

MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC

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July 15, 2016

Dear Fellow Investors,

This quarter had been an exceptionally good one for our portfolios until Brexit. We still ended up with gains but the panic and uncertainty created by the British vote to exit the EU came right as we closed the books on the quarter. The market has since recovered, as have our investments, and we have a number of holdings trading at high water marks. All that is to say that the quarter-end numbers seem out of date already and we're hardly two weeks into July. What the numbers do reflect is the heightened degree of uncertainty and volatility in global markets. We expect that to continue this summer and possibly for the rest of the year. So even though equity valuations are generally high and we have done some selling, we do expect to see some opportunities to buy as we did immediately following the Brexit vote.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q2 2016	1.52%	2.46%	-0.94
2016 Year to Date	0.84%	3.84%	-3.00
Annualized Return Since Inception	8.54%	8.73%	-0.19
Total Return Since Inception	92.95%	95.29%	-2.70

Data reflect total returns (including dividends) net of fees as of 6/30/2016. 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.

Britannia Makes the Waves

It may seem like investors shook off the Brexit news fairly quickly and resumed buying stocks. But that's a very simplified picture. The whole panic following the British vote to leave was pure uncertainty and speculation. Like the dog who finally catches the car and has no idea what to do with it, no one in Britain seemed to have any idea of how an exit would work. Even now with a new Prime Minister, they are still feeling their way in the dark. It is impossible, at this point, to quantify the long-term effect on investments.

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Brexit did, however, have some secondary effects. Most significantly, it has affected interest rate expectations. Investors are now expecting interest rates to stay low or negative for an extended period of time. If very low yields are unattractive for investors, negative yields are worse. Low-yielding U.S. Savings accounts mean that it would take 107 years to double your savings in a 1-year deposit account. But Germany issued 10-year negative debt on Wednesday, meaning that Germans now pay for the privilege of lending money to the government. All this makes investing in bonds extremely unattractive, to say the least. Still, some investors are fearful and are putting their money into bonds despite the lack of return. Others are pumping money into the stock market because it's the only place they can earn a decent return. So the rally in stocks seems to be driven by fear of earning nothing, rather than optimism about corporate profits or global growth that would normally drive stock prices higher. That's an unusual situation and a potentially volatile one.

For our part, the rally has helped most of our investments, and if it goes on we may even do more selective sales. However, we own several investments that are sensitive to interest rates, particularly banks, that could be worth substantially more if rates were to rise. These were all doing well earlier this year when the Fed indicated it was going to raise interest rates again. But Brexit seems to have derailed all that, temporarily we hope.

Our one major casualty of Brexit was JLL (formerly Jones Lang LaSalle) which is a commercial real estate firm that does 17% of its business in Britain. This long-time holding dropped more than 20% following the vote. That was clearly an overreaction as much of its British business is in long-term property management contracts. But JLL also brokers property deals, and following the Brexit vote the appetite for deals vanished. Everyone took a wait-and-see approach to better understand the impact. Investors in UK property were dumping real estate funds so quickly that several of the largest funds froze withdrawals. At that point, we stepped in and started buying. Even if deals are on hold right now, they won't be on hold forever and JLL actually could have a massive opportunity as properties change hands over the course of the British exit. Ultimately this panicked reaction could be a golden opportunity.

Not only are British properties on sale, but the British pound is also at a 30-year low against the U.S. dollar. So if you are in the mood for shopping in Britain, your dollar goes much further. Bloomberg suggests buying a Scottish Castle (or two) in today's magazine. ([*Brexit Means You Might Be Able to Afford a Scottish Castle \(or Two\)*](#))¹

Five Signs You Own the Right Portfolio (and Other Investing Wisdom)

If you follow us on Twitter, you'll have seen this already, but we couldn't resist sharing again. Financial journalist Jonathan Clements has come up with 11 signs that you own the right portfolio.² We have reprinted a handful here because we think they should resonate with our investors.

- You're so well diversified that you always own at least one disappointing investment.

¹ Hall, Tom. *Bloomberg*. <http://www.bloomberg.com/news/photo-essays/2016-07-15/brexit-means-you-might-be-able-to-afford-a-scottish-castle-or-two>

² <http://www.jonathanclements.com/home/2016/5/31/eleven-signs-you-own-the-right-portfolio>

- If the stock market's performance over the next five years was miserable, you wouldn't be.
- You have no clue how your investments will perform, but a great handle on how much they'll cost you.
- You don't have any hot stocks to boast about.
- Jim Cramer? Who's that?

Taking a leaf out of Mr. Clements' book, we have come up with our own little collection of investment wisdom and investment fallacy. Investment gurus are full of wise saws and modern instances – not all of which qualify as good advice. We've divided these into three categories based on veracity:

► False

Experts can predict the direction of interest rates/commodity prices/currencies/stock market. Like the infinite monkey theorem (enough monkeys typing for a long time would eventually produce the works of Shakespeare) enough "experts" predicting enough things will eventually come up with something true. That doesn't mean they have the power of prediction.

Markets are efficient. If the market is so rational, why would it fall 9% at 2:40 PM then shoot up 6% by 3 PM? Markets are driven by people. And people are driven by uncertainty, overconfidence, and emotion. If behavioral finance research has taught us anything, it is that humans are not rational economic actors.

More investments = better. Yes, diversification is good up to a point. But buying one of everything means you've bought a lot of junk along with your good stuff. We call this *di-worse-ification*. The good investments can't soar because they're chained to a mountain of mediocrity. Sometimes more isn't better, it's just more.

Insurance is an investment. Insurance isn't an investment, it's a transfer of risk. Some insurance products have niche uses for unusual tax situations. But mostly, insurance products offer low returns for the buyers (you!) and fat commissions for the seller (your agent). There are useful insurance products like term life insurance, disability insurance, and auto insurance which all transfer the risk of a substantial loss to another party. That is often wise expenditure – but it's not an investment.

There's a secret world of investing for fat-cat insiders like hedge funds. Hedge funds generally must disclose their holdings to the SEC each quarter. Mainly they invest in stock. Sometimes they'll buy an option or a convertible bond. Some funds sell stocks short, and many funds buy stocks on margin. A retail investor with \$50,000 can do any of these things. And those amazing returns? The average hedge fund lost 3% in 2015, while the S&P 500 gained 1.4%³.

► True

Take full advantage of your employer's 401k match, because it's free money. This seems obvious, but many people don't do it. Take an employer who matches 50 cents on the dollar up to 10% of an employee's salary. That's a guaranteed 50% return on your investment. Who wouldn't take that?

³Copeland, Rob. "Wasted Opportunity: Hedge Funds Falter." *The Wall Street Journal*. January 1, 2016.
<http://www.wsj.com/articles/rough-year-adds-more-stress-to-hedge-funds-1451690758>

Keep enough cash for a rainy day. We recommend enough cash on hand to cover 3-6 months of spending. A rainy day can be a leaky roof or a broken furnace. It can also be a volatile market that gives you a great buying opportunity.

Diversify your portfolio. “Diverse” can take on many different meanings. Stocks can be big, small, domestic, foreign, a public utility, a service firm, or a tech company. An often overlooked form of diversification comes in the form of tax status. Is it best to have a traditional IRA where you pay tax on withdrawals, or a Roth IRA where you pay tax up front and enjoy tax-free withdrawals? We think both have their virtues.

Good investing should be boring. How many trades has Warren Buffett made so far in 2016? There are three that we know of: he bought Apple, and sold AT&T and Procter & Gamble. He also added to some of his existing holdings and reduced his stake in a few others. How boring would it be if CNBC reported only on really great investors?

► **Maybe**

I can apply a magic formula to my investments. Some magic formulas are more useful than others. The Shiller PE (also known as PE/10 or CAPE) tells us when stocks are overvalued. It turns out that since about 1982, stocks have *always* been overvalued. Useful in the real world? Not really. (Though if the Shiller PE ever said stocks were undervalued, we’d shovel every dollar we could find into the market.) Another kernel of advice suggests withdrawing 4% of your portfolio in retirement each year, while another tells us that 120 minus your age approximates the percentage of bonds you should hold. The real world is more complicated, but these latter two axioms generally land in the right ballpark.

Rental properties are a good way to generate current income. Consider a one-bedroom apartment selling in downtown Chicago for \$300,000. Buy it with 80% financing – you invest \$60,000. Rent will be somewhere around \$2,200 per month. Subtract interest (10,000 per year), taxes (4,000), maintenance (5,000), utilities (1,000), and vacancy (1,000), and you can expect annual income in the neighborhood of \$6,400. If your time is worth \$100 per hour, can you manage the property for 64 hours each year? And maybe a better question is, do you want to spend 64 hours each year managing the property? If the answer is yes, then have at it. But many people find that it’s more than they bargained for.

You should prepay your mortgage. This goes hand in hand with the idea that “debt is always evil.” Your mortgage is almost always tax-deductible. Someone paying 4% on a mortgage and 28% in taxes really only pays 2.88% interest. If you prepay your mortgage, that’s your return on investment: 2.88%. That isn’t too bad if your alternative is a bank account. But if your alternative is the stock market, you’ll probably do much better in the market.

Your partners in investing,



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