

MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC

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Dear Fellow Investors,

We are pleased to share with you some thoughts about our investments this quarter. Read on for our take on the market environment, emerging market opportunities, and diversification. Without further ado, here are the returns as they stand at the end of March.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q1 2011	4.89%	5.92%	-1.03
2010 Full Year	18.81%	15.06%	+3.75
Annualized Return Since Inception	11.02%	3.60%	+7.42
Total Return Since Inception	33.29%	10.21%	+23.08

Data reflect total returns (including dividends) net of fees as of 3/31/2011. 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.

A brief look at the quarter

To begin, we'd like to make a few comments on the three months just passed. In aggregate, our performance lagged the S&P 500 Total Return index. We don't attach any special significance to beating or trailing this index in a given quarter. But over the long haul – 3 years or more – we do aim to outperform this type of investment by:

1. Investing in high-quality companies
2. Investing only when these securities are cheap
3. Selling stocks that become overvalued

There are certainly a healthy number of exceptional companies we can pick from. We currently have more than 70 companies on our list of great investments that we would buy at the right price. This is less than 1% of companies we have to choose from (we're very picky), but still an ample amount to fill a portfolio. We do, in fact, own the majority of these firms. We own them in many of our portfolios because the prices were right in previous years. But this quarter, we were hung up on price. There just weren't enough screaming bargains to warrant a buying spree.

This doesn't mean we think stocks are generally overvalued yet. We estimate that the stocks we follow are at about 85% of fair value today. So we are slowly adding to our holdings and keeping most of the ones we already have. We have no idea what the market will throw at us next quarter and beyond. But we have enough cash to take advantage of any bargains that might come our way. Looking back over the quarter, our performance would have been a bit better had we deployed our cash more quickly. Even so, we believe it was the right decision to tread carefully in these markets where an array of destabilizing external forces (which we discussed in our last letter) are battling with burgeoning investor optimism.

Investor optimism

Investors are warming to the stock market and it's not hard to see why. It's easy to feel confident in a market like the one we saw in the first quarter. Stocks have risen steadily: days on which the S&P advanced outnumbered declining days by 50%. When the market did decline, pullbacks were mild: on average, only 0.68%. Compare this with the infamous first quarter of 2009 when declining days and advancing days were equal, and the average decline was 2.2%. This lack of volatility has led to a sense of bravado among investors, who have been funneling money into stocks.¹ Professional fund managers have also jumped on the bandwagon. A recent Merrill Lynch survey finds that "investors are more bullish towards global equities than at any time in the past decade."² Without constant reminders that one's money can vaporize within a few moments, investors focus solely on recent returns. Those who couldn't stomach the thought of buying a great company a few months ago start buying state-owned Chinese telecoms, citing greater potential for growth.

Ironically, this lack of fear can create a riskier environment than one with lots of ups and downs. Increasing demand for stocks pushes prices up. This, in turn, leads people to invest more aggressively. Even intelligent investors can get sucked in. They can see that valuations are less attractive, yet they feel stupid missing out on all the gains in a rising market, and it's far worse to look stupid alone than with plenty of company. When a correction finally happens, the money will come pouring out as quickly as it came pouring in. The intelligent investors and the lemmings will all get burned together. There's no shortage of intelligent investors, but every bit as important as intelligence is discipline.

¹ According to the Investment Company Institute, an estimated \$29.3 Billion entered stock funds in the first quarter through March 23, 2011. During the same period, \$18.3 Billion entered bond funds.

² Bank of America Merrill Lynch Survey of Fund Managers from February 4 to February 10, 2011. The survey collected data from 188 fund managers managing a total of \$569 billion.

Investing in emerging markets

Many of our investors want to know how to benefit from the forecast growth of economies like China and India. Our answer has been: indirectly. We want to invest in emerging economies without exposing ourselves to unacceptable risks. Most emerging economies are hamstrung by weak or non-existent private property rights, government abuses and corruption, and lack of reliable company data, just to name a few. We can't invest in a company whose financial data is sketchy and whose assets could be confiscated at any time. We've addressed this a bit in past letters. However, one of our largest holdings, Brookfield Asset Management (BAM), recently articulated this philosophy very well in a conference call. So we thought we'd share this excerpt with you as an example of how your money is being invested overseas.

"In the past five years, as you've seen us, we've dedicated a lot of our extra resources to Australia, Brazil, and Canada. And the strategy has seen us put a significant amount of capital into these three countries. We've benefited substantially as these economies have outpaced most others in the world and in fact, their currencies have also outperformed. Therefore, we have had a double win, I guess.

We now have exceptional businesses in these countries, which should allow us to capitalize on the organic growth opportunities over the next decade as the dynamics of the emerging middle class in these countries play out. *We decided to pursue this strategy of participating in growth of economies such as China and India instead of participating directly in them, through countries such as Australia, which stood to gain from selling products to Asia; but where we were more comfortable in owning and operating land line assets.* (italics mine) As a result of that, and consistent with our investment philosophy, we have accepted gains at a more measured pace, like usual, than if we had invested into the Asian countries but without the issues that sometimes come along with those countries.

As a result of these initiatives, approximately 50% of our capital is now deployed in Australia, Brazil, and Canada and we are therefore benefiting from the positive conditions of these export-oriented economies, in particular compared to the U.S. This does though also mean - and I would make sure that people understood this - we are more directly exposed to the economies of the Asian countries than we have been in the past, both through the businesses we own and through the revenues we earn in currencies of countries which rely in part on China for their growth. And while acknowledging the short-term fluctuations which may occur in these markets, we believe this exposure has been and still is a prudent diversification for Brookfield and over the longer term will continue to be an excellent place for the capital we have."³

Diversification and Jell-O salad

Speaking of diversification, we have a different philosophy of portfolio construction than most managers and a recent client discussion inspired us to return to this important topic here.

³ Brookfield Asset Management 2010 Fourth Quarter, Year End Results Call. February 18, 2011.

Like most money managers, we do believe in the value of a diversified portfolio. However, we don't believe this means that we have to have "one thing from each bucket". Most mutual fund managers are required to hold a certain number of firms in each sector, industry, and country. The idea is that portfolios with "one of each" investment are less volatile on the whole and therefore less risky. There is a lot of research to show this approach decreases volatility. But does it decrease risk?

We think of risk as the chance of permanent capital impairment – the risk that the company in question is permanently worth less than it was before. A bio-tech with one drug in its pipeline is risky because if the drug is not approved, it could be worth \$0. A Russian firm that could be nationalized by the government could be worth \$0 to us, even if it is doing well today. We don't buy these sorts of firms. We don't want anything from those buckets.

Building on our potluck supper analogy from a previous letter: if there are seven different types of tuna-noodle casserole on the buffet table – and you don't like tuna-noodle casserole – you don't need to sample even one. You can simply skip them and go straight to the Jell-O fruit salad. In fact, if you really love Jell-O salad with suspended fruit, then you can heap your plate with all ten kinds!

We want each and every one of our holdings to be a great investment. If we find industries that are lousy investments, we take a pass on the entire industry (not even a no-thank-you helping). Certain industries are exceptionally profitable, so we fill our plates with those firms instead. As Warren Buffett said, "I try to buy stock in businesses that are so wonderful that an idiot can run them. Because sooner or later, one will." We like industries and businesses that are so good that they're hard to mess up.

Diversification is a way to manage risk because it is risky to put all your eggs in one basket. We could make a mistake in our analysis. The firm could get hit by a meteor/flood/hurricane/lawsuit. Management could do something illegal. We don't want any one firm to comprise too much of anyone's investment – even if it is the greatest firm we've ever seen. But on the flipside, buying firms in unprofitable industries does not make our portfolios better; it's just a waste of good money.

Yours,



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