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

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Dear Fellow Investors,

There was a substantial disconnect this quarter between our portfolio and the portfolio of large U.S. stocks against which we measure ourselves, the S&P 500 Index. That is intentional on our part. We have been increasingly diversifying away from big U.S. companies because we think they are comparatively less attractive than smaller companies and emerging markets. The market didn't happen to agree with us this quarter. Returns were lackluster all around, but large domestic companies performed better than other categories. Right now, investors think that the U.S. Economy is the best looking horse in the glue factory.[1] We are inclined to agree. Large U.S. stocks have higher price tags – and therefore less attractive potential returns.

It's impossible to say what will happen this next quarter, but the beginning has been choppy. Take a rising U.S. dollar and falling oil prices, then marry that with stagnant overseas economic growth, civil unrest, and even Ebola and we have an atmosphere of heightened uncertainty. But while we're cautious, we're also optimistic that dislocations in the market will open up a few new opportunities.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q3 2014	-2.39%	1.13%	-3.52
2014 Year to Date	2.33%	8.34%	-6.01
Annualized Return Since Inception	10.47%	9.54%	+0.93
Total Return Since Inception	86.36%	76.79%	+9.57

Data reflect total returns (including dividends) net of fees as of 9/30/2014. 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.

[1] We gratefully acknowledge Kai Ryssdal of NPR's Marketplace for providing us with this metaphor.

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Todd vs. Dow – Who's the Better Borrower?

Todd recently refinanced the mortgage on his home. He was pleased with his interest rate of 4.375%. The same week, Dow Chemical issued $500 million of bonds at 4.625%. Todd brought this to the attention of the team at Midway. We were trying to determine who got the better deal. On the one hand, Todd's loan puts his home up for collateral. Dow's bonds are unsecured, so it makes sense Todd's rate is lower. Todd 1, Dow 0. On the other hand, Dow earned almost $4.5 Billion last year. Todd did not. Todd doesn't have any debt except his mortgage. Dow does. But Dow has $6 billion in cash. Todd does not. The score is now tied, 2-2.

The team at Midway debated whether Todd was getting better borrowing terms than Dow, and the score kept growing. But the one point all could agree on is the identity of the losers. Both Todd's and Dow's respective lenders were getting the short end of the deal. The lenders will have to pay tax on the interest income from these loans. That will push their after-tax return well below 3%. On the other side of the coin, Todd gets to enjoy tax savings from his loan. That puts the actual cost of his loan at around 3% also. Todd could have paid cash for his home outright, but it would have meant liquidating his investment portfolio. In effect, by borrowing instead of selling his investments, Todd is betting that he'll earn more than 3% after tax over the next 30 years. That's a good bet. Dow is making a similar bet that it can take the money it borrowed and make more than a 3% return.

Both Todd and Dow have been taking advantage of cheap money. However, cheap money could vanish soon. The stock market has recently been abuzz with talk about rising interest rates. The Fed has been (by historical standards) quite clear that rates will increase in 2015. It's slowed its bond-buying program, which is likely to be eliminated by year end.

Because interest rates have been exceptionally low for so long, no one really knows what will happen when rates rise. The markets are uncertain about how companies will deal with the end of cheap money. One widely-held view is that small companies will suffer disproportionately. A popular hedge fund trade has been to bet against all small companies as a group.[2] The theory goes that these firms are more dependent on borrowing than large companies. It follows that an increase in interest rates will have the dual effect of making borrowing more expensive (so companies can't borrow as much), and putting companies with too much debt at risk of failure, particularly if the economy sputters when rates rise. The broad market has generally gotten on board with this line of thinking. Of the 3,000 U.S. companies tracked in the Russell indices, the largest 1,000 returned +0.65% in the third quarter. The smallest 2,000 returned -7.36%.

Certainly many small companies depend on debt financing, and those that do will find life more difficult if money becomes expensive to borrow. But many small companies – and especially the ones we like to own – have no debt or minimal debt, and they are quite good at reinvesting their borrowings in higher yielding investments. Just as Todd feels he can earn more than 3% on his investments after tax, we think our smaller holdings have the same kind of earnings potential.

Betting against all small companies is the classic example of throwing out the baby with the bathwater. In the market's efforts to divest itself of debt-dependent companies, it's thrown out everything that *may* fit that definition without checking to see if it *does*.

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[2] Hwang, Inyoung and Sofia Horta e Costa. Hedge Funds Score With Small-Cap Shorts in Russell Drop. *Bloomberg News*. http://www.bloomberg.com/news/2014-09-28/hedge-funds-score-with-small-cap-shorts-in-russell-drop.html

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You may have noticed that most of our recent trades in your portfolios favor small company stocks. That's not an accident. These are precisely the waters we love to fish in. When the price drops for all small capitalization stocks, without regard to quality, it's time to start picking through the bargain bin to find the gems.

Assessing Investment Risk When Things are Different

This time, it's different. Legendary investor Sir John Templeton once said that those were "the four most dangerous words in investing." We take that to heart. Most people who assess risk take that seriously. We can all picture some young wide-eyed kid, still wet behind the ears, telling us how the past doesn't matter, experience is irrelevant, and that it will be different this time. It sounds like a dangerous philosophy and it is.

But what if things are changing? What if it is different this time and we fail to recognize that? That isn't an easy line to cross, because the past is almost always a good window to the future. However, investing only really affords us data from the recent past. Modern financial markets haven't been around very long – a mere blink of an eye in geologic time. We can look at 100 years of stock market data and think we've got a very comprehensive sample. But what if we're looking at forces that change over a much longer period of time?

With the increasing prevalence of "unusually" severe weather (droughts, floods, freezes, storms, etc.), we are concerned that climate volatility may impact our investments in unpredictable ways. In other words, we are questioning whether the global climate we've experienced and documented through the last few centuries may not be representative of the next century. On the one hand, it is easy to look at historical data on things like disasters. We can predict how often hurricanes happen and how severe they might be based on the data we have documented. Insurance companies do the same thing and decide how much to charge for insurance coverage. We look at the data and decide whether to buy an insurance company stock. But on the other hand, if the past data aren't a good guide to the future, where do we go? How do we value an insurance company that may have plenty of money on hand to handle the average disaster of the past century, but not larger, more frequent catastrophes?

This line of thinking has pushed us to evaluate risk in a different way. As we've said before, we define investment risk as the chance of permanent capital impairment. In other words, the chance that a company is permanently worth less than it used to be. A good example might be a company that primarily manufactures menthol cigarettes. If the United States decided to outlaw menthol cigarettes (the idea has been floated) then the aforementioned cigarette company could lose most of its market. The value of the company would be immediately lower. In the case of increasing climate volatility, we've had to dial up the risk on any firm that could be affected by unusual weather.

One example of this is a small firm we invest in called Pico Holdings (ticker=PICO). Two of its three businesses are dependent on the weather. Pico owns water resources in very dry areas of the southwestern United States. It makes money by selling this water to customers like cities, utilities and developers. Historically, growing populations and agricultural operations have guaranteed that the southwest uses more and more water each year, giving Pico nearly a guaranteed market for its water rights. But the drought in California may accelerate this demand. Our estimates of what this water might be worth needs to change in that the water may be sold sooner than we expected and for more money. On the flipside, the drought may

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accelerate conservation efforts and water usage patterns may change drastically in the southwest. In other words, the range of possible outcomes has become much wider.

The same thing could be said of Pico's agribusiness operation. It owns a canola crushing facility in Minnesota. The amount of money it makes is based on the price of canola seed but also the supply. Extreme weather and natural disasters can severely affect the canola harvest, making it impossible to get enough supply to operate profitably or sending seed prices through the roof and making canola products relatively unattractive to consumers. Though the historical data make canola processing look attractive, the range of possible outcomes is much wider in the future.

Is it different this time? Perhaps the answer is "no." It's always been difficult to price risk. And although we can discern patterns from past events, the future is never an exact repeat of the past. But the changing world does challenge us to look at businesses in a new way. We're reminded of the housing bust just a few years ago and how many knowledgeable investors thought that house prices would never fall. Or in the inimitable "Fed speak" of Alan Greenspan, "a national severe price distortion seems most unlikely,"[3] Clearly, it was different that time. It's a humbling reminder that successful investing is more than just rehashing the ideas that worked in the past.

Yours,

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

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[3] Ip, Greg. The Worst Ideas of the Decade: Housing Prices Always Rise. *The Washington Post*.
http://www.washingtonpost.com/wp-srv/special/opinions/outlook/worst-ideas/housing-bubble.html

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