

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

An All-Cap Investment Strategy Focused on Absolute Value



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SECTOR — GENERAL INVESTING

TWST: Could you tell me a little bit about the Intrepid Disciplined Value Fund (ICMCX)?

Mr. Estes: Sure. The Intrepid Disciplined Value is an unconstrained equity fund with all-cap investing. The firm's philosophy itself is one of, we would say, kind of a Hippocratic Oath, of do no harm for our investors, which means for us, we'd rather participate in an up market, try and protect capital in down markets rather than fully participate in a down market, to try to outperform or swing for the fences in a good market.

For us that means absolute value investing. We don't want to own something just because it is cheap relative to other stocks or if it's historically inexpensive. In today's market, that means finding a good business at a good price, and it's extremely challenging. So we're trying to stick by the old value-investor mantra: Buy low, sell high. It's tough in this environment; it's more like a buy high, sell higher environment.

TWST: And maybe you can talk a little bit about why the fund does make sense in the current environment and what the environment might turn into as the year continues?

Mr. Estes: Like I said, it's extremely tough right now, but we think if we are measured over a full market cycle that we've shown better results than the broad market itself. Right now it's definitely more of an exuberant market. I'm focusing now on reviewing 2016 and the fourth quarter, trying to prepare some commentary for our investors, and I was reminded of a song, my

kids love, from "The Lego Movie" called "Everything is Awesome." This seems like a market where everything is awesome. Before the election, the market rallied when I thought Hillary Clinton would win, and then after the election, it's rallied on what they believe are the positives that President-elect Trump will bring.

Then on top of that, you have a market now that is looking forward to seeing earnings growth in S&P 500 companies for, I guess, the second quarter in a row now. I think, however, things are very expensive, and at some point price does matter. In addition to that, when you have interest rates starting to creep up, you finally get to the point where we move from there is no alternative, so we must be invested in stocks, to there is an alternative, and maybe some of these investors might start to consider pulling back from their equity exposure and rotating that into other asset classes that are at least offering something, where in the past they weren't offering anything.

TWST: Can you highlight a stock you find interesting?

Mr. Estes: **Western Digital** (NASDAQ:WDC) is one that I've been pretty bullish on. They are a market leader in hard disk drives, but they've now transformed themselves into a complete storage company with an acquisition of **SanDisk**. I became interested in the spring of 2016. The market was concerned about **Western Digital's** ability to fund the acquisition of **SanDisk** because they had lost the assistance of an outside Chinese investor, Tsinghua, **Unisplendour** (SHE:000938).

Highlights

Greg Estes discusses managing his firm's value fund, which is an unconstrained equity fund with all-cap investing. Mr. Estes says his firm would rather participate in an up market and protect capital in down markets, which means he focuses on absolute value investing. Mr. Estes goes by the old value-investor mantra "buy low, sell high." He shares his current top picks in today's environment. Companies discussed: Western Digital Corp (NASDAQ:WDC); Unisplendour Corporation Limited (SHE:000938); Oaktree Capital Group LLC (NYSE:OAK); Teradata Corporation (NYSE:TDC); NCR Corporation (NYSE:NCR); Amazon.com (NASDAQ:AMZN); Microsoft Corporation (NASDAQ:MSFT) and Northern Trust Corporation (NASDAQ:NTRS).

But I had a different perspective than the existing shareholders at the time; they were concerned about the price paid for **SanDisk**, it being too high. What I thought was, this is a firm, even with the increased debt load, that would be able to not only manage the debt load through their cash flows; there was a margin story here. There's a lot of opportunity for **Western Digital** to eliminate costs, not only by reducing the number of production facilities, but also because within the last year the Chinese government has allowed the company to mostly consolidate a subsidiary, **Hitachi Global Storage Technologies**, which is based in China. They'll be able to consolidate that and reduce cost there.

1-Year Daily Chart of Western Digital Corporation



Chart provided by www.BigCharts.com

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There are also synergies in **Western Digital** now owning **SanDisk**, which is a market leader in flash drives. **Western Digital** has well-established relationships with original equipment manufacturers, so there's a possibility to drive increased sales of **SanDisk** flash-based storage in those channels. But my thesis mostly revolves around improving the operating margins from the cost side; incremental revenue growth from those synergies is a bonus. My projected non-GAAP operating margin for **Western Digital** tops out around 21% a couple of years from now. Right now the current 2017 projection is about 16%, so there's still room for improvement.

The company now is a complete storage player and can address the needs of enterprise-level customers and data centers. If a customer needs low-latency storage for a mission-critical data, they can supply it through their solid-state drive offering; if they want massive cheap storage for colder data, **Western Digital** can supply it through their hard disk drives. So they've got the ability now to be a one-stop shop.

TWST: And is there a growth area in that sector on the macro level from which they could benefit?

Mr. Estes: Absolutely, and it's common across all of IT really, and that's the explosiveness — just the sheer volume of data being collected. Everything that can be recorded is recorded, and the increase in internet usage is also important. A lot of times now you have people that operate like we do here: software through the cloud. You've got one simple piece of hardware, and most of the processing is being done at a data center. So there's a secular growth story there.

TWST: Do you want to mention a second company?

Mr. Estes: **Oaktree Capital Group** (NYSE:OAK), which is

predominantly a distressed debt investor. They offer an assortment of closed-end and evergreen funds. I would just start off by saying I have tremendous respect for the way Howard Marks, Bruce Karsh and their team approach investing. They're risk-sensitive, opportunistic and very savvy, and given the rate environment we've been in for years, they've been very challenged to find distressed debt opportunities where they would get paid a prospective return that's commensurate with the risk. In those cases, they sat on the sideline.

Howard Marks, whose letters I like to read, mentioned in the past, FOMO risk, which is the fear of missing out. Oftentimes investors feel compelled to invest just because if they don't, they could miss out on some possible return, regardless of whether the investable opportunities are worth the risk. I think **Oaktree** tries to avoid that game, and I respect that. They are a registered investment company, so they're passing through the investment income and realized gains in the form of incentive income to the Class A unitholders.

With limited recent opportunities, those realizations are down. As an example, by the end of 2013, **Oaktree** had passed out \$4.71 per share in dividends over 12 months. Today, for the past 12 months, they passed out \$2.25, so those realizations are way down. But the trailing dividend yield is 6% today. So in some respects, you're getting paid to wait. And with rates beginning to inch up, management thinks they're seeing some signs of investable opportunities on the horizon, which is good for **Oaktree**, because right now they have about \$100 billion in assets under management, but only \$79 billion of those assets generate a management fee; the rest is dry powder, so they're there waiting for opportunities.

There's one other thing that I like about **Oaktree**. They are an original investor in Jeff Gundlach's **DoubleLine Capital**. They have a 20% stake in that firm at a carrying value of the original investment, which is about \$26 million. **DoubleLine's** AUM now has crossed the \$100 billion mark. So that stake is worth significantly more than the original \$26 million investment.

TWST: And I understand that they're involved with pension plans, insurance companies and sovereign wealth funds. Are there certain issues that are going to be raised in the next year or two with regard to these kind of funds that would benefit the company or provide them with opportunities?

Mr. Estes: Yes. What I would say about that is, things have been so staid, so there's been such a lack of uncertainty. These guys benefit from potential volatility. And since we haven't had that really in years, I do think that any kind of increase in volatility that might be experienced is to this company's benefit. Really what I'm advocating here for is buying something that's out of favor now — because we're in such a low-volatility environment — buy it now because once they start up a new cycle, as an investor, you may see some benefit down the road.

TWST: And they could benefit from the increasing interest rates, too?

Mr. Estes: Absolutely. Right now it's incredibly easy. I guess what I would say is, they're not dumb enough to chase after risky opportunities if they're not going to get paid for it. And right now, anybody with a pulse can get a loan or get it from somewhere. So **Oaktree** would absolutely benefit from increasing interest rates, because it kind of separates the savvy investor from the unknowledgeable lender.

TWST: Do you want to mention another company?

Mr. Estes: Going back to what we were talking about with the explosion in data requirements, this is a company that's in a turnaround situation, which is **Teradata** (NYSE:TDC). They are a leading data warehousing and management company. They were spun out of **NCR** (NYSE:NCR) back in 2009. The original story for **Teradata** was that it would go to its customers and sell them a combination of its software on proprietary hardware, oftentimes significantly marking up that hardware. Customers tended to be large enterprises because it was too expensive to maintain a dedicated data warehouse unless you as a customer had a significant budget. These data warehouses allow customers to research their own information — whether to manage their inventory, analyze billing procedures, things like that. The company stayed that way for a very long time, and they've admitted they grew sedentary in that approach.

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1-Year Daily Chart of Teradata Corporation

Chart provided by www.BigCharts.com

But the landscape for data analytics has changed significantly with the rise of Big Data in which anything that can be recorded will be recorded, whether the information is valuable or not. On top of the growth in the sheer volume of data, there is also the rise of the cloud. Many customers don't want to dedicate resources to housing their own hardware. **Teradata** has been a step slow in adapting to these landscape changes, but I think they're now addressing them.

So the first step was when the board asked for the resignation of Mike Koehler earlier in 2016. He'd been in place since before the **NCR** spinoff. For 2008, as an example, **Teradata** generated \$1.76 billion in revenue. In 2015, they had generated \$2.53 billion in revenue. The annualized growth rate there is about 5.3% in a field that has been growing much faster than that. And, according to **IDC**, it's projected to grow by more than 10% over the next several years. **Teradata** was caught flat-footed. The board replaced Koehler with a board member, Vic Lund, and while his background is in the grocery business, I believe what he has done for the company is instilled a sense of urgency in **Teradata**.

The first step was to move away from tying software to specific platforms. **Teradata** is already a market leader in data warehousing and data management, so the software product is good. What management has been able to do is now offer that service via the public cloud such as **Amazon Web Services** (NASDAQ:AMZN) or

Microsoft Azure (NASDAQ:MSFT), and that's part of their drive to be deployment agnostic, as they call it. It also allows for a customer to scale up the use of **Teradata** service as it grows. There's no need for a customer to spend millions up front to set up a proprietary in-house data warehouse anymore. **Teradata** will now price its offerings by the amount of processing power that the customer desires.

Right now, markets doubt that **Teradata** can achieve its aggressive revenue growth target of 20% over the next five years, particularly since management admitted that revenue growth for 2017 would be down almost 4%, and that's after the company saw a revenue drop in 2016 of 10%. In my opinion, the market obviously is in no mood to be patient; however, I am. I think the company is well-capitalized. I think it's going to be able to get through its trough here in 2017. So this is definitely more of a contrarian pick. But like I said, when you're a value investor, you have to be willing to be patient at times.

TWST: They have a consulting arm that looks at Big Data analysis and business intelligence and those kinds of things. Could that be a growth field for them?

Mr. Estes: Absolutely. I think that is where analysis, data analysis and analytics, is the direction it's really headed in. It's pretty impressive to me. I'm not a super math whiz or anything like that, but the amount of information that can be gleaned, the sheer volume of data that companies now collect on anything and everything, is absolutely an opportunity for them down the road.

TWST: Do you want to mention another company?

Mr. Estes: Sure, I'll mention one more, **Northern Trust** (NASDAQ:NTRS). Everyone's heard of **Northern Trust**, the wealth manager and custodial bank. It has and should continue to benefit from rate increases. I will admit I've been early in predicting when rate increases would have occurred, but they have finally had a beneficial impact on custodial banks, which for several years had to offer fee waivers to their clients on their money market funds. Those fee waivers have finally evaporated as rate increases have given **Northern Trust** some breathing room and that, in turn, helped the company's net interest margin.

I will point out that a bigger story for **Northern Trust** has been the post-election story. And this does make me somewhat cautious. The stock moved from \$73 a share just before the election to about \$89 today. Obviously the markets rallied everywhere, but nowhere near as much as **Northern Trust** in that same time period. I think some of that is the market in its exuberance assuming that a Trump administration will relax many of the regulatory burdens on banks set forth in Dodd-Frank, as well as in reining in FSOC, the Financial Stability Oversight Council.

Obviously those would be good things on a general level, but at today's price I would say **Northern Trust** is fairly valued. I try to be sensitive not only to business quality, but also to price. **Northern Trust** is a great business. It's not as cheap as it had been, obviously, with this rally. That rally has really been huge for banks across the board, especially smaller banks.

TWST: And do you think that even if Dodd-Frank isn't completely thrown out, but maybe just tailored a little bit, it would help these kind of financial institutions?

Mr. Estes: That's a real dicey question. I do think that the burdens of the increased regulations have been particularly onerous on the smaller banking institutions just from the expense of having to

address all of them. I certainly wouldn't want to return to a time where banks engage incredibly risky behavior, because potentially that would blow up. But I do think there is some happy medium there where regulations could be reduced and companies could benefit from not having to spend so heavily to address those regulations.

TWST: And in terms of reducing regulations, would that be among the best things that the Trump administration can do? What would be some of the best things they could do to help businesses along in the next couple of years?

Mr. Estes: Yes. I guess I'm a little bit skeptical about how all of these changes are going to necessarily help companies. Obviously if you can cut the taxes, that has a clear benefit to a company's bottom line, and reducing regulatory burden would also. But on the other hand, if we've spent so long in this cycle — this part of the cycle with rates as low as they have been — if you do those things and you start seeing some serious earnings growth, there's no choice, I believe, but to raise interest rates faster than they have been.

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We've been going at a snail's pace. We just had another increase, but it's been incredibly slow. I think the rate question is more of a lever than anything else. And I think that could put the brakes on this equity market more clearly than things on the fiscal side that the Trump administration might do.

TWST: Thank you. (ES)

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

TOP TEN HOLDINGS as of 12/31/16	(% OF NET ASSETS)
Western Digital Corp.	4.4%
Corus Entertainment, Inc. - Class B	4.2%
Oaktree Capital Group LLC	3.8%
Teradata Corp.	3.3%
Northern Trust Corp.	3.1%
Verizon Communications, Inc.	3.0%
Leucadia National Corp.	3.0%
The Bank of New York Mellon Corp.	2.8%
Apple, Inc.	2.6%
Coach, Inc.	2.1%

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