect periods with flat returns to continue unabated. The markets move in cycles, and as the old Persian fable says, "this too shall pass." The disclaimer about past performance applies whether one is observing 5 years of hot performance or 5 years of lackluster performance!

We did see some life breathed into the share prices in many of our companies in mid-September. A dramatic rotation from momentum strategies into value strategies gave us hope that perhaps investors' mentality toward risk was beginning to turn. I came to discover after this shift in sentiment that some of the recent market favorites hadn't done so well. Amazon (ticker: AMZN) and Netflix (ticker: NFLX), both members of the tech darling "FAANG" stocks, found their share prices down 8% and 27%, respectively, in the third quarter. This is a small consolation for me as the Portfolio's manager, who delivered a negative 1.50%, net-of-fees, return for the same period.



The common theme between strategies that have fared best over the last year is *duration*, which can be thought of in terms of payback period or interest rate sensitivity. As interest rates plummet, the market's mantra seems to be the more duration the better. Long duration investments – those with longer payback periods – have benefitted from a bull market in bonds that resumed around the Fed's July rate cut, the first in 10 years, but really began in 1981, when 10-year Treasuries offered a 15% government-guaranteed coupon (and no one wanted them back then, by the way!). Compare that to today, with "investors" clamoring to buy 10-year Treasuries with a 1.5% yield. As an example of the effect this year's sharp drop in rates has had on longer-duration bonds, the holder of a 30-year Treasury bond at the end of 2018 would have seen a 20% return by the end of September!

But duration doesn't only apply to bonds, as Jim Grant, editor of the *Grant's Interest Rate Observer* newsletter, pointed out in a recent issue. "By definition," he writes, "every common stock is a perpetual [no defined payback period] security. But growth issues carry a longer imputed duration than value names, because so much more of their anticipated payoff lies over the temporal horizon. The bond bull market has not smiled on fixed-income investors alone. It's showered its riches on Silicon Valley, the private-equity business and the venture-capital community as well."

To truly understand duration, though, we also have to understand the problematic implications of ultra-low or negative interest rates, which are the new norm in Germany, Japan and elsewhere. Just think, you could lend your money to the German government for as long as 25 years today in exchange for the "privilege" of getting less money back at maturity. No, I am not making this up!

Would you invest $1,000 today to get $1,000 back a year from now? Most people would answer no; they'd rather keep the money unless they expect to receive more back in the future. Time value of money tells us that a dollar in the future is worth less than a dollar today, and the difference is determined by a discount rate – the implied return an investor demands in exchange for waiting to receive his dollar back. As the required rate of return rises or the payback period gets longer, the present value of that

future dollar gets smaller. Conversely, as the required rate of return falls or the payback period gets shorter, the investor should be willing to pay more for the future dollar today. In other words, those expected future dollars become more valuable.

But what happens when the prevailing rate of return demanded by the market falls close to zero or even negative? Not only does lending or investing a dollar today to get less back in the future defy common sense, but it distorts the whole relationship undergirding cash flow-based valuation. With a 0% discount rate, duration (payback period) becomes irrelevant, because a dollar returned 20 years from now is worth just as much as a dollar today.

The point of this theoretical exercise is that cheap credit matters in everything. Unprofitable companies like Netflix or Uber (ticker: UBER) have economic value today because at some point in the future, their shareholders expect them to begin generating cash instead of burning it. For each of these companies and most of the ones that have gone public in the last few years, profitability is a distant prospect. But in a world where the benchmark 10-year Treasury dipped below 1.5% a few weeks ago and $17 trillion of debt globally sported negative interest rates at the end of August, those far off "maybe dollars" are worth almost as much in the minds and spreadsheets of investors as an actual dollar today – a situation that, in theory, justifies massive valuations for these companies but would never be sustainable in a more normalized rate environment.

I believe this is an "emperor has on no clothes" moment in the market, one that years hence we will look back on incredulously. Rate suppression activity by central banks around the world has encouraged all sorts of shenanigans to persist, in my opinion, from financing larger U.S. budget deficits, to unicorns like WeWork, to an IPO market of largely unprofitable offerings.

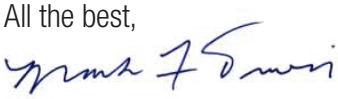
The potential for capital destruction is huge if rates were to actually rise instead of continuing to fall, as is the Fed-driven consensus belief today. Even "safe" investment grade bonds stand to suffer more than they would have historically, as the average issue's duration has drifted up to 3x its coupon. Said another way, a 1% increase in rates would wipe out 3 years' worth of interest payments.

The way we intend to help mitigate this risk in the Portfolio is to take a lot of "4-foot putts" with a mix of cash, short duration corporate bonds that should be paid back within a year or two, and carefully selected stocks that should, in our opinion, generate high levels of free cash flow relative to their market cap and enterprise value. Holdings in the Portfolio with these characteristics include companies like Skechers (ticker: SKX), Hanesbrands (ticker: HBI), Vistra Energy (ticker: VST), and SP Plus (ticker: SPP), all of which we have discussed in past letters. Shares of companies that make money from shoes, underwear, electricity and parking lots and that generate healthy free cash flow should aid us if and when interest rates rise.

For the three months ended September 30, 2019, the Portfolio's largest contributors were Vistra Energy (ticker: VST), Skechers (ticker: SKX), and SP Plus (ticker: SPP). The largest detractors Cabot Oil & Gas (ticker: COG), Garrett Motion (ticker: GTX), and FRP Holdings (ticker: FRPH).

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

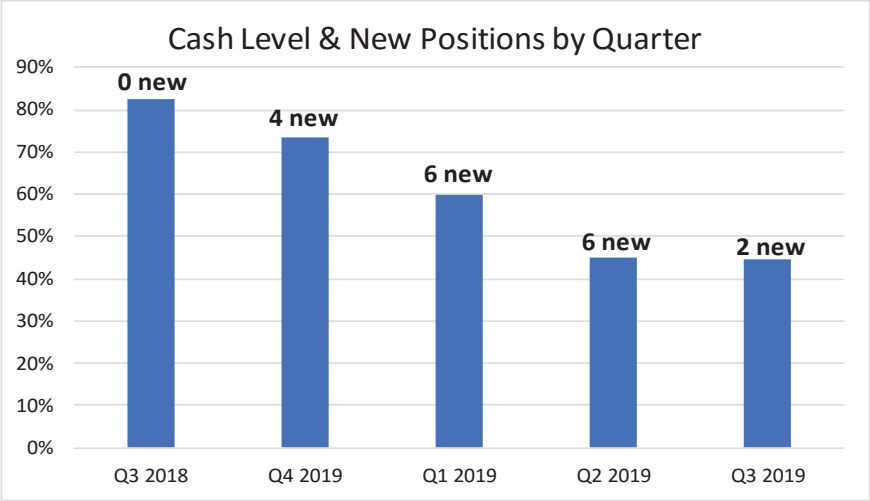
Like last quarter, the third quarter of 2019 was a period heavy on news flow, with trade wars, geopolitical tensions, swings in interest rate expectations, and political uncertainty whipping market sentiment in many directions over very short periods.

Also, like last quarter, there was some meaningful volatility in the middle of the period, with the Russell 2000 index falling 7.44% from peak to trough during the first four weeks of August.

We reacted to that volatility a bit differently this quarter than last. Instead of adding a number of new positions, we found it more opportune to take advantage of the volatility by purchasing more shares of our existing holdings. This allowed us to increase the position size in certain high conviction holdings at attractive prices.

In fact, after the "buying spree" over the previous nine months in which we added 16 new positions to the Intrepid Small Cap Portfolio (the "Portfolio"), we only added two small new holdings during Q3 2019. Along with the aforementioned additions to existing positions, cash levels ended the quarter relatively unchanged from the previous quarter at 44.6%.

The new holdings in calendar Q3 2019 were Manchester United PLC- Class A (ticker: MANU) and Liberty Braves - Class C (ticker: BATRK). European soccer giant Manchester United is one of the most valuable sports franchises and brands in the world. Management has had a tough time putting a winning team on the field over the last few years and has been hampered by a weak British currency and a disappointing domestic television rights package. Over the long-term, however, the company has a great track record of growing and monetizing the brand through the team's unique worldwide appeal. By contrast, the Liberty Braves, the owner of the Atlanta Braves professional baseball franchise, has made the playoffs for the past two seasons. Liberty is also developing a large real estate project around the new Braves stadium that has seen very successful occupancy and income gains to date.



In past letters, we have discussed how the change in the Portfolio's cash levels is not formulaic but is driven by the opportunity set of quality small cap stocks selling at attractive valuations at any given time. We believe this quarter's slowdown in i) new stock purchases and ii) the trajectory of lowering cash levels relative to the last three quarters is a good reflection of this discipline.

We would also like to explain the Portfolio's position in cash, which – at 44.6% - is a frequent source of investor questions. Importantly, the Portfolio is an *absolute* return-oriented strategy. This means we will not purchase a stock unless it is trading below our estimate of intrinsic value and we believe offers an expected return which appropriately compensates owners for its risk. When we are unable to find stocks meeting these criteria, we hold cash. With many of our favorite valuation metrics pointing to a broadly overvalued market in an economy that we believe looks increasingly likely to be late cycle, we find ourselves holding a significant amount of cash. By contrast, most managers are forced to evaluate stocks *relative* to a benchmark and have mandates requiring them to own stocks even if the manager believes they or the market are overvalued.

We believe absolute return strategies are far more sensible for most investors than simply aiming to outperform an index. To illustrate, consider a story from the *Wall Street Journal* in July which reported that several European junk bonds were trading at a *negative* yield. In other words, investors who purchased these bonds and held them to maturity would guarantee themselves a loss on the investment, before even considering any credit risk. As absurd as this may sound, the article goes on to quote the chief investment officer at a global asset manager as saying that such an investment is "not completely crazy" because "… for some investors, there is an acceptance that it's not about absolute returns, but relative returns." The implication here is that even negative returns are okay as long as they're less negative than peer or benchmark returns. Rest assured that we strongly disagree with this line of thinking!

Finally, one last thing to discuss relative to last quarter is our discussion of growth vs. value relative performance. Last quarter, we lamented the underperformance of value (particularly small value) over the last four years, but we emphasized our belief (based on history) that this would not and could not last forever. Fortunately, late in this most recent quarter, those growth versus value trends reversed a bit, providing a nice tailwind for the Portfolio's performance in September. While it's impossible to predict what will happen next for growth and value, we were encouraged by the Portfolio's performance during the abrupt (and hopefully not short-lived!) change.

Performance

In the third quarter of 2019, the Portfolio returned -0.81%, net-of-fees, compared to -1.81% for the benchmark Morningstar Small Cap Index. The outperformance was mostly due to the Portfolio's higher cash level compared to the benchmark.

Our top three contributors to performance during the quarter were:

- **Skechers (ticker: SKX)** – Skechers reported a great second quarter fueled by stellar growth internationally, which drove margins higher than analyst projections. Skechers was a top detractor in the prior quarter and a top contributor in the quarter before that. Despite the volatility, it has returned 63% in the calendar year-to-date period and has been one of the Portfolio's top contributors to performance over this period.
- **SP Plus (ticker: SP)** – This parking lot operator steadily ground higher during the quarter. The stock performed notably well during periods of volatility, and we believe many investors may be drawn to SP's defensive business model during periods of uncertainty.
- **Sykes Enterprises (ticker: SYKE)** – A leading outsourced call center operator, SYKE reported in-line results for Q2 2019 but communicated a very positive outlook about upcoming customer and program ramps through early 2020. Combined with aggressive share repurchase activity in the quarter, the outlook fueled investor optimism about the company that drove the stock higher.

The top three detractors to performance during the quarter were:

- **Garrett Motion (ticker: GTX)** – Garrett's stock suffered along with other auto manufacturers and suppliers as the global slump in the auto industry continues to worsen. Despite its sensitivity to the auto cycle, we think investors are overlooking the company's flexible cost structure, excellent returns on invested capital, and secular growth opportunities from increased penetration of turbochargers. Although the business is saddled with some debt and legacy liabilities, we think these are manageable given the company's robust free cash flow generation.
- **Greensky (ticker: GSKY)** – Greensky reported Q2 2019 results on August 6th that demonstrated significant operating deleveraging despite 20% or higher growth in its key operating metrics. The company also pulled its full year guidance and announced a review of strategic alternatives. While the growth profile of the company remains attractive, we divested our position entirely due to concerns about the performance of the business model that was not scaling profits with revenue, making the company difficult to value with a high degree of confidence looking forward.

- **Cabot Oil & Gas (ticker: COG)** – Cabot's stock suffered during the quarter due to continued weak natural gas prices and the deliberate reduction of its 2020 production growth plans. With a great balance sheet and a position as one of the lowest-cost producers, we are very comfortable with Cabot's ability to manage through the challenging gas environment and applaud their decision to scale back production until prices improve. However, given the difficult supply environment, we did slightly reduce the Portfolio's overall exposure to Energy during the quarter.

Positioning

We continue to judge ourselves by the framework we laid out in past commentaries:

i) **Avoiding large drawdowns on your capital**. The Portfolio has clearly performed well on this objective, highlighted by substantial outperformance during the fourth quarter of 2018 when the Portfolio returned -3.46%, net-of-fees, versus the benchmark Morningstar Small Cap Index return of -19.54%. The Portfolio also outperformed in May and August of 2019 when volatility briefly re-emerged.

ii) **Taking advantage of volatility.** The Portfolio used these bouts of volatility over the last twelve months to transform its positioning, increasing its equity exposure by over 3x and reducing cash levels from 82.5% to 44.6% as prices for high-quality small cap stocks increasingly reflected more attractive risk/return profiles.

iii) **Generating positive absolute returns.** Despite slightly outperforming the benchmark during the quarter, we are disappointed to deliver a slightly negative absolute return.

As a result of the activity described above, the Portfolio looks quite different than a year ago – most notably with the percentage of the Portfolio invested in equities increasing from 17.5% to 55.4%. However, these changes were made in a manner consistent with achieving our objectives above.

We believe this positioning bodes well for future performance. With over three times as much exposure to small cap stocks, the potential return profile of the Portfolio is much higher than a year ago. And with 44.6% of the Portfolio still held in cash, we retain the ability to be flexible and opportunistic should volatility continue within our high-quality small cap stock universe.

We hope to have the opportunity to continue to exploit this positioning and stand ready to do so. Our track record over the past year of deploying significant capital quickly – and in a disciplined manner – stands as a testament to this ability.

As part of that activity, we deliberately avoided some of the most high-flying small cap growth and technology stocks due to obvious concerns about profitability and valuation. Late in the quarter, coinciding somewhat with the value/growth rotation mentioned above, these stocks experienced extreme volatility – with some down 30-50% in short order. This change in sentiment was perhaps most evident in the initial public offering market, where front-page stories appeared almost daily during September about how popular but unprofitable recent IPOs were hitting new lows, including Uber (ticker: UBER), Lyft (ticker: LYFT), SmileDirectClub (ticker: SDC), Chewy (ticker: CHWY), Slack (ticker: WORK)[2], and Farfetch (ticker: FTCH), or getting cancelled altogether (WeWork).

Our primary focus is always on capital preservation. Our three goals highlighted above are designed to create guardrails to take risk with your capital when you are adequately compensated, and avoid risk when you are not.

As a result, you can be confident that any future declines in cash levels will be based on the opportunity to allocate that cash in a manner that we believe can generate attractive risk-adjusted returns on your capital, and not a pre-determined path to get more invested or blindly chase the best-performing sectors.

In summary, we will continue to manage the Portfolio in a very flexible and opportunistic – yet disciplined – manner. Thank you for your investment.

2 Slack was a direct listing, and while not technically an IPO, first began trading publicly in June 2019

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

As most US market observers are aware, high earnings growth and high valuations have been the common characteristics shared by the top-performing stocks for the better part of the last half decade. Late in the third quarter, however, equity market participants witnessed a violent rotation out of momentum and high growth and into value. As is often the case with abrupt trend reversals, there was no warning and no specific catalyst or identifiable reason for the change. The most popular thematic trades this year – long the dollar, Treasuries, long-duration bonds and stocks in defensive sectors – simply worked until they didn't.

While you wouldn't know it from the flat S&P 500 headline return, September 9, 2019 marked the worst single-day momentum unwind in U.S. equities this decade.[3] We have highlighted in the last two quarterly letters that growth has been favored over value for an extended period of time, so the change did not come as a surprise. In fact, we were astounded by how long investors seemingly ignored fundamentals and the extreme disparity between the relative performance of growth and value.

While value stocks received some love late in the quarter, let's be clear – this may not be the start of a new trend. It may very well be nothing more than a reset in valuations for the most expensive equities. However, many economic indicators are beginning to turn, while others are already signaling a slowdown. If there is something bigger on the horizon, like a recession, we believe value is undoubtedly the best place to be in the equity markets.

The Intrepid Disciplined Value Portfolio (the "Portfolio") returned 2.57%, net-of-fees, for the third quarter ending September 30, 2019, compared to -0.09% for the S&P 400 MidCap Index, 1.70% for the S&P 500 Index, and -2.40% for the Russell 2000 Index. We were pleased with how the Portfolio navigated through the quarter, which included the first Fed Funds Rate cut in over 10 years, followed by a sharp selloff in August and another rate cut in September.

We continue to find pockets of value in unloved and misunderstood parts of the market. One example is Select Interior Concepts (ticker: SIC), an undervalued small cap that started trading publicly about a year ago and is only followed by two sell-side analysts. The Atlanta-based building materials and services company completed a direct stock listing last year, and in doing so missed out on the publicity surrounding a traditional IPO. As a result, it has likely fallen under the radar of many investors. We began building a position late in the second quarter and into the third quarter. Today, it is the largest holding in the portfolio. The company operates in two segments – Residential Design Services (RDS) and Architectural Surfaces Group (ASG) – that were part of a roll-up strategy beginning in 2014 by Trive Capital, but whose roots extend back over 30 years.

Residential Design Services is a leading provider of interior design and installation services for flooring, countertops, and cabinets and accounts for roughly half of the parent company's operating profits. It operates 35 locations, including 21 design centers. RDS is commissioned by top national builders including Toll Brothers, D.R. Horton, and Lennar, to work directly with the homebuyers to help customize their home with the specific style they want to achieve. Upselling is one of the business' core strengths, as it has had an 85% success rate in convincing buyers to upgrade from the standard choices to higher margin products, which benefits both RDS and the homebuilder due to a revenue share agreement. Furthermore, RDS has built a reputation for dependability – it has never missed a closing date deadline in its 30-year history, which is likely one reason why 90% of its business has been repeat customers. This business has strong organic growth and is expanding geographically via tuck-in acquisitions. The market is highly fragmented, with the top six players combining for only 20% market share. The remainder is composed of small regional and local operators, which RDS has been able to acquire at very attractive multiples.

Architectural Surfaces Group distributes natural and engineered stone slabs and tile. About 60% of sales is repairs and remodeling, which have tended to hold up relatively well in recessions. As a distributor, ASG's business model has high variable costs, allowing management to quickly adjust if end market demand fluctuates. This business is expanding as well and currently has about 8% national market share. Management has opened three storefronts in new local markets as a test, and the results have been promising. The upfront investment is about $1 million and at the end of 12 months the stores are at a run rate of $1

3 Kawa, Luke. "Everything that Worked in Global Markets in 2019 Suddenly Doesn't." *Bloomberg.com.* 10 Sept 2019. Web. Accessed 3 Oct 2019.

million in EBITDA. Longer term, we believe this may be an avenue of growth, but in the near term most of the growth is expected to come by way of small accretive acquisitions in addition to steady organic growth.

We purchased shares at less than 7x EBITDA, which is a discount to where peers trade. One potential catalyst for a higher price would be a split of the two businesses into separate companies. There is very little cross selling or synergies between Select Interiors Concepts' two segments, and a breakup could add value by allowing the public markets to value them independently at different multiples. After pressure from an activist investor, Select's board of directors announced in May that it has hired an advisor to oversee a formal strategic review, which we view as a positive development.

Another potential near-term catalyst would be refinancing ASG's term loan, which carries a balance of $154 million and an egregious effective interest rate of 9.69%, or about 600 basis points higher than the rate charged on its credit facility. We believe the shares of Select Interior Concepts are materially undervalued under the current structure and agree with the activist in that significant value would be unlocked via a strategic action like a split or outright sale of the business.

The top three contributors to the Portfolio in the quarter were Skechers USA (ticker: SKX), Vistra Energy (ticker: VST), and Dollar General (ticker: DG).

A shoe business may sound like a boring investment, but Skechers is quite the opposite. It has both a wholesale business and retail stores, and it sells its products globally. Skechers is expected to grow much faster than the industry, yet it is priced as if it is an old sleepy brand. In its most recent earnings report, the company blew out sales and margins expectations. We used this as an opportunity to trim our position as shares approached what we estimate as intrinsic value. Later in the quarter, as more news broke about Chinese tariffs, the shares came under intense pressure despite management's claim that the company has no tariff risk. We repurchased shares after they had fallen to levels that we deemed to more than discount any potential tariff risk, and we continue to hold a moderate sized position today.

Vistra Energy is one of the largest power producers in the country and is a position we discussed last quarter as a top detractor. We noted that despite having hedged 100% of its natural gas and power price exposure for the year, the market did not care. Shares were punished due to unfavorable weather trends in Texas that had caused a sharp selloff in 2019 and 2020 peak prices. If the market was determined to overreact on the downside, we were happy to see that at least the same pattern held true when Texas experienced an extended heat wave this summer, causing peak power prices to skyrocket. The shares reacted positively and shot back up to the highs for the year. We continue to view Vistra as an attractive and undervalued business.

Dollar General operates 16,000 stores across the country selling low-priced goods. It has been a long-term holding in the Portfolio. We increased our position size in March after the market overreacted to what we considered a solid earnings report. The company has executed flawlessly in the two earnings reports since then, which has helped buoy shares. Dollar Tree (ticker: DLTR) shares have significantly lagged Dollar General's this year as it works to turn around its Family Dollar banner. While we still admire Dollar General's business, its valuation is extended. On the other hand, Dollar Tree remains undervalued and it represents our largest holding. We believe that the dollar stores are uniquely positioned in the retail landscape. They have a long runway of future growth and remain insulated from some of the risks other retailers are facing.

The top three detractors in the quarter were Teradata (ticker: TDC), Party City (ticker: PRTY), and Discovery (ticker: DISCK).

Data analytics and data solutions company Teradata has disappointed investors in back-to-back quarters. It announced earnings at the beginning of August that were again muddied by its transition to a subscription model. We believe investors were disappointed with the 11% constant currency recurring revenue growth, as well as guidance that implies a sharp acceleration in the fourth quarter. We believe that once free cash flow begins to grow again, the shares will rerate. The timing of the inflection has taken longer than we originally expected, but we anticipate seeing evidence of an upward trajectory in the intermediate term. Historically, management has opportunistically bought back shares after material declines in price, and we suspect the company may be a buyer at current levels. As part of our risk management process, we did not add to the position during the quarter

despite it hitting new 52-week lows. Assuming the transition goes as planned from here, we value the business significantly higher than where it trades today.

Party City is the leading party goods and Halloween retailer in North America. Our investment did not work out as planned. The helium shortage proved to be a bigger problem than we expected and much worse than management had initially communicated to shareholders. The issue has not been fully resolved after a year, and while the company has found additional sources for helium, it comes at higher prices. The company carries a large debt load – something we typically try to avoid – which has proven to be problematic as sales have been negatively impacted by the helium shortage. The company is now focusing on deleveraging by selling off assets like its Canadian stores. Our initial thesis did not play out as expected, so we acted by exiting the position during the quarter.

Discovery is one of the world's largest pay television programmers. Its brands include Discovery Channel, TLC, Animal Planet, HGTV, Food Network, and many other popular networks. Discovery's poor share price performance in the quarter was not due to a deterioration in underlying business performance. In fact, Discovery reported accelerating US ad growth, US affiliate fee growth, international ad growth, and international affiliate fee growth. The shares outperformed some competitors, so we would point to negative sentiment surrounding the industry as the culprit for Discovery being a detractor in the third quarter. We used the weakness to add to our position.

The Portfolio exited the quarter with a high cash level of 14.8%. The increase is largely a byproduct of exiting several positions, including Party City and Western Union (ticker: WU), which hit our valuation. From a risk control standpoint, we believe the portfolio is defensively positioned yet the valuations of our current investments leave room for significant upside. We continue to work through our list of potential new investments and remain excited for the future prospects of the Portfolio. Thank you for your investment!.

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

When is the last time you thought about plumbing? Probably after a pipe burst in your home. Like many things that do not break often, plumbing becomes relevant when it stops working. The same can be said of the esoteric plumbing that props up the modern financial system – most people do not start thinking about it until it starts to break down like it did in September.

The rickety pipe that started to leak in the financial system's plumbing in September is the market for repurchase agreements, commonly known as the "repo market." Over $3 trillion worth of debt is financed each day in the repo market, making it one of the largest and most important components of a healthy, liquid financial system. The repo market enables banks and financial institutions to raise cash by lending collateral, oftentimes overnight, in exchange for what is usually a small amount of interest.

However, in September repo rates spiked as high as 10%, forcing the Federal Reserve to begin an open market operation to soothe this important short-term funding market and stabilize rates. This operation represents the first direct injection into the banking sector by the Fed since the Great Financial Crisis. The cause of the repo rate spike is complicated but stems mainly from a supply/demand imbalance. To be more specific, there were not enough parties willing to lend money overnight to satiate the demand for cash. Therefore, to entice more overnight lenders, repo market participants that needed cash were forced to pay higher and higher interest rates. When banks cannot get access to cash through repo markets, bad things start to happen. One of the reasons banks like Lehman Brothers failed over a decade ago was because they were unable to tap repo markets.

Other rates are also affected by the repo market. Volatility in the repo markets briefly pushed the effective federal funds rate to 2.30%, above the upper limit of the Fed's target range. The secured overnight funding rate (SOFR) also spiked to 5.25% in mid-September, over 300 basis points above where it was earlier in the month. SOFR, which will likely replace LIBOR as the de facto benchmark rate for floating rate securities, affects about $285 billion of outstanding debt. Prolonged spikes in SOFR could have catastrophic consequences for overleveraged borrowers that would have trouble servicing debt that is suddenly twice as expensive.

The Fed will likely continue having to bolster money markets to prevent more leaky pipes. As this letter goes to print, Federal Reserve Chairman Powell just announced a plan for boosting the level of bank reserves on the Fed's balance sheet through the purchase of Treasury securities. Early estimates call for around $200-$400 billion of stimulus from these measures. Even though the Fed is adamant that this is not another bout of quantitative easing, we cannot help but scratch our heads and wonder what the difference is. At some point, injecting all this capital into the financial system will have consequences.

Over the past several quarters we have written about the perils we see presiding over the credit market. Add the volatility in repo markets to the litany of other concerns we have, including record levels of debt, weak covenants, and inflated ratings. In this perilous environment, we continue to cautiously evaluate every potential investment opportunity and we remain biased towards short-dated credits issued by companies with stable cash flow generation and healthy balance sheets.

The domestic fixed income markets produced strong results during the quarter ended September 30, 2019, led once again by a decline in rates. The Bloomberg Barclays US Aggregate Bond Index (the "Aggregate"), which is a broad measure of the investment grade fixed income market in the United States, produced a 2.27% gain. The Aggregate's relatively high exposure to longer duration US Treasury and agency securities meaningfully assisted the index's return and was only slightly offset by modestly widening corporate debt spreads.

Investment grade corporate bonds returned 3.07%, as measured by the ICE BAML US Corporate Index. The lower quality ICE BAML US High Yield Index was up 1.22%. Given the Intrepid Income Portfolio's (the "Portfolio") shorter duration and higher quality biases, we also cite the shorter-duration Bloomberg Barclays US Govt/Credit 1-5 Year Total Return USD Index (the "1-5 Year TR Index"), which gained 0.89% over the same period.

The Income Portfolio returned 0.44%, net-of-fees, in the third quarter. Given the Portfolio's shorter duration, we did not benefit as much from declining rates as the indices we cited, which accounted for most of the performance disparity. We also saw spreads on some of our high yield positions widen during the quarter. We have cut down our exposure to some of these positions as we anticipate more volatility and further widening of spreads as this cycle draws closer to an end.

The Portfolio's three top contributors for the quarter were Central Garden 5.125% due 02/01/2028, Vitamin Shoppe convertible notes due 12/01/2020 and Great Western 9% due 09/30/2021.

Central Garden notes continued to be the beneficiary of a sanguine interest rate environment. The return for the quarter has less to do with the business fundamentals than with the price increase caused by these lowering rates. As one of our few longer-dated positions, we were fine with the duration and happy to participate in some of the upside. However, towards the end of the quarter we decided to lock in our gains as the bonds had run up quite a bit from our purchase price.

In August, Vitamin Shoppe (ticker: VSI) announced it was being purchased by Liberty Tax (ticker: TAXA), which sent our convertible notes from the high 80's to just under par. We believe the convertible notes will be called at par once the deal closes sometime in the 4th quarter. VSI is emblematic of the type of fixed income securities we like to own – creditworthy, unrated, neglected (broken converts are often passed over), and small (these converts only had $60 million outstanding). We continue to diligently search for more credits like this one.

Great Western (ticker: GWB) announced 2Q19 results in July and completed the redetermination of their credit facility, which was a nice positive for the notes we owned. Despite E&P securities being extremely volatile during the third quarter, these 9% notes continued to trend up into the upper 80s, well above our purchase price. Although we continue to like the credit, we have reservations about E&P sentiment and the credit window for near-dated maturities like this one. Therefore, we decided to take our gains and exit this position.

The Portfolio's three top detractors for the quarter were Ensign 9.25% due 4/15/2024, LSC Communications 8.75% due 10/15/2023, and Unit Corporation 6.625% due 05/15/2021.

Ensign (ticker: ENSG) and Unit Corporation (ticker: UNT) were two of our other energy holdings that were volatile throughout the third quarter. In the case of Ensign, the company continued to prove out the synergies from their Trinidad acquisition and pay down debt. Despite this progress, the sentiment around E&P service companies worsened considerably during the quarter and the notes traded down into the mid-90s. We still believe the bonds to be creditworthy but anticipate more volatility until the company is able to deleverage more. We reduced our position accordingly but would consider buying back bonds if the dollar price dropped more from here.

Unit Corporation is a name that Intrepid has owned on the debt and equity side in the past. Although this company has been around for decades and survived multiple commodity cycles, their 2nd quarter results this year were abysmal. Before that print, we felt good about the company's strong balance sheet, with less than 2.0x leverage, long-tenured management team, and diversified portfolio of upstream, midstream, and drilling assets. However, during the second quarter the company's differentials on the upstream side of the business widened, rig utilization declined, and the company started to draw on their previously untapped revolving credit facility, bringing the leverage multiple up.

Following the earnings announcement, the bonds tumbled on the market's anticipation that Unit would have trouble refinancing their 2021 notes, which became callable at par in July. Although we believe Unit will find a way to refinance the notes, we decided to reduce our position given the volatility we expect between now and whenever that happens. The company announced it planned to cut capital expenditures in the back half of the year and generate free cash flow to pay down the revolver. We will scrutinize the company's results carefully to see if they are able to deliver on this promise of deleveraging over the next couple of quarters.

We have now entirely exited our position in LSC Communications (ticker: LKSD). Back in mid-June, the U.S. Department of Justice (the "DOJ") unexpectedly sued to block Quad's (ticker: QUAD) acquisition of LSC, which sent the bonds lower. At the time, we were told by LSC's management team that they were going to fight the DOJ decision in court. Normally these DOJ lawsuit processes take months and sometimes even years to play out, and we believed that there was a good chance the deal might eventually get approved. In the meantime, we figured LSC would hum along and we would continue to clip an attractive 8.75% coupon. A month later, however, another unexpected announcement surfaced stating that LSC and Quad had called off the merger and would no longer challenge the DOJ. This indicated to us that Quad no longer felt LSC was worth pursuing and that the company's operating results, which had not been stellar during the period when it looked like the deal might close, were probably not faring well. We decided to sell right after the deal was called off and it proved to be good timing – since then, the bonds have sold off another 10 points.

Several of the Portfolio's short-term bonds matured in the third quarter, including two of our larger holdings in Twitter (ticker: TWTR) and Sherwin-Williams (ticker: SHW). We also had six positions called during the quarter. The maturing and called issues were replaced primarily with investment grade bonds maturing in the next two to ten months. We believe opportunities are also present in the front end of the high yield curve, and we are working hard to find new positions with adequate yield for their risk as credit spreads continue to widen.

Since the end of the quarter, U.S. Treasury yields have continued to trend down. The benchmark 10-year yield continues to flirt with 1.5% compared with 3.2% in the first week of October last year, which was the highest level since early 2011.

The consensus projection is that the Federal Reserve will continue to consistently lower rates over the next year, whereas a year ago the consensus was they would continue to raise rates. A lot can change in a year.

Although we are pleased with the risk-adjusted return of the Income Portfolio over the last year, we are even more excited about how we are positioned going forward. We believe the portfolio is well constructed and will enable us to redeploy cash from maturities into higher-yielding securities as they become available. As we have said over the past several quarters, we continue to see signs of excess in the credit markets, including the cracks in the financial system's plumbing, i.e. the repo market, historically high leverage ratios across ratings, and loose covenants.

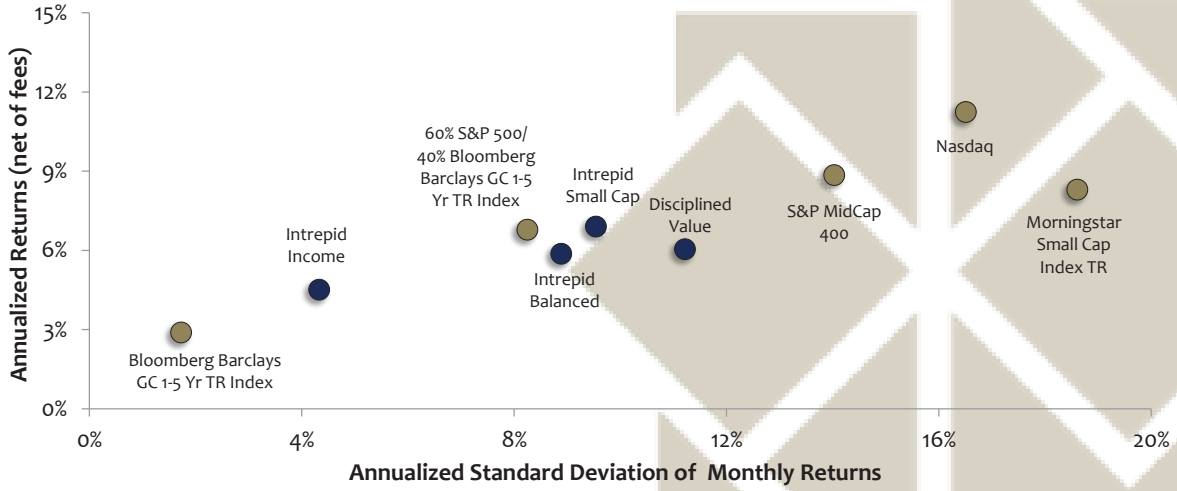
We do not deploy capital based on an expectation that lenders will continue to underwrite debt to grossly overleveraged companies forever, and we will not pretend to be able to forecast the direction of interest rates. We will continue to follow a bottom-up process to identify attractive fixed income investments and apply rigorous fundamental analysis when analyzing credits.

Risk Adjusted Returns

Intrepid Capital

Trailing 15 Year Risk/Return

September 30, 2004 to September 30, 2019



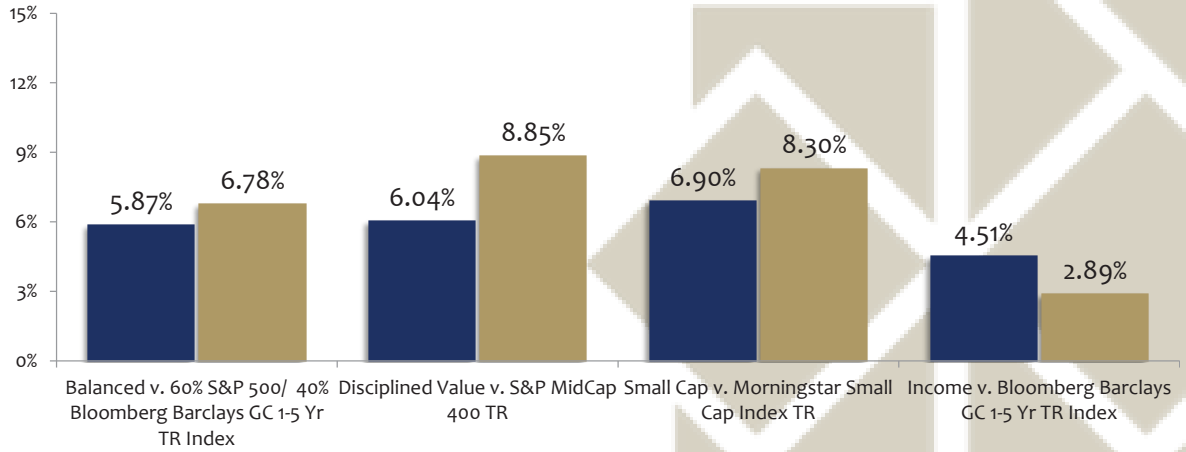
Past performance is no guarantee of future results. Intrepid composite returns are presented net of investment advisory fees and all returns are presented annualized for the 15-year period ending September 30, 2019. Returns reflect the reinvestment of dividends and other earnings. The volatility of the 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

September 30, 2004 to September 30, 2019



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