

MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC

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Dear Fellow Investors,

Volatility returned this past quarter, thanks mostly to the words of Fed Chairman Ben Bernanke. After he hinted that interest rates might rise, there was a broad sell-off of investments that depend on low interest rates to flourish. We would call this a general selling of risky assets. A lot of investors were betting that rates would stay low indefinitely. We think is very unlikely. We have been investing with the belief that rates will eventually rise and a number of our holdings will benefit in this scenario, including banks and money market fund providers.

We are generally pleased with our investment results this quarter. Our banks with pent-up earnings power helped us, even as we have been holding more cash than usual. There aren't a lot of investments that are cheap just now, but we have found some excellent bargains in both emerging markets and domestic real-estate. We'll continue to be picky about new investments if stocks remain at today's levels.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q2 2013	2.92%	2.91%	+0.01
Year to Date 2013	15.07%	13.82%	+1.25
Annualized Return Since Inception	9.28 %	7.01%	+2.27
Total Return Since Inception	55.85%	40.30%	+15.55

Data reflect total returns (including dividends) net of fees as of 6/30/2013. 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.

Bernanke Makes a Splash

We understand why you might skip news articles with "Bernanke" in the headline. The Fed chairman's remarks are often dull at best, incomprehensible at worst. But he really made a splash this May and June when

he talked about pulling back on the bond-buying program. Specifically, he suggested the central bank *might* start winding down bond purchases this year and *might* stop entirely by the middle of 2014. He took pains to point out this week that the Fed is still committed to keeping short-term interest rates low until unemployment improves, however. This all seems pretty tame on the surface, but Bernanke's remarks sparked a wave of bond selling that was remarkable in its size and intensity. Bond fund and bond ETF investors dumped their shares in record numbers, making it the largest bond outflow event in history¹. So it is worth examining what really happened here and whether we should care.

What Bernanke really said, when you read between the lines, is that interest rates will probably rise in the next few years. He was preparing the markets for an eventual increase in interest rates. This should not be news to anyone even though some investors seemed to believe that the Fed would keep rates low indefinitely. That looks like a risky bet, and we believe most savvy investors see an end to bond-buying as inevitable. PIMCO's Bill Gross argues, and we would agree, that the markets are being "artificially supported" by the Fed's actions.² They can't go on spending that much on bonds every year – they will run out of things to buy.

If you watch interest rates carefully – maybe you are shopping for a mortgage or refinancing – you have noticed that rates have already risen. This is a market response to Bernanke's comments. Unless you are looking to borrow money, or you own a lot of bonds, this is probably a good thing. Anyone with a savings account or a money market fund should be happy at the prospect of better returns. Bernanke has acknowledged that low rates are bad for savers. However, he has thought it more important to encourage borrowing and spending to get the economy going again.

What about stocks though? It certainly appears that the stock market dislikes the prospect of higher interest rates. It fell after Bernanke's remarks. It rallied this week when he tempered those remarks, and many attribute this to the fear that higher borrowing costs would discourage companies and consumers from spending. However, when we take the long view, things look different. Over the past 50 years, the stock market typically has risen along with interest rates in economic recoveries.³ This is because the two are correlated. The Fed has usually raised rates in response to an improving economy, and the improving economy fueled higher stock prices. When more people have jobs, spending rises, and this can offset the drop in spending with borrowed money. Assuming such a virtuous cycle, we will actually be happy to see the Fed have less influence in the markets.

What about bond owners? We think bonds still offer poor returns at this point and in our previous letter we shared our thoughts on what we believe is a bond bubble. So we're not exactly hot on bonds as a long-term investment right now. But they are very useful to investors who may need money soon and we have actually recommended certain bond investments from time to time. The good news for bond holders is that Bernanke's remarks were probably blown out of proportion by investors. If you own laddered bonds, you are in fine shape and interest rate changes won't hurt you if you hold those bonds to maturity. Even if you own a bond fund, it is not time to panic. These funds typically rebound as old bonds roll off and the fund buys new

¹ Data from TrimTabs Investment Research

² William H. Gross. "The Tipping Point." July 2013. <http://www.pimco.com/EN/Insights/Pages/The-Tipping-Point.aspx>

³ Comparison of 10-year Treasury yields below 5% to the S&P 500 index. Data from JP Morgan Asset Management.

bonds with higher yields. If bonds are part of your investment strategy, stick to your knitting. But if you have a longer time horizon, we'd still avoid bonds right now. If a little "tapering" talk by the Fed sparked a huge bond sell-off, there could be more bad returns to come. Interest rates are still near record lows, and they only have one way to go. As rates go up, bond prices come down. There is still a lot of risk in bonds right now.

Pfizer and Zoetis Part Ways

Those of you who own Pfizer (PFE) shares may have received a solicitation from the company this past quarter inviting you to exchange your shares for Zoetis (ZTS), formerly the firm's animal health business. We always take care of responding to these offers on your behalf because they require some time and expertise to evaluate. We decided not to take the offer and we currently don't own any Zoetis. However, we thought you might enjoy hearing about how we evaluate deals like this and getting to know these investments a little better. Much has happened at Pfizer over the five years we've held it and it makes an interesting narrative.

We first bought Pfizer in 2008. At that time, investors were wringing their hands over what would happen when Pfizer lost patent protection for its blockbuster drug Lipitor, whose patent expired at the end of 2011. Lipitor once made up a quarter of Pfizer's sales, bringing in nearly \$13 billion annually at its peak. So the end of exclusivity represented a large potential loss in sales. However, we looked at how much money Pfizer could make even without *any* Lipitor sales – the worst case scenario – and concluded that the company was worth more than its market price, even without its blockbuster drug. This often happens when investors sell on fear rather than fundamentals.

Since the patent expiration, Pfizer's share price has climbed considerably and the firm still pays a generous dividend. But it has not been standing still. The company has undergone a significant transformation. Pfizer was quite acquisitive over the preceding decades, but starting in 2011, the firm reversed course. It divested the Capsugel business line that year, selling it to a private equity firm for \$2.4 billion. Late in 2012, the company sold its Nutritionals business to Nestle for almost \$12 billion. During this same time period, the company spent \$17.2 billion repurchasing its own stock (a smart investment given that the stock outperformed the broader market in both 2011 and 2012). After shopping its animal health business to potential suitors, Pfizer decided to carve out the business line as a separate company, called Zoetis, and sell the shares in a public offering.

Before selling Zoetis to the public, Pfizer issued \$3.6 billion of debt to be paid by Zoetis, keeping the cash for itself. Then on February 6 of this year, Pfizer sold 20% of Zoetis in the public market, which generated about \$2.5 billion. In all, Pfizer received \$6.1 billion in cash in exchange for selling 20% of Zoetis.

In May this year, Pfizer announced its intention to divest the remaining 80% of Zoetis. Pfizer was trading for around \$30 per share at the time, and Zoetis was trading for around \$33. Pfizer offered its shareholders the opportunity to swap Pfizer stock for Zoetis stock at a ratio of 1.01:1. In other words, a Pfizer shareholder could trade in 101 shares of Pfizer selling for \$3,030 and receive 100 shares of Zoetis, currently selling for \$3,300.

We decided not to accept Pfizer's offer. Even with this discounted price, we didn't find Zoetis stock to be a good value. Paraphrasing his mentor Ben Graham, Warren Buffet said⁴, "Price is what you pay; value is what you get." Based on our estimates, the value of Pfizer is probably \$30 per share, but we think Zoetis is only worth about \$20 per share. Thus, by participating in Pfizer's offer, we'd be trading something worth \$3,030 for something worth only \$2,000. So we decided to give it a pass and continue to hold our Pfizer shares.

At the end of June, the company announced that the owners of 1.7 billion shares chose to exchange their Pfizer for Zoetis. However, only 400 million Zoetis shares were available, so these investors received only a portion of the shares they asked for. While this might seem like an astonishing success – four times as many shares were requested as were available – consider that Pfizer has 7.2 billion shares outstanding. In other words, 76% of Pfizer shareholders (us included) *didn't* offer their shares for exchange.

We think we got the better end of the deal here. Pfizer arguably sold Zoetis for about 50% more than it was worth. It already took \$6.1 billion in cash out of Zoetis before the sale. It's no wonder the majority of Pfizer shareholders opted to stick around rather than seek greener pastures.

Where does this leave Zoetis? The company sells animal health products. This includes products for pets, but two thirds are products that farmers and livestock owners use to keep their animals healthy. We think the company has decent growth prospects overseas, particularly in developing nations where meat and milk consumption is growing and farmers are increasingly willing to pay for medicine and vaccines. However, we would like to see a more reasonable price for the shares before taking a serious look.

Final Note

If you have ever wanted to look at your Midway Capital account on your iPhone or iPad, the wait is over (Android app coming soon). You can download the app from the Apple app store. It is called "netexchange client mobile." It works with your existing username and password: you don't need to set up anything to use it as long as you have already set up your account online with your computer. We've tried it out and found the interface intuitive and easy to use. We hope you find it useful.

Yours,



Rachel Barnard, PhD
and the Midway Capital team

⁴ <http://www.berkshirehathaway.com/letters/2008ltr.pdf>