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January 15, 2016

Dear Fellow Investors,

The fourth quarter was a decent one for our investments, but we could have done better if we'd avoided anything related to oil or emerging markets. The end of the year was marked by a tumultuous quarter for oil prices and investments across the globe. However it looks downright placid compared to the first two weeks of 2016. As this week comes to a close, crude oil prices ended their trading day below $30 per barrel for the first time in 12 years. Stocks started the year with returns that were not merely disappointing, but the worst returns ever for the first ten days a new year. In an environment like this, we are naturally focused on what's ahead for 2016 so we're going to jump right in with our strategies, along with some expert views as well, to give you a sense of what we may be in for.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q4 2015	3.33%	7.04%	-3.71
2015 Year to Date	-4.65%	1.38%	-6.03
Annualized Return Since Inception	9.01%	8.79%	0.22
Total Return Since Inception	91.00%	88.06%	2.94

Data reflect total returns (including dividends) net of fees as of 12/31/2015. 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.

What's Ahead for 2016

Humans have always been fascinated by the seers and sibyls that could peer into the future. The Romans kept the Sibylline books, a collection of prophecies, under heavy protection in the Temple of Jupiter and consulted them in times of national emergency. The story goes that the Cumaean Sibyl offered to sell king Tarquin the Proud nine books that contained the destiny of the world. The price was three hundred pieces of gold and the king laughed at the ridiculous sum. Only after she had burned three of the books, then three more, did the king relent and agree to pay the full price for the last three remaining books.

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We are struck by how many of our modern seers and sibyls are willing to give away their predictions for free. That alone is probably proof that their forecasts have little value. Nevertheless, all of us want to know what is ahead so we can prepare for tomorrow. So we want to tackle head-on the topic of preparing for what is ahead as it relates to investing, the stock market, and the economy. But – spoiler alert – we're not going to tell you what the stock market is going to do this year because we don't know. Neither does anyone else, although many smart people like to look into their crystal balls. Just reading this morning's news, we came across countless predictions for 2016. Here is a sampling:

> "We're not forecasting a recession" – Jamie Dimon, J.P. Morgan Chase[1]
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> "To bring down an $18 trillion [U.S.] economy requires a disturbance of major magnitude, and I see no such impediment to growth this year." – Bernard Baumohl, Economic Outlook Group[2]
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> "As most listeners know, U.S. economic growth and U.S. earnings growth are more stable than the stock market. The stock market bounces all over the place with a long term average return of about 10% per annum. It is rare that the stock market has back-to-back years of single-digit moves [but] we saw single digit growth in 2015. We expect the same in 2016 and it will be the first time in a long time." – Bob Doll, Nuveen Asset Management[3]
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> "We're in the midst of a real market decline, bordering on a bear market. But the speed at which this is happening is just a reassessment of the risk, reassessment of where we're going. I actually believe there's not enough blood in the streets, we have to test the markets lower and … it's going to be a pretty good buying opportunity. Stocks could fall another 10% from here. – BlackRock CEO Larry Fink[4]

The issue that these experts are grappling with is a real one. The stock market is in the red so far for 2016 and market volatility has been exceptionally high. No one is sure what this means for the year ahead. This is a tricky issue because the U.S. economy actually looks very strong. The two big developments that have knocked the market off kilter are oil price declines and weakness in emerging markets, particularly China. There are pockets of weakness at home too, particularly in oil, mining, and manufacturing, but as Baumohl alludes to, the U.S. depends very little on foreign trade. Exports account for only 13% of gross domestic product. The fact that over 100 million people here work in service jobs brings a lot of stability to the economy.

What we'd really like to know, if a Sybil came along peddling her books, is how far the stock market will go down before it goes back up and when the next recession will be. Then we'd know exactly when to buy and sell. But even if this oracle doesn't show up, we can still prepare in a rational way. We do know there will be a

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[1] Zumbrun, Josh. "Global Malaise Spurs U.S. Growth Worries." *The Wall Street Journal*. January 15, 2016.

[2] ibid.

[3] Bob Doll on Asset.tv. January 11, 2016. https://www.assettv.com/video/2016-ten-predictions-bob-doll-investors-see-glimmers-hope-along-rocky-path?chid=59

[4] Larry Fink on CNBC. January 15, 2016. http://www.cnbc.com/2016/01/15/prepare-for-stocks-to-fall-another-10-larry-fink.html

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recession in the future at some point; we also know it will be followed by a recovery. We know that the market will go down in the future; we also know that it will recover, and as Doll says above, we expect it will have "a long term average return of about 10% per annum." Some of those years will be down, some will be up, but we have to remain invested in the market if we want to capture that long-term return. We believe that the best way to prepare for a fall in stock prices or a recession is to invest in high-quality businesses that will continue to make money, even during bad times, and will survive and thrive in a recovery.

We expect most businesses will feel the pinch if there is a recession. During bad times, people and businesses tend to buy less. But that's not a reason to stop investing. If you owned a small widget factory, you wouldn't close it down during hard times just because profits were a little lower. You may tighten your belt, but you'd keep selling your widgets as always, knowing that profits would improve when the economy recovers.

In this same way, we don't have a different strategy for bull and bear markets. We invest in things that offer the most value and lowest risk for a discounted price; if there is nothing to buy, we don't buy. Likewise, we sell things that seem priced too highly relative to their value and things that have become too risky. For example, during 2015 we sold more stocks from our portfolios than we have ever sold in a year. That's not because we're expecting bad times ahead. It's because stocks were more expensive than they had been during the past seven years and we thought, in certain individual cases, that value was not keeping up with price. We also had some concerns with financial engineering (which we will discuss in the following section).

On the flipside, we continued to buy companies with exposure to emerging markets because we believe that pessimism about the developing world has driven prices to bargain levels and we want to benefit from the recovery in emerging markets when that happens. We don't know when that will happen. (The *Wall Street Journal*[5] reports widespread pessimism by economists, 53% of whom say that emerging economies will weaken and only 18% of whom think they will strengthen this year.) However, we do know that by the time economists are bullish on developing markets, most of the money will have already been made. So far we've been wrong on emerging markets (though we prefer to think we're just "early" to the party) and that hasn't been fun. Still, we need to remain in front of the trend. So we ignore the predictions and focus on value.

That may all be fine in theory, but it can still be difficult to look at stock prices and see nothing but red, or to look at the financial pages and see the proverbial "blood in the streets." It's unsettling. If you are ever concerned, give us a call. We're steeped in this every day and we can always give you our take on the latest developments and opportunities. Even better, you can always put aside the financial page, mutter "this too, shall pass," and focus on better things while we worry about the investing.

The Perils of Paper Moves

It's a wonder to watch a child play with Legos. Within minutes, a few dozen rectangles become a spaceship. To an adult, the simple, angular design is a beautiful pairing of speed and strength. But to a child, it's just the beginning. Add some weapons, and side thrusters! Throw a periscope in the aft control center, and attach more flames to the ion blasters! Before long, the simple elegance is lost in pursuit of *more*. In the eyes of its

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[5] Zumbrun, "Global Malaise."

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creator, things are *much* better now. But to an outsider, often "it seems that perfection is attained not when there is nothing more to add, but when there is nothing more to remove."[6]

When Wall Street starts attaching more flames and more ion blasters, we begin to worry. The latest buzzword is "Financial Engineering," or tweaking a company's results through a series of high-level "paper" moves. Essentially, the company is increasing profits without selling more product or trimming costs. A great example of financial engineering would be a company's decision to relocate overseas in order to enjoy a lower tax rate. This is essentially a paper move. No employees, factories, offices, or bank accounts are moving offshore. But by following the letter of the law, an American company can become an Irish corporation subject to lower Irish tax rates. Another favorite engineering technique is for a company to repurchase its own shares, which leads to the same income being spread among fewer owners (higher earnings per share because the denominator decreases). However it uses money that could have been invested in building the business, creating better returns in the future.

To be sure, there are some cases where financial engineering makes logical sense. One of our holdings, Devon Energy, recently split off its pipeline business. This gave Devon a big cash injection, and also an agreement whereby Devon can sell its assets to the pipeline operator in the future. In 2013, Pfizer split off Zoetis, its animal-health business. This split relieved Pfizer of $6 billion in debt and brought proceeds of $11.4 billion in Pfizer stock, which including dividends, has appreciated roughly 26% since the split.

However, when another one of our holdings, Towers Watson, announced its intention to be acquired by Willis Group, alarm bells started blaring. Willis is domiciled in Ireland and therefore subject to a lower tax rate. That is an obvious benefit to the combination. But in a highly unusual move, Towers agreed to be bought for less that its market price. This is like offering to buy a house at full asking price only to have the seller counter with a lower price. Management justified the price by promising billions in cost savings. We opposed the merger outright by voting against it. Initially, Towers Watson didn't receive shareholder approval to complete the merger. On the second try, the deal went through after Willis sweetened the pot.

We had held Towers Watson for a very long time, and by and large, we liked what management did with the company. Earnings grew from $2.04 per share in 2010 to $5.09 at the end of fiscal 2014. Over the same five fiscal years, Willis' earnings shrank from $2.68 to $2.03 per share. To be fair, Willis' revenue grew by 15% over this period, but additional expenses chewed up the gains and more shares diluted earnings. In short, we were not fans of the new partner. So we decided to sell. Still, we were sad to see Towers Watson depart our portfolios. It was like saying goodbye to an old friend. Adding to the pain, we felt the company's pursuit of a low tax rate blinded it to the flaws in its new-found partner. By seeking to raise earnings via financial engineering, we're afraid Towers may have bought more than it bargained for.

Yours,

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

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[6] Antoine de Saint-Exupéry. *Wind, Sand, and Stars.*