

MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC

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Dear Fellow Investors,

Economic turmoil in Europe, a slow recovery at home, and a massive oil spill in the Gulf set the stage for a brisk decline in the stock market this past quarter. But painful as these dips can be, we had the opportunity to buy several stocks on our wish list as the prices declined. We love the improvement in the quality of our holdings, even if it's otherwise hard to love the quarter.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q2 2010	-11.16%	-11.43%	+0.27
2010 Year to Date	-4.14	-6.65	+2.51
Annualized Return Since Inception (7/1/08)	1.21%	-8.13%	+9.34

Data reflect total returns (including dividends) net of fees as of 6/30/2010. 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.

Investment notes

As these numbers show, our investments did beat the index by a small margin this quarter. Doing better than the competition is certainly one of our goals, and we're always pleased to report that. But our more important goal is simply to make money, something that we didn't achieve this quarter. As we have said before, we don't expect to make money every quarter. In fact we need stock prices to fall from time to time so we can buy investments at attractive prices. As disappointing as down quarters can be, these opportunities to "buy low" are actually essential to achieving our long-term goal of building wealth. You should expect us to buy more aggressively when prices are low and hold or sell when prices rise. So during these quarters we try to be philosophical, hold our noses, and take the medicine. We don't like it either – but it's the only way to reach our ultimate goal.

In order to maintain a long-term perspective, we look at our investments in terms of value rather than current price. If price is what you pay and value is what you get, then we want to pay the lowest price and

get the highest value. Regardless of the prices at which our investments happen to change hands at any particular time, we focus on the actual value of the holdings. In that sense, we are like a collector scouring garage sales for the ultimate bargain – a chance to buy something whose price does not reflect its true value. And in that sense, we've had a very productive quarter.

Portfolio Update: Oil in the news

The explosion and subsequent sinking of the Deepwater Horizon really need no introduction. As of this writing, oil is still gushing from the damaged well, easily making this disaster one of the largest and most costly in U.S. History.

Naturally, this has affected investors. Shareholders of British Petroleum (BP) have seen the value of their holdings sliced nearly in half. You know, of course, that we do not have any investments in BP. In fact, we have very little exposure to the energy sector in general at this time because we don't think the prices are attractive. But even as BP's price has fallen, we aren't interested in owning any of the firm. The ultimate amount of claims on BP's profits is simply unknowable. There is a real chance that these claims could extract so much value from BP that the firm's future would be in jeopardy. Given the enormity of the risk, we're not interested at any price.

However, we *are* interested in another company that has been affected by the oil spill. We have owned St. Joe (JOE) for nearly 2 years and have recently increased our holdings as the price has become extremely attractive.

By way of background, St. Joe is a large owner of land in the Florida panhandle. Joe acquired much of its land as a timber company in the 1930s. As the company and the region evolved, Joe gradually deemphasized its timber operations, shifting its focus to the firm's vast land holdings. The company owns a number of resorts, and has developed communities stretching from Destin, about 70 miles east of the Alabama coast, to Port St. Joe, about 90 miles southeast of Destin. Because the company owns hundreds of thousands of acres – most of which are within a few miles of the coast – developing the entire swath immediately (or selling the raw land) would be difficult and illogical. Instead, Joe has patiently developed small portions, selling developed and undeveloped land when the market wanted more, and holding back in less favorable times. The company's resort and timber operations are sufficient to cover operating expenses, and it keeps its balance sheet virtually debt-free. We like the smart way in which Joe is managed and we believe the landholdings in this area of Florida will ultimately be worth much more than we are paying for them.

When the oil spill occurred, Joe's management team quickly set about documenting the condition of their land. They collected soil and water samples from key locations and documented the appearance of the land through aerial photographs. The company came up with several programs to encourage tourists to visit despite the threat of oil on the beaches. Joe offers live beach views online and a money-back guarantee if visitors are unable to use the beaches at any time. To date, Joe has seen only a minimal impact on its beaches with a few tar balls washing ashore during a week in June. Still, a significant number of tourists are steering clear of Gulf coast beaches and this will surely impact Joe in the near term.

We were surprised, however, to see St. Joe stock decline in lockstep with BP until early June, by which time both stocks had fallen by close to 40%. Clearly, the long-term impact on these two firms will be vastly different. Even in the worst case for Joe – unfavorable ocean currents, lingering oil and tar balls, sluggish real-estate sales – the company would still continue to operate and the long-run value would be much the same. The worst case for BP could be massive dilution for equity holders or even bankruptcy. The best case for Joe would be a single slow summer followed by a lucrative payout from the BP claims fund for any damage to its business, whereas the best case for BP still involves years to recover its staggering losses and the damage to its reputation.

The surprising symmetry of the two stock prices – and the marked asymmetry in the potential outcomes – caught our eye. Clearly, panicked investors were throwing the babies out with the bathwater. As the price of St. Joe declined, we took the opportunity to add to our holdings at prices that didn't fully reflect Joe's value. And while it's too early to describe the outcome, we – like Joe – are content to wait until temporary disfavor washes out and a more sensible assessment of value returns.

International Investing: Midway's approach

Barely taking a back seat to news coverage of the oil spill, is the debt crisis in Europe. We've had several questions from our investors on international investing broadly and we wanted to take this opportunity to talk about Midway's approach to investing outside of the U.S.

International investing can be beneficial in diversifying risk. Foreign economies grow at different rates, produce a different mix of products, and many have currencies that fluctuate independently of the U.S. dollar. That said, in times of economic stress, all correlations tend to go to "1" – meaning that it is likely that all markets tumble together when there is a crisis. We saw this very clearly in 2008. So we would characterize the salutary effects of international exposure as more akin to "smoothing out the small bumps" rather than protection from the effects of economic stress here at home.

We don't think of international investments as a magic bullet – a "must-have-it-at-any-price" asset class. But we do like to buy companies that have meaningful exposure to overseas markets and currencies if they meet our usual stringent criteria for investing: competitive advantages, good management, solid balance sheet, and a bargain price. We own a number of global companies, but we prefer those headquartered in developed countries. Investors often forget that in more developed countries, companies are required to provide better disclosure, management tends to be better, and the rule of law is often stronger.

That brings us to the countries often referred to as “emerging markets.” This term is essentially a euphemism for third world countries with some growth potential and a boatload of risk. We tend to shy away from these types of investments for three reasons. First, we don't claim any special knowledge of, say, Lebanese construction companies, and would never feel comfortable putting client capital in a company that we don't thoroughly understand. Second, we demand a large volume of detailed disclosures so we can assess every aspect of the business and its financial positions. This is rarely available in emerging markets. And third, we want to know that our legal claims as owners will be honored, so we need a strong legal system to back us up. As such, when we invest internationally, we

tend to look for companies that have exposure to overseas markets and consumers, but avoid direct exposure to sketchy governments, which can be capricious. This gives us the benefits of diversification (markets, products, currencies) without taking on an unacceptable level of risk.

Diworsification

This point about diversification leads us to our concluding thought. In his January 1965 partnership letter, Warren Buffett talked about several reasons why investors underperform. One was “an adherence to certain diversification practices which are irrational.”¹ This often means that investors feel compelled to have one of everything. With a zillion types of mutual funds out there (or nearly so) investors are told they need to own every type to achieve diversification. Similarly, investors often feel bound to buy companies in every industry or every geography. Our industry talks so much about diversification that it seems like a goal in itself. But it is not. It should be a way to mitigate risk. Investing in a lousy unprofitable industry is usually a way to increase risk. So is buying a firm in an unstable country. There is a term for this: *diworsification*.

The investment world has become a great potluck supper, with a huge number of dishes on offer. But as usual, about half of them are really the same tuna casserole. No one needs to have a helping of each and every dish on the table. And we can pass by the ones that don't look appetizing in favor of the really good stuff.

Yours,

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¹ Letter of January 18, 1965 p. 4.