

MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC

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Dear Fellow Investors,

Even if you don't follow the markets on a daily basis, you will know that this quarter was characterized by economic uncertainty. The situation in Greece is coming to a head and euro area countries are justifiably jittery about the possible fallout. Here at home, unemployment remains stubbornly high. Consumer and investor confidence are both ebbing and we saw the results of these trends in a roller coaster ride for stocks.

The good news is that corporate profitability remains very strong. We favor companies with high profit margins and robust growth prospects, and we've been pleased to see many of our holdings produce record earnings this quarter. Not only that, companies report large piles of cash and relatively little debt. The Wall Street stage is set for growth and investment. But it needs Main Street, Washington, and Brussels to play along. The ride could be anything but smooth.

That said, we remain reasonably optimistic and have positioned our portfolios to take advantage of rising corporate profits. We missed out on the rally in defensive stocks this quarter (consumer staples, utilities) and suffered a small decline overall. While we are never happy with a quarterly loss, we remain very pleased with our current holdings and their long-term prospects.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q2 2011	-3.06%	0.10%	-3.16
2011 Year to Date	1.68%	6.02%	-4.34
Annualized Return Since Inception	8.92%	3.33%	+5.59
Total Return Since Inception	29.22%	10.33%	+18.89

Data reflect total returns (including dividends) net of fees as of 6/30/2011. 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 Greek debacle and what it means for our portfolios

Poe dreamed of coming home “to the glory that was Greece” – but even the most ardent philhellene would find it difficult to love Athens in its current state. The word “Catastrophe” (fittingly derived from the Greek) about sums it up. If you listen to the news, particularly the financial news, you’ve been inundated with talk of the Greek debt situation. Here we’ll try to put it in perspective and talk about what it means to us as investors.

The situation is complex, but the facts are essentially these¹. Since it joined the European Union, Greece has been writing huge volumes of rubber checks. It had been hiding the extent of this for years by cooking the books, deliberately fabricating numbers to conceal the amount of its actual debt from EU members and its own citizens. When the fraud was finally discovered by a new government, the Greek debt came to \$1.2 trillion. That is about four times 2010 Greek GDP and is rising.²

Greece has two main groups of creditors: the global debt markets (bond investors, banks) and its own people. Greece took massive loans from outside investors and was able to borrow at low rates because, as a member of the EU, it is backed by the credit of the other member states. At the same time, the Greek government was making lavish promises to its population in the form of governments pensions. Neither of these groups is willing to give up its IOUs without a fight. And now the country finds itself between Scylla and Charybdis.

If it fails to pay the bond holders, Greece will be in default. This could mean the practical end of its membership in the euro and would result in bankruptcy at Greek banks (which hold Greek government debt as capital) as well as the end of its credit line with the world’s investors. That scenario would be devastating for the Greek economy and could cause investors to lose faith in other teetering eurozone members like Portugal, and Ireland. On the other hand, if Greece decides to renege on promises to its citizens (the current “austerity” is the beginning of this), the riots and unrest will likely intensify and Greeks may decide to throw the government out in favor of a new regime which would pledge to default on its debt to bond holders instead. Austerity could work in some form, but the odds are against it. As a member of the EU, Greece can’t devalue its currency and pay off its obligations by printing money. It will have to cut government jobs, guarantees, and pensions aggressively and then somehow grow its way out of an economic collapse.

Given the magnitude of the country’s obligations, we expect Greece to default in some way. It may be carefully manicured by an EU hoping to keep the fragile European economies afloat. It may be a disaster. But the way this plays out will affect investors around the globe.

Midway Capital does not have any direct exposure to Greece. Our portfolios don’t own any Greek bonds or Greek companies. Neither do we own shares in European banks that own significant Greek debt.

¹ For an entertaining and enlightening overview of the Greek debt crisis, we recommend Michael Lewis in Vanity Fair: “Beware of Greeks Bearing Bonds”. October 1, 2010.
<http://www.vanityfair.com/business/features/2010/10/greeks-bearing-bonds-201010>

² GDP as estimated by the IMF at \$305 billion for 2010.

However, our holdings will inevitably be affected by the health of the global economy. The real threat to us, and most investors, is that a Greek default destabilizes Europe the way Lehman Brothers' bankruptcy upended the United States. This could cause the euro to plunge in value and spread contagion across the globe. This is a worst case scenario, and the most likely scenario is not quite this bleak. But until the magnitude and extent of the Greek default is clear (this may be a while) it will hang like a sword of Damocles over global financial markets.

To be clear, we don't believe the Greek crisis, however it is resolved, will have any lasting impact on any of the companies we own, including those who do business in Europe. We're not shying away from investing in such firms at the right price. But bad news from Greece could easily spark a sell-off in stocks around the globe, so we're cautious about making any big moves until the bad news – whatever it is – hits the markets.

Corporate profits

Now for the good news: corporate earnings are a ray of sunshine in an otherwise gray economic picture. It seems like the economic news was largely bad this quarter, but in fact, business fundamentals are very strong. Debt is down, companies have more cash, their margins are wide, and profit growth has been fantastic coming out of the recession. Last year across the whole economy, corporate profits grew more than 25% year over year. Many of our holdings have done even better than average. To give you some quick examples, let's take the two companies we own that reported quarterly earnings most recently. Both Carmax (KMX) and Discover Financial (DFS) made their results public two weeks ago.

Carmax buys used cars and then resells them to consumers or auctions them to dealers. It also makes auto loans to some of its customers. This past quarter, the firm's earnings – its bottom line – were up 25% compared with last year. Sales numbers were up and Carmax opened new stores. Credit quality was also very high, meaning that customers are paying their loans and paying on time. We saw a similar pattern at Discover, a credit card company. Thirty-day delinquencies are at an all-time low, meaning that customers are paying on time. This is a boon to Discover because it doesn't have to set money aside to cover delinquent loans. It is also writing off fewer bad loans.

None of this should be surprising when we consider that the share of household income going to servicing debt is approaching a record low. Households in the U.S. are paying down debts and not taking on new ones. They have an increasing amount of disposable income, but are cautious about spending as much as they could. All of this is good news for companies and for us as owners of these companies.

There are still a few caveats. The record federal deficit needs to be reduced. We will almost certainly pay for this in the form of higher taxes, fewer entitlements, and a devalued dollar (inflation). As in Greece, the process will not be painless. And as we said above, the situation in Europe is likely to bleed into investments around the globe. Still, we believe that the health of the companies we invest in is very encouraging. We have no idea exactly when the economic clouds will lift, but companies certainly have the capacity to invest and hire when they decide it is prudent. Consumers are in good financial shape. We're waiting on Washington and Brussels to do their share.

Parting thoughts

Midway Capital hit a milestone in June – our third anniversary. The investment industry considers this a sort of “coming of age” because a three-year record is a fairly good indicator of a manager’s skill. For us it is a chance to reflect on what we’ve accomplished, taking a hard look at our best investments and also our worst ones. Though there is no recipe for investing success, it seems that hard work, discipline and patience are still the key ingredients. We look forward to the challenges of the next three years – and the next thirty years – and we thank all of you, our clients, for helping us reach this milestone.

Yours,

A handwritten signature in cursive script that reads "Rachel Barnard".

Rachel Barnard, PhD

and the Midway Capital team