MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC
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Dear Fellow Investors,

As I write this, two of the most widely-followed stock market indexes – the Dow Jones Industrial Average and the S&P 500 – are hitting record highs. On the one hand, that is great news for us as stock investors. On the other hand, higher valuations for stocks should make us more cautious investors.

Over the past five years that Midway Capital has been investing on behalf of clients, there were times when almost everything was on sale. But now that prices better reflect underlying value, this presents new challenges. Right now, we feel that stocks still represent the best place to invest for long-term growth. Our average holding trades at 91% of what we think it's worth today. We're happy to hold stocks at these prices because we believe they offer positive real returns for investors. However, we prefer to buy stocks with a larger margin of safety – usually at 75% of fair value or better – because our estimate of fair value can be wrong. With holdings trading at 91 cents on the dollar, we are finding fewer and fewer stocks on sale. Long story short, we're doing a lot of holding and not much buying. Our returns below reflect the performance of a high-quality group of holdings that we've now been building for half a decade.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	**S&P 500 TR Index**	**Difference**
Q1 2013	11.80%	10.61%	+1.19
Annualized Return Since Inception	9.13%	6.74%	+2.39
Total Return Since Inception	51.43%	36.33%	+15.10

Data reflect total returns (including dividends) net of fees as of 3/31/2013. Inception date is 7/1/2008. 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.

The news of new market highs raises two questions: 1) When is it time to sell? and 2) Will there be a correction soon? None of us knows the precise answer to either of these questions, but we do need to grapple with them just the same.

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The way we think about selling is part and parcel of our investment process as a whole. For each stock that we consider owning, we perform a thorough valuation. Valuations involve assumptions. While rarely perfect, they give us a good estimate of what a company is worth. Our estimate includes our required rate of return (the return we will demand in order to buy this investment). After all, we could put our money under the mattress and have no risk of loss (except through inflation) so we demand some sort of return greater than zero to take the risk of buying an investment. We also demand a return greater than the rate of inflation or else we lose purchasing power.

For our purposes, we demand a return greater than 10% annually when we buy a stock (this may change in the future depending on factors like inflation). So if we believe a stock is fairly valued at $100, that implies that we would get at least a 10% annual return by buying it at $100. Buying it at a discount should increase our return. But buying it at more than $100 should mean that we earn less than our required rate of return. If we think the potential return on an investment is not adequate, or if we find a better return elsewhere, we will sell. If investments become too overvalued, the implied return could be negative, in which case we'd prefer to own cash. We give ourselves a wide margin of safety around our value estimate because our assumptions can be wrong. In other words, we wouldn't buy the stock at $100 and sell at $101 because we can't estimate value with that type of precision. Nor, we believe, can anyone else.

With our average holding trading at 91 cents on the dollar, we think the returns should be good from this point. That said, not all holdings are average. We continue to buy things trading at a discount, and we will sell anything that doesn't offer a good return. As conditions change, we will alter our buying and selling accordingly.

J.P. Morgan was often asked what the stock market would do, and his famous answer "It will fluctuate"[1] is still the most correct response. From here, we could have a correction, or prices could continue to climb. As investors, we have to be prepared for either scenario. However, a close study of past market data can give us some valuable insight into how we should behave at market highs and lows.

We want to buy stocks at a low price. When the market is trading at a 52-week high – the highest price it has traded at all year – we ask ourselves, "if I invest now, what are the chances that I am making a mistake? Will I be able to buy at a lower price during the coming year?" In other words, we wonder whether to buy now or wait for a sale. What are the odds that stocks will be on sale at a lower price during the coming year? According to our data, there is an 87% chance of that. If you buy within 2% of the top (not right at the high) your odds are better. In that case, there is a 65% chance that you will get a lower price if you wait[2]. And while investing at a high point isn't *always* a bad idea, the odds are squarely against you. Therefore, we try to be cautious at times like these. There are no hard and fast guarantees, but it's always better to have the odds in your favor. And at this point, the odds favor a decline sometime within the next year. Since stocks still offer good return potential we continue to buy quality companies judiciously, but we wouldn't be aggressive buyers under these conditions.

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[1] J.P. Morgan quoted in Benjamin Graham, *The Intelligent Investor* (HarperCollins, revised 2003) p. 54.

[2] Midway Capital study comparing weekly closing prices for the S&P 500 Index over the past 20 years (1993-present) to the eventual low over the subsequent 52-week period.

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News and Events Worth a Second Look

A lot of significant economic events have transpired already in 2013, but none has yet derailed the market rally. The sequester came and went. Europe's troubles bubble up on a daily basis. Angela Merkel and Mario Draghi have been in a high-stakes game of Whac-a-mole, battling one eurozone crisis after another. The lack of fallout may lull us into thinking that there is nothing very significant happening. But we would like to draw your attention to two events which we think are interesting, because they could have much larger implications for our economic futures. The first is the Cypriot bail-out. The second is the bankruptcy of Stockton, California.

Cyprus

The Cyprus bail-out is still evolving. Just this morning, we learned that its creditors have upped the ante on how much it will cost the island. Previously, Cyprus was required to come up with €7 billion to secure the €10 billion in promised funds. Now that number will be €13 billion, a number which might not be feasible for an economy as small as Cyprus's. But whatever of the outcome of this messy process, we think the EU has already opened Pandora's box. Depositors the world over should be shifting in their seats.

As you probably know, the EU suggested that Cyprus seize the only large assets available on this small island – bank deposits. This is a new wrinkle in the way bail-outs have been done. It also opens the door to seizures of bank deposits by other governments in times of crisis, and that is the scary part. Granted, the deal as it stands now only confiscates uninsured deposits (above the €100,000 threshold). So the promise of deposit insurance is intact for now. But depositors above the threshold may have to pay up to a 60% "tax" on the uninsured portion of their deposits.

Cypriot banks were risky in a number of ways. They were paying huge interest rates on deposits – much higher than comparable global banks. Deposit interest was funded by buying Greek government bonds, which later defaulted. The banks also had lax oversight and favorable tax laws that encouraged fraudulent offshore companies to set up in Cyprus and launder their money through Cypriot banks. According to the Wall Street Journal, tiny Cyprus is "Russia's largest source of foreign investment,"[3] thanks to the money flowing through there. These factors should be a huge red flag to any legitimate depositor.

However, it's not only Cypriots and Russian Oligarchs who need to watch this carefully. There are implications for bank customers around globe. First, bank deposits are fair game. This shouldn't be a concern for well-run well-capitalized banks in stable countries. But it does underscore the necessity of understanding the banks you do business with. Second, if it looks too good to be true, it probably is. Today's low interest rates have forced savers to search for yield. Inevitably, this hunger for a decent return will entice some unwary savers into investments that are too risky, or that they barely understand. Before the housing crisis, plenty of trusting investors bought incredibly opaque and complicated CDOs and sub-prime mortgage securities that Wall Street labeled "AAA." Now we call them "toxic assets." While it's easy to say that the

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[3] Forelle, Charles and Matina Stevis. "Money-Laundering Suspicion Stalls Europe's Latest Bailout." *The Wall Street Journal*. March 4, 2013.

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Cypriot savers should have seen the writing on the wall, the challenge to us, as investors, is to recognize the next “too-good-to-be-true” investment for what it really is.

Stockton, CA

While Cyprus may be looking toward a bail-out, Stockton, California is officially bankrupt. This bankruptcy could have immense implications for cities and towns – and even states – across the U.S. that are struggling with unmanageable pension and healthcare obligations to their public employees.

The term “bankruptcy” has a chilling ring to it, but the ability for failed companies to file bankruptcy is actually good for our economy. It provides a fair, legal way to wind down a firm that can no longer pay its bills. Zombie companies, those firms on life-support with no prospect of recovering, destroy value. Japan has a huge problem with zombie companies that the government has propped up to keep from failing. Essentially they suck up the money that could otherwise be used to invest in profitable ventures.

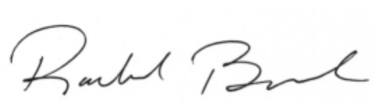
The U.S. is developing its own problem with zombie cities. California has a number of cities that promised the moon and stars to city employees during the housing boom when revenue was pouring in. Stockton now owes the California retirement system (CalPERS) nearly $900 million to cover promised pensions, which is a crippling debt for a city of just 300,000. There is no way Stockton can pay all its creditors and keep city services operating. On April 1, a judge allowed the city to declare bankruptcy. This is arguably the best thing for both the citizens of Stockton and its creditors. The citizens get to restructure their debts so they can have a reasonable hope of paying some of them, and the creditors will get something (though not 100%).

Up until now, it was unclear if cities like Stockton would be eligible to enter bankruptcy (some states make this illegal). There still could be an appeal. But for now it looks like California has provided a path for cities to deal with their past mistakes without becoming zombies. The implications could be huge for places like Detroit. But it may have an even bigger impact in places like Illinois whose state government is already insolvent. Unmanageable debt burdens are bad in any case, even for governments with the power to tax. The judge in Stockton may just have opened a crucial relief valve for an overburdened public sector.

Final Note

As always, we welcome your questions and comments. Many of our letter topics come directly from our investors and we love hearing your thoughts. It is a privilege to be your investment advisor and we look forward to working with you and your families during the rest of 2013 and beyond.

Yours,



Rachel Barnard, PhD
and the Midway Capital team