MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC
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Dear Fellow Investors,

There wasn't much happening this past quarter. You might even say it was downright dull: stocks were nearly flat and volatility was low, so we had few real buying or selling opportunities. But instead of working on our golf games (or snowball-making skills here in the arctic tundra we call Chicago), we have been researching some exceptionally promising investments overseas, particularly in emerging markets where we see a haven of value right now.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q1 2014	1.38%	1.81%	-0.43
Annualized Return Since Inception	11.25%	9.23%	+2.02
Total Return Since Inception	84.63%	66.12%	+18.51

Data reflect total returns (including dividends) net of fees as of 3/31/2014. 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.

Why We Like Emerging Markets

Jeremy Grantham isn't particularly well-known outside of Wall Street, but within investing circles, he's a highly-regarded sage. Throughout his nearly 50-year career, Grantham has been remarkably accurate – eventually.

Grantham famously called the technology bubble about three years before it burst. He continued to cry bubble throughout the first decade of the 2000s, and didn't change his tune until the lowest of the market lows in 2009. While this was remarkably accurate in hindsight, it's essentially a 10-year stretch of watching interest arrive in a savings account. From the perspective of a money manager, it's tough to justify your existence by pointing out what you *didn't* do.

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In any case, he has a well-earned reputation as a pessimist, so we were particularly intrigued by a recent interview with Grantham in which he said, "Emerging markets collectively are selling at very close to fair value. And the value stocks in most of Europe are pretty close to fair value. High-quality stocks in the U.S. are not nearly as bad as the rest of the market." And bonds? "They look absolutely, nerve-rackingly overpriced…they could make stocks look like a safe haven if the next bust occurs at the federal levels of the large countries."[1]

We were struck by the irony of a general pessimist eschewing government bonds in favor of emerging markets stocks. Every piece of academic literature tells us emerging markets are risky – always and forever, and government bonds are the risk-free asset. But while Grantham's advice may look contradictory, we would agree that the case for emerging markets is a strong one. (If you're a regular reader of our letter, you know we're bearish on bonds as well.)

The phrase "emerging markets" sounds like a euphemism, and it usually is. At the time it was coined, "emerging" was a polite way of saying, "don't drink the water." But with time, emerging economies' standards of living have improved dramatically. Most people wouldn't consider South Korea to be a third-world economy. But MSCI, the index provider who calculates the emerging-market indices, still lumps South Korea and Russia in the same bucket. When Wall Street considers two things to be equal when they clearly aren't, our attention is piqued.

Right now, sovereign debt is a big issue for emerging economies. To summarize, countries that historically had been unable to borrow were suddenly given a limitless credit line before the 2008 financial crisis. In past situations where governments had more debt than they could cope with, the solution – painful to everyone – has been inflation. But it's important to understand not all emerging economies are created equally.

Some emerging economies are rich in natural resources, have large gold and currency reserves, and consistently run large trade surpluses, all of which would tend to reduce the risk of inflation. Russia is a good example of the foregoing, and it also illustrates that there's more to investing in emerging economies than just crunching some numbers. Some countries, though, are fiscally sound, politically stable, and by most measures, should now be considered "developed." Typically, there's a reason why they aren't, but it can be shallow, like "because it's in South America."

Even so, these countries offer good opportunities. Imagine a good business in a stable industry in a stable country. Then imagine it's trading for half the price of a competitor in a different stable country. Is geographic isolation really that unsettling? If so, why does Australia get a pass?

As investors panicked over sovereign debt, many foreign stocks went on sale. While first world stock markets have generally rebounded, emerging-market stocks are still trading at far lower multiples than stateside competitors. As we started looking outside the large, blue-chip names, we found even more to like. Providers of household staples in South Africa can be purchased for one-fourth the multiple of an American counterpart. Smaller companies tend to behave differently than state-controlled monopolies.

That leads us to the concept of risk. For generations, developed nations have had *carte blanche* to do all sorts of things that are *verboten* in emerging nations. Italy ran huge budget deficits. Greece fudged its numbers and

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[1] Strauss, Lawrence C. "Learning to Live With a Stock Bubble." *Barron's*, March 15, 2014.

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borrowed the difference. (As an interesting side note, MSCI promoted Greece to a developed market in 2001, then demoted it back to an emerging market last year.) So as we're looking for stocks, would we rather buy a niche Italian soft-drink maker, or a niche Chilean soft-drink maker? Chile's national debt is around 10% of GDP, compared to more than 100% in Italy. Humans have an unending love for sugar water. So why is the Chilean company more risky? Because it's in South America?

Really, that's the million-dollar question. From an objective standpoint we can see that a lot of emerging nations are in better shape than developed nations, yet emerging-market stocks are still branded high risk. Grantham has noted this fallacy as well. But has the rest of the world? Eventually, we think they will, and we have the patience to wait.

IPOs Boom and Fizzle

If you're ever asked us about IPOs, we have told you that we almost never buy one. For one thing, the odds are against us. During the first five years after an initial public offering (IPO), those companies underperform their peers by an average of 3.3% per year.[2] So the deck is stacked against us if we buy an IPO. Nevertheless, there were 64 IPOs in the first quarter of 2014, more than double the number in the first quarter of last year. The majority of these companies did not even make a profit. Why are so many IPOs now? Because the time is right for sellers – but not for investors.

Most of our readers are probably familiar with IPOs. It's hard to miss the news surrounding big issues like Facebook or Twitter. Simply put, an initial public offering is the first time a private company offers its stock to the public. For some reason, the private company needs money, so it sells a piece of itself to investors via the stock market. It may sound like this gives average investors a chance to get in on the "ground floor" of a new company, but in reality, that's not the case. Someone already owns the company. That someone has decided it's a good time to sell. While that's not always a red flag, it certainly should invite caution. If the investors, who presumably know the most about the business and its prospects, are cashing out, should you be jumping in?

There are a number of reasons for going public. We think of them as the three "G"s: Greed, Growth, and Generations. Greed is simple – the owners want their money. The owners may be the founders, early investors like venture capitalists or private equity, and even the employees of the company who have stock options. They all want to turn their stake into cold, hard cash at the right time. Growth is another motive. Businesses need money to invest in hiring people, building facilities, and developing new products. An IPO may be the only way to get a large chunk of money for growth. The generational motive is also powerful. A founder who wishes to pass her company onto her children will have a hard time if there isn't enough money to pay the estate tax bill. Sometimes, selling part of the company is the only way to ensure that it will be passed down in the family and not sold at a fire-sale when the founder dies.

We think the "greed" motive is probably the most common impetus for an IPO. But whatever the case, the sellers want the best price for their stakes, so they are looking to sell when the market is hot, or maybe when

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[2] Ritter, Jay. "Returns on IPOs during the five years after issuing, for IPOs from 1970-2011." Updated April 11, 2013. http://bear.warrington.ufl.edu/ritter/IPOs2012-5years.pdf

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the market will overpay. A quick look at the 2013 numbers will tell you that IPOs were hot last year. It was the best year since 2000, with 222 companies going public and raising a combined $55 billion. Even better, buyers were rewarded with returns of 41% from the average IPO in 2013.[3] Can you blame companies for hopping on the gravy train?

And hop they have. First quarter IPOs were double the number that we saw last year. But it looks like the boom is beginning to fizzle. King Digital Entertainment (of "Candy Crush" fame) saw its stock take a 15.5% dive on the first day of trading, making it one of the year's major flops. Both of the big IPOs this week, LaQuinta Hotels and Ally Financial, were disappointing. So the bloom may be off the IPO rose for now. But it will be back, because the three "G"s are powerful motivators. There is still a lot of pent-up supply from sellers who have had to sit tight during the financial crisis, waiting for the right moment to sell their companies for top dollar.

As buy-and-hold investors, it is the rare IPO that would interest us. There may be years like 2013 when IPO investments soar, but given the dismal track record of longer-term underperformance, the average IPO is simply a raw deal. That said, we are happy to take a look at newly public companies – once their share prices have fallen back to earth.

Overwhelmed by Proxies?

If you get paper proxies, your mailbox will be telling you that proxy season has arrived! Proxy statements are sent out every year by companies in advance of their annual meetings. As shareholders, you are entitled to vote your shares and companies are required to send you the materials that allow you to do so. If you prefer, you can choose to receive them via email rather than regular mail. Log into your account online, hit the "go paperless" button, and choose e-delivery for Proxy/Shareholder Communications. And while reading the proxies and annual reports is a great way to know your investments, that is really our job. So if you would prefer to delegate the voting to us, you can. Contact either Todd or me and we can send you a form that allows *us* to get the proxies and vote on your behalf.

Yours,

Rachel Barnard, PhD
Todd Schrade, CPA
and the Midway Capital team

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[3] Brown, Joshua M. "Quack Quack: Demand, meet Supply." Reformed Broker Blog. April 6, 2014. http://www.thereformedbroker.com/2014/04/06/quack-quack-demand-meet-supply/

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