WINDWARD CAPITAL

Risk Averse Asset Management

2016 Fourth Quarter Review

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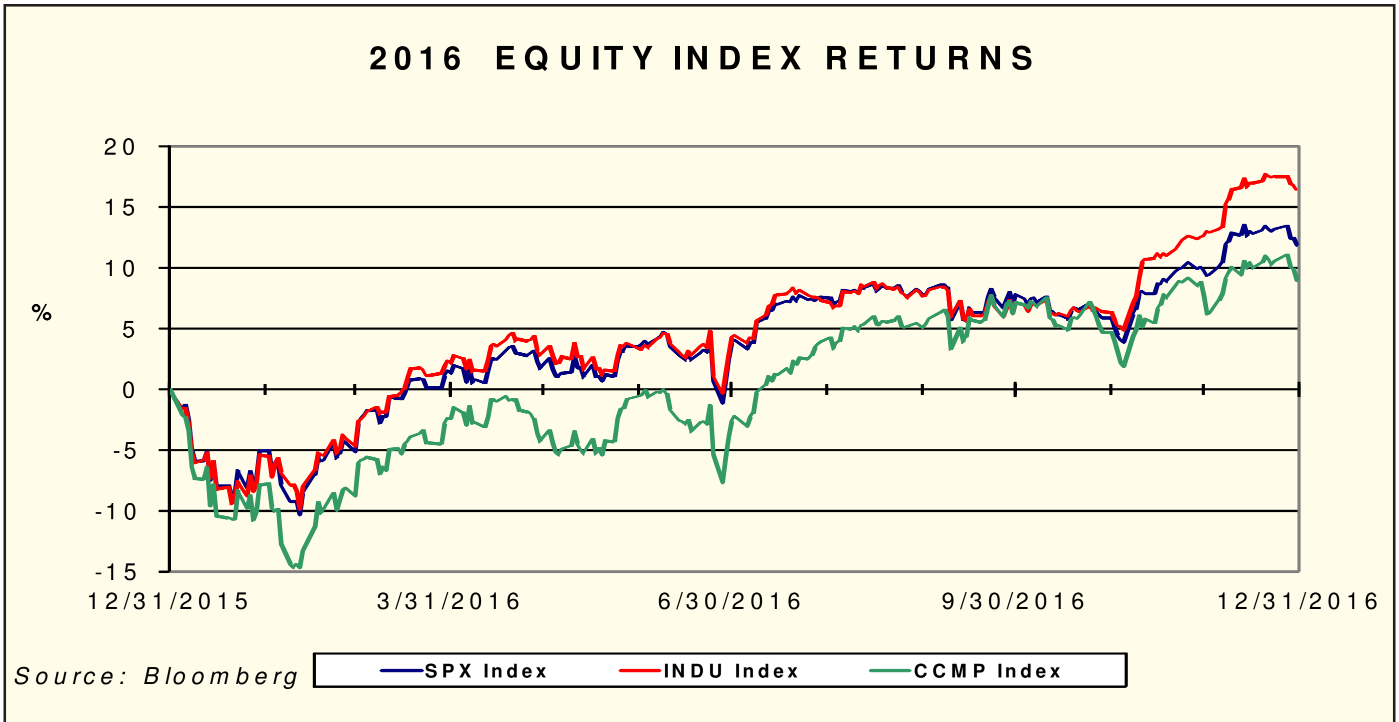

Confirmation Bias

"An unexciting truth may be eclipsed by a thrilling falsehood."

—*Aldous Huxley* (1894-1963)
English Writer, Novelist, and Philosopher

The major U.S. equity market indices moved significantly higher after the results of the November 2016 U.S. Presidential election as a consequence of optimism regarding the potential for positive economic impacts from the Trump administration's new policy agenda (eg., tax reform, deregulation, and fiscal spending) combined with an investment asset reallocation out of fixed income securities and into stocks. From November 08, 2016 through the end of the year, the S&P 500 Index (S&P 500), Dow Jones Industrial Index (DJIA), and NASDAQ Composite Index (NASDAQ) increased +4.98%, +8.21%, and +3.87%, respectively—a two-month return that nearly equals the returns generated during the entire preceding 10-month period. For the Fourth Quarter of 2016, the S&P 500, DJIA, and NASDAQ increased +3.82%, +8.66%, and +1.69%, respectively, while increasing +11.95%, +16.50%, and +8.97%, respectively, for calendar 2016 as a whole, and continuing to advance to historic highs during January 2017.

Most of the equity market rally since the Presidential election has been driven by economic sectors that we, in general, consider "low quality"—eg., Commodities, Industrials, and Financials. The long-term growth and stability of revenue and earnings in these economic sectors has historically been weak, making investments in these sectors prone to higher risk. In addition, these economic sectors generally are not comprised of dominant, financially strong, leading companies with best-in-class managements, high incremental returns on invested capital, or business models with sustainable competitive advantages. As such, with the exception of specific and unique companies that have strong underlying financial dynamics/characteristics independent of their sectoral limitations, we typically de-emphasize these sectors in *Windward* portfolios and will, consequently, underperform during market rallies led by such low-quality business models.

Historically, however, our technical analysis of internal financial market divergences reveals that, among other conclusions, equity market rallies/"bull markets" must, at some point, include "high quality" stocks—typically growth companies (usually NASDAQ stocks)—in order to be sustainable. As a result, the current low-quality equity market rally may not continue unless it is joined by the stocks of high-quality companies like those held in *Windward*'s portfolio strategies.

With regard to the fixed income markets, many investors and most asset allocators have been consistently selling equities and purchasing fixed income over the last few years. A preliminary analysis of the Trump administration's economic policies implies that there will be an increase in fiscal spending by the U.S. government which could, potentially, lead to inflation and/or a monetary offset policy response by the U.S. Federal Reserve (the Fed) (which would, in essence, move to cancel out the positive aggregate demand effects of any fiscal plan in an attempt to arrest inflation and/or smooth out the business cycle). This could cause interest rates to rise and lead to losses in fixed income equivalents. The magnitude of the interest rate increases and/or fixed income securities losses is indeterminable at this time; however, we believe that the possibility that investors were overweighted in fixed income relative to equity securities—combined with an anticipation of future losses—may have exacerbated the sell-off in the bond market beyond what is rational (especially given the ongoing global macroeconomic surfeit of supply and dearth of demand)—commensurately exaggerating the gains in the equity markets.

Based upon the (by historical standards) unprecedented degree of uncertainty associated with the incoming administration's ultimate policy agenda/directives (and their domestic and international ramifications), we believe that these near-term financial market movements may prove unsustainable. Donald Trump's campaign rhetoric was far-reaching, wide-ranging, vague, and, oftentimes, contradictory. From an economic perspective, he has (among other issues) advocated policies of trade protectionism and immigration reduction, individual and corporate income tax cuts, infrastructure investment, and the deregulation of financial services, healthcare, and energy policies. In our opinion, there is currently too much uncertainty and lack of details associated with the policies and directives of the incoming administration to be able to confidently make any definitive assertions regarding their impact on the geopolitical and global macroeconomic outlook, much less the financial markets. Until there is further clarity, we can only be confident that the investment environment will continue to exhibit greater uncertainty and increased volatility.

Indeed, what part of Trump's America-first political campaign policy rhetoric will translate into reality and what are the details as to how it will be implemented? No one knows. As investors, we remain politically agnostic in evaluating the economic and corporate impacts of public policy. That is the reason why we would prefer to analyze the actual legislative mandates and policies that are enacted and determine their corporate beneficiaries before considering major changes to the current investments in *Windward*'s portfolio strategies. As a result, in the interim, our strategies may underperform to the upside relative to the market indices over the short-term given the degree to which other market participants make ungrounded assumptions and/or high-frequency trading and algorithmic "investment" strategies engage in daily financial market trading based upon such things as Trump's "tweets" (as an example).

Opportunistically, we were, however, able to take advantage of the Fourth Quarter financial market volatility and make some changes to *Windward*'s portfolio strategies that we had previously anticipated implementing. We believe that these will be profitable investments regardless of the policy initiatives ultimately enacted by the Trump administration. We will continue to monitor domestic and international political and economic developments as they unfold.

From our long-term perspective (and consistent with the recent U.S. election results), 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 Review*s, 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, underscoring 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.

- ✓ With monetary policy no longer providing extraordinary stimulus to domestic growth, the U.S. needs intelligent, innovative, and aggressive tax and fiscal policies to shoulder the responsibility of catalyzing economic activity. Although the outcome of the political election has been determined, it still remains uncertain what progress, if any, will be made on these fronts.

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 near-sighted 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.

"Trumponomics"?

Much has been made of Trump's current economic plan, which amounts to a massive fiscal stimulus: tax cuts across the board, a $1 trillion blitz on infrastructure, and increased defense spending. Some view it as a replay of "Reaganomics" from the early 1980s, a form of turbo-charged Keynesian reflation that disregards the impact on the deficit. It also promises to create a pro-cyclical economic boom via deregulation of a variety of industries, including energy, financial services, and healthcare.

Legislatively, Mr. Trump enjoys the huge advantage of Republican control over both the House and Senate, averting the potential for paralyzing gridlock and obstructionism to his goals. There may be some friction, but House Republicans will hardly resist his plan to cut the corporate tax rate from 35% to 15%, or to cut personal income tax rates from 39.6% to 25% for high income earners, to 20-25% for middle income earners, to 10% for those making less than $54,000 per year, and to 0% for those under $29,000.[1] Nor are they likely to block his call for national reconstruction of U.S. bridges, tunnels, telecommunications, cyber security, water systems, pipelines, and the electric grid (part of a $3.6 trillion backlog of projects identified by the American Society of Civil Engineers)—all built with "American steel" and supposedly modeled on Eisenhower's highway expansion of the 1950s.

It is uncertain whether or not the Trump administration will follow through on all of his economic rhetoric, however—particularly as it relates to global trade. Washington's permanent government and the 'K' street lobbyists of corporate America may have greater influence, as they have historically had a way of co-opting U.S. leaders.

Trump's assault on trade is, in fact, escalating. First, its targets were China and Mexico; now, it includes the entire world. The Trump transition team has proposed an import tariff of 10% across the board, doubling down on earlier talk of a 5% duty. This is sobering. Such thinking is of a different character to Mr. Trump's campaign rhetoric, which mostly hinted at trade sanctions to force concessions. A catch-all tariff is a change of belief systems. It overthrows the free trade order that has been upheld and policed by Washington since the 1940s.

We support intelligent, innovative, and aggressive tax and fiscal policies to shoulder the responsibility of catalyzing economic activity. However, in our view, the current Trump trade plan does not yet meet these criteria. His fiscal expansion will boost the budget deficit and this, in turn, will automatically reduce the U.S. savings rate. Such a policy must lead to an increase in capital inflows, and therefore to a greater trade deficit to offset them through the mechanism of a stronger Dollar. (There is no way around this accounting truism.) Contrary to what Trump wants or intends, the trade deficit will, therefore, increase. The rising Dollar would further aggravate trade tensions, leading to further tariffs and trade curbs in a self-feeding vicious circle. The strategy as currently conceived and stated is economically unscientific, whether or not viewed as a free trader or as a protectionist. We hope that more reasoned judgment will be applied to whatever is included in the final economic plan.

Indeed, we do believe that the fallout from a protectionist U.S. trade policy would not necessarily be symmetric. The lesson of the 1930s is that those countries running a structural current account surplus suffer most once protectionism takes hold. The deficit countries get off relatively lightly (in certain circumstances they may even benefit). The inexorable fact is that America runs an approximate $500 billion deficit and serves as consumer of last resort for the world (even as China continues to rebalance its economy toward higher Consumer spending); and the world cannot afford to lose that demand given the global savings glut. Yes, the U.S. would be damaged by trade wars, but the damage would be worse for those mercantilist states that feed off of the open U.S. market without fully reciprocating.

Mr. Trump has threatened to name China a "currency manipulator" from day one, automatically triggering negotiations. This comes even though the Chinese Communist Party is now in the opposite position, struggling to stop the Yuan falling because of accelerating capital flight.[2] Punitive tariffs could be traumatic, given the symbiotic nature of corporate "Chimerica." Yet a trade war between the U.S. and China would not be symmetric. The disguised weakness of the Chinese trade/financial position would become painfully obvious and might bring forward the day of reckoning for China's banks and corporate debtors despite their State support.

Although trade wars might cause more havoc in Asia, Europe, Latin America, and the Middle East than in the U.S. itself, it would still be negative for overall global macroeconomic growth. The international system and liberal trading order upheld by the U.S. since the Second World War could disintegrate in short order. A series of walls—both metaphorical and real—would obstruct the flow of global goods and capital that are currently being taken for granted. Emerging market economies would suffer dramatically. Interlocking supply chains of global commerce would become unworkable. Risk metrics would increase.

The question remains whether Trump actually means the things that he has said, or whether he will retreat toward a more moderate position. The financial markets are behaving as if they will get the "good Trump" (tax cuts and fiscal stimulus) rather than the "bad Trump" (trade wars), despite mounting evidence to the contrary. Global macroeconomic growth awaits the verdict.

Loose and Tight

On December 14, 2016, the Federal Open Market Committee (FOMC) raised the Federal Funds (Fed Funds) rate by +25 basis points to 0.75% and has signaled its intention to continue raising rates in 2017. The Fed's "hawkish" comments, Trump's fiscal spending plans, and the fixed income asset reallocation (discussed earlier), have combined to instantly tighten financial conditions, pushing up yields on the 10-year U.S. Treasury bond to a high of 2.64% on December 15, 2016 (double the recent low of 1.32% reached on July 06, 2016) and lifting three-month Dollar Libor rates to the highest level since mid-2014. (These are the two key benchmark rates for the international monetary system, setting the price for trillions of Dollars of financial contracts.) The tightening was transmitted through the interlocking global financial complex, with the usual amplification in southern Europe and across emerging markets.

Although Fed Chairwoman Janet Yellen has been careful to avoid any hint that tightening aims to pre-empt the inflationary logic of Mr. Trump's massive fiscal stimulus (ultimately worth over 5% of Gross Domestic Product [GDP], per our calculations, if passed by Congress), it is no secret that the Fed model assumes that fiscal loosening of 1% of GDP implies an incremental increase of +50 basis points to the equilibrium rate of interest.[3] As a result, the Fed has more or less been forced to raise short-term rates since the markets are already driving up long-term borrowing costs sharply. How high interest rates go remains to be seen, given the increased significance of current global macroeconomic forces, which remain skewed toward deflation, not inflation. (We continue to believe that the global macroeconomy remains in an era where there is still too much capacity relative to aggregate demand.)

More importantly, the U.S. Trade Weighted Broad Dollar Index has surged to a 14-year all-time high, compounding the tightening effects. The currency has been rising relentlessly since Mr. Trump's election as markets undergo a tectonic shift, switching from deflation worries to a radically different bet on global reflation. Mr. Trump's wish list of tax cuts, infrastructure spending, and military rearmament represents an even bigger blitz than "Reaganomics" in the early 1980s—an expansionary fiscal policy that led to ballooning budget deficits and forced the Fed to keep monetary policy on a tight leash. The consequence of this "loose fiscal/tight money" mix was an explosive rise in the Dollar as the U.S. attracted capital from the rest of the world—with grim consequences for Dollar debtors in Latin America. A variant of this was repeated under the "Clinton Dollar" in the late 1990s, which led to the East Asian Crisis and again shook Brazil and Argentina to their foundations. The current risk is that the powerful and immediate effects of financial tightening will overwhelm any trade benefits for the rest of the world from Donald Trump's stimulus plans and a stronger Dollar—even for countries that export heavily to the U.S.

Externally, the Fed has shown little concern about the surging U.S. Dollar, insisting that the latest rebound in economic growth and rising inflationary pressures implied that additional rate increases may be necessary. Yet we doubt whether the Fed has fully adapted to an international system with open capital flows that is more "Dollarized" than at any time in history. The Bank for International Settlements (BIS) recently stated that there are already signs of a global "Dollar shortage" (which lowers global liquidity) and warns that the more the currency rises, the more it forces automatic deleveraging for banks in Europe and Asia (and the more it sets off financial stress through complex swap contracts).

The resurgent U.S. Dollar is already setting off a credit crunch across large parts of the world economy, forcing countries to tighten monetary policy and/or intervene in the exchange markets to defend their currencies. Importantly, global borrowing costs are not going up because economic growth is accelerating—they are increasing because the whole world is importing monetary tightening from the U.S. Rising U.S. bond yields have triggered a global stampede into U.S. assets, draining the international system of Dollar liquidity. It is the exact opposite of what happened in the glory days of the emerging market boom when Quantitative Easing (QE) by the Fed flooded the world with cheap Dollar credit.

Although it remains to be seen whether higher bond yields and borrowing costs are appropriate for America in its current economic circumstances, they are definitely toxic for most emerging markets still struggling with the fallout from debt bubbles. The core problem is that global finance is more Dollarized today than at any time in history, with $10 trillion of Dollar debt trading globally outside of U.S. jurisdiction and control—up fivefold since 2002.[4] According to the International Monetary Fund (IMF), aggregate debt ratios are at an all-time high of 225% of global GDP, with $152 trillion of outstanding liabilities. As a result, no one knows how much Dollar tightening the world can endure. This effect is compounded by threats of U.S. tariffs and by fears that globalization is starting to unravel, undermining the core development model of emerging markets: Asia's growth model is built on globalization, and it feeds an entire ecosystem centered on China (this is the real concern).

Credit markets tend to anticipate risk long before the equities markets do. This has been the pattern in each spasm of financial stress over recent years; but these early-warning indicators can be hard to read, and currently they are sending mixed signals. The moves in Libor and the bond markets are not dramatic compared to past episodes in 1987, 1994, 1999, and 2006, but the great unknown is whether today's globalized world can cope with *any* tightening *at all*. Unlike previous spasms of trouble in emerging markets, this episode has not been accompanied so far by a general flight from risky assets: in fact, the equity markets are soaring, and European equities are holding steady. But that could merely reflect complacency. It is clear that pressure is building across developing Asia, Latin America, the Middle East, Africa, and even parts of Eastern Europe. The risk is that the spike in yields will inevitably slow the global economy, halt the rally in commodity prices, and kill off talk of an inflation cycle. The fear is that Trump's fiscal stimulus at this late stage of the economic cycle will do little to boost underlying growth. Hopes of a Trump-driven fiscal boom are, for now, driving stock markets to new highs, reducing the equity risk premium over benchmark bonds to multi-year lows. This divergence in the normal relationship between equities and bonds is anomalous and unlikely to last for an extended period of time, in our opinion.

Arrivederci Roma!

Nowhere are these global deflationary forces more in evidence than the Eurozone—and in Italy, in particular. We discussed Italy's economic situation in detail in our *2016 Second Quarter Review*. Since that time, Italian Prime Minister Matteo Renzi has been voted out of office, and *Monte dei Paschi di Siena*, Italy's third-largest (and the world's oldest) bank, has failed and was bailed out.

The painful saga of Italy is by now well-known: The country is stuck in a depressionary debt trap. Trend growth is below 0%. GDP is still 9% below its pre-*Lehman Brothers* crisis peak. Industrial output is back to levels reached 30 years ago.

The contours are worse than the 1930s. It is a lost decade turning into a second lost decade. No large developed country in modern times has ever suffered such a fate. Italy is the victim of a vicious cycle of labor hysteresis as economic stagnation and weak productivity reinforce each other. Its exchange rate is overvalued by 20-30% against Germany. Italy cannot now deflate its way back to viability since this shrinks the underlying base of nominal GDP and automatically steepens the debt trajectory. It is an impossible task for a country with a public debt ratio of 133% of GDP, and is self-defeating. There is no plausible way out for Italy within the current contractionary structure of the European Monetary Union (EMU). Only infinite ECB bond purchases can maintain this dysfunction.

Yet it is patently obvious that QE is nearing political, legal, and technical limits. ECB President Mario Draghi is already under attack by German officials. The ECB has been accused of sliding down a slippery slope, straying from genuine monetary policy, and instead rescuing bankrupt States in violation of EMU treaties. Per the ECB, it has bought €1.4 trillion of bonds so far. Its balance sheet currently approximates 35% of Eurozone GDP—much higher than the Fed ever reached in the U.S.[5] It is becoming increasingly difficult for the ECB to extricate itself without significant losses (which are anathema to the German public). The inevitable "taper" battle is now raging within the ECB's Governing Council.

This invites the perennial question as to whether Italy, Portugal, and perhaps others, can fund themselves *at all* in the capital markets, given that the Eurozone has done almost nothing since the debt crisis of 2011-2012 to put monetary union on workable foundations: there is still no fiscal union, no shared debt issuance, no banking union, and no expansionary fiscal New Deal to lift the economy. All that has been done is to tighten surveillance. Europe's "taper tantrum"—when it comes—will inevitably turn into a fresh stress test of monetary union itself.

The ECB's Draghi knows the dangers, but he is caught in a struggle with the dominant power of Europe: Germany. Germans regard the experiment of QE and negative rates as a violation of the orthodoxies that anchor the nation's post-War political and economic thinking. They view ECB policy as threatening the European project as a whole for the sake of short-term financial stability. They believe that the benefits from ever-looser policy are diminishing while the litany of distortions, perversions, and disincentives is increasing. Savers are "punished" and speculators "rewarded." "Bad" companies survive, while "good" companies are too scared to invest.

The moment of real danger for Italy will come as soon as the ECB starts to taper bond purchases—or even hints at a change in course. Unfortunately, the global reflation shock since the election of Donald Trump is bringing matters to a head faster than anticipated: Italian borrowing costs have risen in lockstep with U.S. Treasury yields—even though Italy is not reflating at all and is certainly not about to enjoy any fiscal benefits. In a way, Italy is one of the biggest casualties of the Trump effect and the tornado of imported U.S. monetary tightening. Its banks own €400 billion of Italian government bonds, and these are suddenly worth less. Some paper losses must be marked to market, further eroding core capital ratios. The banking crisis is driving up sovereign bond yields, and higher yields are in turn driving the banks into deeper trouble. This is a vicious circle.

The situation in Italy serves as a reminder that the Eurozone has not overcome its structural incoherence. A combination of low-priced oil, a cheap Euro, QE, and less fiscal austerity have disguised this, but the short-term effects are already fading. The regime is almost certain to be tested again in the next global downturn—this time starting with higher levels of debt and unemployment, and greater political fatigue.

The ECB is now in an untenable position, trying to reconcile conflicting roles as banking regulator, Troika enforcer in rescue missions, and agent of monetary policy. Its own financial integrity is increasingly in jeopardy. The central bank already holds over €1 trillion of bonds bought at "artificially low" or negative yields, implying huge paper losses once interest rates rise again. An exit from QE is becoming increasingly difficult, as the consequences could potentially be significant. Yet there is no possibility of political union or the creation of an EU Treasury in the foreseeable future—which would in any case require a sweeping change to the German Constitution (an impossible proposition in the current political climate). The European project must therefore function as a union of sovereign states, or fail.

At some point in the future, Europe will face a new economic crisis. Although we do not know the timing, we believe that the Euro will be unlikely to survive.

Great Expectations

The equity markets have recently exhibited substantial volatility, and the potential for a more significant correction always remains possible given the risks we have noted above. However, the U.S. economy continues to grow, 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.

Our investment process utilizes a combined top-down/bottom-up approach whereby, based upon our analysis of the components of global macroeconomic GDP, we identify a variety of investment themes, both secular and cyclical, that drive further fundamental analyses of individual businesses that meet our investment criteria. Currently, some of our investment themes include:

- ✓ *Rise of The Rest*
  Globalization and the development of the middle class in emerging markets is a long-term secular trend.

- ✓ *Disruptive Innovation*
  Companies that are disruptive innovators are well positioned to outperform their peers in the current economic environment.

- ✓ *Regulation*
  Financial Services regulation, Healthcare reform, and Climate Change policy are all currently areas of government focus, and the economic sectors within these areas may, therefore, be subject to challenges or opportunities based upon how successful the government is in implementing its programs.

- *Continued De-leveraging*
  De-leveraging and the shrinking of private and public balance sheets will be a multi-year process that will restrain global macroeconomic growth.

- *The Great Unwind*
  The eventual "normalization" of monetary policy may result in unforeseen and unintended consequences.

- *China Rebalancing*
  The rebalancing of China's economy from investment- to consumer-driven has significant global macroeconomic ramifications.

- *Supply and Demand*
  Global macroeconomic growth remains anemic due to a surfeit of supply and a dearth of demand.

- *Demographics*
  Demographically, the aging of the populations of the developed, and some developing, economies will have important implications for future demand growth and entitlement costs.

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

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 income 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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