MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC
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Dear Fellow Investors,

As we close the books on 2013, we are seeing what a remarkable year it's been. Almost all of our holdings gained in value and volatility was unusually low. Our portfolios had their second best year on record (after 2009). We are certainly gratified to see all the hard work and research of previous years pay off for our clients. Perhaps the only downside was the paucity of bargains. As our old investments become fully valued, we are always working on the new ideas that will drive returns for the next 3-5 years down the road. We still think there are a few hidden gems out there; we just have to turn over a lot more stones to find them.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q4 2013	8.59%	10.51%	-1.92
Full Year 2013	33.74%	32.39%	+1.35
Annualized Return Since Inception	11.41%	9.31%	+2.10
Total Return Since Inception	81.15%	63.17%	+17.98

Data reflect total returns (including dividends) net of fees as of 12/31/2013. 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.

The markets are at all-time highs. Should you be worried?

By all measures, 2013 was a fantastic year for stock investors. Since 1897, there have been only 15 years in which the market has returned more than 30%[1]. Now 2013 joins that elite group. And while we're very pleased with the results, it does invite a note of caution.

[1] Data from J.P. Morgan and Bloomberg and compiled by 361 Capital; Based on the Dow Jones Industrial Average from 1897-1927 and the S&P 500 Index thereafter.

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Wall Street, however, remains very optimistic. Check in with any cable news network or financial website to see what we mean. Pessimists are hard to find. On the one hand, all this optimism is to be expected. When markets go up, more people want to invest in stocks. Drawn like moths to a light, retail investors have been lured back into stock funds; 2013 is the first year since 2007 that stock mutual funds have seen net inflows[2], meaning more money has gone into stock funds this year than has come out.

On the other hand, we'd expect a little more caution from savvy investors after such amazing gains in the recent past. We've certainly paused for some careful consideration, and so we want to share some thoughts with you on the topic of stock valuations.

First of all, there is no rule that bad returns must follow good, or vice versa. Some pundits seem stuck on the concept that poor returns *must* follow good returns as markets revert to their historical averages. This is simply not supported by the data. It is true that markets tend to revert to the mean over time, but that could be a long stretch of time, even a decade or more. In fact, the data we do have indicates that strength typically begets further strength.

As fundamental value investors, we believe that company profits ultimately drive the prices of stocks. So we wouldn't put much credence in a theory of alternating good and bad returns anyway. But we do acknowledge that 30%+ gains are rather rare, and the odds favor a year of more typical returns in 2014.

One way of gauging the valuation of the market is to see how the price-to-earnings ratio (P/E) compares with previous years. P/E is a ratio of the price of a stock to its profits (earnings). If investors now are willing to pay more for a dollar of profits than in the past, that could be a red flag. In fact, some investors argue that the market is currently overvalued by historical standards. But the calculation is very problematic and is far from easy to interpret. Right now, the average stock in the S&P 500 index is trading around 16 times estimated 2014 earnings[3]. The median P/E ratio for the past 25 years is actually a tad higher at 19. So we might conclude that stocks today are slightly *under*valued compared to historical norms. However, there are a few items to consider that complicate this analysis. The technology stock bubble of the late 1990s influenced the historical data to some extent. Prices went sky high for companies with no earnings, skewing the historical average upward. We could easily argue that the "actual" historical P/E is lower than 19. If we expanded our time horizon beyond the past 25 years, we would also get a lower P/E multiple.

So we could make a reasonable argument that the current P/E is slightly higher -- or slightly lower -- than normal. However, it is certainly not anywhere near a record level (compare the P/E of 24 in 1999) and it is less than one standard deviation from the average. We think it is reasonably safe to say that the market's valuation is close to its long-term average. It's definitely not cheap, but it's not expensive by historical standards either.

A more meaningful way to think about this is to simply look at the inverse of the P/E ratio, called the earnings yield. If the market P/E is 16, then the earnings yield (E/P) is 1/16 or 6.25%. This number tells us that companies are expected to earn 6.25% of their current price next year. So we would expect a return of just over $6 on our $100 investment. Assuming our companies will grow their earnings a bit each year, we

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[2] http://www.ici.org/info/flows_data_2014.xls

[3] Data from Goldman Sachs and Computstat

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add a few points for modest annual growth. So at a 16 P/E, we might expect a return of 7-8% per year. We think this is a pretty decent return, particularly when we look at alternative investments choices like bonds or bank accounts.

Of course, these returns are not guaranteed. Profits may not be as high as we are expecting. The Fed could raise interest rates and thereby curtail spending and investment. Right now this does not look imminent, but bond yields have already been on the rise for more than a year. Other voices in the news have noted that corporate profits could drop due to competitive forces. Corporate profits (as a percent of GDP[4]) are at historically high levels. That means that more company profits are going to investors rather than to employees. Wages have been stagnant since the recession and if the labor market gets tighter, companies might have to raise wages to keep their employees. This could crimp corporate profits, at least for a while. Right now unemployment is high at 7% and the labor market has some slack, but that could certainly change if hiring picks up in the new year.

On the flipside, the economic engine could shift into high gear and profits could be higher than we expect. When the Great Recession hit back in 2008, companies retrenched. They didn't make new investments or hire new employees. This led to slack demand, which in turn led to a leaner corporate spending environment. Meanwhile, the lack of jobs led consumers to defer big purchases like homes, remodeling projects, and new vehicles. Such a "death spiral" can go on for a while, but eventually, deferred spending becomes pent-up demand . Machinery and equipment wear out and must be replaced. Doing so requires spending, which leads to new jobs and then more spending. That is the virtuous cycle.

Since roughly 2009, we've been hearing stories about pent-up demand waiting to be set free. The most common phrase we hear is "logjam" as executives wax optimistically about the eventual gush of demand waiting just on the other side. What we've seen instead is more akin to water trickling through the logjam. We haven't seen a sudden gush of demand, but it's been slowly increasing.

There are a lot of things to ponder here. We cannot predict what will happen this year, or any year. But at the end of the day, we are basically optimistic that stock returns will justify the risks in the near future. We think there is still a lot of room for the economy to expand. The situation in Europe is slowly improving. The energy sector in the U.S. is booming. Instead of sending supertankers full of dollars to Middle-Eastern oil companies, we've sent our dollars to Texas and North Dakota. Consumers are more confident than they've been since 2008, and also for the first time since the crisis, homeowners have positive equity in their homes. We do acknowledge, however, that it is difficult to find the kind of fantastic investing bargains we have enjoyed over the past 5 years. And we certainly don't expect another high-return, low-volatility year like the last one. But we don't see glaring signs of impending doom just yet. When we do, you can be sure that will move into a different set of investments and hold cash if necessary.

Finding Hidden Gems in the Dusty Corners

While we effectively have a "hold" recommendation on most of our stocks, there are a few areas where we see potential for larger long-term gains. Utilities sold off as a group in the middle of last year. That gave us the

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[4] Corporate profits after tax are at approximately 11% of GDP according to data from the St. Louis Fed.

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opportunity to buy our first utility stock. Although the group has rebounded a bit in the beginning of 2014, we still think they are relatively attractive. Municipal bonds are also a surprise bargain. Many investors sold these investments last year, fearing interest rates would rise and send bond prices down. But municipal bonds sold off even more than other bond categories. We believe some of this was fear of defaults like the Detroit bankruptcy, but we think other investors also harvested tax losses at the end of the year. This has resulted in municipal bonds being a much better bargain that other bonds, particularly as the predicted "wave" of bankruptcies has not happened and tax revenues are on the rise in most states, making defaults less likely.

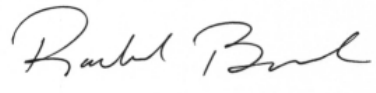
We also like the prospects for emerging markets. Most of these countries have not participated in the stock market gains that the U.S. has seen. If fact, the cyclically adjusted P/E ratio (also called CAPE or Shiller P/E) for the MSCI Emerging Markets Index is currently around 10, which is significantly lower than its historical average. CAPE measures the price relative to earnings, but also averages in the past ten years of data to adjust for cycles and inflation. In the past, valuations at this level have preceded decades of double-digits returns. Again, that is not a guarantee, but emerging markets do look like a good value, and an even better value relative to the U.S. right now.

Finally, we remain bullish on real estate. We've been progressively investing more in this category in 2013 because it's been one of the few attractive sectors. Real estate investments were one of the worst performers last year, which probably hurt our returns a bit compared with the overall market. But we think the outlook for both housing and commercial real estate is steadily improving. It should only be a matter of time before the market catches on.

Your 2013 Tax Reporting Documents

On a more practical note, tax season will soon be upon us. Our bank will begin delivery of 2013 tax reports on January 31, 2014. For most taxable accounts, if all the tax details and classifications have been received for the securities held in the account, then the 1099 will be mailed out on the January delivery date. A second mailing will be sent on February 18, 2014. For accounts where the 1099 data are still incomplete by February 18th, a letter will be sent detailing the investments that have yet to deliver their tax reporting information. As always, we are happy to help you find any tax information that you need, just give us a call or email.

Yours,



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