WINDWARD CAPITAL

Risk Averse Asset Management

2018 Third Quarter Review

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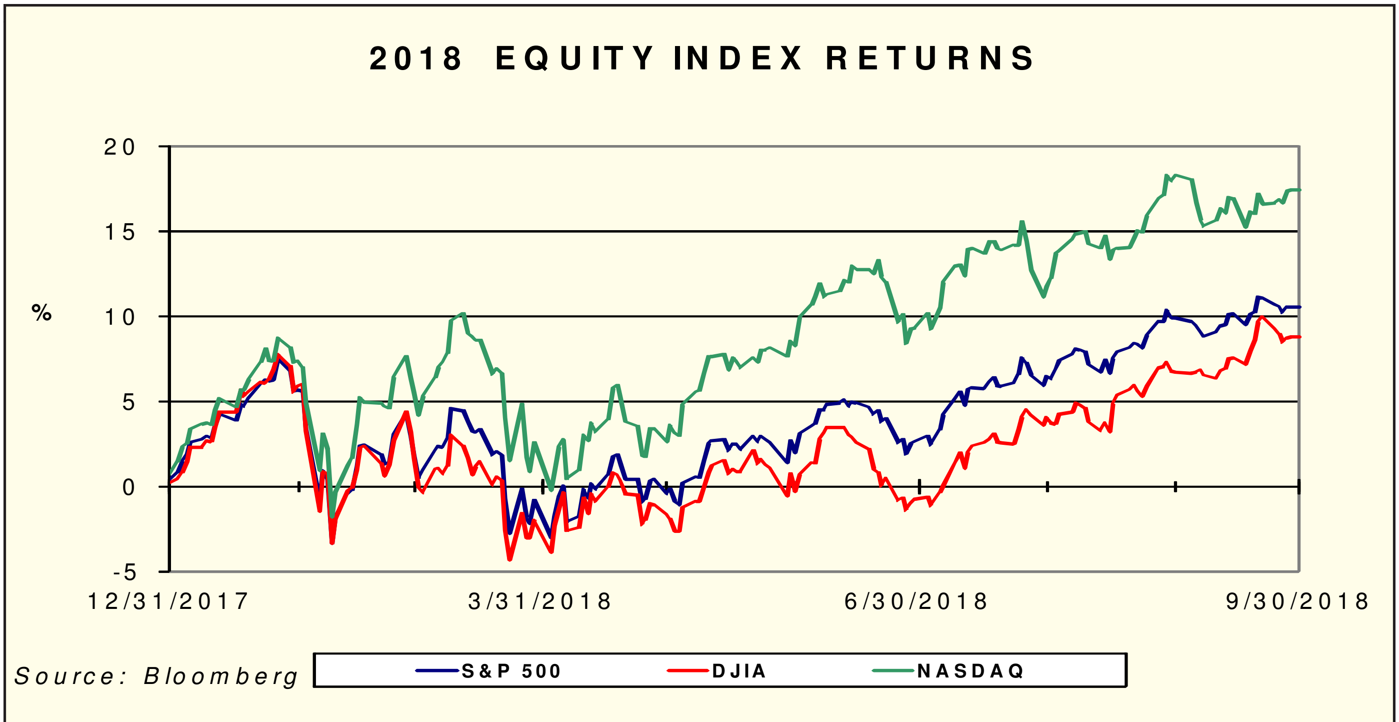

Look Out Above?

"Who you gonna believe? Me? Or your lyin' eyes?"

—Richard Pryor (1940–2005)
American Stand-Up Comedian

The major U.S. equity market indices steadily advanced during the Third Quarter of 2018, with the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) returning +7.71%, +9.63%, and +7.42%, respectively, for the period. For 2018 Year-to-Date, the S&P 500, DJIA, and NASDAQ have returned +10.56%, +8.83%, and +17.49%, respectively.

The near-term corporate revenue and earnings outlook remains positive: for the Second Quarter of 2018, year-over-year S&P 500 Revenues and Earnings growth was +10.1% and +25.0%, respectively, with estimates of +6.9% and +19.3%, respectively, for the Third Quarter of 2018. Additional factors supporting the markets include: consistent but moderate economic growth, 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 managements, 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 long-term impact on the geopolitical and global macroeconomic outlook, much less the financial markets. Until there is further regulatory and/or legislative clarity, we can only be confident that the near-term investment environment will continue to exhibit greater uncertainty and increased volatility—a risk that may be poised to increase as the November mid-term 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-and-a-half 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.

Loony, Eh?

On September 30, after an acrimonious 13-month negotiation that had hindered the Canadian economy and damaged relations between the two countries, Canada and the U.S. agreed on a new North American free trade agreement (named the U.S.-Mexico-Canada Agreement [USMCA]). Although retaining the primary (and most secondary) features of the 24-year-old North American Free Trade Agreement (NAFTA), the USMCA does make several policy changes. Many of the changes, however, are incremental in nature. And where there is entirely new text that was not in the original NAFTA, a substantial portion of it was borrowed from the 2016 12-country Trans-Pacific Partnership (TPP), an agreement that President Trump had previously disparaged and subsequently withdrawn from. (The TPP, which included the U.S., Canada and Mexico, was intended, in part, to serve as a vehicle for modernizing NAFTA.) According to our analysis, since the bulk of the USMCA is NAFTA—or where it has been modernized, it is basically the TPP—we do not anticipate that there will be any significant variation in the current trajectory of U.S. economic growth based upon this new agreement.

USMCA, then, can essentially be considered NAFTA 2.0, with changes on automotive industry issues, and new policies on labor and environmental standards, intellectual property protections, and digital trade. The most noteworthy modifications include:

Vehicle country of origin rules and labor provisions. Automobiles must have 75% of their components manufactured in Mexico, the U.S., or Canada to qualify for zero tariffs (up from 62.5% under NAFTA). In addition, 40-45% of automobile parts have to be made by workers who earn at least $16 per hour by 2023. Mexico has also agreed to pass laws giving workers the right to union representation, extend labor protections to migrant workers, and protect women from discrimination. (The countries can sanction one another for labor violations.) Automakers must also buy 70% of their steel and aluminum from North America. In our opinion, it is unclear what the real-world impact of these changes will be. Automakers could choose not to disrupt their current supply chains and manufacturing facilities and disregard the new requirements, instead paying a tariff on their cars; they could replace more workers with robots; they could redirect cars to markets outside the region; or they could choose to move more production out of North America altogether.

U.S. farmers get slightly more access to the Canadian dairy market. Canada will set new, higher quotas for dairy imports from the U.S.—especially for what is known as “Class 7” milk products such as milk powder and milk proteins (the U.S. used to sell a significant amount of Class 7 products to Canada, but that changed in recent years when Canada started heavily regulating this new class). Although Canada will still put tariffs ranging from 200% to 300% on dairy products that exceed the quotas, the new, higher quotas are expected to give American dairy farmers access to approximately 3.6% of Canada’s market (up slightly from the 3.2% share originally agreed to in the TPP). Consensus estimates suggest that this will increase exports to Canada by $70 million, or 0.0004% of U.S. GDP. It should be noted that the U.S. sends far more dairy products to Canada than the reverse: over the past few years, the U.S. exported an annual average of $675 million of dairy products to Canada and received about $282 million in return.

Intellectual property and digital trade. The USMCA extends the terms of copyright to 70 years beyond the life of the author (up from 50 years). It extends the period that a pharmaceutical drug can be protected from generic competition (from 8 years to a revised 10 years for biologics). It also includes new provisions to deal with the digital economy, including prohibiting duties on things like music and e-books, and protections for internet companies so that they are not liable for content their users produce.

No section 232 tariff protections. Section 232 is a trade loophole that President Trump has used to impose +25% steel and +10% aluminum tariffs on Canada, Mexico, and the European Union. It basically states that the U.S. can block the import of materials “critical for national security” in order to ensure that the country has reliable supplies in the event of a war. Both Canada and Mexico wanted protections from these tariffs, but they did not get them under this agreement. They did, however, get the U.S. to make a side agreement that protects them from possible auto tariffs under Section 232.

Canada preserves the special trade dispute mechanism. One of Canada’s red lines was the preservation of NAFTA’s Chapter 19, which sets up an independent mechanism to resolve special trade disputes between the countries (rather than trying to litigate them in domestic courts). Canada sees Chapter 19 as a way to defend against protectionist trade policies by the U.S., and it was able to maintain this defense.

Sunset clause. The agreement puts in a 16-year “sunset” clause—meaning the terms of the agreement expire, or "sunset," after a set period of time. The deal is also subject to a review every six years, at which point the U.S., Mexico, and Canada can decide whether or not to extend USMCA.

One area of particular interest in the new agreement is that the fine print of the USMCA requires any country in the pact to give three months notice to other parties if it is entering into trade negotiations with a "non-market" economy—such as China's. If one country enters into a deal with China (or another similar economy), the rule allows a country to give six months notice to *terminate* the three-way deal and replace it with a bilateral agreement. Importantly, this provision is expected to be a template for future U.S. trade deals aimed at constraining China. Indeed, the Trump administration has made clear that, with the USMCA in hand, it is now preparing to set its sights on the trade war with China—enlisting Canada and Mexico as allies in the process. This surprise clause in the USMCA about a western trade alliance against China, and the implications that it carries for Canadian and Mexican sovereignty, is a reminder that there may be additional "under-the-radar" issues hidden in the many details of this wide-ranging trade agreement that was negotiated behind closed doors and under deadline pressure.

Most of the provisions of the USMCA will not take effect until 2020. Legislatively, the process of finalizing the merged three-country agreement is still far from over. By announcing the new deal by the September 30 deadline, the three parties are on schedule for an official signing ceremony before December 1—current Mexican President Enrique Peña Nieto's last day in office. The difficult part will be U.S. ratification of the agreement, which will entail a vote sometime during the next Congressional session. Clearly, how such votes proceed will be significantly influenced by this Fall's mid-term elections. Regardless of the electoral results, however, there could be reasons for both Republican and Democratic reluctance to approve the deal. Republicans in Congress are wary of Trump's protectionist instincts and their impacts on their constituents; Democrats, meanwhile, are unlikely to actively help Trump realize one of his key campaign promises. Thus, the USMCA's Congressional path currently remains unclear.

In the meantime, the original provisions of NAFTA will remain in effect.

Building a Great Wall

As discussed at length in our *2018 First Quarter Review*, we noted that the ongoing U.S. "trade conflict" with China is more about existential matters such as the struggle for technological leadership, mutually accepted rules and regulations in industrial policy, and national security than about trade. The secret Beidaihe Summer Summit of the Chinese Communist leadership in August concluded that Washington's true purpose is to "thwart China's rise." China has been gearing up for a fight ever since the release of the U.S. National Security Strategy in December 2017 that named the country as a strategic rival that seeks to "challenge American power, influence, and interests, attempting to erode American security and prosperity."

Consequently, we believe that the current dispute is, instead, a strategic contest for geopolitical hegemony. Although financial market participants do not appear to currently appreciate this important distinction—perhaps because the economic impact so far has not been that large (and the earnings and revenue effects even less)—we believe that this strategic conflict could have significant long-term ramifications for both the global macroeconomy and the financial markets.

With regard to the more-immediate trade elements of this struggle, the Trump administration wants its tariffs on China to address three main issues. First and foremost is the massive trade deficit that the U.S. runs with China, which reached a record-high $375 billion in 2017. Trump also wants to ensure stronger protections on U.S. intellectual property. Another source of contention has been "Made in China 2025," a $300 billion Chinese program intended to transform the country into the world's leading high-tech powerhouse.

China, by contrast, is looking to establish itself as a formidable world power. President Xi Jinping has taken pains to portray his country as a sober-minded alternative to an uncompromising United States. And it is no accident that the products covered by China's tariffs target Trump's political base.

Over time, the cumulative effects of a long trade war could push up global inflation and dampen demand. A strong U.S. Dollar has kept U.S. non-fuel import costs in check recently, but local prices for steel, metals, and some consumer products affected by tariffs have risen sharply. A weaker Chinese Yuan, on the other hand, and higher tariffs have combined to raise China's import prices by around +9% since January. Such developments will eventually acquire some pass-through effects and may be reflected in bond yields.

In addition, the disengagement between the U.S. and China is not confined to trade. It is also unfolding in foreign direct investment, and may spill over into services, such as tourism and education. As a result, there might not just be a switch in spending as U.S. and Chinese firms look to alternative suppliers in the Americas and Asia to avoid tariffs, but also lower *aggregate* spending, as well.

China's future behavior in the trade conflict will be critical because the "tit-for-tat" stage between the countries is nearly over. The U.S. imports four times as much from China as the flow in the opposite direction, and it is now targeting higher tariffs on half of its imports from China. Beijing's Dollar-for-Dollar response now covers nearly all of its imports from the U.S.. President Trump has threatened to extend tariffs to *all* imports from China. What are China's options?

The three "market" options open to China could all have negative implications for the financial markets: Pushing up tariffs on the U.S. to much higher levels would destabilize China's gradually slowing economy. Selling U.S. Treasuries would be more of a posturing maneuver and remains a pointless exercise in self-harm. Devaluing the Yuan to compensate for the U.S. tariffs could easily destabilize the Chinese financial system, capital flows, and confidence at home. (The Yuan will probably depreciate anyway in the next year, but a large devaluation would be aggressive and widely disruptive.)

China has other alternatives, however. In the past, when China has been involved in political disputes with Japan, Mongolia, Norway, the Philippines, and South Korea, it has targeted companies operating in China, restricted outward tourism, and even orchestrated nationalist protests. Some sort of campaign against U.S. firms operating in China is likely—especially if President Trump extends the tariffs further.

More red tape, greater scrutiny and delays over licensing and customs procedures, and more intrusive regulatory requirements are already being reported (the American Chamber of Commerce recently said, for example, that more than half of its members reported a rise in non-tariff barriers). The government could potentially raise the pressure and introduce regulations or initiatives that undermine U.S. companies' supply chains, restrict outward tourism to the U.S., or, if the political climate deteriorated far enough, disrupt U.S. technology and pharmaceutical companies by flouting U.S. intellectual property rights. In other words, there are many ways beyond tariffs for China to negatively impact the functioning of large, U.S.-based multinational corporations operating in its country. China will have to tread carefully, however, because U.S. companies contribute significantly to Chinese manufacturing, employment, exports, and technological progress, and any significant economic disruption could foment domestic political and social unrest.

For all of these reasons, we remain alert to the consequences of a protracted, and escalating, trade conflict. The effects on the global macroeconomy will depend on how much further Washington wants to go and how Beijing chooses to respond. If Chinese President Xi Jinping wants to demonstrate resistance—as the Chinese Dream narrative demands—it will be harder to make concessions. In so doing, he may stifle further chances of needed economic reforms critical to the country's rebalancing from investment-driven to consumer-driven.

In our *2018 Second Quarter Review*, we discussed, at length, the tactical implications of trade disputes. We noted the multiplier effects that this economic disruption could create due to the increased interconnectedness of today's global trade system, which comprises complex supply chains and the dispersion of raw, intermediate, and final goods production across a variety of countries. Along with the introduction of a variety of tariffs (and immigration restrictions), the Trump administration's recent vague threats to withdraw from the structures and administrative organizations that support and regulate international trade (like the World Trade Organization [WTO]) seem to be intended to destroy the "system" for the perceived benefit of a political base. Perversely, the actual societal ramifications of these actions could backfire severely. As occurred during the onset of global trade—particularly with the eventual admission of China into the WTO in 2001—retrenchment of the current system will lead to additional, and unexpected, "winners and losers" of uncertain magnitude.

Shifts Happen

U.S. Federal Reserve (Fed) officials raised the benchmark short-term Federal Funds lending rate by +25 basis points for the third time this year to a range of 2.00-2.25% at its September meeting and forecast a steeper path of hikes in 2019 and 2020, citing an improving economic outlook. After growing at annualized rates of +2.2% and +4.2% in the First and Second Quarters of 2018, respectively, U.S. Real GDP appeared to be continuing to charge ahead at a growth rate faster than +3% during the Third Quarter. At the moment, the Fed looks on track for four rate hikes in 2018 of 25 basis points each, with an additional three to four hikes in 2019 as well.

Of greater significance than this recent interest rate increase and the Fed's removal of language in its statement that had characterized its policy as "accommodative"—both of which we expected given that global central bankers have been tightening monetary policy for some time now—is that the Fed appears to no longer be guided by the concept of the "neutral rate," or R* ("r-star").

As you may recall from our discussion in a previous *Quarterly Review*, the equilibrium real rate of interest, or R* in the jargon of macroeconomists, is the real short-term interest rate that would pertain when the economy is at "equilibrium," meaning that unemployment is at the natural rate and inflation is at the 2% Fed target. R*, therefore, is the goal toward which the Fed's "normalization" of U.S. monetary policy leads. The relevance of the Fed's recent stance is that if it is, at least temporarily, de-emphasizing the importance of R*, then it is less clear how high the Fed will raise interest rates because the incoming economic data will become of greater importance in its decision-making process—and these data currently remain on an upward trajectory: the U.S. unemployment rate remains below 4%, annualized Real GDP growth is above +3%, and inflation is slightly below the 2% target.

At the moment, incoming U.S. economic data remain far too strong for the Fed to contemplate an end to rate increases. In fact, Federal Reserve Chairman Jerome Powell recently gave a glowing review of the U.S. economy, stating:

> From the standpoint of our dual mandate, this is a remarkably positive outlook. Indeed, I was asked at last week's press conference whether these forecasts are too good to be true—a reasonable question! Since 1950, the U.S. economy has experienced periods of low, stable inflation and periods of very low unemployment, but never both for such an extended time as is seen in these forecasts.

Since it appears that the Fed is far less confident that they know the correct level of R* with any certainty, they will continue to hike short-term interest rates until policy turns more "restrictive"—a point that will only be known after the fact, based upon the resultant economic data. This means a Federal Funds rate in the range of what is considered "neutral" has no special significance as far as policy is concerned.

This is obviously hawkish relative to any expectations that the Fed would pause as policy rates approach a level that neither stimulates nor restricts the economy, and it again highlights the importance of the incoming economic data. The fixed income markets have taken notice of this risk through a recent upward shift across the entire yield curve (the yield curve is a plot of interest rates as a function of maturity that is specifically focused on the difference between interest rates on short-term U.S. government bonds [e.g., two-year Treasury notes] and long-term U.S. government bonds [e.g., 10-year Treasury notes]).

Even New York Federal Reserve President John Williams, a previously-staunch R* proponent, made clear in a recent speech that the neutral interest rate is no longer a guiding star for monetary policy. Williams' previous attachment to R* cannot be overstated. At a professional level, it has been a key element of his research agenda. As recently as May he said that for "the moment, R* continues to shine brightly, guiding monetary policy, but hold steady, low on the horizon." That moment appears to have quickly passed. He has now tossed aside the metric, saying that it has "gotten too much attention in commentary about Fed policy." (A remarkable shift after just two 25-basis-point rate increases since his May comments.)

Williams now argues that R* only served as a useful metric when policy rates were far below neutral. Now that policy is closing in on R*, it actually becomes a less clear concept because of the uncertainty of neutral-rate estimates. Since R* is just one of many measures tracked by the Fed, what is the guiding metric now? Williams says he "will be guided by our dual mandate, a heavy dependence on data, and a steadfast commitment to transparency." With the Fed now operating in what central bankers view as a "normal" economic environment, it appears that interest rate policy is all about the economic data.

Williams' speech marks the end of a transition in policy away from explicit forward guidance. It began this past August with Fed Chairman Powell's Jackson Hole speech in which he noted the uncertainty surrounding estimates of key variables like the neutral interest rate. Fed Governor Lael Brainard pushed this point further in a subsequent speech, adding further uncertainty by differentiating between short- and long-run neutral rates—and that the short-run neutral rate tends to be cyclical. It continued in the September Federal Open Market Committee statement with the removal of the description of policy as "accommodative." And it ends with the primary proponent of the R* concept—Williams—throwing it into the trash bin of crisis-era monetary policy artifacts.

The demise of R* has two important implications for financial market participants. First, it has fairly hawkish implications for policy. Had the Fed thought they did not need to raise rates above current estimates of R*, they could simply have held onto the R* concept and prepared markets for a pause in the tightening cycle on the basis that policy rates would soon be in the range of those estimates. Instead, they downplayed the relevance of R*. The message is that they do not think a pause is imminent.

The second is that the incoming economic data should be the primary focus. Arguably, the data were just a sideshow in the early stages of the current tightening cycle. Forward guidance indicated that rates were far from neutral. As long as the economy retained even a modest pace of growth, rate hikes would continue. That is no longer the case. The data will be the final arbiter of the level of policy accommodation, not some theoretical construct. Brainard made this clear in her recent speech by noting that while she cannot precisely estimate the neutral level of rates, the fact that job growth has strengthened and financial conditions have eased since the Fed began raising rates clearly indicates that policy remains accommodative—and possibly even no tighter than in December of 2015 (!). What that means for policy is that the rate hikes will keep coming. Per Brainard:

> Over the next year or two, barring unexpected developments, continued gradual increases in the Federal Funds rate are likely to be appropriate to sustain full employment and inflation near its objective. With government stimulus in the pipeline providing tailwinds to demand over the next two years, it appears reasonable to expect the shorter-run neutral rate to rise somewhat higher than the longer-run neutral rate. Further out, the policy path will depend on how the economy evolves.

With this recent dramatic change in posture, the risk has increased that, in this tightening cycle, the Fed will continue to raise rates *well beyond* R*. Unfortunately, it remains uncertain whether that particular level of interest rates, when reached, will have a material negative impact on U.S. economic growth. It is this uncertainty which has led to the recent volatility in the financial markets.

Keep Calm and Carry On

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 lies with the potential for an international trade conflict in an environment of global central bank monetary policy 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.

Sources:
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Bank for International Settlements
Bloomberg
Congressional Budget Office
FactSet
Federal Reserve Banks of New York, San Francisco, and St. Louis
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Office of the U.S. Trade Representative
Organisation for Economic Co-Operation and Development
Reuters
State Administration of Foreign Exchange, China
U.S. Bureau of Economic Analysis
U.S. Bureau of Labor Statistics
U.S. Department of the Treasury
U.S. Federal Reserve

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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