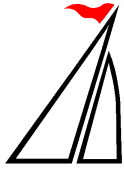
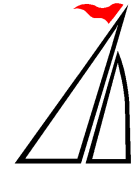


WINDWARD CAPITAL

Risk Averse Asset Management



2018 First Quarter Review

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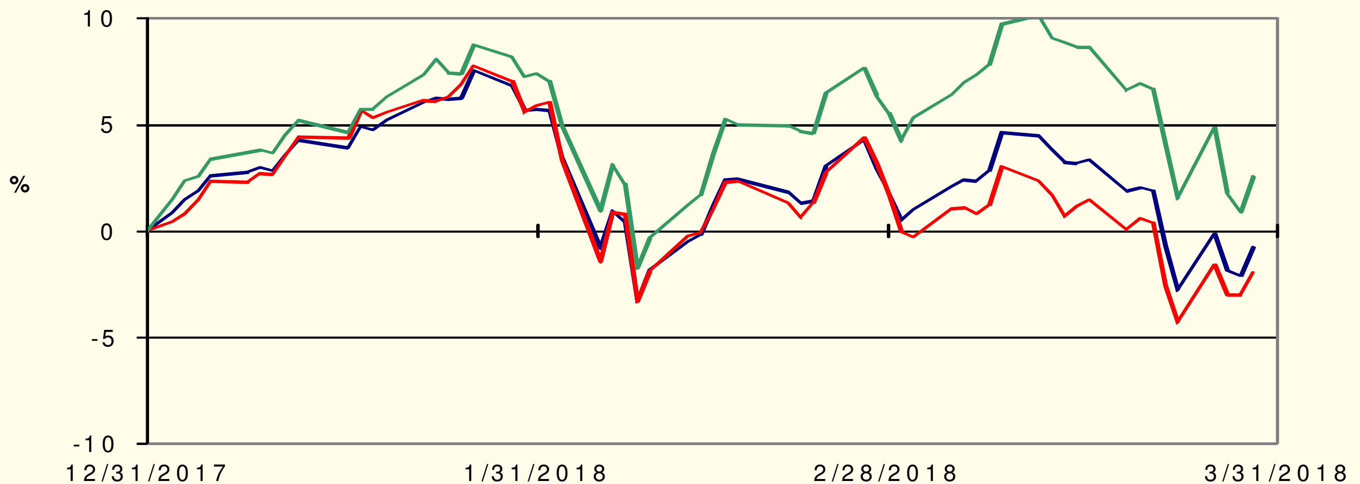

Stormy Weather

"Contrary to what people may say, there is no upper limit on stupidity."

—Stephen Colbert
American Comedian

After advancing to historic highs during the First Quarter of 2018, the major U.S. equity market indices succumbed to the effects of growing global macroeconomic uncertainty, and the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) ultimately returned –0.76%, –1.96%, and +2.59%, respectively, for the period.

However, despite recent financial market volatility, the near-term corporate revenue and earnings outlook remains positive, with estimates of year-over-year S&P 500 Revenues and Earnings growth of +7.3% and +17.1%, respectively, for the First Quarter. Additional factors supporting the markets include: consistent but moderate economic growth, a weak U.S. Dollar, optimism regarding the positive impact from "tax reform," liquidity effects, reemergence of the "reflation trade," and momentum. As we noted during our *2017 Fourth Quarter Review*, some of these factors necessarily raise concerns regarding market valuation. Although we share this valuation concern and believe that the equity markets may still be "overbought" on a technical basis in the short term, we believe that this risk is mitigated in *Windward* portfolios to a large degree by the fact that we are invested in "high quality," dominant, financially-strong, leading companies with best-in-class manage-

ments, high incremental returns on invested capital, and business models with sustainable competitive advantages.

As we have discussed before, based upon the (by historical standards) unprecedented degree of uncertainty associated with the Trump administration's ultimate policy agenda/directives (and their domestic and international ramifications), we believe that near-term financial market movements may continue to be unpredictable. 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 remains too much uncertainty and lack of details associated with the policies and directives of the Trump 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—a risk that may be poised to increase as the November midterm Congressional elections approach.

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? Although no one knows, the first year of the Trump Presidency appears inconclusive.

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 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). Regardless of the policy initiatives ultimately enacted by the Trump administration (and despite ongoing financial market volatility), we believe that we will, however, continue to be successful in making profitable long-term investments for *Windward*'s portfolio strategies.

As always, we continue to monitor domestic and international political and economic developments as they unfold. As a result, from our long-term perspective, 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. 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.

The Chinese Dream

Ostensibly, the global macroeconomy is potentially on the brink of the most dramatic trade confrontation of modern times after Donald Trump openly threatened “trade wars” as a tool of U.S. policy, prompting warnings of full retaliation by major powers across the world. The measures are viewed universally as an impetuous and unprovoked assault on the trade system, evoking memories of the Smoot-Hawley Tariffs of 1930 that ended up extending the negative economic consequences of the Great Depression, which was a contributing factor to the onset of World War II.

Conceptually, free trade is the idea that different nations can exchange goods without any taxes or other

limits on imports or exports, taking advantage of their natural comparative advantages. In actual practice, however, many countries and trading blocs have historically put taxes or tariffs and quotas on certain products. Their intention is to stop cheaper goods from other countries flooding their markets, thereby making it easier for in-country manufacturers or producers to compete. Since the end of World War II, there has been a general move in the global macroeconomy *away* from protectionism. The U.S. has been a leader in this regard, crafting numerous multilateral free trade agreements (such as NAFTA and KORUS) with (currently) 20 countries.

The admittance of China into the World Bank and International Monetary Fund (IMF) in 1980 and, more importantly, World Trade Organization (WTO) in 2001 changed the global macroeconomic trade dynamic. In previous *Quarterly Review*s we have discussed, at length, many of the recent issues surrounding the Chinese economic growth model. In terms of context, however, it is important to recognize that China has a command economy that is (relatively) closed and is pursuing a mercantilist strategy of export-led growth.

Some—particularly those in developed economies such as the U.S.—believe that the admittance of China into the global trade order has resulted in the collapse of certain industries (such as steel and coal production) because of China's unfair trade practices. Under free trade theory, jobs in these industries would be replaced through the generation of new opportunities in higher-value-added, non-commoditized industries. In reality, however, these new jobs were not always created in the same geographical location or in industries similar to those which were lost, thereby resulting in significant economic and social disruption. This situation is now having geopolitical ramifications which, by definition, often create incoherent economic policy responses.

Although economists and Wall Street bankers are providing estimates of what a Chinese trade war would cost in terms of economic growth, jobs, and corporate earnings, the bigger, longer-term consequences are more difficult to forecast. Perhaps these trade issues will be resolved through negotiations. The crisis might, therefore, dissipate, with Chinese President Xi Jinping tossing a few concessionary crumbs at an impatient and inconsistent Trump, who may prefer quick, "tweetable" wins to the hard work of changing the Chinese trade practices that really threaten U.S. business. Financial markets could remain volatile on an inter- and intraday basis given that they are, in the short run, driven primarily by algorithmic, high-frequency trading strategies that are triggered by news reports instead of by underlying secular economic and/or corporate fundamentals.

In our view, however, financial market participants may be missing the broader and more significant strategic geopolitical factors at issue beyond the narrow scope of these trade discussions.

Trump's declaration of tariff warfare against China could be, at its core, less about trade than about raw power: a struggle over which of the two sparring superpowers will dominate technology and "run the world" in the 21st century. Indeed, the latest U.S. *National Security Strategy Report* for the first time names China as a strategic rival that seeks to "challenge American power, influence, and interests, attempting to erode American security and prosperity." "Trade wars" may, therefore, merely represent the opening salvo in a more significant and critical turning point in history, reflecting the irreconcilable ideological and economic differences between the world's two most important countries.

Trump is breaking with decades of U.S. foreign policy designed to avoid just such a conflict. Ever since Richard Nixon met Mao Zedong in 1972, Washington's strategy has been to coax China into the international order crafted by the U.S. and its allies after World War II. Trade and investment would bond the country with Western democracies. The U.S. opened its huge consumer market to Chinese exports and invited Beijing into the foundational institutions of the global economy—the IMF, the World Bank, and the WTO—to give Red China a stake in the free world's economic system. The whole idea was to cooperate with Beijing's quest for economic development, to transform it from potential adversary to ally, and, possibly, from dictatorship to democracy.

Advocates of the West's pro-integration approach can point to critical successes. China—now the world's largest exporter—did become an integral part of the global economy, and its momentous ascent has so far been remarkably peaceful. For much of the past 40 years, the country seemed to be moving in the "right" direction—toward a more market-oriented economy and a more open society.

However, China was never really following the path that the West anticipated. It borrowed the tools and trappings of capitalism while dispensing with the liberal political, economic, and social principles that have traditionally accompanied it. As we have discussed at length in previous *Quarterly Review*s, with regard to the rebalancing of China's economy, the vested interests' (including the Communist Party's) primary objective is to retain its wealth and remain in power—not reform itself out of existence. "Economic reform" is, therefore, only a means to an end. Although earlier Chinese regimes were at least slowly allowing the market and private sector more influence in its still-State-led economy, Xi has turned toward more nationalistic policies. He has painted himself as a national hero: a defender of Chinese interests against a bullying West, and someone who is destined to return the country to its proper place on the world stage. While Trump calls his program "Make America Great Again," Xi labels his the "Chinese Dream."

Although Xi spouts the usual promises to continue "opening up" and to champion globalization, in reality he has dropped even the pretense that China is heading in that direction. His regime is regressing into a one-man dictatorship: a national congress in March amended the Constitution to allow him to serve for life. He has also announced that a body of political philosophy bearing his name called "Xi Jinping Thought" would be written into China's Constitution, effectively anointing Xi as the country's most powerful leader since Mao Zedong. He shows little regard for the rules and norms of the global economic system, preferring to capitalize on the openness of Western economies while dragging his feet on reciprocating that openness. He is creating rival institutions to those of the West, such as the Asian Infrastructure Investment Bank, a multilateral lender akin to the World Bank. While discussing pro-market reform, Beijing is intensifying Communist Party influence over business and heavily subsidizing many high-tech companies to give them an advantage over Western competitors, whose intellectual property he is at the same time appropriating.

Despite these serious issues, however, it is important to recognize that China began to let its currency rise in 2005, and its current account surplus has shrunk from 10.1% of Gross Domestic Product (GDP) in 2007 to 1.3% in 2017 (and the IMF expects near-balance by 2022 as the country continues to transition and rebalance toward consumer-driven and a better welfare system brings down the precautionary savings rate). China is, in fact, no longer a "trade sinner" in volume terms (Germany is actually deemed to be a greater violator), and, as a result, protectionist "trade wars" do not appear to be an appropriate response under these circumstances.

There are many approaches to dealing with the costs of globalization, but protectionism is a dead end. Trade restrictions address the symptoms and not the underlying causes, and they introduce other costs and distortions. While such measures might generate a temporary boost to growth from greater domestic production and consumption, these would likely be offset by a range of other costs. Over time, such measures would retard productivity growth and thereby shrink the economic pie. Instead, policies need to focus on providing workers affected by globalization with job retraining to cope with technological change, job security, and worker mobility. It is also important to remember that a nation's trade balance reflects more than just its trade policy, and that restrictions only impact the composition of trade but not the actual gap between imports and exports, which is driven by the difference between domestic investment and savings.

In fact, there is a possibility that the U.S. and Chinese economies are so intertwined and interdependent that they simply must find ways of getting along. This implies that the old policies—of encouraging greater integration—will endure in some form and that disagreements between the two countries will remain under negotiation and, thus, under control. Some trade agreements could be updated or improved upon.

However, at the same time, China's trade practices are essential to its national agenda. Its leaders recognize that the country's economic and geopolitical future depends upon their ability to upgrade its industries and foster technological innovation (thereby escaping the "middle income trap"), and they are unlikely, therefore, to significantly alter their industrial program under any circumstances. Trump may be able to pry open a market here or remove a regulatory hurdle there. Maybe he can even prod Beijing into treating U.S. companies more "fairly." But he is not likely to persuade "Emperor" Xi to give up on his "Chinese Dream."

Europhile Dysfunction

The Eurozone is currently experiencing a cyclical recovery driven by negative interest rates, QE, the end of fiscal austerity, and a catch-up effect from severe recessions that were deeper for Southern Europe, Ireland, and Finland than during the Great Depression. Yet this burst of growth will prove ephemeral unless the Eurozone uses the opportunity to grapple with its own dysfunctional pathologies—rigid labor and product markets, non-performing loans, zombie companies, warped welfare incentives—and to reestablish the currency union on workable foundations before the next crisis hits.

The Eurozone's slump from 2008-2015 was so deep that it crossed into hysteresis, the point where cyclical unemployment becomes structural and causes lasting damage to job skills and economic dynamism. Hysteresis is why austerity policies become inherently self-defeating: they lower trend-growth rates decades ahead, making it even harder to bring debt ratios back under control. Public debt ratios are much higher as a share of GDP than in 2008 before the *Lehman Brothers* crisis: +31 percentage points in Italy (to 133% of GDP), +60 in Spain (to 99%), +54 in Portugal (to 126%), and +29 in France (to 97%). Countries are running out of time in this finite global expansion to rebuild their economic and social buffers.

Germany permitted the ECB to operate as a lender-of-last resort since the Summer of 2012, when contagion to Italy and Spain almost blew up monetary union. By September (when the ECB's bond buying program ends), the ECB's balance sheet will have ballooned to 44% of GDP without having lifted the Eurozone out of a "lowflation" trap. As a result, the monetary union risks crashing back into deflation in the next recession. The next global economic downturn could be traumatic, given that significant monetary and fiscal powder has been used up, and popular consent for globalization is exhausted.

In the meantime, much of central Europe is in populist revolt. Across the European continent, a once-durable dichotomy is dissolving. Fueled by anger over immigration, a backlash against the European Union (EU), and resentment of an out-of-touch elite, anti-establishment parties are taking votes left, right, and center from the traditional power players. They generally are not winning enough support to govern, but they are claiming such a substantial share of the electorate that it has become all but impossible for the establishment to govern on its own. The result is a continent caught in a netherworld between a dying political order and a new one taking root.

The traditional structures of political alignment in Europe are breaking down. Although it started in the smaller countries, it is now happening everywhere—even in Germany, the ultimate postwar symbol of staid political stability. Five months after they went to the polls, Germans finally formed a government. Although the establishment hung on, it was just barely—and with no evident enthusiasm, either from the voters or from the centrist politicians who will continue to lead the country even as the public increasingly gravitates to the margins.

A similar phenomenon can be seen in countries from East to West, North to South. It took the Dutch 208 days to form an ideologically messy four-way coalition last year after an election in which 13 parties won seats in the parliament. The Czechs still do not have a functioning government after voting in October yielded an unwieldy Parliament populated by anti-immigrant hardliners, pro-market liberals, communists, and a loose al-

liance of libertarians, anarchists, and coders known as the Pirates. Hungary and Poland have both repudiated Western judicial ideology and have effectively left the EU from within, while retaining membership privileges.

The fragmentation of European politics takes what had been seen as one of the continent's great strengths and turns it on its head. Unlike in the U.S. and U.K., where winners take all, continental Europe primarily uses proportional systems in which the full spectrum of popular opinion is represented in office. That worked fairly well when the major parties captured 80-90% of the vote, as they did in countries across Europe for decades after World War II. But lately, the major parties have been downsized. In Germany, the "grand coalition" won just 53% of the vote. In Italy, neither of the traditionally dominant centrist parties exceeded 20%.

As voters vent their discontent with sclerotic political systems that never seem to address their grievances, hyper-fractured election results add layers of difficulty to the process of forming governments, passing meaningful legislation, or achieving the sort of consensus needed to reform the Eurozone into a complete monetary, fiscal, and political union. It appears that the EU is caught in an unstable equilibrium: obeying the awful logic of monetary union while attempting to press on with ever-deeper integration. But this approach defines its future failure. There is no popular consent anywhere for subsuming the ancient nation States of Europe into a supra-State construct. The drive for "ever closer" union already seems an anachronism; yet monetary union cannot function without it.

Although financial markets appear to have become inured to various global risks after a series of apparent "false alarms," we would suggest that sometimes risks resolve in different ways—either immediately or over time—and that, in investing, complacency is one of the biggest risks of all.

Spreading Squeeze

U.S. Federal Reserve (Fed) officials, meeting for the first time under Chairman Jerome Powell, raised the benchmark short-term Federal Funds lending rate by +25 basis points to a range of 1.50-1.75% at its March meeting and forecast a steeper path of hikes in 2019 and 2020, citing an improving economic outlook. U.S. monetary policymakers continue to project a total of three interest rate increases this year. Exactly where we are in the current global macroeconomic expansion cycle remains a subject of debate. It is clear, however, that peak monetary stimulus has long passed. The Fed will continue to unwind Quantitative Easing through a combination of short-term interest rate increases and accelerated unwinding of its balance sheet. The European Central Bank (ECB) is scheduled to discontinue its bond purchase program after September, and the Bank of Japan has reduced its government bond purchases.

Although the Trump administration's tax cuts may keep the liquidity party going for a bit longer, global monetary tightening is already causing the money supply to slow sharply: six-month real M1 in the biggest G7 and E7 economies combined has dropped to the lowest level since the Great Recession ended, and growth of real M2 has been negative for several months. Money supply movements are important indicators because they are usually harbingers of economic growth/contraction, with the data usually leading the real economy by six-to-nine months.

As a result of these trends, a key stress gauge of global credit has surged to levels not seen since the Financial crisis in 2009, prompting worries that global monetary tightening has begun to have an impact on the global credit/funding markets: the closely-watched "Libor-OIS spread" in the Dollar funding markets has more than tripled since late last year to 60 basis points. The Libor-OIS spread measures the extra cost that banks charge each other for short-term "unsecured" Dollar loans on the London interbank market relative to rates on secured short-term government loans. Libor (the London Interbank Offered Rate) is used to price a vast

nexus of financial contracts around the world: a third of all U.S. business loans are linked to Libor, as are most student loans and 90% of the leveraged-loan market. The Libor-OIS spread then, in essence, takes the pulse of the lending markets and is an important measure of risk and liquidity.

It is important to recognize that there are many moving parts in the complex Libor system, and it can give false signals. A surge of Treasury-bill issuance by the U.S. following the debt-limit deal in February may have distorted the picture. In addition, there is no sign of banks' distress or strain in the Euro funding markets.

Admittedly, the current absolute Libor-OIS rate of 60 basis points remains benign given that the measure surged to over 350 basis points during the height of the Financial Crisis. However, the current level has risen to levels reached during the onset of the Chinese currency crisis in early 2016, and is higher than during the Eurozone sovereign debt drama six years ago. Importantly, the recent spike is transmitted almost instantly through global finance and may be signaling an incipient squeeze in the offshore Dollar funding markets, the culprit that caused the 2007-2008 crisis to metastasize.

It is critical to note, however, that it would take a stronger U.S. Dollar, in combination with the rise in Libor-OIS, to initiate more significant concerns. At the moment, the U.S. Dollar remains weak. This could change, however.

U.S. corporations (led primarily by technology companies) are starting to repatriate approximately $2.5 trillion in offshore liquid assets in order to comply with the recent tax law changes. Since much of that money is already in U.S. Dollar assets, there are no currency exchange implications when it returns to the U.S.. However, U.S. entities have little incentive to lend that money back out internationally because of risk weightings and capital charges. Consequently, these funds are essentially being drained from the pool of available global lending and are reducing offshore liquidity, thereby rationing credit for Asia, Latin America, Russia, and the Middle East. As a result, borrowers could suddenly find it harder to roll over three-month Dollar loans. (This is what happened in 2007 and 2008 when offshore markets seized up and threatened to bring down the European banking system.)

The global scale of Dollar-denominated debt is historic in magnitude. BIS data show that offshore Dollar credit has ballooned from $2 trillion to $11.6 trillion in 15 years, turbo-charged by leakage from the Fed's QE program. The BIS has identified a further $13-$14 trillion in disguised lending through derivatives contracts that are "functionally equivalent" for a total of approximately $25 trillion in global Dollar-denominated debt.

As we have discussed in the past, Dollar liabilities on this scale are unprecedented and leave the world financial system more vulnerable than ever before to moves in the U.S. Dollar and to moves in Dollar funding costs (i.e., interest rates). As a result, any serious stress in the global financial system could quickly turn into a vast Dollar "margin call." This is the leading edge of a broader issue: the $70 trillion edifice of global bonds is currently structured based upon the assumption of a deflationary global liquidity trap lasting deep into the 21st century with almost $10 trillion still trading at negative yields. This structure has yet to be tested by a global monetary tightening cycle.

Indeed, although we continue to believe that, for a variety of reasons, global macroeconomic growth will continue to remain anemic by historic standards due to a surfeit of supply and a dearth of demand that will only be exacerbated by demographic trends (and, thereby, favor deflationary versus inflationary forces), there are many moving parts driving the highly-interconnected global financial markets. The complexity associated with the credit markets, in particular, has only increased since the Financial Crisis, and the effects of the unwinding of historically-unprecedented, globally-coordinated monetary policy largesse has heightened the potential for a central bank policy mistake. As a result, we continue to pay close attention to a variety of credit market indicators (like Libor-OIS), as well as monitor the U.S. Dollar index, in order to proactively manage the risk to companies held in *Windward*'s portfolio strategies.

Second-Order Thinking

The most recent increase in inter- and intra-day financial market volatility appears to be related to a variety of factors, including: still-elevated stock market valuations, a less accommodative pivot by global central bankers, wayward U.S. fiscal policy, a market structure influenced by the rising dominance of machines and algorithms that increase the interconnections between different markets and asset classes, and a chaotic U.S. White House devoid of process and shrouded in random policy actions whose consequences are ignored and/or not fully comprehended. This has created a backdrop of unpredictability and uncertainty that is in marked contrast to the relatively calm experience of the last several years when there was a consistent expansion of price/earnings multiples, markets without corrections, record low volatility, near-zero interest rates, and generous monetary policy.

It is important to remember that the U.S. equity markets have exhibited significant strength since 2009. To us, rather than an asset bubble, the greatest risk of an equity market correction continues to revolve around the numerous global macroeconomic and geopolitical risks that we have elucidated upon in our introduction and that we have discussed over the years since the onset of the 2008 Financial Crisis. Of these, the most imminent risk continues to lie with projected central bank policy actions, which currently imply a bias toward further monetary tightening.

However, despite these current challenges, 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 potential market volatility can create 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 types 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.

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.

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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.

NOTES

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