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Dear Fellow Investors,

We're pleased to report that we made money again in the third quarter of what has really been a remarkable year for investing. As usual, we've put together a few reflections that pertain to our investments and our outlook for the markets. We hope you find it engaging.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q3 2013	7.03%	5.24%	+1.79
Year to Date 2013	23.16%	19.81%	+3.35
Annualized Return Since Inception	10.24%	7.70%	+2.54
Total Return Since Inception	66.81%	47.65%	+19.16

Data reflect total returns (including dividends) net of fees as of 9/30/2013. 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.

A Remarkable Year

If it seems like 2013 has been a remarkable year for the stock market, it has. There are very few cases when stocks have delivered such high returns with such little volatility. Stocks have continued to climb and prices have been very stable, with none of the wild swings we have become accustomed to during the financial crisis and in the years following. To put that feeling of calm into numbers, the Sharpe Ratio for the S&P 500 index ranks in the 98th percentile since 1962.[1] The Sharpe ratio measures return relative to volatility, and a high number means that investors have enjoyed a lot of return (numerator) for very little volatility (denominator). Some have compared 2013 to 1954[2], the year when the Eisenhower Rally finally marked the stock market's

[1] Data courtesy of Goldman Sachs Investment Research

[2] Kisling, Whitney. Eisenhower Rally Repeating as S&P 500 Tracks Gains of '54. *Bloomberg News*: September 30, 2013.

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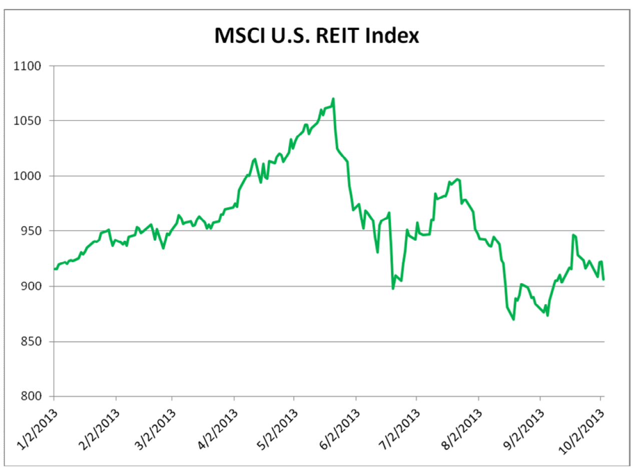
recovery from the Great Depression. If you remember that terrific year for stocks, you will probably recall the confidence that spilled over into the general population as people began seeing that economic crisis in the rear-view mirror. So far this year, the S&P 500 returns have been tracking 1954 almost exactly.

We aren't suggesting that history will repeat itself. Certainly the government shut-down, debt ceiling and other events could derail any further gains in the market, and the 45% return of 1954 is an awfully high bar. However, we do want to underscore the fact that 2013 – so far – has been an extraordinary year. That makes it very unlikely that we will see this environment again, maybe for another 59 years. It makes no sense to go on investing like it will be 2013 forever. To be clear, we do think US stocks offer good returns at current prices, but probably not more of the extraordinary returns we've enjoyed this year.

To that end, we are looking more seriously into areas that have not performed as well and are undervalued. At present we like emerging markets and real estate.

Emerging market stocks have suffered for a couple reasons. First, there have been real problems in the flagship emerging markets of Brazil, Russia, India, and China. To sum these broadly, there have been a lot of growing pains, particularly as these countries try to keep up with changing economies. Second, the prospect of higher US interest rates has led to an exodus of money from foreign countries. A lot of money was parked abroad as US investors sought higher returns when interest rates were low at home. Now the prospect of rates rising has spawned a rush to the exits as no one wants to be the last one out the door. Developing countries need foreign investment to keep growing. And so they have been priced as if they will cease to grow. While this does all sound bad, it is hardly permanent. We're looking for the good investments overseas that other investors have left behind. When emerging markets do recover, there is a lot of money to be made.

Real Estate is a similar story. The prospect of higher interest rates has spooked investors. If interest rates go up, property owners will have to pay more for borrowed money. The whole property sector runs on mortgages. Like most homeowners, owners of offices, apartments, and shopping centers also take out mortgages on their buildings. Higher interest rates can prevent them from expanding or from buying more properties. This, in turn, can make properties a less attractive investment. The chart on the left shows the price of the MSCI U.S. REIT Index in 2013[3]. The peak in May corresponds with a change in interest rate expectations.



Investors also point out that real estate companies seem to do better in falling interest rate environments and worse if rates rise. But these data there aren't conclusive and the correlations don't hold up in every instance. We've been in a falling rate environment for more than three decades now, making it difficult to gauge the effect of rising rates on 21st century real estate. If the economy continues to expand, this could be very good for office properties and shopping malls, for

[3] The MSCI U.S. REIT Index is composed principally of US property Real Estate Investment Trusts and is weighted by market cap. It is a good proxy for U.S. real estate investments available to the general public.

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example. They may be able to sign up more tenants. Apartment owners can raise rents quickly if their costs increase, and with home mortgages becoming more expensive, it looks like the popularity of rental housing will continue. We think real estate remains an attractive investment for long-term holders, and today's low prices mean that we're being paid more than adequately to take on the interest rate risk.

Healthcare Exchanges: We Already Own One

Healthcare exchanges are in the news almost constantly now. The commencement of the Affordable Care Act has introduced them to the public. You may not know, however, that we already own one through Towers Watson (TW). The firm landed three big clients this year and saw 100%+ growth. They're expecting a further 145% growth in their healthcare exchange in fiscal 2014.

The trend toward exchanges is bringing major change to Towers Watson. Formed following the merger of Watson Wyatt and Towers Perrin in 2010, the company traces its roots back to the 19th century. For much of its history, Towers Watson focused on actuarial work, lending its statistical expertise to insurance companies and large pension plans.

As pension plans started losing popularity with the advent of the 401(k), Towers Watson's predecessors began diversifying into other business lines. This diversification was generally successful, but the lion's share of revenue still originated in some way through the old, enormous corporate pension. These plans require a significant amount of annual upkeep to ensure benefits are paid in a timely and accurate fashion, and the plans can be almost comically long-lived. Civil War pensions were paid to widows as recently as 2003![4] Since many pension plans offer spousal benefits, they will see this same longevity. That can be a real headache for employers, and this is part of the reason businesses now favor the 401(k).

The 401(k) transfers almost all the risk and responsibility from the corporate entity to the employee. Instead of promising a predefined benefit after a given term of service, employees receive (generally) some contribution from the employer, and are able to make their own contributions as well. Management of deposits, withdrawals, and investments are at the sole discretion of the employee. Today, we're witnessing a similar trend in the administration of healthcare benefits.

The Affordable Care Act places a great deal of emphasis on health insurance exchanges, which are essentially marketplaces for various policies from multiple insurers. Think Orbitz for health insurance. The idea of an exchange isn't new; indeed, Extend Health (recently acquired by Towers Watson) was founded in 2004. Extend Health focuses on retirees who are buying supplemental Medicare policies. Thus, a company offering retiree healthcare coverage gives their retirees a set payment and directs them to purchase adequate coverage on their own.

This should sound very familiar. Previously, a company would negotiate group coverage for all its employees and retirees. Coverage may have been excessive or insufficient, but the sole responsibility for providing it the fell on the shoulders of the corporate parent. The new trend is to leave more of the responsibility to the

[4] Gertrude Grubb married John Janeway, an 81-year-old union veteran, in 1927 at age 18. She passed away in 2003 at age 93.

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individual, just as the 401(k) plan emphasizes more responsibility at the employee level. Already, Extend Health serves 300 businesses, and it recently announced that IBM's 110,000 retirees will join the ranks in 2014.

We think this is a trend that's likely to continue, and even expand. Health insurance is expensive, and the marketplace is horribly inefficient. It's impractical to obtain multiple quotes because the evaluation process takes so long, and switching coverage is a hassle in and of itself. By hiring a private exchange, companies can outsource the entire selection process to the exchange and employee. News recently leaked that IBM is paying its retirees between $3,000-3,500 for supplemental coverage. Employees who find cheaper coverage can draw on the remainder for co-pays and out-of-pocket expenses. IBM's annual costs are thus fixed for each retiree. If there were an unexpected rate hike, the retirees would have to make the tough choices. However, competing bids are prominently displayed, so the retirees could readily choose another provider. In any case, this takes a big burden off of IBM.

The shift from defined-benefit pension plans to defined contribution 401(k) plans has forced Towers Watson to evolve. While the shift may take decades (perhaps, centuries), the company cannot rely forever on what has been a dependable business line. But as one door closes, another opens. Towers Watson can be nimble. It doesn't have factories to re-tool. As a consulting firm, its assets are its employees and we rely on their brains to craft the next generation of benefits management tools. It looks like they are already well ahead of the curve.

The Nobel Prize in Economics

And finally, we couldn't resist a brief comment on the Nobel Prize that was announced this morning. Two of our Chicago neighbors won (Eugene Fama and Lars Peter Hansen) along with Yale's Robert Shiller. All three economists study asset pricing, something we wrestle with every day. The irony is that Fama and Shiller represent polar opposite views of how investments are priced. Fama's work suggests that markets are rational, and Shiller calls them irrational. The fact that both views are influential (and worthy of a Nobel Prize) underscores just how little the world actually understands about why prices move or how to predict the next moves. The committee in Stockholm must have had a few good chuckles at the juxtaposition of these two philosophies. Perhaps the Nobel laureates are looking at different parts of the same elephant. At Midway Capital, we believe that assets are frequently mispriced but tend to revert to a fair price in the long term. We haven't won the Nobel Prize for that, but we still think it's the best asset pricing philosophy for those of us who toil on the practical side of investing.

Yours,

Rachel Barnard, PhD
and the Midway Capital team

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