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Dear Fellow Investors,

What a difference a year makes. Last year at this time the stock market had just plunged and everyone was wringing their hands about a recession. This year, stocks are posting new highs. We find it both instructive and humbling to look at how unreliable economic sentiment and forecasting can be. With that backdrop, we've chosen to devote this letter's market commentary to how we're preparing for volatile economic times, and then discuss some very important "behind-the-scenes" developments that will affect your investments in more subtle but important ways.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	**S&P 500 TR Index**	**Difference**
Q4 2019	6.59%	9.07%	-2.48
2019 Year To Date	27.75%	31.49%	-3.74
Annualized Return Since Inception	10.36%	10.72%	-0.36
Total Return Since Inception	210.7%	222.5%	-11.8

Data reflect total returns (including dividends) net of fees as of 12/31/2019. 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.

Market Commentary

At this time of year, many people ask for our view on where the stock market is going. The one thing we can say definitively is that we don't know. But it is our job to be prepared for what is ahead so we do have some thoughts on the investing climate. First of all, the total return for the S&P 500 this year would indicate a phenomenal year, but we see it in a broader context. If you remember our letter from last year at this time, we had just seen the market take a nosedive, with the same S&P 500 down -13.52% in one quarter. We started that commentary by asking "Are we headed for a recession?"

Our view has changed little despite the dizzying ups and downs – we aren't expecting a recession but we are cautious about the sky-high valuation in stocks. Therefore, we have invested more conservatively and we maintain a cash position. This means, of course, that we won't match the market returns in a huge rally, but our investments should also perform better in a downturn, as they did in the fourth quarter of last year.

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Interestingly enough, our long-term investment returns, since we began in 2008, were at 10.36% annually this quarter, exactly where they were right before the market fell in 2018. So we've maintained a consistent return without compromising our strong risk management discipline, and that's our aim during both ups and downs.

There is no shortage of experts weighing in with their economic forecasts. You may have read the Barron's roundtable[1] from this past weekend, as we did. Picking one pundit whose views particularly resonated with us, we'll quote Meryl Witmer (Eagle Capital Partners)

> The consumer is in good shape; consumers will continue to spend, and the Fed looks like it will be very cooperative. We usually say slow growth is nirvana for the market, but with valuations this high, I would not expect a robust year for the market. Everything I look at is trading where it should trade in 1½ or 2 years from now, which means valuations are 15% to 20% too high. We could have a really sideways-to-down market; if something happens to cause fear, it could really topple. Then, maybe we'd get some good valuations again. It's good to have some cash around.

High valuations make us cautious too, particularly because in 2019 most of the increase in stock prices was attributable to the amount people are willing to pay, not appreciably higher earnings or dividends. The concentration of returns in just a few mega-cap stocks is also worrying. For example, Apple stock is now worth more than the value of the entire US Energy sector. (Yes, AirPods are wonderful, but….) In addition, Merrill Lynch reports that US stocks have never been at higher valuations versus the rest of the world. Global stocks are priced at a 70-year low by comparison. The high concentration of money in a few large companies makes us more committed to diversified holdings, including investments in non-US companies and markets.

Chart 91: Apple now worth more than US energy sector

Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg

Big Changes in the Brokerage Industry

You may have seen the recent news that Schwab and TD Ameritrade are merging. This is a very big deal in the world of investments and we guarantee that it will affect you whether or not you do business with either of those two brokerage firms. In fact, it has already affected all of our investment management clients because your trading commissions went down to $4.95. But there is a lot more going on behind the curtain.

Schwab and TD primarily serve retail investors, so their move to $0 commissions is a very public move designed to attract more clients. It also forced all the other players in the industry to evaluate how they charge for their services. Despite the $0 commissions, Schwab and TD obviously make money somehow. They do it behind the scenes in two primary ways. First, they pay very small amounts of interest on the cash that clients have in their accounts. Our custodian, SSG, pays a full 1% more on your cash than TD and Schwab. Second, they engage in payment for order flow, a practice which routes trades to places that pay them to do so; in

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[1] "There's Almost No Chance of a Recession This Year, Experts Say. Here's Why." *Barron's*. January 10, 2020.

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return clients get worse prices on their trades (i.e. your shares might cost you $50.02 vs. $50.00 on the open exchange.) Vanguard investors will notice this in particular. These types of behind-the-scenes charges are now how most brokerages make money but very few retail clients have picked up on these tricks. Brokerage firms also save money by cutting back on client service, as Schwab is planning to do after the merger. You can bet that clients will still be paying for their services, just not with commission dollars anymore.

Of course, we're fans of low prices (we're value people, after all) but we are not fooled into thinking that there is a free lunch if commissions come down. We also value service very highly, and we hold SSG to a very high standard. We want them to earn enough money from us, and from other advisors, to be able to pay their exceptional staff for the service we have come to expect. We also value the fact that they don't engage in payment for order flow and that they pay a good rate of interest on client cash. We have done the math and find that for our clients, the value of higher interest on cash and better trade execution far exceeds the value of zero commissions. We bring this to your attention, though, because these changes in the industry have an impact on all of us. Making money in a zero-commission world is going to be a challenge for all brokers, and it's important, as investors, to be vigilant about keeping track of exactly where our money is going.

New Rules for IRAs – What you Should Know

Forget everything you knew about inherited IRAs. Most of it is now obsolete. If you own an IRA that you might pass down to your children, or if you might inherit a parent's IRA, then you need to think through the implications of the new IRA rules that took effect this year. The best opportunity to minimize taxes lies with the IRA account owner *before* he or she dies, making thoughtful planning over multiple years much more important.

If you spend your entire IRA before your die, then these rules don't make much of a difference. The IRS thanks you for the timely contribution to its coffers. However, when an IRA owner dies with money left in his or her account, the job of emptying the account passes to the beneficiary. If that beneficiary is a spouse, not much has changed. But if the beneficiary is a child, there's a lot to consider. Under the old way of doing things, the beneficiary of an inherited IRA had the choice of draining the account within 5 years or stretching the withdrawals over his or her own lifetime. Almost everyone chose to stretch withdrawals over a longer period, thus the nickname "Stretch IRA." That was great for the beneficiary, but it meant the government had to wait a long time for its tax money. The SECURE act eliminates the provision for Stretch IRAs. Now accounts need to be drained within 10 years, except in limited circumstances. For most people, this will mean draining the account faster. The increased income may push beneficiaries into a higher tax bracket.

There are a number of strategies you can choose as an IRA owner or beneficiary and these depend a great deal on your individual circumstances. Here are the primary choices:

1. **Beneficiary takes the whole distribution immediately in a lump sum**. We'd generally avoid this except in the case of a very small inherited IRA or a financial difficulty. IRA withdrawals are taxed at ordinary income tax rates, and this could easily push the beneficiary into a higher tax bracket.

2. **Beneficiary takes equal distributions from the IRA over a ten-year period.** This is probably what most beneficiaries will do. However, there is a disadvantage with large IRAs (say $1 million or more) in that the beneficiary could be in a higher tax bracket for ten years. If she already earns

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$100,000 per year at her day job, the additional IRA income will push her from the 24% tax bracket to the 35% tax bracket every year for ten years.

3. **Wait and be opportunistic.** One potentially better option would be to wait. There's no rule that forces beneficiaries to take ten equal distributions. She could leave her account alone for ten years, allowing it to grow and compound without an annual tax bill. She would then be forced to withdraw the entire amount in year ten, and that would push a lot of income into the highest tax bracket. This isn't a good strategy on its own, but it could be useful if, for example, the beneficiary knows that she'll retire soon. She could defer withdrawals until then, when she'll be in a lower tax bracket. This could also be a useful strategy if she is a business owner and has a loss year: she can use business losses to offset a larger IRA distribution. If the stock market takes a dive, she could use the opportunity to withdraw money when the value of the account is at a low point.

4. **IRA owner uses a Roth strategy to limit taxes on the beneficiary.** The owner of the IRA can take planning action to minimize the amount of taxes his children will pay when they inherit his IRA. In addition to his normal withdrawal, he could convert a portion of his traditional IRA to a Roth IRA each year. He can then use the Roth himself, or bequeath it to his children. Roth distributions are not taxable for either party. The children would still have to empty the Roth within ten years, but there would be no tax consequences. The owner has effectively prepaid the taxes, keeping his children out of a higher tax bracket. Roth conversions could be especially useful for retirees between age 59.5 and 72. This is the period before required minimum distributions start at age 72.

5. **Use a trust as the beneficiary.** Let's say the account owner realizes that his children lack the responsibility to handle a $1 million inheritance. Accordingly, he could set up a trust as the beneficiary of his IRA. A trust holds the IRA's funds after they're distributed and doles them out according to a schedule. The trust will have to pay tax on the IRA distributions and investment earnings (it's worth mentioning that trusts are subject to unfavorable tax rules), but if the choice is between paying more tax or seeing a beneficiary squander his or her inheritance, then this may be the best option.

There are a dizzying array of options here. In the real world, we'd be dealing with hunches and guesswork. People will be in different tax brackets each year. The market will move unpredictably, and rules will almost certainly change, although we don't know how or when. We think the best strategy in an uncertain environment is to diversify – keep some assets in a traditional IRA, some in a Roth IRA, and perhaps even leave some in a taxable account. But above all, it's important for IRA owners to realize that they're now responsible for ensuring a tax-efficient transfer to the next generation. If you're in this situation, you should discuss your options with your children or parents, and your advisor.

Your partners in investing,

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

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