

MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC

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Dear Fellow Investors,

It has certainly been a quarter to remember. Stock prices fell across the board, volatility was at a record high, and investors big and small were hoarding cash and buying Treasuries. But while many investors would like to forget this past quarter, we looked on it as a season ripe with opportunity. The investments we made this quarter should set the stage for many years of superior returns to come. We couldn't be more pleased with the portfolios of outstanding businesses we have been able to assemble at irrationally low prices.

Still, the market was unkind to almost all equity investors in this past three months, and we here at Midway Capital were no exception. Our composite portfolio, which measures the performance of our individual portfolios as if they were one large fund, dropped by 24.72% during the fourth quarter; the average individual portfolio lost 21.38%. For comparison, the S&P 500 Total Return Index lost 21.96%. We dislike losing money at any time, period. But we do recognize that it is one of the inherent risks of investing. We also realize that falling stock prices have a bright side because they present opportunity. This past quarter has served up investing opportunities not seen for 30, or in some cases 80 years. This, in turn, should allow us to deliver much higher returns than we could have anticipated even a few months ago. The average stock we hold now is priced at less than half our estimate of its intrinsic value.

	Q4 2008	Total Return Since Inception (7/1/08)
Midway Composite (net of fees)	-24.72%	-21.20%
S&P 500 Index	-21.96%	-28.48%
Difference	-2.76%	7.28%

Data reflect total returns (including dividends) net of fees as of 12/31/2008. 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 over the past quarter.

Why we hold stocks – and fear inflation

We generally avoid macroeconomic predictions when deciding which stocks offer good value, but we will offer our view on one macroeconomic topic that is vital to investing: inflation. We believe it is a far greater threat over the next decade than deflation.

The market does not agree with us. The current yield on a ten year government bond is 2.5% and the prices of TIPS (Treasury Inflation Protected Securities) reflect a widely held opinion that inflation will be non-existent in the next ten years. There is some evidence to suggest that the market is correct. For instance, an index of treasury bonds returned 24% in 2008 while the S&P 500 Index produced a 37% loss. In fact, the total return (price plus dividend income) of the S&P 500 Index in the past decade is -1.38% per annum. Keeping cash in the bank would have been better than buying the S&P ten years ago.

While we would have been better off investing in T-bills for all of 2008, we think the price increase on T-bills and price decline of most stocks has now reversed the risks. The nominal principal amount of T-bills is guaranteed by the Treasury and bank deposits are guaranteed by the FDIC. What the government does not guarantee is *purchasing power*. Measuring purchasing power is difficult, but few would argue that a dollar today buys much more than 75 cents of what a 1998 dollar purchased. Few would disagree that in the past 100 years the purchasing power of the dollar has declined by at least 95%. A nickel in 1908 would buy about what \$1 will today. We see no reason to suspect the destruction of the buying power of the dollar will cease.

This opinion is not speculation on our part. The Federal Reserve has more than doubled the size of its balance sheet since the end of 2007, and the current excess reserves (funds that could be lent out) at commercial banks stand at about \$770 billion compared with about \$3 billion at the beginning of 2008. Add to that the stated intention of virtually all levels of government to proceed with deficit spending on a massive scale and we think a huge dose of increasing prices is a near certainty.

We may rail against this type of action as imprudent, but we think our job at Midway is to manage the funds entrusted to us in a manner that will protect capital and earn a decent return. When we think of protecting capital we think of protecting it in terms of purchasing power. A dollar invested in 1998 would have had to increase to at least \$1.30 by the end of 2008 to merely break even in terms of purchasing power. This return would have soundly beaten the return of the S&P 500 Index, but would have merely broken even in terms of purchasing power (and that doesn't include taxes on the "gain"). We think the loss of purchasing power in the next decade will equal - and probably exceed - the loss of buying power in the previous decade. To combat this incessant destruction of buying power we think it is necessary to avoid long term fixed income instruments like the plague. In general, the best chance for doing well in the next decade is to buy the stocks of businesses that earn good returns on capital and have at least some pricing power.

The good news is that stocks in general offer better value than ten years ago, in our view. We will use Dow Chemical as an example. Dow is trading at about 50% of its market price ten years ago, but its earning power per share is about twice what it was ten years ago. We measure the earning power by the average net income for Dow from 2003-2007 (full year 2008 results aren't available yet) and 1994-1998 divided by the current shares outstanding. Dow has some added uncertainty thanks to its Rohm & Haas acquisition, (we discuss Dow in depth below) but this type of value is not unusual today.

Had we been perfect we would have held all cash until October 2008. We aren't perfect and our 2008 performance doesn't sit well with us. However, we are confident that what worked in 2008 (buying Treasuries) has a good chance of leading to poor results going forward. Furthermore, a number of good quality stocks offer excellent value at current prices. Add the fact that bonds and cash stand no chance of making up for the declining purchasing power of the dollar, which is the consequence of inflation, and our view slants ever more toward holding stocks.

Stock focus

In the fourth quarter we purchased a stake in two chemical companies, **Dow Chemical (DOW)** and **Rohm & Haas (ROH)**. Dow inked a purchase agreement for all of Rohm & Haas' shares in July for \$78 per share in cash. At the time, we weren't interested in either firm. Dow was trading in the mid-\$30s and Rohm & Haas was trading in the mid-\$70s, very close to the price Dow had agreed to pay. Warren Buffett's Berkshire Hathaway agreed to help finance part of Dow's acquisition of Rohm & Haas in exchange for convertible preferred stock. Buffett's preferred shares convert to Dow common stock at \$41 per share. Because we follow Buffett's actions closely we followed Dow and Rohm & Haas as the financial markets became increasingly dislocated since July.

Only a few months later the stock prices for Dow and Rohm & Haas became far more interesting to us. Dow's price had fallen to the low-20s and Rohm & Haas had declined to the high-60s. Dow is one of the largest chemical and plastics firms in the world. It earns good returns on its capital invested in the business, and has paid a dividend for nearly 100 years. Dow's products are found in everything from car dashboards and cell phones to corn seeds and insulation. Rohm & Haas is another large chemical firm that has earned good returns on invested capital over many years.

These companies have been getting lively press coverage recently because Dow had planned on using cash from a joint venture with Kuwait to buy Rohm & Haas. But the deal fell through when Kuwait backed out and Dow is now looking for other partners. It is still obligated to close the Rohm & Haas acquisition once approved by regulators, though it will now use its own cash and debt. The deal is imminent and may have occurred by the time this letter reaches you. If the acquisition closes as planned, we will earn a sizeable return on our Rohm & Haas stake. We still think the odds of the deal closing at \$78 per share in cash are good.

In our view, the market prices for both Dow and Rohm & Haas ignore any assessment of the quality of either business or the quality of Dow after the acquisition (assuming it occurs). We are confident that Dow is worth far more than the current market price and more than our cost – with or without Rohm & Haas. Dow is trading at a single digit price to earnings multiple, even using the most conservative estimate of earning power. A risk we have considered is that Dow may issue some form of equity to pay down debt from the acquisition. This would dilute our current ownership stake, but we think the upside, over time, would still be strongly in our favor.

The bottom line is that we see this as a win-win. We should do fine no matter what happens. We expect an immediate jump in Rohm & Haas shares if the deal closes. If not, we expect Dow to rise. In either case, we own two high-quality companies at prices we think are low enough to account for adversity and we paid little or nothing for any upside. And these stakes could be worth even more if Dow does find another partner for its joint venture, a scenario we think is likely in the future.

Another purchase we're quite excited about this quarter is **Berkshire Hathaway (BRK.B)**. We have long been fans of Berkshire Hathaway and Warren Buffett, as his teachings have helped to inform our investment process at Midway Capital. And while we're always watching Berkshire's moves, we hadn't invested in the business itself until just recently, because while we've always believed it to be great company, the price just wasn't right...until now.

For those of you unfamiliar with Berkshire, it is an investment conglomerate built by Chairman Warren Buffett over the last several decades. Insurance is Berkshire's biggest business, where it benefits from unparalleled financial strength—a quality many companies are lacking today. The attractiveness of the insurance business for Berkshire is that it provides Buffett with float—collected insurance premiums that

have not been paid as claims—to invest in other businesses. Berkshire has recently purchased additional public equity securities at very attractive terms and has been active over the last several years acquiring a host of well-run family enterprises at reasonable prices. As a result, the company has significant streams of additional earnings beyond insurance, which has helped to further diversify and strengthen its overall business.

We hadn't invested in Berkshire until a couple of months ago because even though we liked the company, we felt that we had better investment opportunities with higher expected returns. But late last year Berkshire was caught up in the general market panic and its price dropped substantially. We finally believed we could make a very attractive return on capital for our portfolios by investing in Berkshire, especially considering the recent moves Buffett had made and the opportunities in front of him. Over the last year, Berkshire has made a bevy of fixed income and equity investments, which should, in aggregate, work out nicely for shareholders over the next several years. What's more, with many private equity firms effectively being shut out of buying companies because they can't get financing, an all-cash buyer like Berkshire will have an advantage in making reasonably-priced acquisitions down the road. And finally, since the overall insurance industry has become capital constrained, the resulting higher prices over the next year or two should be a boon for the profitability of Berkshire's insurance operations.

It really doesn't get much better. Not only can we buy Berkshire's current assets on sale, we believe the seeds Berkshire is planting today will make it even more valuable to owners in the coming years. Buffett himself puts it well, "Price is what you pay, and value is what you get," and we are very excited about the value we see in Berkshire today.

News this quarter

As you know, we consider the quality and depth of our company research to be keys to success here at Midway Capital. We were very pleased to be able to add further research talent to our staff this quarter.

Justin Fuller joined the firm in October and has been devoting his time to both investment research and client service. Justin is a CFA charterholder with an MBA from the University of Notre Dame and comes to us from Morningstar where he was most recently an equity strategist. He created and managed the Ultimate Stock-Picker's Portfolio and is an expert on a number of industries and companies, including Berkshire Hathaway. He is also currently editor-in-chief of Buffettologist.com, a site well worth your time if you like to follow the doings of Warren Buffett as we do.

We were also pleased to welcome Andrew Richards to Midway. Drew is a Morningstar alumnus and a former Navy officer with an MBA in finance from Yale. He is working exclusively on research, and is currently looking into restaurants and retail. If you notice that we don't own any restaurants (yet), it is because Drew is not easily impressed and sets a very high bar for investments and their management teams. Both Justin and Drew add additional depth and insight to our research team. We believe that the team we have built makes Midway a stronger organization with increased capacity to serve our clients' needs, now and in the future.

And in case you're looking for any more background on the team or our firm, do investigate our new website at www.midwaymgt.com. We will be adding additional content throughout the year, but the current website contains much of the essential reading on who we are and what we do, including our quarterly letters. We welcome your thoughts on useful additions. Though, as always, we hope you will call us anytime you have questions, no matter how big or small.

A last word on the investing climate

Over the past quarter, many clients have asked us the same question – "Is buy-and-hold dead?" We think the answer is "no" - but with a few caveats. And it is not a bad question at all. As we mentioned above, an investment in the S&P 500 Index ten years ago would have returned -1.38% annually and investors would have lost 23% of their purchasing power on top of that. All in all, that is not a ringing endorsement of socking away money and leaving it in the market.

But the reports of the death of buy-and-hold has been greatly exaggerated. A buy-and-hold strategy, as practiced intelligently, has historically been quite successful. It is predicated on two principles:

1. It is impossible to time the market, and
2. Investors can select good-quality investments

Not timing the market implies that investors should not pick just one moment to invest everything, but rather average into positions over time. They should not expect to be able to sell everything on one date either, but sell gradually. This mitigates timing risk by ensuring that an investor wouldn't inadvertently buy at the top or cash out at the bottom. On average, stocks have gone up over the past 100 years and we expect the future to be similar.

The second principle puts the onus on an investor to pick good investments. We all know people who invested a bundle in hot technology stocks in 1998 and lost their shirts. That makes even the poor return of the S&P 500 look relatively attractive. Picking good companies takes research and judgment.

The upshot is that buy-and-hold does not mean "buy anything at any time and it will go up". A good buy-and-hold strategy is not as simple as it sounds and is not always easy to execute. However, practiced correctly, it can be a powerful tool for building wealth. We practice our own version of this classic strategy by ignoring what the market is doing and looking for companies that are attractively priced. Extensive research helps us find exceptional companies, and a focus on valuation means we only buy when the price is right. Then, and only then, are we big believers in holding until the rest of the market comes to its senses. And it always has, in time.

Yours,

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Matt Nellans

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