MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC
150 N. MICHIGAN AVENUE, SUITE 800, CHICAGO, ILLINOIS 60601

October 10, 2012

Dear Fellow Investors,

Looking back on the third quarter, we're satisfied with our investment performance, but we're particularly glad we swore long ago never to invest according to the advice of market pundits. Back in May, Wall Street had near absolute consensus that summer 2012 would be a repeat of the volatile summers of 2010 and 2011. In fact, the opposite happened: stocks moved slowly and steadily upward. We're struck that all of the reasons cited for a volatile summer – the fiscal cliff, slow growth in China, and fiscal unrest in Europe – still loom unresolved today. When confronted with this uncertainty, there's no penalty for playing both sides of the coin to ensure at least some bets pay off. Investing isn't like gymnastics or diving; there are no extra points for added difficulty.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q3 2012	2.54%	6.35%	-3.81
Year to Date 2012	14.65%	16.45%	-1.80
Annualized Return Since Inception	6.34%	5.14%	+1.21
Total Return Since Inception	29.87%	23.72%	+6.14

Data reflect total returns (including dividends) net of fees as of 9/30/2012. 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.

Housing Rises from the Ashes

Amidst the backdrop of uncertainty, strong and weak performers have emerged in some unexpected places. For at least the past decade, housing has been a feast-or-famine business, and as of late, optimism abounds. Home prices are finally rising across the country and housing starts have picked up. We've thought housing stocks were attractive as early as 2008, arguably a bit too early. Back then we picked up St. Joe (JOE) which has acres of prime seaside land waiting for development. We also bought Mohawk (MHK), a carpet company

TELEPHONE 312.445.8562 ✢ FAX 773.345.3637 ✢ WWW.MIDWAYMGT.COM

that was set to benefit from any pick-up in homebuilding or remodeling. We've since sold Mohawk because we believe it is now too optimistically valued. But we still think JOE has plenty of potential. In 2011 we added Pico Holdings (PICO) which had been buying up houses, lots, and land in California and Washington after the housing bust. Pico scooped up very valuable properties for almost nothing and is now beginning to re-sell the houses and build on the land in order to take advantage of rising prices.

The trend looks like it is here to stay. The most recent Case-Shiller 20-city index (data through July) shows that home prices have risen 5.9% during the first seven months of this year. This was the best showing for home price gains since 2005. In fact, 2012 marks the third year in a row when home prices have not declined. Consumers are also catching on. Fannie Mae's September housing survey reported that the majority of respondents expected house prices to go up or stay the same during the next year. Only 11% of consumers expected prices to decline.

Chalk much of this up to a sharp increase in demand for homes. Individual investors have been buying up properties and renting them out for several years now. But the big money has also jumped in with both feet. Besides our own Pico Holdings, other institutional players are in the market now. Blackstone Group, a private equity behemoth, spent more than $1 billion this year alone buying single-family homes in foreclosure[1]. The firm expects to make 6%-7% renting them in the short-term. However, it also expects to make more money selling the homes once house prices rebound further. In addition, Blackstone is looking to borrow more money to buy even more homes, a risky move if prices don't appreciate significantly.

The shortage of single-family homes available for sale is also helping homebuilders. Orders are up by double digits across the industry and homebuilding stocks have climbed by 73% this year to date in anticipation of higher demand. Even hard-hit Las Vegas, ground zero for the housing collapse four years ago, is seeing a big rebound in demand for homes – so much so that new construction is beginning again.

Multifamily (rental apartment) housing is in a boom, and arguably approaching bubble territory. Rents have been steadily rising, occupancy is averaging 95% (which is basically full), and construction of new units is soaring. We own several investments that have exposure to multifamily, including Forest City (FEC-A) and Brookfield Asset Management (BAM).

At the other end of the spectrum, consumer electronics stocks are woefully out of favor. Many stocks in that sector are below their 2008 lows, and with the notable exception of Apple, growth is essentially non-existent. Several of our most recent acquisitions fall into this category of consumer electronics. We believe, as with housing, it is merely a matter of time before consumers buy the next computer, device, or TV that starts the pendulum swinging back to growth in this industry.

How to Navigate the Coming Tax Changes

Quite a few tax changes are on tap for 2013. At least, they're currently on tap. Congress could change the law before year end. Or, the new Congress could retroactively change 2013 tax law once they take office.

---

[1] Karmin, Craig, Robbie Whelan, and Jeanette Neumann. "Rental Market's Big Buyers". *The Wall Street Journal* 4 Oct. 2012: C3.

TELEPHONE 312.445.8562 ⁘ FAX 773.345.3637 ⁘ WWW.MIDWAYMGT.COM

Depending upon the election results and Washington's priorities come November 7, a drastic set of changes may be on tap. We don't know precisely how this may play out, but there are some simple actions one should consider before the end of 2012.

There are two major changes taking effect next year. First, the Bush tax cuts are set to expire. This will raise dividend tax rates from a favored rate to the ordinary income rate. The expiration of the tax cuts will also affect capital gains tax rates. Currently, long-term gains are untaxed at lower income levels, and are taxed at favorable rates for higher income levels. Absent congressional action, these rates will rise across the board. Short-term capital gains are currently taxed at ordinary income rates. That treatment will continue, but since ordinary income tax rates are set for a slight increase, the tax on short-term gains will increase as well. Check the table below for an overview of what will change:

<table>
<tr><th colspan="2">Ordinary Income Tax Rates</th><th colspan="2">Dividend Tax Rate</th><th colspan="2">Long-Term Capital Gains Rate</th><th colspan="2">Short-Term Capital Gains Rate</th></tr>
<tr><th>2012</th><th>2013</th><th>2012</th><th>2013</th><th>2012</th><th>2013</th><th>2012</th><th>2013</th></tr>
<tr><td>10%</td><td rowspan="2">15%</td><td rowspan="2">5%</td><td rowspan="2">15%</td><td rowspan="2">0%</td><td rowspan="2">10%</td><td>10%</td><td rowspan="2">15%</td></tr>
<tr><td>15%</td><td>15%</td></tr>
<tr><td>25%</td><td>28%</td><td rowspan="4">15%</td><td>28%</td><td rowspan="4">15%</td><td rowspan="4">20%</td><td>25%</td><td>28%</td></tr>
<tr><td>28%</td><td>31%</td><td>31%</td><td>28%</td><td>31%</td></tr>
<tr><td>33%</td><td>36%</td><td>36%</td><td>33%</td><td>36%</td></tr>
<tr><td>35%</td><td>39.6%</td><td>39.6%</td><td>35%</td><td>39.6%</td></tr>
</table>

In addition to these changes, an investment[2] income surtax of 3.8% is set to affect individuals earning over $200,000 and married couples earning over $250,000. This would effectively increase the top dividend tax rate from 39.6% to 43.4%. Notably, recognizing a large gain may trigger this rule. For example, if a retiree living on social security and a modest pension sells a longtime stock holding for a $250,000 profit next year, it will be taxed at 23.8% (20% rate + 3.8% surtax) instead of 15% had the sale occurred in 2012.

Tax increases aren't exactly cause for celebration, but given reasonable notice, astute investors can work with their tax professionals to minimize their tax liability. The current problem lies in the fact that both political parties wholly reject planned changes, which will *automatically* take effect unless new legislation overrides them. There's a strong chance any new law would require bipartisan cooperation, which essentially means there's a strong chance our politicians will dance their dance of political brinksmanship until the last possible moment. In that case, who knows what – if anything – might emerge?

When the stock market throws uncertainty our way, we respond by spreading our bets and by looking for outcomes that are highly likely to occur, even if they don't offer the highest payoff. We think it's wise to treat this tax uncertainty the same way.

We like to keep dividend paying stocks in IRAs, since the planned 2013 rates could potentially halve their after-tax payout. Most people can contribute to some kind of account that functions like a traditional IRA; we

[2] This surtax applies to dividends, capital gains, and interest income

TELEPHONE 312.445.8562 ⁜ FAX 773.345.3637 ⁜ WWW.MIDWAYMGT.COM

advise our clients to take advantage of this opportunity to the fullest extent possible. We favor Roth IRAs for younger investors, since a longer period of market appreciation should make up for the foregone benefit of a current tax deduction. Though statutory limits don't allow high earners to make major contributions, most taxpayers are eligible – even (what a great gift idea!) teens with a summer job.

Finally, don't overlook the flexibility afforded by taxable accounts. Say an investor is currently sitting on $300,000 in capital gains in a taxable account. Selling and immediately repurchasing the existing holdings will create a tax liability for this year, but the basis of the assets will increase by $300,000. Thus, tax has already been paid on the $300,000, and subsequent withdrawals won't be taxed. And, if the value of the account should drop, losses can be netted against gains elsewhere (and usually, against ordinary income as well) that would otherwise be taxed at higher rates. When dealing with taxable accounts, there are quite a few strategies that can be employed to create a situation favorable to the taxpayer. It's best to discuss these with us or your tax preparer so you can plan for your individual situation.

New Website

In case you haven't been to our website lately, we wanted to let you know that we've recently put up a brand new site at **www.midwaymgt.com**. Besides being a bit more stylish than our old one, we also have a new "Clients" page that we hope you will find useful. There is a link to online access for your accounts, a link to our Twitter feed, an archive of our quarterly letters, and our composite performance. And if there's anything else you'd like to see up there, we're more than happy to add it. Just let us know!

Yours,

Rachel Barnard, PhD
and the Midway Capital team

TELEPHONE 312.445.8562 ⁘ FAX 773.345.3637 ⁘ WWW.MIDWAYMGT.COM