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

January 15, 2015

Dear Fellow Investors,

Thank you again for your support and confidence as we navigated 2014. The fourth quarter ended with a bang, not a whimper, thanks in particular to falling oil prices. We have put together a few reflections on the investments we made – or didn't make – this past year and what we are watching in 2015.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q4 2014	7.49%	4.93%	+2.56
2014 Year to Date	9.99%	13.69%	-3.70
Annualized Return Since Inception	11.28%	9.97%	+1.31
Total Return Since Inception	100.32%	85.50%	+14.82

Data reflect total returns (including dividends) net of fees as of 12/31/2014. 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.

Perspective on Investing in 2014

The investing landscape is becoming more varied and more interesting, due in large part to rapidly falling oil prices. The fourth quarter of 2014 was comparatively exciting and our accounts outperformed the index by a wide margin, though we were still behind for the full year. We always like to assess what worked and what didn't, and the fourth quarter really illustrates the results of the portfolio choices we made this year.

First of all, we made a choice to put some money toward emerging market stocks and dial back a little on our exposure to U.S. equities. In particular, we sold several banks that had rebounded nicely since the darkest days of the financial crisis. Our portfolios are still predominantly in U.S. and global stocks, with emerging market exposure around 5-7%. However, that sliver sets us apart from other U.S. stock indexes, like the S&P 500, and emerging markets did not fare so well in 2014. The United States was the place to be – and almost the only place to be. Both stocks and bonds in the U.S. did well and the U.S. dollar rose against other major currencies, most notably the euro. Even though the domestic economy is still in recovery and not running full

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steam, on a relative basis it is still the cleanest dirty shirt in the laundry basket. Global investors are parking their money here and the numbers on Janet Yellen's dashboard are trending in the right direction.

All this sounds positive, but it also means that U.S. stocks are becoming gradually more expensive so we are looking elsewhere for value. As we detailed in a previous letter, we think the price to value ratio in emerging markets is very compelling. These economies may not recover in tandem. Many emerging economies are heavily dependent on commodity energy (oil in particular) and mining. But on balance, falling oil prices are a boon for GDP growth in the majority of nations, including emerging markets. Less money spent on fuel means more money to spend on other things. Our investments here are concentrated in companies selling consumer products to locals, things that the average Chilean, Chinese, or Indian citizen will have more money to buy if oil remains cheap. And over the longer term, we believe the demand for consumer products will only increase as emerging societies become wealthier. We want to own a piece of that future growth to offset the slower growth of more mature markets like the U.S. and Europe.

The second big decision we made this year was not to buy any oil or oil services companies. That turned out to be a prescient decision as oil prices took a nosedive in the fourth quarter, taking oil-related stocks along for the ride. It would be disingenuous to say we predicted the oil collapse, because we did not. We did an in-depth look at these stocks over the summer and simply concluded that they were not attractive with oil prices over $100 per barrel. The price of oil has been exceptionally volatile over time – remember the 1980s? We see no reason to believe that will change. If we want to buy oil companies, we need to wait until oil prices fall because historically, that's when oil companies are thrown into the bargain bin.

The lure of the oil business is strong. Nearly every person on earth is a customer. And in the U.S., about half the cost of a gallon of gas goes to oil producers, so we're talking about a big slice of an enormous pie. These are all things we like. So we've spent hours, days, and months looking for the best firms and sifting out things we dislike: high debt levels, marginal assets, short-sighted management, bloated operations, pacts with unfriendly nations, environmental liabilities…the list is long. We found one little gem called Devon Energy a few years back, though we bought that mainly as a long-term bet on domestic natural gas production.

We did identify some firms we would like to own. Ideally, of course, we would like to pull the trigger when oils stocks are at the very cheapest. While it will be nearly impossible to hit that right on the nose, we are waiting for both low current oil prices AND low oil price forecasts. Goldman Sachs analysts are currently predicting oil to rise to $65-$70 per barrel in 12 months[1] (today's price is around $47) and that rise in future oil profits is still priced into stocks. When the world is expecting low oil prices to last forever, then it's time to buy some oil. But for the last four months, we've been happy with our decision to sit on the sidelines.

Oil Prices Still in the Driver's Seat

Oil was the top economic story of the fourth quarter and it continues to dominate the news today. We already addressed the obvious question of how much direct oil exposure we have in the portfolio (very little

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[1] Goldman Sachs analyst Jeffery Currie and colleagues, quoted in Bloomberg on January 12, 2015. Oil forecasts of $65 and $70 for West Texas Intermediate and Brent crude oil respectively. http://www.bloomberg.com/news/2015-01-12/goldman-sees-need-for-40-oil-as-forecast-for-opec-cut-abandoned.html.

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right now). But we can't overemphasize the importance of the rapid change in oil prices. The decline has been so dramatic and so abrupt that it caught every energy market participant (basically, everyone who drives a car) by surprise and the markets are still grappling with the enormous ramifications of this change. On today's Marketplace Morning Report on NPR, contributor Alan Sloan joked that commentators are pinning every market move on the price of oil. "If the market goes up, it's oil. If the market goes down, it's oil." [2] So, which is it? As investors and consumers, is this a net positive for us, or a net negative?

Low oil prices, at least for now, seem to be a net positive. If you are a Russian or Venezuelan, low oil prices are bad news. Countries whose collective national income depends on $100 oil are in for a beating. Their malaise may spread for a while, but countries such as these make up a tiny share of the global economy. For the majority of the world, energy costs are more like a tax, in the sense that we heat our homes and drive to work before we plan our next shopping spree. The effect on global GDP should be positive over the next two years if oil stays around $40 per barrel.[3] For the average American, your energy costs have gone down and your disposable income is about to rise by an average of $700 per household this year.[4]

But that's not all. Consumer discretionary companies should benefit as shoppers spend more money on those little extras. Restaurants have already seen increased traffic. Airlines will benefit, since fuel is their largest operating expense. Automobile retailers are seeing customers come in for bigger cars like gas-guzzling trucks and SUVs. Inflation (deflation) could go from 1.1% growth in U.S. consumer prices, to a -0.7% decrease if oil stays at $40 per barrel.[5] This is already having an effect on bond prices. As inflation expectations keep dropping, bond yields are falling. That forces bond prices up. So we can already see oil price changes rippling through our economy.

How long will this continue? Right now, there is an oversupply of oil and demand is slack. Nevertheless, OPEC has kept production high. The Saudi petroleum minister recently said that OPEC won't cut production regardless of whether oil is $50, $40, or $20 per barrel. The Saudis have a point. What sense does it make for them to reduce output so high-cost producers don't get run out of business? This would be like Wal-Mart closing for a month so Mom-and-Pop Shop could stay afloat. It would be a boon for Mom and Pop, but Wal-Mart would be footing the bill. The Saudis suggested that if Mom and Pop want higher prices, Mom and Pop should close their doors for a month. With no one willing to cut production, prices could well remain low for many years.

What will happen to the U.S. oil industry remains to be seen. Companies have engaged in a land grab over the past few years, shedding their foreign assets in favor of plays in Texas and North Dakota. And as American

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[2] Alan Sloan, Washington Post Columnist interviewed by David Brancaccio. Marketplace Morning Report from National Public Radio on January 15, 2015.

[3] Isaac Arnsdorf and Simon Kennedy. "How $50 Oil Changes Almost Everything." January 7, 2015. http://www.bloomberg.com/news/2015-01-07/oil-at-40-means-boon-for-some-no-ice-cream-for-others.html.

[4] Societe Generale economists' estimate, quoted at CNBC. Matt Clinch. "Oil's fall could make you $700 better off this year." January 9, 2015. http://www.cnbc.com/id/102324165.

[5] Data from IHS Global Insight, quoted in *The Wall Street Journal*. Josh Zumbrun. "Fed Likely to Stare Down Oil Price Drop." December 14, 2014. http://www.wsj.com/articles/fed-likely-to-stare-down-oil-price-drop-1418587447.

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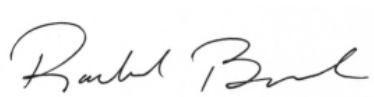
petroleum engineers gained more experience in these fields, the cost to produce oil in the U.S. fell substantially. Now that much of the land is spoken for, how quickly will companies drill? We think some of the better fields will still be profitable at $50 or even $40 per barrel, but this represents only the elite few recent discoveries. At today's prices, we'd expect more rigs to be idled.

Whenever markets move this abruptly, there's always some component that gets mispriced. With all the focus on oil, the natural gas market has been neglected, and we aren't quite sure why. Natural gas is unlike oil in that it can't be easily transported overseas, so OPEC's actions shouldn't have as much of an impact on this market. Gas is almost always found alongside oil, so the recent oil drilling boom has produced an abundant supply of gas, making natural gas extraordinarily cheap in the U.S., despite 80% of gas rigs being idled since 2008. But if domestic producers slow their oil production, natural gas production will drop too. Once that happens, we think natural gas will become more of a seller's market.

That's one of the reasons we like Devon Energy. They stopped drilling for gas a couple years ago, but still control huge gas fields that they can tap at any time. They also invested heavily in Canadian oil. These oil sands projects require large up-front construction costs, but can produce cheap oil for decades to come. Just within the past year, Devon's thermal oil project in Alberta finished construction and is turning out profits. Like the rest of the energy sector, Devon took some serious lumps this past quarter, but we think they're in a good position to weather the storm, having low debt, good assets, and good management.

We look forward to adding a few more firms with good assets in the future – if and when the markets come to agree with industry insider, Prince Alwaleed bin Talal that cheap oil is here to stay. In his words: "If some supply is taken off the market, and there's some growth in demand, prices may go up. But I'm sure we're never going to see $100 anymore. I said a year ago, the price of oil above $100 is artificial. It's not correct."[6] This could become the prevailing view just as easily as everyone was expecting $200 prices and talking about the fashionable "peak oil" theory in 2008. Taking a longer view, we think that prices are guaranteed to fluctuate, and we hope to take advantage of any bargain prices that result from those fluctuations.

Yours,



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

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[6] Interview with Maria Bartiromo for *USA Today*. January 11, 2015. http://www.usatoday.com/story/money/columnist/bartiromo/2015/01/11/bartiromo-saudi-prince-alwaleed-oil-100-barrel/21484911.

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