

MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC

150 N. MICHIGAN AVENUE, SUITE 800, CHICAGO, ILLINOIS 60601

January 12, 2012

Dear Fellow Investors,

We had a good fourth quarter, but the full year 2011 will not go down in history as a great year for stock investors. It was especially rough for foreign companies and smaller firms, the best performers being large-cap defensive names. As you recall, we were very cautious in the first half of the year, but stock prices tumbled during the summer as Europe's economic troubles cast a pall over world markets. This gave us room to start buying stocks again, particularly in companies that are poised to benefit from a recovery in the US market and a resolution of the European debt debacle. Despite terrific returns for these stocks in October, 2011 was a year when investors played defense. We used this as an opportunity to invest in solid firms that are positioned to play offense once the clouds from Europe lift.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q4 2011	9.77%	11.82%	-2.05
2011 Year to Date	-12.22 %	2.11%	-14.33
Annualized Return Since Inception	3.17%	1.75%	+1.42
Total Return Since Inception	11.54%	6.26%	+5.28

Data reflect total returns (including dividends) net of fees as of 12/31/2011. 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.

What's in Store for 2012

If you've ever asked anyone at Midway Capital to make a prediction about the markets, you know what our answer is: "we don't know." Neither, we believe, does anyone else. Making predictions about the broad economy is guesswork and even the experts are right about 50% of the time – exactly what you'd expect if

you flipped a coin. For an engaging take on “The Folly of Prediction” we highly recommend the *Freakonomics* podcast of the same name from June 30, 2011¹. However, it is both fun and interesting to read about predictions for the new year because these educated guesses are often the very assumptions which are “baked in” to the investment mindset that prevails in the market. In that spirit, we bring you a list of 2012 predictions by Bob Doll, Chief Equity Strategist for Fundamental Equities at BlackRock² (ticker:BLK). Here is what Mr. Doll sees in his crystal ball for 2012.

1. The European debt crisis begins to ease even as Europe experiences a recession.
2. The US economy continues to muddle through yet again.
3. Despite slowing growth, China and India contribute more than half of the world’s economic growth.
4. US earnings grow moderately but fail to exceed estimates for the first time since the Great Recession.
5. Treasury rates rise and quality spreads fall.
6. US equities experience a double-digit percentage return as multiples rise modestly for the first time since the Great Recession.
7. US stocks outperform non-US markets for the third year in a row.
8. Dividends and buybacks hit a record high.
9. Healthcare and energy outperform utilities and financials.
10. Republicans capture the Senate, retain the House and defeat President Obama.

The fact that Mr. Doll was correct in only 5 of his 10 predictions for 2011³ indicates that we should take his 2012 forecasts with a grain (or 2) of salt. However, there are a few points here that are worth noting. Numbers 6 and 7 are the same predictions that he made last year. The reason he’s willing to keep forecasting these positive trends for US stocks, despite all the other economic hurdles and hardship he sees in the crystal ball, is that US companies just keep looking more and more attractive as investments. Earnings are rising, profit margins are at an all-time high, and companies are sitting on big piles of cash. Like Mr. Doll, we also believe that it is merely a matter of time before investors realize the bargain that stocks represent. As profits continue to climb, investors are getting a greater amount of company earnings for each dollar of investment. This won’t go on forever. Eventually, stock prices will rise along with earnings and we will get the returns that Mr. Doll has been forecasting.

Another interesting trend that Mr. Doll notes (#8) is that dividends are hitting a record high. We too have been seeing this in our investments across the board. Companies both big and small have been raising their dividends and giving more cash directly back to their investors. This is a trend we like, and one worth examining in more detail.

¹ *Freakonomics* blog and podcast. <http://www.freakonomics.com/2011/06/30/the-folly-of-prediction-full-transcript>.

² Predictions for 2012 from BlackRock. <http://www2.blackrock.com/global/home/InvestorRelations/pressReleases/index.htm>. We picked Mr. Doll from among the many economic soothsayers because we own stock in BlackRock and because he very helpfully provides himself a scorecard on his past predictions.

³ Mr. Doll gives himself a 7 out of 10 because he scores himself as “half-correct” on a few answers. That seems a little fishy to us, but feel free to read his predictions at the link above and judge for yourself.

Dividends are Back!

It may seem intuitive to us, the owners of companies, that paying dividends to your shareholders is a good thing. Owners demand a return on their investment, and dividends mean we get cold hard cash at regular intervals regardless of what the market is doing. But a company's dividend policy depends on the interests of many stakeholders, not just minority owners. Over the past few decades, and particularly during the dot-com era, dividends have been associated with stodgy, boring companies that had few good uses for extra cash. "Growth" companies, it was assumed, didn't pay a dividend because they needed every penny to invest in expanding their businesses – new factories, new products, more people, etc. Investors in these growth companies realized a return on their investment by selling their shares for a profit – no dividends necessary.

While there may be a grain of truth in this, the perception of dividend-paying companies as "slow growth" actually prevented many companies that should have paid a dividend from doing so. They wanted to maintain their status as high-growth companies. Paying a dividend was tantamount to flashing a signal to influential Wall Street analysts and growth investors saying "we don't have any good growth opportunities." That could lead, of course, to massive selling of the firm's shares by the "growth" crowd. It could also mean a loss of prestige for the company and its management. Since a typical CEO receives very little of his or her compensation from share dividends, there is almost no incentive for company leaders to pay big dividends unless they already do so.

This situation has resulted in a colossal waste of shareholder money. Potential dividends are frequently spent on overpriced or unnecessary acquisitions as well as share buybacks at the top of the market. In other words, companies prefer to flush cash down the toilet rather than admit that we could spend it better than they could.

However, the "great stagnation" of 2011 is changing that. Many shareholders have become convinced that stocks are not going to appreciate enough to give them a decent return on their investments. Indeed, if you look at broad US market returns over the past ten years, *excluding dividends*, investors have not even kept up with inflation. Holders of dividend-paying stocks had an edge. And companies have been responding to the new widespread demand for dividends. During 2011, US stocks increased their dividends by \$50.2 billion⁴. That is nearly double the \$26.5 billion increase in 2010.

At Midway Capital, we are fans of this trend. We seek to own companies that are extraordinarily profitable, but we also want to make sure management will spend its profits in a way that benefits owners. It is a rare company that meets both of these criteria. Private companies often do well in this regard because the managers *are* the owners. But in the public company world, where owners are predominately outside passive minority investors, we would like to see managers behave more like owners. We believe that most of the companies we own should strike a balance between new investment (when it is profitable) and returning cash to owners. The recent dividend trend is a step in the right direction.

⁴ Standard & Poors data quoted in *Barron's*. Michael Aneiro. Dividends "Rise in Fourth Quarter, More Gains Seen in 2012." January 4, 2012. <http://blogs.barrons.com/incomeinvesting/2012/01/04/dividends-rise-in-fourth-quarter-more-gains-seen-in-2012>.

Yearning for a Taste of the Private Life

As we mentioned above, we think privately held companies tend to be better managed organizations in virtually every aspect and we like to hold our investments to “private company” standards. The big difference between public and private companies is the motivation driving management’s decision making: instead of looking to please just a few intimately involved individuals, public companies are owned by tens of thousands of individuals lacking a strong collective voice. Consequently, management has greater license to engage in questionable decision making.

Take, for example, ownership. Public companies graciously dole out ownership to practically every employee in the form of stock options. Compare this to a privately held law firm where “making partner” represents the highest attainable level and – at long last – ownership in the law firm. Private companies also tend to be much more judicious in their acquisition policies. Public company executives often feel the pressure to deliver revenue growth, either because their bonuses are tied to this metric or because Wall Street demands it. Consequently, they’re willing to pay exorbitant sums (often using company stock) to acquire. Even dividends tend to differ significantly. Often, private companies declare dividends when the owner deems it appropriate and when the cash is not required for investment.

Of course, private companies have drawbacks as well, and it is much more difficult to build an individual investment portfolio with private firms unless you are Warren Buffett. The best of both worlds is a public company whose managers truly act in the best interest of the shareholder, which is why we like to take a “private company” yardstick to public companies.


Notes and Asides

If you would like to see just how important dividends are to your portfolio’s over all return, we always include a column on your Portfolio Holdings Detail called “Cash Income Gain.” Check this column to see how much cash each investment has paid out. Also included in your quarterly reports is a list of realized gains and losses, which we provide to help you or your accountant with tax preparation. The bank expects to mail final 1099 forms on February 15 and they will also be available online at that time.

Last but not least, if you’d like to hear more of Midway’s perspective on investing, you may be interested in viewing Rachel’s recent interview on Fox Business TV. We have a link to the January 10 interview on our website at <http://midwaymgt.com/news.html>.

As always, it is a privilege to be your investment advisor and we wish you all a very happy and prosperous 2012.

Yours,



Rachel Barnard, PhD
and the Midway Capital team