MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC
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January 16, 2013

Dear Fellow Investors,

This past year was a very good year for the stock market, and an even better one for our investments. We're particularly happy with our 2012 returns because they were higher than major market indexes across the board.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q4 2012	4.29%	-0.38%	+4.67
Full Year 2012	19.57%	16.00%	+3.57
Annualized Return Since Inception	6.97%	4.76%	+2.21
Total Return Since Inception	35.45%	23.25%	+12.20

Data reflect total returns (including dividends) net of fees as of 12/31/2012. 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.

There are a number of things we could cite as contributors to our performance, but probably the thing that helped us most was our discipline of buying and holding undervalued stocks. Several of the names we have held for many years staged comebacks in 2012 and it was particularly gratifying to see those picks work out.

The other thing that helped us out, compared to the indexes, was our small size and independence. Many fund managers and index products have to hold large popular companies. Most investors don't realize that two stocks, Apple (AAPL) and Exxon Mobil (XOM) make up 8% of the S&P 500 index. According to Morningstar, more than 80% of equity mutual funds hold Apple stock and for 12% of them, it is their largest holding. If you own a mutual fund, the odds are that you have exposure to Apple. Here at Midway, we don't own Apple or Exxon, though we might some day. But we don't feel compelled to own them because everyone else is piling in, and we usually prefer to buy things when everyone else is piling out since the prices

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are better. Because we are small, we also don't have to buy more shares of larger companies and fewer shares of smaller companies (cap-weighted indexes like the S&P 500 do this). Very large funds and indexes have to buy larger stakes of bigger companies because there aren't enough shares of little companies available. We can take equal-weighted positions in big and small companies, only increasing the position size if we feel the stock is worth it. This doesn't work in our favor all of the time. But we feel that it is better in the long run. Being forced to buy large or popular stocks because they are large and popular – not because they are a good value – is not a recipe for superior performance.[1]

A Season for Dividends

If you follow the market news, or have checked your statement for dividends lately, you'll know that the fourth quarter was a payout bonanza. The proximate cause was the fiscal cliff and tax rate negotiations dragging on in Washington. Many investors faced the prospect of tax rates rising on dividends in 2013, so companies responded by either paying dividends early (in December instead of January) or declaring special dividends. Some even paid all 2013 dividends in 2012. Of particular note was Dolby Labs (DLB), which paid out $4 per share in a special dividend (about a 12% yield) in December. We wish companies would routinely return capital to investors if they don't have a better use for it. Today's corporate balance sheets are drowning in cash. Perhaps one of the only good things to be said for the fiscal cliff debate was that it lit a fire under some firms that badly needed prodding to pay out their excess cash.

Still Bearish on Bonds

We continue to be surprised by the popularity of bond investments. Any way you slice it, bonds look unattractive right now. That hasn't stopped millions of retail investors from pouring a record amount of money into bond funds in 2012 ($676 billion all told). But anytime the herd is going one way, it should give us pause. Investors have let their fear of the stock market blind them to the building bond bubble. "It's my worst nightmare," says a long-only bond fund manager. "There's nothing I can do — the checks come in [from clients] every day, and I have to invest it."[2]

The danger is real. When interest rates rise, bond prices will fall. Ben Bernanke has said he would keep rates low until at least 2015, so bonds will probably offer investors very paltry positive returns over the next few years. But for longer-term investors, bonds are singularly unattractive. The upside is minimal. Treasury bonds yield less than 3%. Inflation will probably eat most of that. The downside could be huge, depending how much rates rise and how fast. Even individual bonds that will mature within the next few years offer very little return. Since almost all good-quality bonds with near-term maturities yield less than 1%, why risk a downside for such a meager maximum payoff?

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[1] In his partnership letter of January 18, 1965, Warren Buffet makes a similar point while discussing the five reasons why most active managers underperform the index.

[2]Trugman, Jonathon M. "Bond Bubble Bust." *New York Post*, November 24, 2012. http://www.nypost.com/p/news/business/bond_bubble_bust_z56Re3oMqGIjsYzwjb4khO

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There are a couple reasons why investors continue to buy bonds despite the obvious bubble. First, they are scared of equities because the market crash of 2008 is still fresh in the memory. There is not doubt that this was a scary time. But most investors haven't realized that the S&P 500 index is nearly 20% higher now than it was on the day Lehman Brothers failed. Those who sold on the date of the failure – September 15, 2008 – had the pleasure of avoiding what would go on to be a 43% decline. But now, four years hence, they're far behind those who didn't sell.

The second reason is that financial professionals continue to recommend a hefty allocation to bonds despite mounting risks. Bonds offer some protection in a stock market decline. But given that stocks bounced back in four years from one of the steepest declines in history, it is certainly questionable whether bonds – at today's rock-bottom returns – offer much to investors with a longer time horizon. Moreover, bonds were much more attractive in 2007/8 than they are now. Some day, they will undoubtedly be attractive again, but right now they are not.

We believe investors with cash needs in the short-term (including those near retirement) should either hold cash or very short duration bonds. There are also a few sub-categories of bonds we can recommend, including some municipal and floating-rate funds. For long-term investors seeking income, we'd steer you to a number of blue-chip stocks with dividend yields above 3%. A comparable yield from bonds would require a time horizon of a few decades. It's hard to believe stocks won't outperform given the same time frame. And at today's prices, we believe stocks have a lot of growth and inflation-fighting potential. Bonds are exactly the opposite. They have no growth potential and could be devastated by inflation and rising interest rates. Certainly short-duration bonds and cash remain good diversifiers for those who need to tap their savings in the near future. But for those with more runway, we'd give bonds a wide berth.

A Last Word

And finally, if you are eager to get a jump on your taxes, we have included your capital gains and losses for 2012 in your performance report that we sent out last week. Your official IRS form 1099 will be available February 28. As always, we are happy to answer any questions you might have about this – or anything else.

Yours,

Rachel Barnard, PhD
and the Midway Capital team

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