

MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC

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April 7, 2009

Dear Fellow Investors,

For those of you keeping score, during the first quarter of 2009 the S&P 500 Index dropped 20% through February and then jumped 20% in March: a bear and bull market in one quarter! Washington bailed out or effectively nationalized several well-known firms and is now busy re-writing or scrapping the rules that once governed corporations. The federal government is on a spending spree, and the Federal Reserve is printing money on a massive scale. In short, the levels of uncertainty and volatility are extremely high. Against this backdrop, we again managed to outperform the S&P 500 Index and have used the opportunity to add judiciously to the portfolio of businesses we own. And finally some encouraging economic news buoyed the markets during March and April, giving us a welcome tailwind.

	Q1 2009	Total Return Since Inception (7/1/08)
Midway Composite (net of fees)	-10.64%	-29.58%
S&P 500 Index	-11.01%	-36.36%
Difference	+0.37%	+6.78%

Data reflect total returns (including dividends) net of fees as of 3/31/2009. 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 over the past quarter.

Regime uncertainty creates market volatility

The market of the last quarter--or perhaps the last year--has not been unlike your old junior high dance at the school gymnasium. Think about it. All the girls on one side, all the boys on the other, nobody knew what to do, and as such, all were afraid to make a move until somebody else did first. It took a few brave souls venturing out on the dance floor before everyone had the courage to jump in.

Though many investors will admit that bargain stock prices are compelling, government and regulatory uncertainty are helping to paralyze the decision process. Nobody wants to make a move because nobody knows what will change. Markets—and for that matter people in general—like to know what the rules of the game are, and that the stated rules won't change capriciously. This expectation seems completely reasonable to us. But the economic crises over the last year have led many in positions of authority to change their minds frequently, and in some cases even throw out the rule book altogether, all in the cause

of “saving the economy.” This type of action had the unintended consequence of increasing uncertainty, causing investors to pull back even more, exacerbating the already vicious cycle of declining markets.

Among the most damaging interventions have been the government’s inscrutable decisions to “save” certain firms and scrap others. Ad hoc policies concerning which companies get government money, which are left to fail, and which are forced to be acquired, have left investors scratching their heads and caused them to keep their money in their pockets. To make matters worse, it now appears as though many officials are attempting to re-write the rule book altogether. There is now talk of changing regulation for almost all financial institutions, revamping the healthcare system (yet again), and altering the energy landscape in this country, to name just a few of the proposals currently being floated. At Midway, we refer to this risk as “regime uncertainty.”

We understand that this barrage of efforts stems from a genuine desire on the part of government to stabilize the economy. Unfortunately, the unintended fallout has the potential to forestall recovery. And we see this happening nearly every day, as the general market reacts violently, one way or the other, to the latest proposal of the day.

But there is a silver lining. Regime uncertainty actually creates opportunities for us to add to positions in our favorite businesses at even better prices. What is more, it also allows us to consider buying other great businesses that have been thrown out with the proverbial bathwater, even though they have not been caught in the regulatory cross-hairs at all. We think of this as an opportunity for planting the seeds that create long-term wealth. And by venturing out onto the dance floor right now, we get first pick of the most attractive dance partners while the rest of our classmates are still staring at their shoes.

Stock Focus

Speaking of attractive partners, we added several new positions this past quarter and we highlight two of them here. Both of these companies have been on our investment wish list for many years and we finally found the right price when the flood of pessimism pushed the stock market to new lows.

We think **Stryker Corporation (SYK)** is one the most attractive companies in the healthcare industry. Stryker is a growing medical products company that operates along two major business lines: first, it produces large orthopedic implants such as replacement hips and knees; second, it makes common medical devices like imaging systems, scalpels, and hospital beds.

Barriers to competition and high switching costs create a strong competitive position for Stryker. Government regulations create high hurdles that new medical products have to surmount before they come to market. In some cases, this regulatory approval process can stretch to a year or longer, during which time Stryker can establish client relationships and continue to innovate with more advanced products while potential competitors sit and wait. And Stryker does innovate—we estimate that the company will spend over \$2 billion on research and development during the next five years. The firm possesses over 2,000 U.S. and foreign patents which prohibit a competitor from directly copying a unique design or process. Even if a competitor were to come up with a new product, medical professionals are reluctant to undergo the training required to change to alternate products unless the new designs are substantially superior. Lastly, Stryker's diverse product line ensures that even if one of its products were successfully overtaken in the market, the impact on the company’s bottom line would be small.

Stryker is also somewhat insulated from economic pressures. Around 70% of sales in 2008 came from disposable or short-lived items, or from service and repair contracts. These are things that hospitals need every day and have to keep on buying, even as they might delay larger purchases. Hospitals are facing

numerous pressures to cut costs. From government pricing initiatives, to reduced charitable giving, to the beating their endowments have taken in the market, big-ticket items such as a new MRI machine are the first to be postponed or cancelled. Since Stryker can avoid much of this greater budgetary scrutiny, its revenue is likely to remain relatively stable. Stryker's more expensive products, such as a hip or joint replacements, benefit from the fact that these procedures are generally considered to be non-discretionary. So even in severe economic conditions, we would expect that they would continue to be funded, albeit possibly at a lower rate. Furthermore, Stryker's clean balance sheet—the firm has almost no debt, holds \$200 million in cash, and has another \$2 billion in marketable securities—makes financial distress extremely unlikely even if its cash flow is impacted by the sagging economy.

Stryker has a history of robust growth, recently averaging around 12-15% annually. We doubt that these growth rates are sustainable because healthcare spending in the US is expanding at a rate well in excess of GDP growth. And that can't continue forever. For us, the question is when this slowdown will occur and how sharply growth will be curtailed. We assume that revenue growth will average 8% per year over the next five years, slowing to 3% per year over the following five years. This results in a valuation of just under \$50 per share. Recent market prices well below that give us an ample margin of safety in case our growth assumptions prove too optimistic. And if Stryker can grow beyond our conservative expectations, so much the better.

Early in the first quarter, when pessimism around banks was running high, we started a new position in **M&T Bank (MTB)**. Given the firesale prices for banks, both good and bad, we had our pick of just about any institution. We chose M&T because it is an extremely well-managed bank. It remained profitable throughout 2008, maintaining a solid and well-capitalized balance sheet. The bank has a history of profitable growth, low credit losses, and double-digit returns to shareholders in the form of both dividends and profits. We expect this to continue and hope to keep our M&T shares long after the credit crisis is a distant memory. And by buying this bank at just two thirds of its book value, we believe the shares offer an extremely attractive return even if M&T were to quit growing altogether, a very unlikely scenario.

Another reason we chose M&T is its small size, which should help keep it below the regulators' radar. With so much regime uncertainty, many investors are avoiding banks altogether. Everyone is expecting major regulatory changes but so far there is no clarity as to what new regulations might become law or how onerous they might be. It is entirely possible that new rules and regulations will force banks to hold much more capital and make banking inherently less profitable. We believe larger banks will be disproportionately affected, particularly the ones deemed "too big to fail." To be sure, we think the larger banks that we do hold are significantly undervalued by any metric and have limited downside risk. But we think the smaller ones now offer us a little less uncertainty. In any case, as long as banks continue to exist, there is a lot of money to be made here. This could quite possibly be the best opportunity to invest in banks that we have in our lifetimes.

Stocks vs. bonds in the current environment

Some of you have asked about the relative merits of other investments like bonds or treasuries. For long-term investors like us, we think the evidence at this time is overwhelmingly in favor of stocks rather than corporate bonds, municipal bonds, treasury bonds or gold. Our view is probably not widely held and what follows is an explanation of our thinking that will shed light on our approach to managing investments.

First, we admit a bias to owning stocks. We like to be involved in a successful business with capable managers and watch the business thrive. But we try to balance out this bias by focusing on valuation, which should help us avoid over-priced stocks. Of course, if stocks do not offer attractive returns in relation to other investments, we would not want to own them, however compelling the business.

But many current valuations are extremely compelling. Here is an example from a business that Midway does not own at this time (though we may buy shares in the future). This firm has bonds that trade at a yield to maturity of about 9%. The bonds mature in about 20 years and the firm has cash available on its balance sheet that exceeds the entire debt of the firm. This firm has not had a net loss in the past ten years and easily earns enough money to cover the interest charges. Thus, we think the bonds would meet the safety standards of virtually any bond investor. If we wanted to tie up funds for 20 years we'd be fairly sure of earning a 9% yield to maturity on the bonds. However, the stock of the firm pays a 6.5% dividend and the stock trades at an earnings yield of about 16% (measured by the average net income of the past five years divided by the stock price). In our view, it makes very little sense to buy an asset that earns 9% with no upside instead of an asset that earns 16% plus the opportunity to benefit from retaining earnings. And if inflation heats up, the real value of that 9% coupon could erode very quickly.

We'd also like to explain why we do not own gold or gold mining stocks. To begin with, gold produces nothing. In fact, owning gold comes with insurance and storage expenses. It's true that the political environment is volatile and the money printing by world governments is disturbing. However, in the event where the upside of owning gold could pack a punch, it is possible and maybe probable that the government would confiscate gold as it did in 1933. In our view, it doesn't make much sense to fret about the property rights in stocks or bonds or other assets and not worry about the property rights in gold. Further, what would a holder of gold plan to do with the gold? More than likely the holder of gold plans to use it to buy food, gasoline, water and shelter. We think owning a good business that produces the products people plan to buy with gold is a better option than owning gold.

There will probably come a day when we will opt to own bonds or cash rather than stocks. As always, we will determine the relative attractiveness of competing investment options and stick with our disciplined value-driven approach. And this would be a nice problem to have - because it will only happen once our current holdings have appreciated substantially.

Yours,

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