

MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC

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Dear Fellow Investors,

We're never happy with a quarter like this one. As much as we love the bargains in the stock market today, it is always unsettling when we see negative returns. We constantly remind ourselves that it is time for planting and not harvesting right now and if we wait, the harvest will be fruitful. But that doesn't make investing any less difficult. Buying low and selling high is mostly a matter of discipline and patience.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q3 2011	-21.30%	-13.87%	-7.43
2011 Year to Date	-20.03%	-8.68%	-11.35
Annualized Return Since Inception	0.50%	-1.56%	+2.06
Total Return Since Inception	1.63%	-4.98%	+6.62

Data reflect total returns (including dividends) net of fees as of 9/30/2011. 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.

We never have a good quarter when markets become irrational. We believe this past quarter was one of those times. We're buying and everyone else is selling. The last time we reported similar performance numbers relative to the index, we were deep in the credit crisis of 2008. The good news is that our investments performed much better than the index when market conditions began to stabilize and stocks began to trade on fundamentals, rather than fear. We're looking forward to that time. But right now, we are taking full advantage of the bargains out there. Not only are stocks cheap, but companies have stockpiled cash and eschewed debt, meaning that risk of permanent loss is very low. High quality and low prices are a winning combination.

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The global economy – Midway's take

We have been out of step with the markets all year. In the spring, we said that markets were overly optimistic and we discussed all the destabilizing forces that might cause havoc. And now, we're about to tell you that the economic situation is not nearly as bad as people think. Investors tend to overreact to good and bad news. Couple that with shaky recovery from a nasty recession and we've had a very volatile year despite the fact that economic fundamentals have changed very little.

In our April letter, we said the following:

Investors are warming to the stock market and it's not hard to see why. 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

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.

We didn't have to wait very long to see the money pouring out as it did this quarter.² We told you that we were sitting on our hands during the first quarter because we didn't like prices. Now, of course, we're much happier to invest when stock prices are low and other investors run for the exits. So we're quite glad we waited. But has anything really changed beside the mood of the average investor?

There are a few main trouble spots for the global economy. First, Europe needs to figure out how much pain it is willing to suffer to preserve monetary union. Greece is on the path to massive default and the EU needs to be crystal clear to Greek creditors about how much it is willing to chip in to cover Greece's obligations. Until then, the uncertainty will continue to weigh on European markets, particularly banks which hold Greek debt. This is not a new problem. It is the same old problem just dragging on and on without resolution.

Domestically, unemployment is stubbornly high, particularly for blue-collar workers. House prices remain depressed and we're still working through foreclosures. But on the positive side, Americans have adjusted to the new world where credit is harder to procure and houses are not a source of ready cash. Savings rates are higher and consumers are paying down their debts. In fact, credit card companies and banks are having trouble finding enough demand for loans. They have more deposits than they can use and very few customers

¹ According to the Investment Company Institute, an estimated \$29.3 billion entered stock funds in the first quarter through March 23, 2011.

² According to the Investment Company Institute, investors withdrew an estimated \$61.3 billion from US stock funds in the third quarter through September 21, 2011.

wanting to borrow. While Americans are becoming more prudent with their money, the economy has to adjust to lower spending and borrowing. But in the long run, this is ultimately a positive trend.

The third source of investor angst is emerging market growth, particularly slowing growth in China. To be clear, China is still growing, but its double-digit annual growth is giving way to high single-digit rates (think 8% per annum rather than 12%). These revelations caused the recent flight from commodities like copper, corn, and crude oil. Betting on commodity prices has become very popular in recent years as a way to benefit from growth in emerging markets which are big users of these materials. It has also led to speculative excess in commodity markets.³ Now large investors, like hedge funds, who made these big bets are getting out en masse, sending prices down. Again, the slowdown in China should not be a huge revelation. The Chinese government has been aggressively intervening to cool its overheated economy. The rampant wage inflation is also making China less competitive as an outsourcing destination. This will inevitably lead to a decrease in Chinese exports. Still, China is not in a slump, it is growing at a more modest pace. As for commodities, lower prices for materials like oil and corn should help consumers at the gas pump and the grocery store. It should also aid businesses whose raw material costs have been painfully high.

The bottom line on the economy: challenges remain, but fundamentals are slowly improving. We have a patient who was very ill and is now making a slow and painful recovery. Investors have gone wild with every improvement and become despondent with every setback. This, of course, causes markets to be extremely volatile. But this surfeit of emotion is not really tied to global economic fundamentals.

Debt: a four-letter word

In this letter, we've mentioned the word "debt" three times already, each time in a negative way. You might get the impression that we think debt is bad all the time and that investors should avoid it like the plague. The truth, however, is more subtle. Debt is a valuable tool in the right hands, and not always a ticking time-bomb. It takes a lot of due diligence to ferret out companies whose borrowing actually enhances shareholder value without adding risk, but we believe it is worth the effort.

In the aftermath of the credit crisis, "debt" became a four-letter word. It wasn't always so. In previous decades, it was common to hear academics and executives talk about "optimizing" one's balance sheet by using more debt. The theory goes that interest on debt is tax deductible, so it's cheaper to borrow than it would be to find new equity investors who demand juicy returns on their investment. That changed in 2008 when the world received a painful reminder of the pitfalls of lending and borrowing.

But one example of "good" debt comes from real estate investment trusts (REITs), some of the most highly levered investments we own. The structure of these investments is quite simple: management buys a building, rents it out to tenants, and passes along the profits to shareholders after paying expenses. Assume now that rather than buying its buildings free and clear, the REIT pays half the cost as a down payment, and takes out a mortgage for the remainder. Now, the company can buy twice as many properties. To the extent that the net income from these additional properties exceeds the related interest payments, the company has increased

³ For a fuller discussion of these data, see Alen Mattich's commentary: "Commodity Price Falls Aren't All Bad News". *Wall Street Journal*, October 3, 2011.

its income. As owners of the company, we benefit. If times get tough, the bank can take back the property (if it wants to) but cannot touch the other assets of the company.

Here's one example of how this can work in shareholders' favor, even in the worst situations. One of our real-estate holdings, Forest City (FCE-A), is currently developing a new city hall for Las Vegas. Surrounding the city hall will eventually be a hotel/casino, transit hub, office park, and retail space. Rather than committing all of the \$128 million estimated to start this project, the company committed \$86 million and assumed a mortgage for the remaining \$42 million, posting the land as collateral.

The words "Las Vegas" may have been a tip-off for the next part of our story. Rents and property values declined to the point that Forest City could no longer earn an adequate return on its investment. This certainly wasn't good news, but the company's management had prepared for such a contingency. First, this particular mortgage was a nonrecourse mortgage, meaning that if Forest City defaults, only the land securing the mortgage can be seized by the lender. The rest of the company's assets can't be touched. Second, Forest City had plenty of other properties and enough cash to continue with business as usual.

After looking at the numbers, the company decided it would prefer to give the property back to its lender: the corporate equivalent of "jingle mail." This move would relieve the company of its assets in the Las Vegas land, but also any obligations associated therewith, including the \$42 million mortgage. So the worst-case scenario is that Forest City loses two thirds of the value of one investment. The firm owns hundreds of properties throughout the country and this investment was less than one percent of its assets. All in all, not bad for a worst case.

But the worst case never happened. The lender had no interest in taking this property back. It's an open secret that banks don't really want the assets that are pledged to them as collateral. Banks aren't real estate developers either, and given the close proximity to the City Hall, it was likely that the city was going to demand the development proceed on schedule. Faced with a bad outcome or a terrible outcome, the bank sat down with Forest City to renegotiate the loan. Ultimately, the bank agreed to reduce the balance on the loan by \$20 million. In effect, the bank paid Forest City an eight-figure incentive to do what it had agreed to originally.

In this case, borrowing makes good sense. But the stipulations and structures of debt comes in dozens, perhaps hundreds of different varieties and combinations. Any one of these can prove to be a company's undoing. When we examine companies, we consider not only the likelihood that a company can't service its loans, but also the outcome of such a scenario. As equity investors, "debt" is the four letter word demanding much of our attention, but "loss" is the four-letter word we find scarier. The likelihood of a permanent loss is our definition of risk.

Yours,



Rachel Barnard, PhD

and the Midway Capital team