Intrepid Capital
MANAGEMENT INC.

4Q 2019

Index Returns	
10/1/2019 to 12/31/2019	
Dow Jones:	6.67%
S&P 500:	9.04%
NASDAQ:	12.47%
Russell 2000:	9.94%

QUARTERLY COMMENTARY

January 2020

Dear Friends and Clients,

This letter always causes me to stop (however briefly!) and reflect on the past, whether it is the most recent quarter, the past year, 5 years, 10 years, etc. In today's case, it is a much deeper reflection looking back on 25 years since cofounding Intrepid Capital with my father, Forrest. We celebrate our firm's 25th birthday this month.

I sit here today as a 58-year-old, having spent my entire working career in the investment management business; it will be 36 years this summer. At the time I started the firm, I fled a high paying job, up the freight elevator in the now Bank of America tower in downtown Jacksonville, despite a wife at home with our first of two children (who was just 1 year old). I left with the simple idea of creating something better for our clients; a place where my team and I would coinvest with clients, on identical terms as fiduciaries.

Despite an environment that has been challenging for asset management companies, in my opinion, this firm has survived and thrived for the last 25 years for two reasons: 1) a philosophy of balancing both risk AND reward to obtain optimal results for our clients, and 2) staying steadfast to that philosophy despite short-term market conditions.

I named the firm Intrepid Capital after Ted Turner's America's Cup sailboat. The name implies it is not for the faint of heart. This is not to say that I was going to openly embrace risk; I wasn't then and I'm not now. The name to me was more centered around the necessity to look different than our peers, sometimes for the better and sometimes for the worse. While I can proudly show a long-term track record that has outperformed comparative indices the last 20 years (1999-2019), the last five years have been humbling.

Said another way, Intrepid has been successful for clients long-term because it has been willing to look different than the typical money manager - often in a way that meant managing risk more closely when conditions warranted, but at times increasing risk when we saw it as favorable for long-term client outcomes. As a result, I have oftentimes thought of myself as a "Risk Manager" just as much as a "Portfolio Manager."

Unfortunately, over the last five years, our philosophy of managing risk while seeking reward has not kept up with strategies that can be characterized as "highly risk-seeking." We are not proud of our underperformance over this period and are taking aggressive steps to address it. But we also want to emphasize that – over our 25 year history – we have been through periods like this before, and have come through them with our clients in a stronger place each time by remaining focused on risk. Our 25 years of experience covering several market cycles suggests that portfolio managers are like pilots in that "There are old pilots, there are bold pilots, but there are no old bold pilots."

This does not mean we are standing by and simply waiting for market trends to turn in our direction. We remain hard at work finding attractive opportunities – based on a balance of risk AND reward - for the capital you entrusted to us. This past year has been especially fruitful in that sense, as we purchased more new ideas in 2019 than we have in many years. We attribute this increased activity to the same spirit of continuous process improvement we have employed over the past 25 years and are particularly excited about our most recent process tweaks based on early results.

We look forward to Intrepid's next 25 years of navigating through the constant change in the markets. We are thankful for our clients' trust as we continue to employ our "risk manager"-focused strategy, which we think is especially important today in a world where investment portfolios look more and more similar due to the increasing prevalence of indexing. While recent market returns have been dominated by stocks with large weights in the common indexes as investors aggressively seek higher risk profiles, you can entrust Intrepid to stay differentiated from its peers and continue to manage risk prudently.

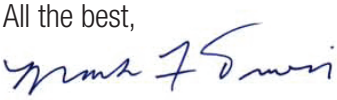
As a real-life example, our balanced strategy mutual fund has the unusual distinction of making The *New York Times* "Mutual Fund List" twice: as a 5-year performance leader in 2011 (when managing risk was rewarded well) and a 5-year performance laggard in 2019 (when managing risk was not rewarded). Same guy, same place, doing the same thing: employing an investment strategy that has done well for clients for over 25 years.

This is the hallmark of the Intrepid name and the driver of our past success. With this philosophy in place, we believe the next twenty-five years should be even more rewarding for our clients.

As for the short-term, for the three months ended December 31, 2019, the Intrepid Balanced Portfolio (the "Portfolio") increased 2.85%, net-of-fees, compared to 5.59% for the benchmark consisting of 60% S&P 500 Index/40% Bloomberg Barclays US Gov/Credit 1-5 YR Index. The largest contributors during the period were Jefferies Financial Group (ticker: JEF), Sykes Enterprises (ticker: SYKE), and Skechers USA (ticker: SKX). The three largest detractors were Vistra Energy (ticker: VST), Select Interior Concepts (ticker: SIC), and Dollar Tree (ticker: DLTR).

Happy 25th Birthday, Intrepid Capital! And thank you to our clients and shareholders for their trust in us. 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

Equity indexes surged in Q4 to cap off the best year for the stock market since 2013. It is quite remarkable how the collective narrative has seemed to yo-yo back and forth this year about how much longer this economic expansion, which is now the longest ever, can continue. The market shrugged off concerns of slowing global growth and a hawkish Federal Reserve in the first quarter of the year, rebounding from the plunge in equities to close out 2018. Worries began to mount again later in the year though, as industrial activity weakened significantly, interest rates tumbled, gold surged, and many speculated that this was a leading indicator of an approaching recession. However, these concerns seemed to recede in the fourth quarter after macro data improved and the Federal Reserve resumed its purchases of treasuries.

As we turn the page on the year, this is about the time when most market pundits and strategists publish their forecasts of what stocks will do in 2020. When one considers how much can change in a year and how quickly markets reflect these changes – as we saw in 2019 – predictions about where stocks will wind up a year from now seem futile. We are reminded of the above quote from the legendary NY Yankees Catcher when we read these prognostications from the experts.

We are often asked where we think the stock market is headed. After all, we are professional stock pickers – shouldn't we have an informed opinion on whether the market will go up or down? Many are left unsatisfied at our "I don't know" responses. We find it unproductive to try to estimate where the entire market will wind up at some point in the future. It's incredibly difficult (impossible?), in our opinion, to consistently forecast how macro factors, geopolitical events, collective psychology, etc. will drive market prices. Instead, we concentrate on analyzing individual businesses whose long-term intrinsic values can be estimated more accurately, we would argue, than the price of an entire market.

That's not to say we have no view on the price of the market and how it impacts our positioning. In general, our positioning (aggressive or defensive) will be based on (a) the prices of our opportunity set and (b) an analysis of where we are in the business cycle. As to the former, we believe small cap stocks are expensive. We have written about this at length in prior letters, and we need not rehash these same points again.

As to where we are in the business cycle, we think this is a more interesting question. There are good reasons to support those in the camp professing that we are late cycle as well as those who claim there is still plenty of room for this expansion to continue. In our opinion, it's hard not to at least acknowledge that we are on the back nine of the cycle given that we are just months away from entering year 11 of the longest running expansion in post-war history. Enormous (and rising) levels of corporate and public debt, high asset prices and investor optimism also suggest we are late cycle. On the other hand, consumer statistics are strong, and we do not see troubling signs of inflation or pockets of significant overcapacity that normally signal late-cycle dynamics. Furthermore, the willingness and ability of the Federal Reserve to support asset prices and continue this expansion are unprecedented.

Where does this leave us? We believe caution is warranted and have positioned the Intrepid Small Cap Portfolio (the "Portfolio") defensively as a result. The businesses that populate the portfolio tend to be priced attractively, in our opinion, and are not dependent upon cheap financing and continued cyclical expansion to compound intrinsic value. Though it is perhaps not the popular opinion on Wall Street at the moment, we have found that superior long-term results do not come from following the herd.

Return & Positioning

The Intrepid Small Cap Portfolio returned 4.85%, net-of-fees, during the first fiscal quarter (calendar Q4 2019) compared to 8.67% for the Morningstar Small Cap Index benchmark. Our relative underperformance was mostly the result of our large position in cash & treasuries which averaged approximately 40% of the portfolio during the quarter. The Portfolio's relative performance was slightly better compared to value-oriented benchmarks which trailed growth stocks once again in the quarter.

The Portfolio ended the calendar year with 61% invested in stocks and 39% invested in short-term treasuries and cash. The year was marked by a number of new purchases and a much higher exposure to stocks than it had at this time last year when cash and treasuries accounted for 73% of the portfolio. As noted in previous letters, the level of cash in the portfolio is not a predetermined target, but rather a byproduct of the prices of our opportunity set. With that said, we would not expect the level of cash to continue to fall at the same rate that it was deployed in 2019, particularly now that small cap stock indexes neared all-time highs at the end of the year. Most of the stocks we follow are trading well above our intrinsic value estimates, and we still believe small caps are broadly expensive. There would most likely need to be significant volatility in the equity markets in order to deploy a similar amount of cash in the upcoming year.

However, with its highest equity exposure in years, we believe the Portfolio is positioned to generate attractive future absolute returns. Perhaps more importantly, we also expect the large cash position and bias toward highly cash-generative businesses to provide meaningful protection should stocks pull back. We think this level of prudence is warranted, particularly considering the outright bullishness (exuberance?) we are observing from others in the market. We stand ready to deploy this capital should our opportunity set become cheaper.

New Purchases

The Portfolio added four new positions during the quarter:

- **Acuity Brands (AYI)** – Acuity Brands is the market leader in US commercial lighting and control systems. Not to be confused with simple, commoditized light bulbs, Acuity manufactures higher end luminaries used in commercial and industrial applications (e.g. streetlights). It is a high-quality business that has generated significant free cash flow, enjoyed high returns on invested capital, and has a great balance sheet. We purchased the stock immediately following a disappointing Q3 earnings report. Although the high growth years of LED conversion are behind them, we think the next cycle of conversion to connected lighting could drive attractive longer-term growth. We initiated a relatively small position due to cyclical risk.

- **Becle SAB de C.V. (CUERVO MF)** – As you may have guessed by the ticker, Becle is the spirits company which owns the *Jose Cuervo* brand of tequila. Despite being the second oldest company in Mexico, Becle only went public in 2017. Tequila has had an impressive rise in popularity over the last decade and Becle is the dominant global player with a market share of approximately 30%. The company has experienced some recent margin pressure as the tequila category has grown, but we think this will mostly prove temporary. Like many large spirits companies, we think Becle is a great business that has tremendous long-term value, particularly if tequila's popularity stretches overseas.

- **Etsy (ETSY)** – Etsy is the leading online marketplace for handmade crafts and other goods. On their website, Etsy.com, you can shop for things like jewelry, clothing, wedding gifts, art, etc. Etsy was a relatively unique purchase for us, in that it has a short operating history (founded in 2005) and we paid a higher multiple of earnings than our typical purchases. For this reason, we think a longer explanation is justified.

  Etsy does not manufacture or sell any goods themselves. Rather, it is a marketplace that aggregates third-party buyers and sellers. For its part, Etsy receives a commission on each item sold on their platform. Digital platform business models like this scale exceptionally well as there is no need to invest in additional physical infrastructure as the number of buyers & sellers grows (Amazon's *Marketplace* and eBay are other examples). As more sellers list their goods on the Etsy website, it entices more buyers to shop on the site which in turn attracts more sellers. This virtuous feedback loop of network growth can create a flywheel of earnings growth that is tremendously valuable. In Etsy's case, we believe its network has become large enough to mostly insulate them from competition in this niche marketplace. In fact, Amazon tried to launch its own competitor in 2015, *Amazon Handmade*, but to date has not been able to gain much traction.

  Etsy also has a quality that is surprisingly unusual among fast-growing technology companies – it actually makes money! Etsy is growing revenue at over 20% and we expect earnings and cash flow to grow even faster as the company continues to scale margins. We think this is a very rare asset to find in today's market – a fast-growing, capital light, profitable platform business model that is not selling at an obscene valuation. The stock sold off sharply from its highs a few months ago, as we think some investors were uncomfortable with how a couple changes to their business model would impact margins moving forward. We used the selloff as an opportunity to initiate a position. Our estimate of intrinsic value is comfortably higher than where the shares trade today.

- **Keywords Studios (KWS LN)** – Keywords is the largest provider of outsourced video game development. Video games have rapidly increased in complexity through the years and most of the leading game creators choose to outsource certain non-critical functions to outside specialists. This could include things like creating background art, translating language for a game's release in a foreign country, or quality assurance testing of a game. The penetration

of game outsourcing is increasing within a game development industry that is already growing at an attractive rate. With that in mind, we think Keywords has a relatively long runway of low double-digit revenue growth. The stock pulled back in the fourth quarter following an earnings report in which margins contracted, possibly worrying some investors. We share the feeling of the company's management, who have stated this was simply because they incurred various start-up costs associated with opening new facilities to support growth. In our view, this is a business which should compound intrinsic value attractively over the next several years.

One thing that may be apparent from the above purchases is that they generally are higher quality businesses than we have purchased in prior years. By "high quality," we are referring to attributes like growth, returns on capital, clear competitive advantages, management talent and a strong balance sheet. This pivot toward better businesses is part of a deliberate attempt to upgrade the quality of the portfolio. Of course, we've had to pay a higher multiple of earnings for these types of businesses. However, we think the higher prices are more than justified in these cases. Within value investing parlance, these more recent purchases are closer to the "great business at a fair price" end of the spectrum associated with Warren Buffett than the "fair business at a great price" end of the spectrum associated with Ben Graham.

Rest assured that we are not indiscriminately piling into expensive but higher quality stocks. In fact, we think the stocks of good businesses growing at above-average rates (the type that many in the investment community like to label "compounders") tend to be some of the most overvalued stocks that we have come across. Instead, the above positions were initiated after careful analysis and disciplined valuation. The purchases were generally made either (a) at prices materially below similar peers, (b) after significant declines in the stock price, (c) after concluding the market was misjudging some feature of the business, or (d) some combination thereof.

Contributors & Detractors

The Portfolio's top contributors to performance for the quarter were:

- **Sykes Enterprises (SYKE)** – Sykes stock surged following their Q3 earnings report which featured good earnings growth and management pointing to solid growth from new business to come in 2020. We reduced our position following the report.

- **Skechers U.S.A. (SKX)** - Skechers reported an excellent third quarter highlighted by 15% revenue growth and expansion in operating margins. International sales grew over 25% organically and Skechers continues to have massive success overseas, especially in China. We also think easing investor concerns over the trade war may have contributed to the stock's rally in Q4.

- **Jefferies Financial Group (JEF)** - Jefferies stock rallied in the fourth quarter along with the stocks of most other banks. We think this is mostly due to a steepening yield curve and easing fears of a recession that seemed to be more prevalent at the end of Q3.

The largest detractors to the Portfolio's performance for the quarter were:

- **Protective Insurance (PTVCB)** - After the buyout rumors fizzled earlier this year, Protective Insurance stock has mostly been flat in a year when small cap stocks soared. The company hired a new CEO in May who we believe brings a much-needed outsider's perspective to a company that has been plagued by internal corporate governance issues in the past. We believe the new management team is rightly prioritizing profitability over growth, and we expect the significant premium increases to eventually work their way into the P&L in a more meaningful way soon. Although loss ratios are already trending down slightly, we estimate it will take until Q1 or Q2 of 2020 before operating results can inflect more meaningfully.

- **Hanesbrands (HBI)** – Hanesbrands's stock was under pressure throughout the second half of 2019 due to concerns about slowing department store traffic and potential deceleration of its growth engine (the booming *Champion* brand). However, the company has posted very strong results to date, is paying down debt aggressively, and has visibility into significant margin improvement and free cash flow expansion in 2020. We believe the market is distracted by small changes to the top line and is ignoring the improving bottom-line trajectory of this market leading apparel company.

- **Take-Two Interactive (TTWO)** – In early November, Take-Two reported strong quarterly earnings, handily beating sell-side estimates on net bookings, adjusted operating profit, and adjusted EPS (Earnings Per Share). However, TTWO's stock shrugged off the robust quarter, likely because of bookings guidance that came in slightly below consensus estimates. We are still bullish on video game publishers and especially excited about TTWO's upcoming pipeline of releases, which the company calls "the strongest development pipeline in our history." The recent successes of titles like *Borderlands 3* in September and *The Outer Worlds* in October bolster our view that TTWO is a premium content publisher that's very adept at marketing its games. We still believe that as the company continues to scale and reach a wider and wider audience of gamers, margins will trend higher and free cash flow generation will grow at an even quicker pace than net bookings.

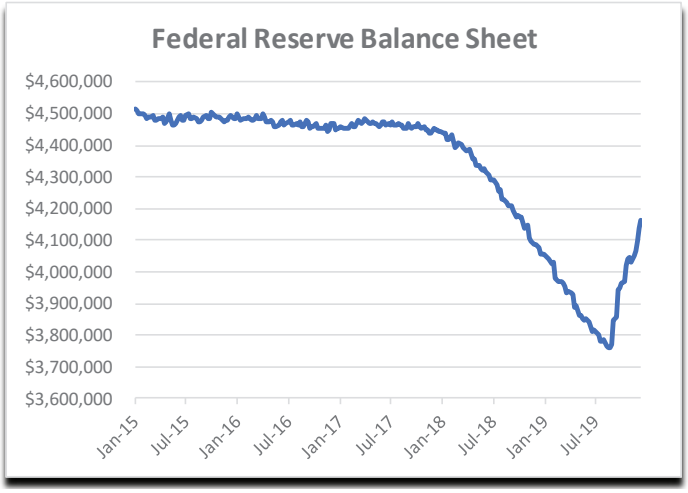
In summary, we remain very optimistic about the future performance of the Portfolio. The quality of the portfolio constituents is higher and the equity exposure is greater, yet we are not abandoning our overall defensive posture. Our large cash position can help to shield us from significant drawdowns while providing the flexibility to be opportunistic in the event of significant future volatility. Thank you for your investment.

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

All is well! It is amazing how much can change in the public markets in such a short period of time. The fourth quarter of 2018 feels like an eternity ago when you consider how sentiment, monetary policy, and the returns of indices have reversed since then. The fourth quarter of 2019 could not have been more unlike that of 2018. Indices experienced very little volatility in the quarter as they rocketed higher capping off the best year since 2013.

The Federal Reserve had already telegraphed that it would be patient and accommodative with interest rates going forward, but it upped the ante on October 4, 2019 when it announced it would extend and expand the "temporary" repurchase operations ("repo") it had begun in September through at least January of 2020. A similar situation took place in 1999 when the Fed's balance sheet expanded as it supplied record amounts of repo ahead of the feared Y2K glitch. In 1999, it helped send the Nasdaq 100 Index up about 50% in the fourth quarter while the S&P 500 Index was up a more modest ~15%. Fast forward to 2019, and we saw a similar effect, albeit not to the same degree.

The Federal Reserve announced on October 11th that it would begin purchasing Treasury bills at a rate of $60 billion per month in the open market in order to maintain ample reserve balances. This program is scheduled to run at least into the second quarter of 2020.[1] While many people consider this to be a form of QE (quantitative easing), Jerome Powell was quick to say otherwise. Call it what you want to call it—the Fed's balance sheet is now rapidly expanding. And that tends to be good for equity markets.



Source: *Bloomberg*

Markets again cheered on October 11th when President Trump announced the U.S. and China had reached a tentative agreement for the first phase of a trade deal. As if "not QE"

1 Board of Governors of The Federal Reserve System. *Statement Regarding Monetary Policy Implementation*. Web. 11 Oct 2019.

and a trade deal weren't enough, the Fed cut the Federal Funds rate for the third time in late October, breathing life into many of the growth stocks that were battered last quarter.

The Intrepid Disciplined Value Portfolio (the "Portfolio") was down 8 basis points, net-of-fees, in the fourth quarter compared to 7.06% for the S&P 400 Mid-cap index, 9.07% for the S&P 500 index, and 9.94% for the Russell 2000 index. Much of the underperformance can be attributed to a rough earnings season. In fact, it was worse than rough. We cannot recall a time where we had as many securities with large (10%+) drops on earnings announcements that were clustered all within a few weeks. Making matters worse, most of these securities were top positions in the Portfolio.

How could you not see it coming? It is a fair question. Stocks can drop significantly for a plethora of reasons, more than most readers would care to hear. Sometimes you can use data to shed light on intra-quarter trends and formulate a view on how the quarter is shaping up. Other times, there may be a major announcement or strategy change in conjunction with earnings that no investor could have discerned. We do not attempt to predict how a stock will react to each quarterly earnings report. Rather, we take longer term views on businesses and focus on those that we believe will grow and increase in value over a multiyear period all while generating strong free cash flow. In a world of immediate gratification, it is hard to preach patience, but that is what is required as an investor—businesses hit bumps in the road.

We added three new positions in the quarter: IAC/InterActiveCorp (ticker: IAC), Alpine Income Property Trust (ticker: PINE), and Etsy Inc (ticker: ETSY).

IAC/InterActiveCorp is a conglomerate with a long history of value creation. It has owned and spun off businesses like Expedia, TripAdvisor, LendingTree, Home Shopping Network, Ticketmaster, and more. The company currently has an 81% ownership in Match Group and an 84% ownership in ANGI Homeservices. It also has a portfolio of other businesses like Vimeo and Dotdash, among others, that generate around $1.5 billion in annual revenue. We purchased IAC after the shares of both ANGI Homeservices and Match Group had fallen materially. At the time of our purchase, the market value of IAC's stakes in those two businesses were worth over $1 billion more than IAC's market value. In other words, the market was assigning a large negative value to the portfolio of smaller businesses that IAC owns. This past summer, management mentioned that it was exploring options on what it may do with its stakes in Match and ANGI. This indicated that a spin of one or both businesses was likely in the near future which theoretically would help unlock the discount in value for IAC shares.

In December, IAC officially announced that it would be spinning off Match Group. IAC will be left with no debt and $2.9 billion in cash on its balance sheet. The following day IAC announced it would spend $500 million to acquire Care.com. The shares have had a positive reaction to both announcements and we continue to own the stock. In this case, we were happy to buy a great business that was trading at a discount to its public market value, and at the same time bet that the fantastic management will continue to create value for shareholders over time.

Alpine Income Property Trust is a recent IPO that is structured as a Real Estate Investment Trust (REIT). Another company that we own in the Portfolio, Consolidated Tomoka, sold/placed twenty of its commercial properties with Alpine in conjunction with the IPO. Alpine focuses on single-tenant net lease properties. It has a high-quality portfolio with an average lease term of over 8 years, 100% occupancy, and Wells Fargo as the largest tenant. The company has zero debt and plenty of liquidity to help fuel growth right out of the gate. If the company exhausts its current liquidity, we estimate that NOI will grow by about 70%. Alpine trades at a ~7.5% cap rate, far higher than its peers. We attribute this to the stigma of having an external management team and small market cap. However, Alpine is different than other externally managed REITs in that the management team is from Consolidated Tomoka, which owns a sizable amount of Alpine common shares as well as units in the operating partnership. In other words, management's incentives are aligned with shareholders since there is an 8% hurdle before it can collect an incentive fee. We view Alpine as a core holding that will grow its intrinsic value at an attractive rate over a long period of time.

Etsy is the leading online marketplace for handmade crafts and goods like jewelry, art, wedding gifts, etc. This is not a typical investment for us due to the higher multiple we paid, but it is a high-quality business that is a market leader with a long

runway for future growth. Etsy operates a marketplace where third-party buyers and sellers come together to transact. Online marketplaces are difficult to build in that you need sellers in place to attract buyers, and you need buyers in place to attract sellers. Etsy's marketplace has grown to a point where we believe it is large enough to be mostly insulated from the competition. It does not manufacture anything so its business model can scale without investment in physical infrastructure. The company makes money by taking a cut of each transaction and it is growing revenue at over 20%. Since it is not a capital-intensive business model, we expect cash flow and margins to grow at an even faster rate as the company scales. For now, it is a small position and we would look to add to it if shares retreat from current prices.

The top three contributors in the quarter were Discovery (ticker: DISCK), Wyndham Destinations Inc (ticker: WYND), and Madison Square Garden (ticker: MSG).

Discovery was discussed in the third quarter letter as a detractor to performance, but after adding to our position on the weakness shares rebounded and it was a top performer this 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. The company is estimated to generate about $3 billion in free cash flow in 2020 and with net leverage below their target 3.0x – 3.5x, we could see more aggressive share repurchases in the coming year. The valuation remains undemanding. Cable tycoon and board member, John Malone, agrees—he purchased ~$75 million of Discovery shares in late November and declared in an interview that the stock is "dramatically undervalued."

Wyndham Destinations is the world's largest vacation ownership and exchange company. Management continues to execute on its plan that was laid out when it separated from the hotel business. There were concerns in the quarter that weather (Hurricane Dorian) might have impacted the business more than anticipated, but the company reported third quarter earnings that beat expectations. The business is generating strong free cash flow which is being used to fund a 3.5% dividend and a robust share repurchase program. The valuation remains compelling at current levels and therefore it is still one of our larger positions.

Madison Square Garden announced it approved the spinoff of all of its entertainment businesses. This is a change from the initial proposal which recommended spinning off the sports businesses. The switch is due to tax efficiency. Additionally, the company disclosed that the entertainment company will not retain any ownership in the sports business, making the transaction much cleaner. This has been on the table for about a year and a half, so it helped provide some clarity as to what the plan looks like. The transaction is scheduled to take place sometime in the first quarter of 2020. Shares still trade at a material discount to the underlying asset value.

The top three detractors in the quarter were Teradata (ticker: TDC), Dollar Tree (ticker: DLTR), and Select Interior Concepts (ticker: SIC).

Data analytics and data solutions company Teradata disappointed investors once again. The company reported solid third quarter results but provided very weak fourth quarter guidance and disclosed that the CEO would be departing. This was enough to send shares 18% lower on the day. We significantly reduced the size of our position. We are concerned with business trends and our conviction in a successful transition has taken a hit. The company remains one of the cheapest software stocks out there but for good reason.

Dollar Tree had strung together a few quarters of solid performance before surprising investors when it reported in November. The company cut its guidance for a variety of reasons. Its gross margin is under pressure due to high freight costs and a higher mix of consumables. Wage pressure continues to push payroll costs higher. And the new list of tariff items acted as another headwind. At the current price, the market is assigning very little if any value to the Family Dollar banner. We believe the situation is ripe for activism as a sale of Family Dollar would likely be well received by investors.

Select Interior Concepts, a residential design/installation and stone distribution company, was discussed last quarter as a new idea. Things went well initially as shares appreciated about 20% from our cost basis. We had valued the business much higher,

so we thought it was too early to begin selling. Unfortunately, shares retreated, and we gave up all of our gains and then some. Select Interior has outsized exposure to the California market, which was sluggish throughout 2019. To combat this, it has been diversifying geographically in order to become less tied to the ebbs and flows of the west coast market. The company reported disappointing results for the third quarter, which implied it would fall short of full year expectations as well. While its stone distribution business continues to plug along, the installation business is facing headwinds. Not only is the market in California weaker than the rest of the country, but many of the new developments being built contain lower-end homes which are lower margin to Select. The company is still undergoing a strategic review, however, and the activist who owned ~10% of the business recently disclosed it had sold out of its stake. Also announced in the fourth quarter was that Bryant Riley would join the board of directors. Bryant is the Chairman & Founder of B. Riley Financial which is the second largest holder of Select Interior Concepts at 11%. We continue to own shares but have reduced the size of the position as a result of the recent developments.

Valuations have become less compelling as the market continues to hit record highs seemingly every day. The Portfolio's cash levels remain elevated at 11.4% as we await opportunities to put it to work at more attractive levels. We are optimistic going into 2020 and thank you for your investment!

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

"A rolling loan gathers no loss."
— Banking adage

The market has a short memory. This time last year, we wrote about an inverted yield curve, a high yield bond issuance drought and how volatile things seemed heading into the 11th year since the global financial crisis. Few predicted that these ingredients would be the recipe for double digit returns in both high yield and investment grade bonds in 2019. Yet here we are, with spreads on corporate debt near record lows to herald in the new decade, and many bonds carrying more turns of leverage than percentage points of yield.

That is not to say volatility has been completely absent. There have been several swings in cyclical expectations this year, with the yield curve inverting again earlier in the year only to snap right back on interest rate cuts and optimism around a trade deal with China. The Fed's unusual decision to ease rates this year despite the backdrop of tightening spreads and equities rallying to all-time highs drove dollar prices on bonds higher and led to a lot of callable debt being retired early. Last year's fears around the ability for highly leveraged companies to refinance their debt were quickly forgotten as over $300 billion of new high yield issuance flooded the market in 2019, up 57% from the previous year according to CreditSights.

We cannot predict when or how this market bonanza fueled by cheap debt and monetary stimulus will end. Our past several commentaries have laid out what we view as some of the biggest risks in today's credit markets, whether it is a lack of liquidity, loose covenants, unstable repo markets, or just too much leverage. We are still wary of these risks.

On the other hand, few economists are predicting an imminent recession and desperate, yield seeking behavior is still pervasive. CCC bonds, the riskiest of performing high yield debt, had a strong rally to end 2019 with spreads tightening to below 1,000 bps for the first time in more than three years. If complacency continues to embolden yield starved investors, we could see this lower-tier debt tighten even further, which could drive big returns for the entire high yield asset class.

This behavior reminds us of the party game *Hot Potato,* where players in a circle toss around a potato while music plays. The player holding the potato when the song stops is eliminated from the game and the last person standing

wins. We fear many fixed income investors are not lending money to risky, poorly rated companies because there is a fundamental investment case for the business to turn around its operations. Rather, these investors are playing a game of *Hot Potato*, hoping the credit jukebox continues to blare music on the Fed's nickel. In this game, investors are no longer focused on how a company can pay down debt on its own merit, but rather how crafty bankers might maneuver a refinancing and convince more people to play the game. As long as there is someone to throw the potato to before the music stops, elimination can be avoided. *A rolling loan gathers no loss.*

We watch other investors play this game of *Hot Potato* with a jaundiced eye. Whether the power goes out or the Fed just runs out of nickels, sooner or later the music always stops, and someone is left holding the potato.

Credit markets had another positive quarter to end 2019, despite some noisy headlines. In October, WeWork withdrew its planned IPO and its unsecured notes due in 2025 tumbled from above par to nearly 70 cents on the dollar before recovering a bit. This felt to us like a long overdue return to sanity for such a risky bond, although we can think of several other cash-incinerating, high yield issuers whose bonds are also due for a price correction.

The Bloomberg Barclays U.S. Gov/Credit 1-5Y TR Index returned 0.50% in the fourth quarter. Given the Intrepid Income Portfolio's (the "Portfolio") shorter duration and higher quality biases, we believe this index is an appropriate benchmark. Investment grade corporate bonds returned 1.15% for the quarter, as measured by the ICE BAML US Corporate Index. The lower quality ICE BAML US High Yield Index saw an increase of 2.61%.

The Income Portfolio returned 1.05%, net-of-fees, in the fourth quarter. We continued to look for short-term, credit-worthy bonds that we believe will produce attractive risk-adjusted returns relative to Treasury bills. We have recently balanced our defensive posture with opportunistic purchases of bonds that we believe will help us participate in any upside left in this aging cycle. That is not to say we have changed anything about our meticulous investment process or the high standards that must be met for any potential holding. We are very excited about the way we are positioned heading into 2020.

The Portfolio's top contributors for the quarter were Cincinnati Bell 8.0% due 10/25/2025, Nathan's Famous Inc. 6.625% due 11/01/2025, and Cincinnati Bell 6.3% due 12/01/2028. The Portfolio's top detractors for the quarter were U.S. Treasuries and Shutterfly Inc. 8.5% due 10/01/2026. None of the detractors for the quarter were material, but we did have a material contributor.

Cincinnati Bell is a wireline operator in Ohio and Hawaii with bonds that offer compelling yield and robust asset coverage. The company has "future-proof" fiber assets that positioned them well to offset declines from legacy copper assets and potentially benefit from 5G once it becomes a reality. We purchased two separate Cincinnati Bell debt issues – the 6.3% secured notes due in 2028 and the 8% unsecured notes due in 2025. We initially purchased the longer-dated secured notes because we liked the fiber assets that secured the notes and felt like even in a worst-case scenario, we would get very close to our principal back. After doing more work on the credit and speaking with the company about their path to organically deleverage their balance sheet, we also purchased the unsecured notes because we believed the 10% yield at the time more than compensated us for the risk. Shortly after purchasing the unsecured debt, Brookfield Infrastructure Partners announced they were acquiring Cincinnati Bell which significantly pushed the prices up of the two debt issues we own. We continue to hold both issues as we believe the yield is still compelling and there is a good chance one or two of the issues will be called once the deal is completed.

Although we had a few other bond positions trade up nicely, the bulk of the Portfolio's returns for the quarter came from interest payments on our existing positions. We had two bonds mature, five bonds get called, and made seven new purchases during the quarter.

The state of liquidity in the fixed income markets has bolstered our view that there is a vital need for active management. Although we saw nothing like the forced selling of December 2018, we have recently observed momentary "flash crashes" in specific securities that we believe were caused by a severe lack of liquidity. In fact, according to a *Wall Street Journal* Article[2], the dips in the high yield market were even more extreme this past autumn than in December 2018 when volatility was rampant. We envision a scenario where passive funds and ETFs could be forced to sell bonds at fire sale prices next time there is widespread panic and money managers hit the eject button. As we have said before, we will happily purchase some of these securities when they are being offered at clearance-level prices.

We remain vigilant in a world of mass uncertainty and overwhelming complacency. As prices gyrate and our short-term maturities come due, we will reassess the risk/reward opportunities that the market is offering and selectively move into higher-risk debt securities when it makes sense. As always, our top priority is generating stable, reliable income and avoiding any situations that put your hard-earned principal at risk. We will continue to follow a disciplined process to find attractive investments and be exceptionally discerning when lending businesses money. Thank you for your investment.

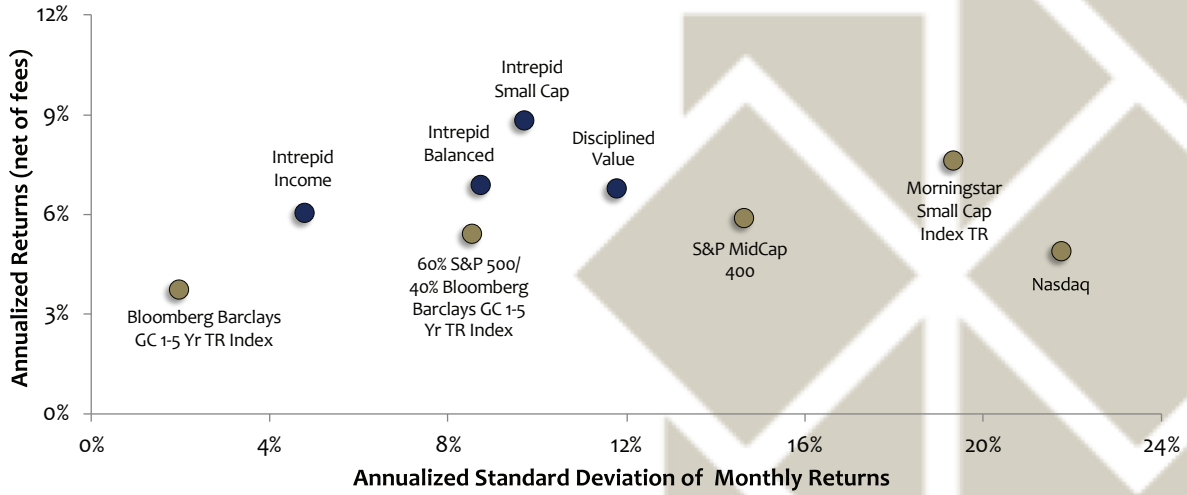
2 Wirz, Matt and McGinty, Tom. "Low Liquidity Fueled Hidden Flash Crash in Junk Bonds." *The Wall Street Journal*. 10 Jan 2020.

Risk Adjusted Returns

Intrepid Capital

Trailing 20 Year Risk/Return

December 31, 1999 to December 31, 2019



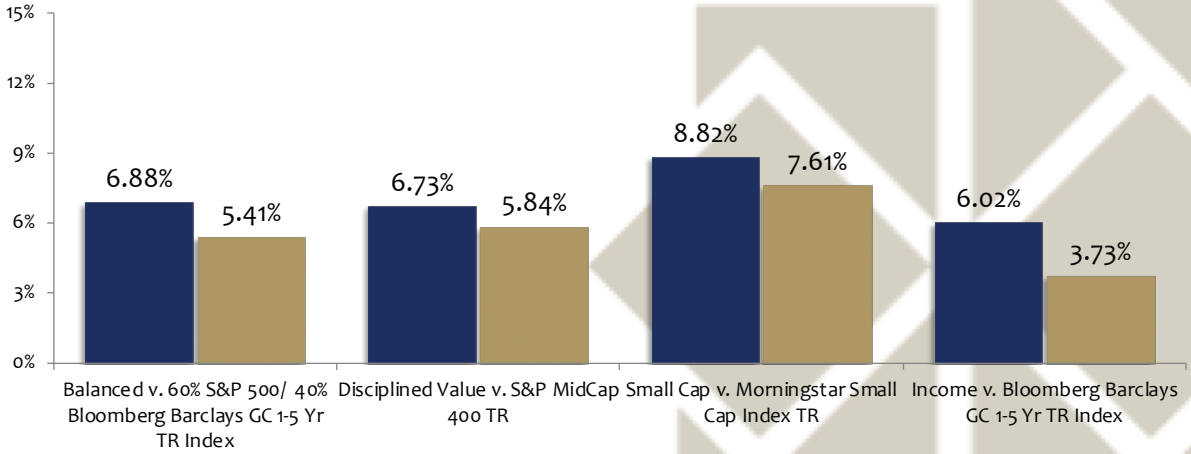
Past performance is no guarantee of future results. Intrepid composite returns are presented net of investment advisory fees and all returns are presented annualized for the 20-year period ending December 31, 2019. Returns reflect the reinvestment of dividends and other earnings. The volatility of the 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 20 Year Performance Returns

December 31, 1999 to December 31, 2019



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