

# MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC

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Dear Fellow Investors,

Our investments have performed very well so far in 2010. This is good news of course. However, we get more cautious as valuations rise. Last year we were scooping up bargains everywhere, but we now have more companies on our wish list than our buy list. Still, we remain optimistic. We added several high-quality companies to our portfolios this quarter and we continue to add judiciously as we find the right opportunities.

## Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
<b>Q1 2010</b>	7.90%	5.39%	+2.51
<b>Annualized Return Since Inception (7/1/08)</b>	8.48%	-2.71%	+11.19

Data reflect total returns (including dividends) net of fees as of 3/31/2010. Returns are unaudited. Your individual returns reported on your statements may vary from the composite depending on when you invested and upon any special instructions or restrictions applicable to your account. The composite return is the time-weighted return of all our accounts added together into one big pool. We believe it is the best indication of how the average client fared during these time periods.

## Performance

As you can see from the numbers above, and from your quarterly statements, performance has been well above average – or at least well above the return you would have enjoyed if you had invested in a fund that tracks the S&P 500 total return index. Why do we choose this as our definition of average? It is certainly not the definitive measure of average-ness, but it is about as close as we can come. Our aim in picking a "benchmark" to measure ourselves against is very simple: we want to give our clients an idea of what kind of return they are giving up when they invest with us. This is your opportunity cost. Funds that invest in the S&P 500 index are both popular and easily-available, making this a pretty good measure of what the average stock investor might choose to invest in.

It is not perfect. The S&P 500 is fully invested, meaning that it holds all stocks and no cash. All of our portfolios have some cash – and our newer portfolios have more – giving us some dry powder in case we find a great investment opportunity. This also gives our portfolios a bit more of a drag when markets are up and a bit of a cushion when markets fall. The index is also not "investable," as is. If you want to invest

in the index, you need to pay someone to do it on your behalf (usually a mutual fund) who will charge you a fee that will lower your actual return. Whereas our returns reported here are after fees.

But even though the index has somewhat of an unfair advantage, we still believe you should expect us to post better returns over the long haul. We put in a lot of work making our returns better than average and we want you to hold us to a high standard. You may have your own definition of opportunity cost. For many investors, the alternative to investing with Midway Capital may be a bank account or treasury bonds. Feel free to use your own yardstick.

Another way to think of opportunity cost is return vis-à-vis purchasing power of your dollars, or real return. We want our portfolios to have a positive real return, meaning your money would purchase more good and services in the future than it did when you entrusted it to us. So if inflation is 6% per annum over the next decade, we want to make sure our returns exceed that. If we can do that, we are actually making money. And at the end of the day, that is how we measure ourselves.

### **How to protect your portfolio from inflation**

Indeed, our investors frequently ask us how best to protect their portfolios from the effects of possible inflation. This is a good question and also a timely one as the government has pumped an unprecedented amount of money into the economy. Although we believe inflation is the likely outcome, there is little evidence of inflation right now, and we believe it is still a good time to lay the groundwork for inflation protection. Unfortunately, there is no easy or iron-clad strategy for doing this.

Essentially, inflation eats away at the purchasing power of your portfolio over time. Think of it this way: you have \$10 in your portfolio, and you decide to go shopping for daisies on a beautiful spring day. Each bunch of daisies costs \$2, so you can buy five bunches. Now if you decide not to buy your daisies today, but to keep your \$10 in a bank account for a year, and make your purchase the next spring, you would have earned a hypothetical one percent on your money over that year. Then you would have \$10.10. However, during that year the price of daisies also increased—due to generally rising prices—by six percent, and now they cost \$2.12 per bunch. You can only buy 4.75 bunches of daisies with your money, while a year ago you could have purchased a full five bunches. Because your portfolio return (1%) lagged the rate of inflation (6%), your purchasing power over that year was diminished. Your real return was a loss of 5%.

To combat the potential loss of purchasing power down the road, we look for investments that will grow *above* the rate of inflation, thereby helping to *increase* our investors' purchasing power over time. For instance, you will not notice many fixed income investments in your portfolios because these securities generally pay a fixed rate, which means that its rate of return will not grow over time. In addition, you generally won't see us venture into government sponsored inflation protected securities, also known as TIPS. Investing in TIPS is not unlike lending the government money and then allowing it to determine—after the loan has already been made—the rate of return it is going to pay you on this loan. The implied incentive for the borrower (the government) is to low-ball the official rate of inflation because (1) it is politically palatable to do so and (2) it reduces government borrowing costs. A lower official inflation rate also reduces an investor's rate of return. And finally, you generally will not see us investing directly in

various commodities for two reasons. First, we do not have any special insight into commodity prices, and second, we know that the growth in commodity prices over long periods of time tends—at best—only to keep up with the rate of inflation, rather than exceed it.

Instead, we favor investing in undervalued businesses which also have the ability to pass price increases on to their customers. The earnings of such businesses should, at minimum, keep up with the rate of inflation because they can raise their prices as necessary. Even better, when we buy growing businesses at discount prices, we should be able to achieve returns higher than inflation by virtue of the additional growth and increased valuations of these businesses over time. In our view, owning a portfolio principally made up of businesses with pricing power is the best way for investors to position their portfolios in any type of market environment, but this is particularly crucial in an environment where inflation threatens.

### **Portfolio update – Potential impact of healthcare reform**

When the President signed health care reform into law recently, a curious thing happened: health care stock prices generally rose, but by a small amount. We thought we'd take a minute to explain why the market's reaction was as positive as it was, since many people expected that the legislation would have a negative effect on the health care sector. We also have a vested interest in the sector since we own a number of health care companies and have our eyes on a few more.

The primary reason healthcare stocks rose is relief. Investors simply hate uncertainty. The reform did not include some of the more extreme possible outcomes, such as a single-payer system which could have had a sweeping effect on how healthcare is paid for and how it is priced. Also, given the political capital required to pass the legislation, we are unlikely to see any other major changes in the next several years. So, the market reaction can be interpreted as a collective sigh of "well, at least it won't be any worse."

This illustrates a larger point that investors often overlook—news is usually “baked in” to a stock's price. Since every trade involves both a buyer and a seller, and most news is equally available to both, a stock's price generally reflects the prevailing expectations. For example, if a buyer of stock in Acme, Inc. believes that its new widget is going to catch the world on fire and lead to massive earnings growth, it's likely any potential seller thinks so too. Therefore, you will only be able to buy Acme stock at a price that reflects the earnings growth provided by the new widget—in other words, the widget news is baked into the stock price. Going back to health care, the market had long worried about the impact of reforms. In the end, the most likely provisions of the new law were already reflected in the stock prices. So when the law was finally signed, the impact was minimal.

How then will the companies we own be affected? For Stryker (SYK), we believe there will be both positive and negative results. By mandating near-universal coverage, the law creates a larger market for Stryker's products. Of course, many of the newly insured are younger, healthier patients, not knee-replacement candidates. But on the whole, bringing more people into the health system should lead to greater revenue. Beginning in 2014 the law does, however, impose a tax on medical device manufacturers that will cut into earnings if it cannot be passed on to customers. But we believe Stryker and its competitors will simply raise prices to cover the tax. The reform legislation did not change the fee-for-

service model of health care, and we think Stryker should be able to offset the effect of the tax through higher prices, leaving profits largely unchanged.

Our outlook is very similar for Pfizer (PFE). There are basically two countervailing factors in the recent legislation that affect the firm. Pfizer, as well as other pharmaceutical companies, will benefit from the increased inflow of insured individuals, which should create greater demand for many of Pfizer's products. Pfizer will also benefit from the legislation because the bill includes measures for stronger patent protection for biologics (a specific class of medicines made through biological processes and often regulated differently from other drugs). Pfizer now has a greater number of such therapies given its acquisition last year of Wyeth. These two benefits are partially offset by fees Pfizer, and the rest of the industry, will pay to help fund parts of the legislation. For the industry, the fee amounts to \$85 billion over the next ten years, and Pfizer will have to pay a very small portion of that overall fee. On the whole, however, we believe owners of companies like Pfizer will probably come out ahead.

### **Midway out and about**

For those of you who have expressed interest in reading or hearing more about investing from the Midway Capital team, here are a few opportunities. Justin writes a regular blog at [www.buffettologist.com](http://www.buffettologist.com) where he comments on the doings of Warren Buffett and Berkshire Hathaway. He will also be attending the Berkshire annual meeting in May, so if you can't go yourself to "Woodstock for capitalists", you can catch all the highlights on Buffettologist. Justin also appears regularly on Fox Business news and we post the links to our "in the news" page on [www.midwaymgt.com](http://www.midwaymgt.com). Rachel, Drew, and Justin are guest lecturers at the Illinois Institute of Technology Stuart School of Business once again this semester. They will be leading the Competitive Strategy class in late April. And last but not least, Rachel will be teaching a class again at Chautauqua Institution this summer. The topic is "Investing in Stocks" during the second week of August. It is open to the public at Chautauqua's school of continuing studies and everyone is welcome to attend. We'd be happy to give you more information if you'd like to catch us out and about. In the meantime, we wish you all the best and thank you for the opportunity to serve your investment needs.

Yours,

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