

# MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC

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Dear Fellow Investors,

We are always pleased to report positive returns and the third quarter was a very good one for our portfolios. Though we've been reading recently that stock picking is a dead art, it has worked remarkably well for us so far.

## Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
<b>Q3 2010</b>	11.69%	11.29%	+0.40
<b>2010 Year to Date</b>	7.08%	3.89%	+3.19
<b>Annualized Return Since Inception</b>	6.17%	-2.74%	+8.91
<b>Total Return Since Inception</b>	14.42%	-6.06%	+20.48

Data reflect total returns (including dividends) net of fees as of 9/30/2010. 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 Quaint and Curious Practice of Stock Picking*

Lately, we've seen more than a few publications criticize stock picking as an antiquated practice.<sup>1</sup> This criticism has grown out of the observation that individual stocks have been generally moving in the same direction. In fact, the correlation between individual stocks is at an historic high. This has led many investors to ask, "if good stocks and bad stocks rise and fall together, why bother separating the wheat

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<sup>1</sup> For instance, *The Wall Street Journal's* article of September 24, 2010: Lauricella, Tom and Gregory Zuckerman. "'Macro' Forces Confound Stock Pickers."

from the chaff?" Instead, many pundits suggest using ETFs to buy a basket of stocks and gain exposure to areas that macroeconomic analysis suggests will perform well. The trend has caught on: there's even an ETF that follows this approach by investing in other ETFs!

As stock pickers, we consider this approach to be speculation. Consider Ben Graham's definition: "An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."<sup>2</sup> Holding a large number of companies can reduce volatility, but it promises neither safety of principal nor an adequate return.

More importantly, we see a substantial amount of opportunity that ETF investors ignore. Consider two widget manufacturers: Megacorp and Minicorp. Megacorp is the big player; it has billions of dollars in revenue, global operations, and an army of salespeople who keep the dollars rolling in. It earns ten cents profit for every dollar of revenue. Unfortunately for Megacorp's investors, its managers are poor stewards of shareholder capital. The company initiates acquisitions at ridiculous prices, it issues debt to repurchase shares at the market's peak, it floats more stock at a trough to repay the debt, and it doles out billions of dollars in stock-based compensation. In contrast, Minicorp is a niche regional player. Its revenues are a tiny fraction of Megacorp's, but management is obsessively stingy, and it earns twenty cents profit for every dollar of revenue. Acquisitions are rare and opportunistic. Share repurchases occur at regular intervals or when management deems them the best use of shareholder capital. Employees are fairly compensated and take pride in their work, but don't receive egregious equity awards.

Based on this description, an investor would clearly prefer to own Minicorp over Megacorp (assuming Minicorp can be had for the right price). However, buying a widget-focused ETF would yield the opposite result. Almost all ETFs follow market-cap weighted indices, so an investor would end up holding far more Megacorp stock than Minicorp stock.

If conditions persist, and Megacorp and Minicorp move in tandem with one another, the gap between Minicorp's price and value will grow wider. Recognizing the opportunity, we expect Minicorp's savvy managers will repurchase more of the company's stock if an outside investor doesn't do so first. If this action doesn't drive up the stock price on supply and demand principles, Minicorp will eventually repurchase *all* of its outstanding shares, essentially taking itself private. Thus, the few patient shareholders who remain delight in Minicorp's fantastic profitability.

While this may sound like a fabricated example, two of our holdings, Legg Mason (LM) and Dun and Bradstreet (DNB), are headed in this direction. They will take themselves private in four and 10 years, respectively, if they continue to repurchase shares at the rate they did last quarter. We don't actually expect this to happen; while the market is short-sighted, it isn't stubborn. Rather, we expect price and value to converge. They always do. So ironically, those times when stocks move in tandem and stockpicking seems moribund are the very best times to be in the stock picking business. As Mark Twain might have said, this report of the death of stockpicking is "an exaggeration."

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<sup>2</sup> Graham, Benjamin, *The Intelligent Investor*, edited by Jason Zweig (New York: Harper Collins, 1973, revised 2003), 18.

## Avoiding the bond bubble

"Do you recommend that I invest in bonds?" This is a question we hear frequently and it was a topic of keen interest at Rachel's investing course this past summer. The press has used copious amounts of ink covering and analyzing investors' rush to bonds during the past two years. Indeed, the amount of money pouring into bonds has been staggering by any historical standard. Investors have sunk more than \$550 billion into bond mutual funds over the past two years, according to the Investment Company Institute.<sup>3</sup> Compare that to the \$497 billion<sup>4</sup> that investors plowed into stock funds during the bubble years of 1999 and 2000 and you can get a feel for why this is being called a "bond bubble."

It's not hard to see why investors like bonds now. They perceive bonds as less risky than other investment alternatives (stocks, real-estate, etc.) and bonds do still have yields above 0%, though yields have been falling across the board. The popularity of bonds at such low yields suggests that investors are banking on a long period of minimal economic growth and the possibility of deflation. Certainly, this is a popular macroeconomic view.

Indeed, bond investors had better be sure that this scenario will play out, because even a small increase in interest rates could be a disaster for bond holders. *The Economist* quotes Royal Bank of Scotland economist John Richards on the subject:

*Mr. Richards recalls another occasion when investors in Japanese bonds were caught out. In 2003 ten-year government-bond yields shot from 0.5% to 1.5% in just three months, sparked by nothing more than fading fears of deflation and casual remarks by the Bank of Japan. Monetary policy did not change. Banks were all positioned the same way, he says. Once the selling began, it became "indiscriminate...it was a bloodbath." If the Fed raises rates to 4% by late 2013, as the consensus expects, bonds will sell off violently.<sup>5</sup>*

At Midway Capital, we are not in the habit of making macroeconomic predictions and we won't start here. However, interest rates are at rock-bottom levels right now and they can only go one way from here. When rates do rise - and eventually they will - bond prices will fall. Bond prices fall as yields rise and vice versa because as soon as rates rise, new bonds come to market with higher yields. No investor would pay \$1,000 for a bond with a 4% yield if he or she could pick up a brand new 5% bond for the same \$1,000. So holders of bonds will see the value of their holdings decline. If rates rise quickly, we could see the bloodbath that Mr. Richards has mentioned.

In order to believe that bonds are a good place to invest one's money now, investors need to believe that rates will remain low for an extended period of time. They also need to believe that they will know when to dump their bonds before everyone else does. Even if they are right about both these things, the best

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<sup>3</sup> Investment Company Institute flow data as of 9/29/10. [http://www.ici.org/pdf/flows\\_data\\_2010.pdf](http://www.ici.org/pdf/flows_data_2010.pdf)

<sup>4</sup> Bloomberg and ICI data quoted in *Bloomberg Businessweek*. Glover, John and John Detrixhe. "Bond Funds Gain Cash Like Stocks in Dot-Com Era: Credit Markets." August 23, 2010.

<sup>5</sup> "A bull market in pessimism." August 21, 2010, pp 60-61.

case scenario is that they earn paltry yields for the next few years. The worst case would be painful and serious financial losses. As you might have surmised, we find it difficult to recommend bonds. We are not buying them for our portfolio and we have been selling the small amount of bonds that we do hold.

The good news is that equities are very attractive, particularly compared to fixed-income securities. The equity risk premium is near an all-time high. The expected earnings yield on the S&P 500 index is just above 7% at this writing. That means that investors should get \$7 of earnings this coming year for every \$100 they invest in the market. Contrast that with the 1% real yield on government bonds. That means investors can expect a 6% excess return for stocks over bonds in recompense for taking on the risk of owning shares (6% is the equity risk premium). This isn't a guarantee of returns, of course. But it has historically been a good gauge of which asset classes are undervalued or overvalued relative to one another. As usual, Warren Buffet has chimed in on this debate and summarized it very succinctly. "I can't imagine anyone having bonds in their portfolio when they can own equities."<sup>6</sup>

### **Portfolio Update: Getting something for our cash**

As we mentioned above, yield is hard to come by in this environment of low interest rates. For cash, it is nearly impossible to get a meaningful return. One thing you will notice in your statements this quarter is that we've changed our option for sweeping uninvested cash. We've selected the Dreyfus Insured Deposit Program (DIDI) because it offers a higher yield – currently 0.20% - than money market funds that we have used in the past.

The Dreyfus Insured Deposit Program is a bank deposit sweep program, meaning that cash is swept daily into bank deposit accounts. The funds are deposited in multiple banks and all our funds are FDIC insured. It is still our aim to be fully invested if prices are right. But for the cash we do hold, we believe this is the best option at this time.

Yours,



Rachel Barnard, PhD

Matt Nellans

Todd Schrade, CPA

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<sup>6</sup> Warren Buffett speaking at the "Fortune Magazine Most Powerful Women conference" on October 5, 2010. Quoted in *Bloomberg* article of the same date. Frye, Andrew and Natalie Doss. "Buffett Compares Wall Street to Church With Raffle."