MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC
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October 12, 2015

Dear Fellow Investors,

It was a rough quarter in the equity markets. Though we've seen a significant rebound in October, we believe there will be more volatility this year as global economic conditions remain difficult. Typically the more volatile markets yield the best investing opportunities, so we will continue adding to our portfolios this year if the prices are right.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q3 2015	-9.02%	-6.44%	-2.58
2015 Year to Date	-7.72%	-5.29%	-2.43
Annualized Return Since Inception	8.84%	8.08%	+0.76
Total Return Since Inception	84.85%	75.69%	+9.16

Data reflect total returns (including dividends) net of fees as of 9/30/2015. 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.

Love the Dips

The other day I was at a cocktail party and a friend of mine asked me about the market (occupational hazard: I'm sure dermatologists get asked about skin conditions, so I guess I'm lucky). I replied enthusiastically that the volatility created more opportunities than we've seen in years and that it was an exciting opportunity to buy some things on the cheap and reposition the portfolios. The pained look on her face betrayed her lack of enthusiasm for stock market dips -- or perhaps it was just that her shoes were excruciatingly painful -- but you can picture the expression. It's not easy to love the dips and most investors don't. But we are not most investors; and at times like these, having a professional manager for your stock portfolio should prove to be a wise investment in itself.

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Since 2009 there have only been two other dips in the broader stock market. Seven years into a bull market it is easy to forget that stock prices don't travel gently upward with minimum volatility. Even if they did, you probably wouldn't want to invest in equities because they would not offer much return. The reason stocks have rewarded investors so handsomely (8-10% annual returns on average for the past century) is that stock investing involves risk, including the risk that prices will go down. As we've said before, we don't regard volatility as risk in the way other people do. There is a real risk that a given company will permanently be worth less than we paid for it. That is risk we try to avoid. But volatility is a risk for the short-term investor. Anyone willing to wait out the dips can see volatility as an opportunity. Prices can easily become divorced from fundamentals and we can sell holdings for more than they are worth, while also buying others for less than they are worth.

In fact, the market has been unusually stable over the past four years. That may sound good, but from our perspective, it is rather like having all your weather be sunny and warm. That's nice for a while -- until the lack of rain sends you into a drought and the earth craves a good rainstorm. We need both the rain and the sun in balance. Likewise, we need opportunities to buy and sell.

We had such an opportunity in the late summer and you may have noticed more action in your portfolios recently. At the end of July and beginning of August we decided that two of our very long-term holdings were trading at prices well beyond their future earning power. We sold all our holdings for C.R. Bard (BCR) and Cincinnati Financial (CINF) for this reason. To be clear, we don't think these are bad investment choices, but just not worth their high prices. Around the same time, we initiated a position in Lincoln Electric (LECO), a maker of arc welding equipment which had been affected (unduly, we believe) by declining exports to China. We certainly were not expecting stock prices to decline last quarter. We never know when a dip is around the corner. But based on fundamental factors, we thought the market was mispricing these stocks.

When the market did correct, the selling was fairly broad. However, a tweet from presidential candidate Hillary Clinton sent biotechnology stocks down even further because she suggested that she would be taking on "price gouging" in the drug market. At that point a stock on our wish list, Gilead Sciences (GILD), dropped into buying territory. After evaluating the probability of drug price regulation from a possible 2017 Clinton presidency, we decided that the chances of any material impact on Gilead's prospects were remote. We began buying the stock at what we feel is an excellent price point.

Coming back around to my friend's question about the market: we don't know what will happen next. However, we do stand ready to take advantage of any opportunities that might arise. As of this writing, October has brought a sharp uptick in stock prices and our portfolios have gained 4.5% this month already. If this continues, we may not do much more buying. But we think it's more likely that the markets remain volatile as the year wears on. Though the U.S. remains on solid footing, many economies around the world are struggling with the steep fall in commodity prices. For those countries which make most of their money from selling commodities (oil, aluminum, steel, copper, etc.) it will be a bumpy road ahead. In the following section, we discuss just how bumpy things might get for oil producers.

Economies Built on Oil are Houses Built on Sand

We typically don't spend too much time worrying about energy prices. To paraphrase J.P. Morgan, we're content to observe that "they'll fluctuate." However, oil prices fell off a cliff last year for fundamental (not

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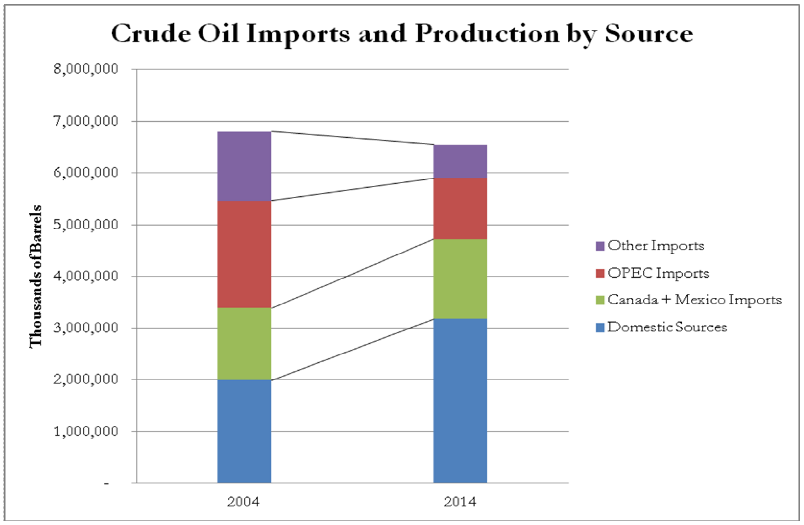
cyclical) reasons and this is shaping up to be the story of the decade. As we discussed in our first quarterly letter this year, the American oil boom dramatically changed the world's energy landscape.

Let's begin with the United States. Even a cursory glance at the chart below will reveal how substantial the shifts have been. The first thing to note is that we are using approximately 8% less oil than we did ten years ago. This looks like a sustainable trend toward Americans consuming less oil overall. The second trend is the drop in oil imports. In 2004, the U.S. imported 71% of its oil.[1] Ten years later, 51% of our oil was sourced from abroad. When you couple reduced demand with increased domestic production, we're importing 30% *less* oil than we did a decade earlier. Of the oil we do import, much less comes from OPEC. Last year, Canada and Mexico were our biggest suppliers. Meanwhile, we bought about half as many barrels from OPEC as we did a decade ago.



Source: Energy Information Administration

America has become increasingly energy independent, its neighbors have become lead suppliers, and OPEC is gradually losing a good customer. For a while, OPEC was content to supply oil to a thirsty new customer: China. But as that country's economic expansion slowed, OPEC found its global power profile shrinking. Thus, the oil cartel – more precisely Saudi Arabia, its biggest contributor – boosted production in late 2014 in order to drive prices down and drive American producers out of business. (This is the same tactic used by Rockefeller and Vanderbilt to drive out their competitors and might be akin to Wal-Mart having a non-stop Black Friday liquidation sale until Target declares bankruptcy).

The price of crude oil did collapse. At the time, many market participants expected prices to rebound rapidly. That hasn't materialized. In fact, things have gotten worse for the Saudis and OPEC, and we believe they may get much worse. American producers haven't responded by cutting production. In fact, no one has cut production appreciably. In the U.S., new development has slowed dramatically, but wells in place are still pumping. More importantly though, technology has advanced so rapidly that newer wells are producing far more oil than their aging counterparts. As old wells come offline, new wells can be completed cheaply and with outstanding results. One of our holdings, Devon Energy, stated that they'll cut their drilling budget by 2/3 next year, yet they still expect production growth. In Canada, oil sands projects require massive up-front investments, then produce cheap oil for decades. The current price of oil doesn't justify any new projects, but that doesn't affect the thirty-some years of future production which existing projects will deliver to market in years to come. Adding to the already prodigious supply of world oil, we have Iran. Sanctions are set to be

[1] Crude oil imports and consumption data from the Energy Information Administration
http://www.eia.gov/dnav/pet/pet_move_impcus_a2_nus_ep00_im0_mbbl_a.htm
http://www.eia.gov/dnav/pet/pet_crd_crpdn_adc_mbbl_a.htm

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lifted soon, and Iranian crude could be on the market as soon as spring 2016. Couple that with tepid demand in China and you've got an awful lot of oil chasing a smaller number of consumers.

This has put massive pressure on oil producing states. While these states can produce oil cheaply, their governments are almost entirely financed by oil revenues. A 50% reduction in the price of oil equates roughly to a 50% drop in money to the government. Saudi Arabia has gone from a budget surplus to a deficit of about 20% of GDP – roughly twice the size of Greece's gap. To finance the gap, the Saudis and other gulf states have raided their reserve funds while maintaining lavish government outlays; Saudi Arabia issued its first government bonds since 2007. Attempts at cutting government spending so far have been rebuffed.

Roughly twelve months into the new world of cheap oil, we're starting to see a new reality. Clearly there is a glut of supply at the current price. To get prices back into equilibrium, someone will need to cut output. We don't think American producers will be the sole source of output reduction, and we don't think increased demand will soak up all the excess supply. That means another historic exporter – likely an economy that's built around oil exports – will need to decrease its output for demand to reach equilibrium, or prices are likely to fall further.

We see a number of parallels between the devaluation of oil and the bursting of the housing bubble. Think of all the jobs – construction, materials, financing, lawyers, realtors – that existed to support an economy where $1 million homes were flipping like hotcakes. Once home prices came down, jobs evaporated. Investors grew more discriminating, and marginal projects didn't get off the ground. We all know how the effects rippled through the economy. Now imagine housing is the *only* industry in the U.S., and you get an idea of the problem facing the Gulf States.

It's not impossible for Gulf economies to right their ships. They'll have to cut social, defense, and infrastructure programs, nurture new industries, and work towards building a whole new economy. None of those things is impossible, but they all represent major undertakings over years if not decades. These measures will be met with resistance. Governments dependent on oil will stop supporting people and businesses dependent on government. Budget deficits don't lead to the fall of a political system, but a collapsing living standard can cause widespread unrest.

We're keeping an eye on this situation because it might be the start of a major power shift in the Middle East. For generations, just a few nations on the Arabian Peninsula have enjoyed significant influence in global affairs. But Saudi Arabia's economy is about as big as the economy of Illinois. We have to wonder if this region's height of influence has passed, and in that case, what the implication may be.

Yours,

Rachel Barnard, PhD
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and the Midway Capital team

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