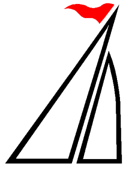
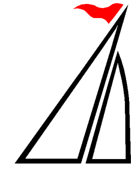

WINDWARD CAPITAL

Risk Averse Asset Management

2015 Fourth Quarter Review

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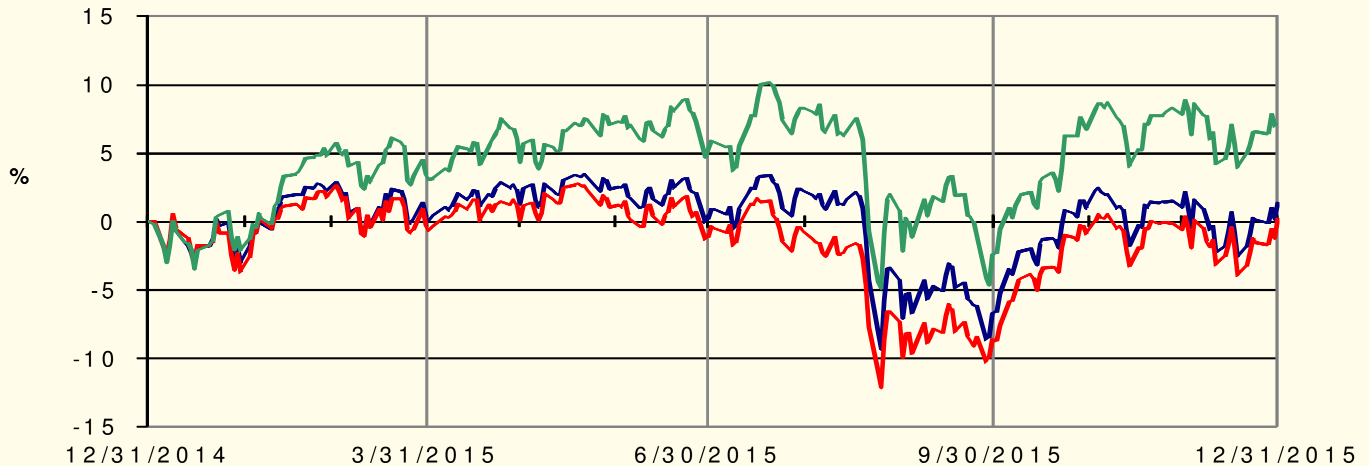

May The Force Be With You

"Do. Or do not. There is no try."

—Yoda

During the Fourth Quarter of 2015, the major U.S. equity market indices erased their negative Third Quarter year-to-date results and generated strong returns, with the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) returning +7.03%, +7.70%, and +8.76%, respectively, for the period. As a result, the S&P 500, DJIA, and NASDAQ reached positive territory for the year with returns of +1.37%, +0.21%, and +7.11%, respectively.

During late December 2015 and the beginning of January 2016, however, the U.S. equity market indices moved lower and experienced significant volatility in response to continuing concerns regarding the global macroeconomic outlook. Despite this most recent downturn in the financial markets, from our perspective nothing dramatically new or unexpected has occurred. Ongoing equity market volatility continues to revolve around numerous global macroeconomic and geopolitical risks that we have elucidated upon in the past. As noted in our previous *Quarterly Reviews*, some of these risks include:

- ✓ Central bankers' aggressive monetary policy antics since the 2008 Financial Crisis have only produced subpar global economic growth. Zero interest-rate monetary policy (ZIRP) has borrowed consumption from the future, underscor-

ing the challenge of future economic growth and resulting in a global dearth of demand and surfeit of supply, with concomitant deflationary risks.

- ✓ No one knows the consequences of an extended period of ZIRP. (Indeed, if there were no consequences to ZIRP, interest rates could have been held at zero forever—in the past, as well as into the future.)

- ✓ Monetary policy overkill (in duration and in the level of interest rates) continues to produce adverse consequences of malinvestment and has resulted in the hoarding of cash and reduction in spending by the disadvantaged savings class.

- ✓ The "exclusive prosperity" of the "haves" (versus the "have nots") is politically unstable, leads to more uncertainty (and unexpected outcomes), and will likely have a negative and more volatile impact on social systems, the global macroeconomy, and the financial markets. As a result, global macroeconomic growth becomes uneven and less predictable.

- ✓ The world has never been more "flat" (i.e., more networked and more interconnected). As a result, country-specific actions have the potential to quickly lead to global consequences.

- ✓ The viability of the European Monetary Union (EMU) remains uncertain.

- ✓ The economies of the BRICs (Brazil, Russia, India, and China), previous drivers of global macroeconomic growth, are slowing—in some cases, quite dramatically and uncontrollably.

- ✓ An increase in U.S. interest rates will have significant negative ramifications for those developing world economies that have dramatically increased their U.S. Dollar-denominated debt over the last decade.

- ✓ High-frequency trading, algorithms, and the pervasive use of ETFs, combined with overall financial market illiquidity, is a recipe for increased volatility.

- ✓ Demographically, the aging of the populations of the developed world will have important implications for future demand growth and entitlement costs.

- ✓ Terrorism (including cyber attacks), religious radicalism, and geopolitical instability are increasing and will be more of a threat in the future than in the past.

- ✓ Global political and economic coordination is at an all-time low, and isolationism/protectionism seem likely to be a mainstay in the time ahead.

We closely monitor these, as well as other, risks when managing Windward's portfolios of investments. Since we take a long-term view, we typically do not react to short-term financial market fluctuations driven by nearsighted market participants. However, should there be a change in the global macroeconomic indicators and/or corporate fundamentals that we monitor, we are prepared to take whatever action is necessary to protect our clients' capital.

As you know, *Windward*'s goal is to protect our clients' capital and mitigate market-related risks by investing in specific, high-quality businesses that have long-term, secular growth opportunities. Indeed, we prefer to take a proactive approach to managing risk by investing in specific companies that are taking advantage of the changes in their operating environment to create long-run opportunities for their businesses. Our long-term performance results demonstrate the success of this disciplined investment approach.

One and Done?

As widely expected, on December 16 the U.S. Federal Reserve (Fed) elected to begin the interest rate "normalization" process by increasing the Federal Funds (Fed Funds) target rate range by a de minimis 25 basis points (from 0.00-0.25% to 0.25-0.50%). This is the Fed's first rate hike in nine years and comes seven years after the Fed Funds rate hit the zero lower bound. According to the Fed, future interest rate increases will continue to be "data dependent" and "gradual" in nature (although somewhere between three to five interest rate increases are expected in 2016, according to recent comments from various Federal Reserve Governors). We believe that the Fed has made a policy error by raising rates at this time.

The global policy graveyard is littered with central bankers who raised interest rates too soon—only to retreat after tipping their economies back into recession or after having misjudged the powerful deflationary forces in the post-Financial Crisis world. The European Central Bank (ECB) raised rates twice in 2011 before the Eurozone economy had achieved "escape velocity" and just as the Southern European "Club Med" countries embarked on drastic fiscal austerity. (The result was the near-collapse of EMU.) The central banks of Sweden, Denmark, Korea, Canada, Australia, New Zealand, Israel, and Chile, among others, were all forced to reverse course on raising interest rates. Some central banks have even initiated a *negative* interest rate policy (NIRP) in order to compensate for current deflationary forces. In our view, the Fed is risking a policy error by tightening at a time when other global central banks are still loosening—a divergence that is historically unprecedented and may, ultimately, need to be reversed.

Fed officials are basically trying to discern which of two possible versions of U.S. economic reality are correct. In the first version, low interest rates have helped the economy build up some significant momentum, and the Fed needs to raise rates more rapidly to keep a lid on inflation and financial excess. Chairwoman Janet Yellen and other Fed officials have argued that pressures like the decline in oil prices and the strength of the U.S. Dollar are temporary and are artificially suppressing inflation, and that (their perception of) strength in the U.S. labor market is a more important indicator. An alternate view is that low interest rates are necessary to preserve the existing modest pace of U.S. economic growth, and increasing rates too abruptly could push the economy into recession.

This is, in fact, the first time the Fed has ever embarked on an interest rate tightening cycle when U.S. economic growth is actually moderating. Manufacturing indicators are contracting, industrial capacity utilization is falling, and U.S. Real Gross Domestic Product (GDP) is growing at an annualized rate of only +2.0% through the Third Quarter of 2015 (the Fourth Quarter rate of growth may, in fact, be less than +1%). Despite a recent unemployment rate of only 5.0%, the U.S. labor market is not as strong as the headline numbers suggest due to this business cycle's extraordinary increase in lower-paid workers, temporary help, and multiple-job holders. As a result, overall wage growth is anemic, and consumer spending growth is slowing. As a consequence of these domestic, and other global, factors, inflation—one of the Fed's policy mandates—remains nowhere near its +2.0% target. To the contrary, this is an environment in which, as we have described in the past, there is a greater risk of *de*flation than *in*flation due to an ongoing global macroeconomic surfeit of supply and dearth of demand (exacerbated by ongoing economic adjustment in China).

As the U.S. economy has settled into a mediocre equilibrium, we believe that fears of inflation or widespread wage acceleration, therefore, remain premature. The Fed does not see things this way, though. It expects that interest rates will need to rise further to tame latent inflationary pressures. In fact, the Fed believes that the U.S. economy will evolve in such a way that it can raise short-term rates back to historical levels.

The Fed's theory relies on long-held notions of a trade-off between inflation and slack in the economy—the gap between output and economic capacity—as well as links between wages and inflation. This thinking is based on research conducted by the researcher A.W. Phillips. Using data from the U.K., Phillips in the late 1950s found that when unemployment was high, wages tended to be low; conversely, wages rose as unemploy-

ment fell. This historic relationship, known as the Phillips curve, has not functioned well since the Financial Crisis, however. The jobless rate has fallen from 10% in 2009 to 5% in 2015, but inflation has also fallen. In our view, a variety of econometric estimates would suggest that the classic Phillips curve influence of resource utilization on inflation is, at best, very weak at the moment. Global macroeconomic forces may be undermining the Phillips curve more than expected.

Are current real interest rates too high or too low? As you know, we believe that distorting one of the primary inputs to natural price discovery (interest rates) can have significant negative consequences, like making it difficult to properly value a variety of asset classes, encouraging malinvestment, and exacerbating income inequality, among other things. In our *2015 Third Quarter Review*, we discussed the "correct" interest rate (sometimes called the "natural" interest rate, or Wicksellian rate) in relation to central banks' concept of the "equilibrium rate of interest" that keeps the economy operating at its potential. Keep the actual rate below the equilibrium rate, and the economy speeds up, eventually generating inflation. Keep it above, and it slows down, eventually tipping into recession.

Since short- to medium-term interest rates are currently artificially manipulated by the Fed, we cannot definitively say whether the natural rate is high or low, and thus whether the Fed is being too loose or too tight. It is easier to make a judgment on whether the Fed has it right by looking to the future when the Fed has tightened and the zero lower bound no longer binds. But the fact that demand is not exactly booming seems more consistent with the natural rate currently being depressed. If central banks were to continue to raise the actual interest rate, it could depress demand further.

Examining the longer arc of financial history indicates that there are times when very low rates have persisted for decades—pretty much whenever inflation is quiescent, as it is now. The interest rate on a 10-year U.S. Treasury note was below 4% every year from 1876 to 1919, then again from 1924 to 1958. The record is even clearer in the U.K., where long-term rates were under 4% for nearly a century straight (from 1820 until the onset of World War I). The real aberration looks like the 7.3% average experienced in the U.S. from 1970 to 2007.

Interest rates historically are most closely tied to inflation. How much investors demand as compensation for lending their money is shaped in no small part by how much they think that money will be able to buy when they get their money back. And the pressures that normally generate inflation seem to have dissipated in recent years. The Fed and its counterparts at the ECB and Bank of Japan (BoJ) have spent the last few years applying most every policy measure in their toolkit to get inflation to meet their +2% target, with limited success. In a world experiencing a dearth of demand and a surfeit of supply, financial markets show little sign that investors believe that this will change anytime soon: the U.S. Treasury interest rate yield curve is, in fact, flattening, with the difference between shorter- and longer-term bond yields narrowing sharply (the spread between the 2- and 10-year U.S. Treasury yields is now below 1.2%—close to the smallest gap since early 2008). This would imply that we are in an economic era more like the late 19th century, with persistent low inflation or mild deflation, or perhaps like the 1950s, when the economy was growing but inflation was firmly in check.

Starting with Japan in the 1990s and now across the advanced world, the predominant problems of the last several years have revolved around weak demand, plenty of supply, low inflation, and resulting very low interest rates. The simple fact that the Fed raised rates slightly above zero does not change those dynamics.

We believed—as we have for several years—that the Fed would not raise rates for some time; and, if they did, it would be a de minimis move. In our opinion, a 25 basis point interest rate increase, in and of itself, is de minimis and is merely the latest in a series of more important credit tightening measures. The real credit tightening began two years ago when the Fed tapered its $85 billion of monthly bond purchases (this squeezed liquidity through the classic "quantity of money" effect). It was the Fed bond tapering that slowly turned off the spigot for a global financial system running on a U.S. Dollar standard with an estimated $9 trillion of foreign U.S. Dollar-denominated debt. China imported

the U.S. "tightening" through its Yuan currency Dollar peg, compounding that country's slowdown that was already under way due to its economic rebalancing from an investment- to consumer-led economy. It was the delayed effect of this tightening that has caused the broad Dollar index to increase +19% since July 2014—the steepest Dollar rise in modern times—and is a significant trigger, among other factors, for the ensuing bloodbath in the global commodities complex. Since the foreign exchange markets are the largest financial markets in the world, it is important to monitor their response to global central bank policy decisions.

Global central bank policymakers implemented ZIRP (and Quantitative Easing) in response to the Financial Crisis. One of the unintended consequences of this interest rate policy was to set off a variety of credit bubbles around the world. (The global debt ratio has increased by +30% of GDP beyond its previous record in 2008.) So while a 25 basis point Fed Funds increase is, in and of itself, de minimis, a tightening bias, in general, can become pernicious as it relates to the credit markets—especially when it is concurrent with deflationary global macroeconomic forces. Credit risks have recently become elevated and are rising—and not just in the high-profile energy sector or junk bond markets, but across many parts of the fixed income complex.

All of these factors leave central bank policymakers little room for maneuver in a highly-interconnected world.

The Trilemma

Similar to the Third Quarter of 2015, once again, events in China contributed to significant global financial market volatility late in December and early in January. Markets were roiled following a sharp drop in the Chinese equity market, a continuing devaluation of the Chinese Yuan's exchange rate, and slowing economic data.

As we wrote in our *2015 Third Quarter Review*:

> What concerns us the most about the Chinese equity market debacle is not the decline in the indices themselves—from which we believe there will be little, if any, economic ramifications. Rather, we are more concerned about the credibility of the Chinese regulatory authorities in their totalitarian approach to intervening in the markets in an attempt to manipulate and stem the decline. Besides the People's Bank of China (PBOC) cutting interest rates to a record low (a rational response), unorthodox measures included banning major shareholders from selling their shares, detaining a journalist for a negative story about the regulator, placing big investment bankers under investigation, suspending new share listings, and threatening to throw short sellers in jail. Other measures were more desperate: officials organized the purchase of stocks using central bank cash, and companies were allowed to suspend their own shares (at one point more than half of the market was frozen). Many of the measures employed by the regulators to halt the panic are unorthodox enough (to put it mildly) that they can introduce all kinds of new convexities and implied options that we do not fully understand and, thereby, undermine our confidence in the Chinese financial system.
>
> That is why it is critical that Beijing defends its credibility. Overall, as we have stated in the past, we believe that, as a result of the inevitable rebalancing of China's economy over the coming years, economic conditions will deteriorate, growth will slow more than expected, debt will rise faster than expected, and the refinancing gap will create huge uncertainty about its resolution. Beijing must consequently resist any temptation to expend credibility (which includes taking on debt) unless the alternative is a financial system collapse.

Precipitating the most recent events, in December China introduced a new currency index in order to re-

focus the market's attention away from the Chinese Yuan's moves versus the U.S. Dollar and instead compare performance against a wider selection of peers. The CFETS RMB Index measures the Yuan's performance against a basket of 13 currencies, with weightings based mainly on international trade, according to the PBOC. The PBOC's moves are being seen as part of efforts to ease concern about Yuan depreciation and prepare the market for further weakness given the increase in U.S. interest rates and concomitant strength in the U.S. Dollar. Separately, the International Monetary Fund (IMF) voted to include the Yuan in its Special Drawing Rights (SDRs) on November 30, fulfilling a Chinese policy goal and giving Premier Li Keqiang scope to refocus his energies on helping revive growth in an economy that is expanding at the slowest pace since 1990. (A weaker currency will help exports, which declined in all but two of the first 11 months of 2015.)

Unfortunately, Chinese authorities botched this switch of the currency peg, accidentally setting off an exodus of money. (Skittish markets suspected that it was camouflage for devaluation.) As a result, China is now at risk of a devaluation crisis as the Yuan threatens to break through the floor of its currency basket, despite massive intervention by the central bank to defend the exchange rate. (The country burned through at least $120 billion of foreign reserves in December, twice the previous record—the clearest evidence to date that capital outflows have reached systemic proportions.)

Global financial markets are acutely sensitive to any sign that China might be forced to abandon its defense of the Yuan, with conspiracy theories rampant that it is gearing up for a currency war in a beggar-thy-neighbor push for export share. Any such move would send a powerful deflationary impulse though a world economy already experiencing only modest growth, and risk setting off a chain-reaction throughout Asia, replicating the 1998 crisis on a more significant scale.

The foreign exchange ramifications are serious. What is worrisome is that the central bank appears to be losing credibility. Premier Li Keqiang has vowed to keep the basket rate "basically stable," yet it has continued to drop. The PBOC insists that it has the firepower to defeat "speculative forces" and keep the currency stable at a "reasonable equilibrium level." It said the market gyrations had decoupled from the real economy, and that a country running a current account surplus of almost $600 billion has no need for a weaker currency. (For good measure, the authorities suspended the foreign exchange operations of *Standard Chartered* and *DBS Group Holdings*, and cracked down on false invoicing by exporters, effectively invoking police powers to stop money leaking out of the country.)

As a result, China's reserves have dwindled from $4 trillion to $3.33 trillion and are no longer far from the $2.6 trillion deemed to be a prudent threshold by the IMF given China's $1.2 trillion liabilities. Although the central bank still has the clout for a "shock-and-awe" blitz to defend the Yuan, this would entail serious costs. Reserve depletion causes monetary tightening, compounding the economic downturn. (It is the exact opposite of the boom years when China accumulated reserves, causing the economy to overheat.) China can, in theory, offset this by cutting the reserve requirement ratio for banks all the way down from 18% to 5%, where it was during the banking crisis in 1998. This would inject $3 trillion of stimulus. Yet to do this would weaken the currency, accelerate the exodus of capital, and trap China in a vicious circle.

Beijing is trying to reconcile impossible objectives: no country can have free capital movement (absence of capital controls), a stable foreign exchange rate, and independent monetary policy, all at the same time. In economic theory, this is known as the Impossible Trinity (or, Trilemma). According to the theory, a central bank can only pursue two of the above-mentioned three policies simultaneously. It remains to be seen which policy Beijing will abandon.

From the broader perspective of its overall rebalancing efforts, every one of Beijing's economic policymaking choices must ultimately choose between higher debt, higher unemployment, or higher transfers of wealth from the State sector to the household sector. Every single policy results in some combination of the three. The time frame within which this must be resolved is set by debt capacity limits, and as our analysis indicates, Beijing probably has no more than five years, perhaps much less, within which to resolve the rebalancing if it

wants to avoid significant disruption.

As we also wrote in our *2015 Third Quarter Review*:

> To us, the events that transpired in China during the Third Quarter (and at other times over the last few years) were not unexpected shocks. As we have stated in the past, China has a dynamic and unbalanced economic system that is in the process of rebalancing away from being investment-driven toward being consumer-driven—and it is doing so with a great deal of debt that is structured in a highly inverted way. Viewing China in this way has allowed us to anticipate these types of dislocations. We expect that these debt-related shocks will occur regularly for many more years, and that each shock will advance or retard the economic rebalancing process.
>
> The overwhelming consensus several years ago (and, to some degree, currently) was that China's growth model was healthy and sustainable, and that it would generate GDP growth rates for the rest of the decade that were not much lower than the roughly +10% seen during the previous three decades. The current consensus for China's long-term annualized growth in GDP is approximately +6-7%. We believe, however, that without a massive (and fairly unlikely) transfer of wealth from the State sector to the household sector, the average Chinese annualized GDP growth rate cannot exceed +3-4% over the medium-to-long term.

Since consensus financial market expectations for Chinese economic growth are currently higher than our analysis indicates is reasonable, we believe that the markets will continue to be at risk for increased volatility due to ongoing relative disappointment. In addition, the uncertainty associated with a lower Chinese growth dynamic could cause financial markets to overreact to the downside until expectations are properly adjusted.

The next two to three years are vitally important for China. In the best case scenario, Beijing will continue to rebalance its economy and to restructure the country's balance sheet and financial system. Yet this cannot happen except under much slower growth. Because the debt burden will continue to rise for at least another four or five years, Beijing will be tested more than ever during that time. To defend itself from crisis, it must increasingly maintain its credibility.

Panta Rei

Although seemingly quiescent, a variety of issues, both ongoing and new, remain relevant with regard to Europe and the Eurozone. Some of these include:

Possible re-run elections in Spain
Recent Spanish elections failed to yield a stable government. Talks between the parties are just beginning, and a minority government looks possible; however, it is unclear how far such a government would get given the continued need for economic reform and tricky constitutional issues, such as potential Catalonian independence, which need to be addressed. The rapid rise of new parties, in particular the far-left *Podemos*, means that the ultimate result is incredibly uncertain and could still lead to an entirely different approach to governing in one of the Eurozone's largest economies.

No long-term solution to the migration crisis
Europe's leaders, as well as the structure of the EU, have proven to be entirely unable to manage this huge challenge. Policies so far focus on processing and relocating refugees but have barely been implemented (only a couple of hundred out of 160,000 refugees have been relocated). Meanwhile, fences and borders have been springing up across Europe, and populist political parties have been benefitting from xenophobia.

U.K.'s EU referendum: "Brexit" is possible
It looks increasingly likely that the U.K. will hold its referendum on EU membership this year. Currently, polls show that it will be a close race. Brexit would be

a big challenge for the EU, which would suffer an existential blow to its political project and see it lose a sixth of its revenue, half of its military, its second largest economy, its financial center, and a vital proponent of free trade.

Greek debt relief negotiations
Eternally delayed, but likely to take place early in 2016, the outcome is likely to be some mixture of extended maturities, further grace periods on interest payments, and possibly linking some payments to growth. There will also likely be a flare up about the future involvement of the IMF in the Greek bailout—which Greece is now opposed to and the IMF is not keen on, but which some northern Eurozone States see as a prerequisite.

Progress on Eurozone structural changes
As we have noted before, there is growing pressure from the ECB for wider changes to the structure of the Eurozone to address the root causes of the Eurozone crisis. Progress remains painfully slow. Another year with little progress on the underlying Eurozone problems would not only disappoint the ECB (and possibly sour its willingness to act in the future) but also underwhelm investors who are in some cases wondering about the long term vision for the Eurozone.

No further easing from the ECB as the Fed drives divergence
At the beginning of December, the ECB fell short of market expectations with its latest round of easing (cutting the already-negative interest rate it pays on deposits from banks, and extending its bond-buying program by six months to March 2017), presenting a potentially longer-term credibility problem. Eurozone inflation rates remain extremely low and are one shock away from outright deflation. Regardless, it seems that the ECB is now back in "wait and see" mode, and it would take a clear and serious deterioration in economic data to drive it to any further significant easing. With the Fed tightening, there will still likely be clear divergence between the U.S. and Eurozone on monetary policy. This should keep downward pressure on the Euro (especially against the U.S. Dollar).

Overall, our previous concerns regarding issues surrounding the Eurozone remain unresolved.

The Long Game

The equity markets have recently exhibited substantial volatility, and the potential for a more significant correction remains possible given the risks we have noted above. However, the U.S. economy continues to grow (albeit slowly), and we do not foresee a recession in the near term. To us, that means that the long-term upward bias in stock prices should continue. We believe, therefore, that the recent market volatility has created an exceptional opportunity to take advantage of the misunderstandings of myopic market participants and purchase high-quality businesses that meet our investment criteria.

Some things to remember during periods of financial market volatility:

- ✓ Disasters have a way of not happening; major market sell-offs (like the one in 2008/2009) are usually generational in nature.
- ✓ "Greed" usually defeats "fear"—over the long run.
- ✓ Pundits with extreme views (i.e., "perma-bulls" or "perma-bears") are attention getters, not money makers.
- ✓ True investors will admit to being wrong or to not knowing all of the answers.
- ✓ It is important to watch investor sentiment when it is at (either) positive or negative extremes—that is the time when the majority of significant investment opportunities often occur.
- ✓ Perception and reality are not always the same thing.
- ✓ Market participants remain distracted by global monetary policy.
- ✓ Quantitative algorithmic trading strategies dominate the financial markets and, by definition, are agnostic with regard to long-term underlying corporate business fundamentals.

As you know, we do not predict, nor does your *Windward* portfolio own, "the market." Instead, we seek to mitigate market risk and generate excess returns by making long-term investments in individual businesses

with the following underlying fundamental characteristics:

- ✓ *Quality*
  Dominant, financially strong, leading companies with best-in-class managements, high incremental returns on invested capital, and business models with sustainable competitive advantages

- ✓ *Growth*
  Companies with predictable and sustainable above-average growth in revenue, earnings, and free cash flow

- ✓ *Value*
  Companies that are undervalued on either an absolute or relative basis, based upon our projections of future cash flow and earnings

For 2015, year-over-year S&P 500 corporate revenues and earnings are expected to decline –3.4% and –0.7%, respectively. (For 2016, a recovery is expected, with a year-over-year increase in revenues and earnings of +4.2% and +7.4%, respectively.) *Windward*'s *RAAM* and *CAPAP* portfolio strategies currently own companies that are, on a weighted-average basis, expected to grow their revenues, earnings, and (most importantly) free cash flow at rates significantly in excess of the major market indices. For 2015, the year-over-year growth of the *RAAM* portfolio's revenues, earnings, and free cash flow are expected to be +4.8%, +20.8%, and +38.8%, respectively, and for the *CAPAP* strategy are +11.6%, +74.3%, and +89.4%, respectively. (For 2016, the year-over-year growth of the *RAAM* portfolio's revenues and earnings are expected to be +7.1% and +14.9%, respectively, and for the *CAPAP* strategy are +9.3% and +16.7%, respectively.)

Windward's portfolios of individual businesses, with their own company-specific fundamental dynamics, are continuing to thrive and prosper. In the short term, this fact may be obscured by "market action"—which results in highly-correlated security price movements during periods of increased volatility—and/or the negative influences of ETFs, asset allocators, and algorithmic traders—whose focus is on baskets of securities or on stock symbols, not on underlying business model fundamentals. However, financial history has proven, time and again, that, over the long term, investors are ultimately rewarded by being owners of these type of companies.

We have been investing this way for decades, and have successfully navigated a variety of historic market environments.

We believe that the "indices" will become less relevant as time goes on and that successful wealth creation and capital preservation in the years to come will become increasingly dependent upon the identification and ownership of those businesses that, although possibly impacted by exogenous events in the short run, remain relatively immune to these global macroeconomic issues over the long run due to their own underlying growth dynamics.

Despite recent market volatility, we remain exceedingly optimistic on the prospects for the individual companies that we own in *Windward* portfolios and encourage you to contact us should you have any questions or concerns.

HAS YOUR FINANCIAL CONDITION CHANGED?

Portfolio decisions are based on an individual's income requirements, tax bracket, time to retirement, risk tolerance, and other characteristics. If your financial condition has changed, or is about to change, please call us. We strive to prepare a portfolio that meets each investor's objectives, and the more information we have, the better the job we can do. If you have any questions regarding your portfolio, your asset allocation, or any investment within your portfolio, please let us know.

THE FUTURE IS NOW

As you may know, we post a weekly commentary on our website every Friday afternoon. We only mail some of these comments out when markets are particularly unsettled. Please be aware that these notes will continue to be available on-line, and we want to encourage you to sign up to receive a password for access to our secure web-site.

Our website provides the capability for clients to review their portfolios, their year-to-date realized capital gains, and expenses. Clients also have access to our weekend market comments. These reports are updated after 8:00pm each Friday, and are available to clients who have requested access. Clients may also request that their accountants and/or attorneys have access to the same information. We hope you will visit us at www.windwardcapital.com.

If you have interest in these capabilities, or if you would like to receive a copy of our Form ADV Part II free of charge, please email Steve Pene at: spene@windwardcapital.com, or call Mr. Pene at our main number: (310) 893-3000.

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