MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC
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July 10, 2014

Dear Fellow Investors,

We hope this finds you enjoying the summer, as well as the favorable stock market, as we have been. Though things have been tranquil, we're happy to see more of a stock-picker's market this year. It's always easier to find good investments when other investors are fearful or selling – neither seems to be the case right now. However, we have managed to ferret out some promising names over the past few months and add a few fresh ideas to our portfolios.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q2 2014	3.40%	5.23%	-1.83
2014 Year to Date	4.84%	7.14%	-2.30
Annualized Return Since Inception	11.38%	9.76%	+1.62
Total Return Since Inception	90.92%	74.81%	+16.11

Data reflect total returns (including dividends) net of fees as of 6/30/2014. 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.

Stock-picker's Market?

We are pleased to see that 2014 is beginning to be a stock-picker's market. Why is that good news? For us, that means that we are seeing some of our "contrarian" investments pay off by performing much better than the market at large. Our investment philosophy centers around owning only the best stocks by carefully researching each company and buying them when their prices are low. For that strategy to give us superior returns, we need the best stocks to outperform all their peers. That doesn't always happen, particularly over short periods of time. Sometimes the whole stock market rises or falls together, with the best and the worst companies all going up and down together. This is known as high correlation. The performance of each stock is highly correlated to the performance of every other stock. Index investments do well in high correlation

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environments. If everything is going up all together, there is no reason to be picky. It's like a rising tide lifting all boats.

But these environments can't last forever. Keeping with the boat metaphor, a rising tide might lift all boats equally when they are sitting in the harbor on a sunny summer day. But when a storm comes along, only the sturdiest boats are going to be left above water. If we were looking to buy a whole fleet of boats as an investment, we could head over to the harbor and simply buy everything on the water. That's easy and quick. True, some of the boats will be leaky or poorly-maintained, but others will be seaworthy crafts that will give us years of service. We essentially get an average fleet of boats. However, if we are savvy investors, we would instead buy only the best boats for our purposes. We'd want ones that won't sink during the first storm. If we're looking for speed, we'd pick the fastest ones. Perhaps we'd seek out the ones which could carry the most cargo per gallon of fuel, or the ones with the most experienced crews. In any case, we'd spend plenty of time carefully inspecting each vessel until we found the best ones. It would take more of our time and effort up front, but we'd end up with a top-notch fleet that would last a long while.

We have the same rationale when purchasing investments. Average investment are OK, but over time we believe that the cream will rise to the top. So we don't bother buying mediocre companies and we're content to avoid unprofitable industries all together. In high correlation markets, that kind of investing may not be noticeably better or worse than average. But in a stock-picker's market – a market where individual companies do not trade in tandem with their peers – then selective investing pays off.

A good example could be an oil company. Let's say we were interested in owning one or more of these firms. We could just buy a little bit of every oil company, giving us an average of the industry. Or we would pick the best one(s) and own them exclusively. As you might suspect, the value of an oil company does depend heavily on the price of oil. If every oil company gets roughly the same price for each barrel of oil it sells, then other factors separate the best companies from all the rest. For example, we'd look for companies who have the lowest cost for producing the oil, so for each barrel of oil they make the highest profit. We might also search for companies that operate in safer geographies: ones where the rule of law is strong and there is little risk of assets be expropriated by governments or seized by rebels. In highly correlated markets, all oil company shares will move together. But in a stock-picker's market, the most profitable companies with the highest profits, best locations, and superior leadership should leave the rest in the dust.

Correlation between stocks has been high since the financial crisis. The highest peak since 2008 was during the euro-zone debt crisis when correlation rose above 0.7 (if the correlation were 1, all stocks would be trading up or down together).[1] However, it has been falling recently, and that is exciting news. Last month correlations fell to 0.27, which is the lowest in three years. Even better, we have seen this show up in our portfolios as stock returns have diverged and some of our contrarian picks have posted unusually good returns.

We have not yet entered stock picking nirvana, however. Stocks have stopped moving in lockstep, but the dispersion is very low right now. Dispersion measures the difference between the best performers and the worst performers. As of May, this difference was the lowest it's ever been in the 25 years for which we have

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[1] Strumph, Dan. "Stock Pickers Have Tough Time in 2014." *The Wall Street Journal*. June 29, 2014. http://online.wsj.com/articles/stock-pickers-have-tough-time-in-2014-1404069851. Quoting data from Axioma.

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data.[2] So even though the market is separating the sheep from the goats, the differences in performance are very small right now. The economy has been inching along on its path of recovery with very few significant market events. It's almost like the beginning of a race when all the runners are still in a big pack. But our runners are off to a good start in 2014 and we hope to see our elite group inch ahead even further as the year proceeds.

We're All Irish Today!

On St. Patrick's Day, everyone is a bit Irish and there's always a reason to celebrate by raising a pint or two of Guinness. But even though St. Patrick's day has come and gone, it seems like Wall Street is still enamored of the Emerald Isle – and other corporate tax havens. Almost every day we hear of corporations seeking to relocate overseas. Just Tuesday, the American pharmaceutical firm, AbbVie Inc., increased its offer for Irish drug maker, Shire.

Alas, it's not the smiling Irish eyes that are attracting the big firms, but the lower taxes. Large multi-nationals are growing selective in choosing their tax homes.

Several of our portfolio companies have been involved in such negotiations. We first took note of this flurry in May, when Pfizer bid for AstraZeneca, a British drug maker. A few weeks later, Stryker took the unusual step of stating that it did not intend to make an offer for Ireland-based Smith & Nephew (though it acknowledged that it had been evaluating the company as a target). Outside the healthcare sector, retailer Walgreen's is mulling what's known as an "inversion" where it would acquire a smaller foreign firm (in this case, Swiss-based), and adopt the smaller firm's headquarters. The list goes on and it is too large to include.

In each of these cases, speculation on the "why" has generally focused on the tax rate. Corporate taxes in the U.S. run about 40% considering federal and state levies. In the U.K., that number is about 21%; in Switzerland, it's closer to 18%, and in Ireland, it's 12.5%[3]. While foreign firms' stateside earnings are still subject to U.S. tax, moving the domicile abroad opens the door to a more favorable rulebook. What's more, an often-exploited loophole in the U.S. tax code leads many firms to keep profits (that is, cash) offshore. As long as profits are being used abroad, they aren't subject to U.S. tax. Firms who have played this game for a long time may have amassed tens of billions of dollars offshore that can't be touched without paying 40% in taxes. But firms that are domiciled outside the U.S. can use those funds at will. Hence, the interest in new headquarters in places like Ireland.

Individuals are getting in the game, too. In 2012, Puerto Rico launched a program to exempt most investment income from tax for individuals moving to the island. This was likely an effort to attract high-net worth individuals from the United States, as Puerto Rico's territorial status allows U.S. residents to maintain benefits of citizenship while avoiding taxes. Indeed, hedge-fund manager John Paulson is promoting Puerto Rico to other wealthy Americans and he recently said the island will become "the Singapore of the Caribbean,"

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[2] ibid. Data from Matarin Capital Management measuring the best-performing 10% and worst-performing 10% of stocks in the S&P 500 Index in data going back to 1990.

[3] http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx

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referencing Singapore's 20% tax on its citizens. Perhaps that explains why Facebook co-founder Eduardo Saverin relocated to Singapore shortly before Facebook's IPO. According to Puerto Rico's Department of Economic Development and Commerce, around 200 wealthy "traders, private-equity moguls and entrepreneurs have already moved or committed to moving."[4]

There's a caveat, of course. Until 2012, Cyprus was a popular tax haven. But when its banks got in trouble, the country levied a "deposit tax" on account balances over €100,000. In effect, the country expropriated bank deposits, many of them foreign sourced. Politicians in the U.S. have proposed changing the rules to make inversions more difficult, and to offer fewer tax incentives for those who do move offshore. Indeed, *any* country can change its rules midstream, either for better or for worse.

The good news for the United States is that tax rate isn't the only consideration. The vast majority of American businesses are pass-through entities, meaning the business' profits are ultimately taxed on the business owner's (i.e., the shareholder's) tax return. Reincorporating abroad therefore means uprooting and actually living abroad. The U.S. also provides ample capital, an educated workforce, strong rule of law, good infrastructure, and a large marketplace of well-off consumers – all things that may or may not exist in a low-tax domicile. The biggest corporations, though (and oftentimes, the ones we invest in), can effect these things on their own. So for them, where to set up shop becomes question of whose burdens are least burdensome. Given the current disparity in corporate tax rates, and the huge amounts of money at stake, we'd expect to see more big firms looking to find a new home across the pond. For now, the old Irish saying seems to hold true: *There are only two kinds of people in the world: The Irish and those who wish they were*.

Yours,

Rachel Barnard, PhD
Todd Schrade, CPA
and the Midway Capital team

[4] Burton, Katherine. "Paulson's Puerto Rico Paradise Lures Rich Fleeing Taxes." *Bloomberg Business*. June 26, 2014. http://www.bloomberg.com/news/2014-06-26/paulson-s-puerto-rico-paradise-lures-rich-fleeing-taxes.html

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