MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC
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Dear Fellow Investors,

We've had some smooth sailing this quarter as markets have climbed and the economy has been chugging along toward full employment. The smooth waters are almost eerie as we're accustomed to more wind and waves. When we look back over our shoulders the turmoil of 2008 still seems very fresh in our memories. That said, the economic forecast continues to call for fair weather and we think that stocks are still the best places to invest our money for superior long-term returns.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q3 2017	4.95%	4.48%	+0.47
2017 Year to Date	16.25%	14.24%	+2.01
Annualized Return Since Inception	10.50%	9.95%	+0.55
Total Return Since Inception	151.9%	140.6%	+11.3

Data reflect total returns (including dividends) net of fees as of 9/30/2017. 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.

Market Update

The markets will fluctuate. Markets revert to the mean. Those are two pieces of market wisdom we can probably take to the bank. By most metrics, the stock market is currently trading above the long-term median valuation. Volatility is also unusually low and there hasn't been even a modest correction this year. Consequently, many investors are expecting that the party can't last forever – that stock prices will fall back to a long-term average and markets will again be volatile. We are expecting that too. However, there is no telling when either of these things will happen. It could be a matter of weeks, months, or years.

Our strategy remains consistent in that we like to buy undervalued companies or industries that are out of favor. In the past few years, we've added emerging market investments, biotechnology stocks, and energy. However, there isn't much that's out of favor right now. Just two sectors of the US economy (out of 11) have

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declined this year and both are starting to rebound. We have some money sitting on the sidelines that we'd like to invest if prices fall, but that hasn't happened. In a market like this, in the absence of deep discounts, we are focusing on buying the best companies. When we do add to our portfolios, you can expect us to buy the highest quality companies – companies with sustainable competitive advantages, high profits, strong growth, and pricing power. We see these companies as having the lowest risk. Their stock prices may fluctuate, but the underlying business are built to survive and thrive under any conditions. In a market with few bargains, we're focused on quality as the best way to navigate this stretch of water.

Are bonds a better option at this time? We wouldn't recommend them right now, except for retirees and investors with near-term cash needs. If stock valuations look high, bond prices are even higher. For reference, the current S&P 500 group of stocks is priced at 19 times earnings, higher than the average of 17 over the past 30 years. The 30-year US Treasury bond (the long bond) is priced at 34 times its yield of 2.9%. The historical average is 18 times. At those prices, it's impossible to make a case that bonds are a better investment than stocks.[1]

What can we learn from the Equifax debacle?

We don't own any shares of Equifax and never have. Even so, there is much to be learned from examining the recent scandal at the firm. First and foremost, it affects us as individual users of credit. You already know that hackers stole personal credit data for 143 million consumers from Equifax. If you have ever had credit of any kind, your data are probably among the stolen files. Unfortunately, there is no magic bullet to protect yourself, unless you're willing to:

1. Regularly change your name, social security number, birth date, and home address
2. Drop off the grid and live in an inaccessible cave in Montana

If you can't manage either of these, our best advice is to monitor your credit. We like the free credit monitoring service provided by Credit Karma, which also allows you to view your credit report. The government offers free access to your credit report through AnnualCreditReport.com. But the monitoring service is nice because it immediately notifies you if there has been a credit inquiry on your report. If you open a credit card, get a loan, sign up for a phone plan – or any other party does that in your name – you will immediately hear about it. We also recommend setting up 2-factor authentication on your email and bank accounts. That way, no one can use stolen information to log into your accounts. Also, monitor your bank statements every month. This is not a perfect solution, but there isn't any way of completely preventing identity theft. There are other tools at your disposal, including credit freezes and fraud alerts. Sadly, experts say these measures do very little or nothing to actually prevent financial crime.[2]

We hope the upshot of this debacle is that companies who offer credit step up to protect their customers. Already credit card companies will cover fraudulent charges on your cards. We all pay for the cost of this

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[1] Thanks to Bill Nygren for drawing our attention to this comparison with bonds. https://www.oakmark.com/Commentary/Commentary-Archives/3Q17-Bill-Nygren-Market-Commentary.htm

[2] http://www.npr.org/2017/09/14/550949718/after-equifax-data-breach-consumers-are-largely-on-their-own

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theft in the price of our purchases. But credit providers can step up security measures and we hope that they do. As for the credit agencies like Equifax, the horse has already left that barn when all the data went out the door, so putting more locks on that barn is merely a gesture.

We think Equifax behaved remarkably badly in all this. Massachusetts Attorney General Maura Healey, called the breach "the most brazen failure to protect consumer data we have ever seen."[3] That incompetence isn't reflected in the former CEO's severance package. Richard Smith, who led Equifax since 2005, retired just a few days after news of the security breach broke. If the thought of cybercriminals exploiting your private information makes you uncomfortable, the cumulative rewards heaped upon Smith for his leadership should be equally galling.

It's hard to pin down exactly how big a check Smith will be cashing following his exit. He technically retired, which would entitle him to $18 million in retirement benefits (the calculated present value of a lifetime of pension payments) and free health insurance for the rest of his life. The board at Equifax has been talking about changing his employment status to terminated-for-cause retroactively. That would cost Smith his free health insurance, but he'd keep the retirement benefits. Smith is also likely to receive some stock awards for prior years' service. He is entitled to 47,000 shares that will vest in 2018 and 2019, the current value of which is a bit over $5 million. And he could be eligible to receive up to 204,000 additional shares depending on the performance of Equifax's stock through the end of 2019.

The Equifax board has been discussing ways to claw back Smith's compensation. The stated clawback policy only pertains to scandal arising from an accounting misstatement, so the deck is stacked against the Equifax board. Still, Smith received more than $120 million during his tenure at Equifax. The amount at stake is about $45 million. Rather than fighting the board of directors in their quest for a pound of flesh, Smith may choose to voluntarily forfeit a portion of his forthcoming awards. After all, it's hard to enjoy one's golden years while being bombarded with subpoenas. It's abundantly clear though, that the ship's captain won't pay dearly for the mistakes that happened under his watch.

We weren't surprised to learn any of this. Every year, we review executive compensation for the companies we own. Since the introduction of the Dodd-Frank act in 2010, we've had the opportunity to voice our support or opposition to executive pay packages on our clients' behalf. The challenge lies in coming down on a yes or no answer when the pay package is neither all bad nor all good.

Overall, the Equifax pay package was friendly to shareholders. Smith's rewards weren't egregious, and they were generally tied to quantifiable numbers. Either the stock outperforms the index or it doesn't; either revenue exceeds the target, or it doesn't. And if the goal of executive pay is to drive good shareholder returns, Smith delivered in droves. Total returns under Smith's tenure trounced the S&P 500, and are well above the benchmark even today following a 25% drop after the breach was announced. Indeed, 95% of Equifax's shareholders voted in favor of this pay package back in May.

If there's a lesson to be learned from the Equifax fiasco, it's that exit packages and claw-back provisions need to be far more shareholder friendly. We routinely vote against golden parachutes and excessive executive pay. However, we are in the minority. When we vote against the compensation package (the so-called "say on

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[3] http://www.npr.org/2017/09/14/550949718/after-equifax-data-breach-consumers-are-largely-on-their-own

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pay" item on the ballot), it's usually due to the exit package. Even companies with good governance aren't immune. For example, the Allergan CEO stands to receive $65 million including $21 million in cash severance. As we've started evaluating pay packages more closely, either the golden parachutes have grown more generous, or we've grown more jaded. Last year, we voted against executive pay proposals about half the time. Our notes reveal one complaint about a corporate jet. There are 11 references to golden parachutes.

We would like to see more accountability built into executive compensation. The Equifax compensation only incentivized the CEO to increase revenue and profits, not to safeguard the very foundation of the company's business, its consumer data. That's rather like paying doctors to see more patients but not caring whether the patients live or die, as long as they see lots of them. The long-term viability of the business depends on protecting its core asset. But the CEO can essentially blow it all up and then run out the door with millions of dollars. That doesn't serve the business or its owners well. As the CEOs technically work for us, the owners, we'd like to see our interests aligned.

When a company's "say-on-pay" provision fails because the shareholders voted against it, the typical response is for management to contact institutional owners to solicit feedback. Sadly, our phone hasn't rung yet. We can only hope that the Equifax breach serves as a wake-up call not just to corporate boards, but also to the large shareholders who haven't advocated enough for their own – or their clients' – best interest.

Notes and Asides

We have received a lot of positive feedback about our financial planning tip of the month, so we intend to continue this feature. If you have any family members or friends who might be interested in receiving this monthly email, please let us know and we can add them to our distribution list.

Your partners in investing,

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