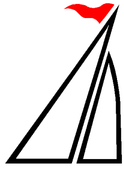
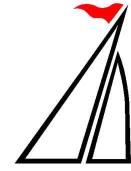


WINDWARD CAPITAL

Risk Averse Asset Management



2019 Second Quarter Review

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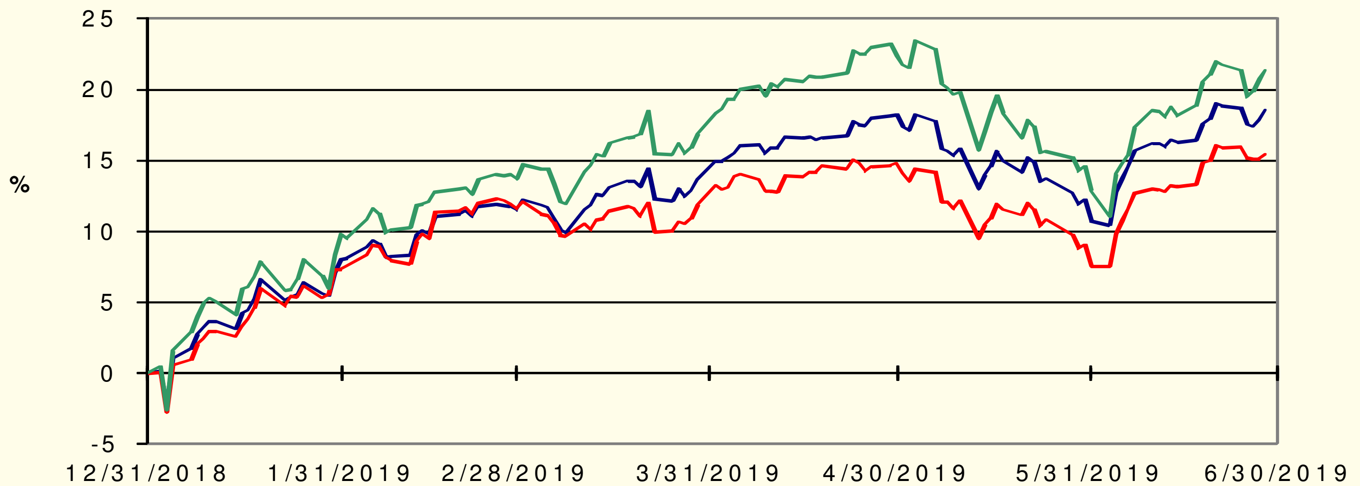

Sellers' Strike

"Common sense is not so common."

—François-Marie Arouet (aka Voltaire)
(1694 - 1778)
French writer and philosopher

The major U.S. equity market indices increased during the Second Quarter of 2019, with the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) returning +4.30%, +3.21%, and +3.88%, respectively, for the period. For 2019 Year-to-Date, the S&P 500, DJIA, and NASDAQ have returned +18.54%, +15.40%, and +21.34%, respectively—and have continued to advance to historic, all-time highs during July 2019.

Factors providing underlying support to the markets include: consistent but moderate economic growth, positive (albeit waning) impacts from the *Tax Cuts and Jobs Act* of 2017, liquidity effects, and momentum. In addition, although slowing, the near-term corporate revenue and earnings outlook remains positive: for the Year, 2018 year-over-year S&P 500 Revenues and Earnings growth was +8.8% and +20.0%, respectively, with 2019 year-over-year growth rate projections of +4.4% and +2.6%, respectively. As we have noted in the past, however, some of these factors necessarily raise concerns regarding market valuation. As a result, we believe that the equity markets may be "overbought" on a technical basis in the short term, and that a correction remains a possibility.

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. From an economic perspective, this administration 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—either positive or negative—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 2020 Presidential election approaches.

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.

We believe that the risk associated with financial market volatility 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 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 actions 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 effective 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.

Longer

The U.S. economy continues to grow, and, although moderating, we do not foresee an economic recession in the near term.

After growing at annualized rates of +2.2%, +4.2%, +3.4%, and +2.2% in the First, Second, Third, and Fourth Quarters of 2018, respectively, U.S. Real Gross Domestic Product (GDP) grew at a strong +3.1% annualized rate during the First Quarter of 2019. This strong reading was primarily driven by a massive increase in inventory accumulation and a narrowing of the trade deficit—components that are not generally reliable indicators of ongoing momentum. The more reliable drivers of growth in the U.S. economy are consumer spending and business investment. While growth in consumer spending—which represents approximately 70% of the U.S. economy—was weak in the First Quarter, incoming data show that it has bounced back and is now running at a solid pace. However, growth in business investment seems to have slowed notably, and overall growth in the Second Quarter of 2019 appears to have moderated. The slowdown in business fixed

investment may reflect concerns about trade tensions and slower growth in the global macroeconomy. In addition, housing investment and manufacturing output declined in the First Quarter and appear to have decreased again in the Second Quarter. Based upon these factors and other recent economic data, we believe that U.S. economic growth has slowed from its First Quarter pace.

We do believe, however, that the U.S. economy is both stronger and more resilient than the consensus expects. So far, none of the downside risks of recent years have been sufficient to derail the recovery from the 2008 Financial Crisis. These risks are mostly external, while the primary engine of U.S. growth is internal and flexible. As long as there is some amount of demographic growth, capital depreciation, technological evolution, and a change in tastes and preferences, there will be a powerful underlying (and under-appreciated) impetus for growth that is almost certain to reveal itself in any reasonably well-managed economy. This ultimately is the reason that, despite the seemingly persistent belief that the recessionary bogeyman is just around the corner, economic recessions are remarkably rare events.

The National Bureau of Economic Research has recorded the history of U.S. business cycles dating back to the 1850s. Since that time, the longest expansion—measured from the trough of the previous business cycle to the subsequent cycle peak—was 10 years (set by the March 1991-March 2001 expansion). The current expansion, which began in June 2009, just tied that record and is poised to become the longest economic expansion on record.

Despite its longevity, the characteristics of this business cycle differ from its historical peers in several important ways, however.

The highlight of the current U.S. economic expansion is the employment statistics. The unemployment rate currently sits at a 50-year low of 3.6% (compared to a nearly 10% rate at the 2009 economic trough). Aided by persistently low inflation (the Core Personal Consumption Expenditure Index deflator has increased at an average seasonally-adjusted annualized rate of only +1.57% since the 2008 Financial Crisis), real wages for production and nonsupervisory workers have been growing (albeit modestly), and the percent of prime age (25-54 years old) workers as a share of the population has been rising steadily (at 79.7%, the prime-age employment-to-population ratio has almost clawed its way back to pre-recession levels).

Aside from the high employment and low inflation statistics, however, the metrics are not quite as robust. On a historical basis, economic growth during this business cycle has been relatively weak. The average rate of growth in Real GDP of +2.3% for the current cycle is the weakest of all of the post-World War II expansions (annual growth in GDP averaged +3% from 1987 to 2007, for example). In addition, the *total* increase in real output since the June 2009 trough has been just +25% compared with +43% for the second-longest expansion (1991-2001). As a result, the current (longest) expansion on record ranks *fifth* in cumulative output generation compared with all expansions recorded over the last 70 years. The slow, shallow nature of this recovery from the deep 2007-2009 recession upended the usual historic pattern of steep downturns followed by sharp rebounds. Economic growth during this recovery has more closely resembled a U- rather than a typical V-shaped pattern and is primarily a result of fiscal and monetary policy choices and decisions made in response to the 2008 Financial Crisis. As a result, the U.S. has experienced much more moderate economic growth than it potentially could have achieved under other circumstances.

In general, an economy's "speed limit" (that is, how fast it can grow without triggering rising price pressures [i.e., inflation]) is primarily determined by growth in the labor force (via demographics, skill levels, immigration, etc.) and productivity improvement. Absent any exogenous events, it appears that the future estimated pace of U.S. GDP growth will remain between +1.5% and +2%, noticeably slower than the typical pace since World War II. The slowdown stems mainly from demographic trends that have retarded labor force growth, as well as a decline in productivity growth.

For the U.S., the civilian labor force has been growing at an anemic +0.5% pace during the current expansion. That compares to an average rate of +1.7% in

the 1980s and +1.2% in the 1990s, a rate that prevailed up until the onset of the recession in 2007. At the same time, U.S. birth rates are falling at an alarming pace to well below the replacement fertility rate of +2.1%. Based upon projections for birth rates, immigration, and mortality, the Congressional Budget Office (CBO) estimates that the U.S. economy's labor force and total work hours will grow less than +0.5% per year, on average, through 2030.

Growth of Real GDP per hour, a broad measure of labor productivity, has slowed since 2004 for reasons that economists still do not fully understand. During the "fast-growth" period from 1995 to 2004, productivity growth averaged +2.5%. During the slower periods of 1973–1995 and 2004–2018, growth averaged only +1% to +1.25% (and that pace dropped dramatically lower during 2010–2018). Although productivity appears to have some persistent cyclical dynamics, it is highly uncertain in both a statistical and an economic sense, and neither statisticians nor economists have a good track record of forecasting changes in trend productivity growth. The trajectory of future productivity growth may be influenced by a variety of factors. Economically, major technological gains could remain narrowly focused, leaving modest and incremental productivity growth as the norm for the broader economy. Alternatively, future growth might look substantially different from the past and reflect the innovative contributions of robotics, machine learning, and artificial intelligence. Or, there might be another as-yet-unforeseen broad-based wave of the information technology revolution. Despite the significant inherent uncertainty associated with predicting future productivity growth, we conservatively assume that U.S. productivity growth will maintain its recent trend of +1 to +1.25% per year for the foreseeable future.

Based upon these trend estimates of growth in the labor force and productivity improvement (and absent any exogenous shocks), our analysis indicates that future U.S. Real GDP growth will approximate between +1.5% and +2% on an annualized basis over the intermediate term.

With regard to the impact of the current U.S. economic expansion's effect on the Federal budget, the CBO has reported that the deficit was $738 billion for the first eight months of fiscal 2019—a $206 billion increase compared with the same period a year ago. The CBO projects a fiscal 2019 deficit of $896 billion, or 4.2% of U.S. GDP, noting that in years when the unemployment rate has been below 6% (the generally-accepted "full employment" rate), deficits have historically averaged just 1.5% of GDP. In the 1990s, shrinking deficits actually turned into *surpluses*. Part of that budget-balancing was unexpected: the 1997 reduction in the capital-gains rate sent tax revenue soaring. But the remainder was due to responsible tax-and-spend policies.

Indeed, a healthy economy should be expected to generate *smaller* deficits as demand for safety-net programs declines and strong income growth yields additional tax revenue—contrary to the current situation in which the 2017 *Tax Cuts and Jobs Act* generated over $1+ trillion in unfunded tax cuts at the height of the business cycle. As a result, the CBO currently projects that the deficits will average 4.3% of U.S. GDP during 2020–2029. Beyond 2029, if current laws were to remain in place, deficits would continue to grow and drive absolute public debt to its highest level in the nation's history. The larger deficits would occur because outlays—particularly for Social Security, Medicare, and interest on the debt—would rise steadily under current law, and revenues would not keep pace with the growth in spending.

With regard to capital spending, the reduction in the corporate tax rate from 35% to 21% as part of the 2017 *Tax Cuts and Jobs Act* was supposed to unleash a flood of business fixed investment. Aside from solid gains in capital spending in the first half of 2018 (which were no stronger than those witnessed in 2011 and 2014), capital spending has been a relative disappointment. Currently, the Trump administration's trade tariffs—whether intended to cure bilateral trade deficits or to serve as a diplomatic threat—combined with a global macroeconomic dearth of demand and surfeit of supply, is serving to dampen international trade and restrain business confidence and investment.

However, despite the unique nature of the characteristics associated with this business cycle, our analyses of the economic data do not currently predict a U.S. eco-

nomic recession in the near term.

This continues to be the longest U.S. economic expansion since 1850: job growth has been persistently strong, inflation remains subdued, the economy is effectively operating at full employment, and Real GDP is now more than +20% higher than its pre-recession peak. Despite the recent slowdown in business investment spending due to uncertainty regarding the global macroeconomic environment, U.S. GDP and corporate earnings continue to reach new highs, unemployment is at a 50-year low, wages are growing modestly, and consumer spending remains steady.

Although the business cycle is not dead—so, by definition, the future is guaranteed to include another economic recession—many things have to start going wrong fairly quickly in order to bring about an economic downturn in the near term. Although the risk of a monetary policy error and/or geopolitical mistake should not be ignored, we believe that a much better bet is to expect that this economic expansion could continue to be a record breaker. Consequently, the anticipated economic slowdown in the months ahead will make for some interesting analysis as it will be easy for pundits to see a recession in every soft indicator. Although we expect to see an increase in soft data as the economy slows, it is important to remember that, historically, "growth" remains the norm, "recession" is the rarity, and "deep recessions"—like that experienced coincident with the 2008 Financial Crisis—are generational in nature.

Insurance

As we mentioned in our *2018 Fourth Quarter Review*, despite an apparent recent increase in geopolitical and global macroeconomic uncertainty, monetary policymakers still retain significant influence over the course of the financial markets. In that regard, it is notable that the U.S. Federal Reserve (Fed) has recently reversed course on tightening. In our view, this policy shift marks a critical moment in the interest rate cycle, with potentially positive implications for global asset markets and for the health of the international economy over the next year.

The Fed is now signaling it will likely *cut* rates in coming months—not because the U.S. is headed into recession, but because of a slowdown in global growth.

At its March 20, 2019 meeting, the Fed effectively acknowledged that its final interest rate hike of 2018 was an error. In trying to fix that error, monetary policymakers have quickly shifted gears from *forestalling* inflationary pressures to *supporting* inflation and extending the U.S. economic expansion. The implication for financial market participants is to expect that the next Fed interest rate move is much more likely to be down rather than up.

At its June 19, 2019 meeting, the Fed held interest rates steady while confirming our previous prediction that a rate cut could come soon—a notable shift from December 2018 when the Fed was in the midst of *raising* interest rates. In explaining what changed, Fed Chairman Jerome Powell cited two developments in particular: a downturn in indicators of global growth and a worsening of trade tensions, which are dampening confidence throughout the world, not just in the U.S..

Weakening global growth has the potential to impact the U.S. via trade links or financial contagion. In 2015, a collapse in oil prices initiated by Saudi Arabia and a bungled currency devaluation by China ricocheted around the world and badly impacted U.S. oil producers and manufacturers. Global sentiment was further dented by Britons' vote in mid-2016 to leave the European Union (EU) (i.e., "Brexit"). Those developments led then-Fed Chairwoman Janet Yellen to take a year-long break from raising rates.

Something similar may be under way now. Manufacturing activity has fallen sharply in Europe and China—in some cases into contractionary territory. American factory activity is now slowing in lockstep. Some of this is probably due to the U.S. tariffs on Chinese imports and the threat of more tariffs, not only on goods from China but also from other trading partners, including Mexico, Japan, and the EU. American companies that are more exposed to China have seen their equity market valuations decline relative to their peers.

Mexico may now be in recession, which is likely hampering demand for U.S. exports.

The global economic outlook influences Fed policies because the U.S. Dollar's central role in global finance means that changes to U.S. interest rates impact almost every country—especially those developing world economies with Dollar-denominated debt. The Fed raised its short-term interest rate target from a range of 0.25% to 0.5% in late 2016 to a range of 2.25% to 2.5% in late 2018 as U.S. economic growth strengthened, inflation firmed, and unemployment fell to levels that, in the past, have usually fueled inflation. But that tightening forced emerging markets that rely on Dollar borrowing to also raise rates, strengthening their currencies and slowing their economic growth. Many have since stumbled, which may explain why commodity prices, which are sensitive to global growth, began falling last year.

The Fed's current policy rate of 2.25% to 2.5% is now the highest among major advanced economies. Australia cut rates to 1.25% from 1.5% in June. Canada's key rate stands at 1.75%, Britain's at 0.75%, and Japan's at *negative* 0.1%. The European Central Bank's target rate is *negative* 0.4%, and its President, Mario Draghi, recently signaled it may go more deeply negative. The growing differential between U.S. and foreign rates has supported the Dollar, restraining U.S. growth and inflation, which is already below the Fed's +2% target. More generally, the dovish direction of its foreign peers should prompt the Fed to reconsider whether 2.25% to 2.5% is appropriate. Though stimulative by historical standards, it may be *restrictive* in a low-inflation, slow-growth world.

For the past year, the U.S. has defied global economic trends as a tax cut and a Federal-spending boost lifted growth well above the level of other advanced economies. As that stimulus fades and U.S. growth moderates, so, arguably, should its monetary policy.

The Fed apparently has finally realized that the combination of moderate economic growth and persistent low inflation could become problematic. In the push for higher interest rates, the Fed seemed to have lost sight of the policy challenge they still face years after the end of the 2008 Financial Crisis: the close proximity of interest rates to the zero lower bound leaves the Fed with comparatively little room to respond to a full-blown recession (absent through the use of extraordinary monetary policy measures, like Quantitative Easing). Weak inflation complicates this asymmetry because it leaves real rates still high even if the Fed pushes nominal rates back to zero.

To avoid the problems of the zero lower bound for as long as possible, the Fed needs to ensure that inflation stays sufficiently high to hold expectations at its target. The policy implication, then, is that they need to err on the *dovish* side. The December rate hike was an error on the *hawkish* side. They now realize that error and have set the stage to move in the other direction.

The need to correct that error became more imperative given the increase in downside risks from trade tensions and slower global macroeconomic growth. There is no need to risk a sharp slowing in the U.S. economy given that inflation remains low. Moreover, if the Fed wants to sustain the expansion, they cannot delay a rate hike until the data reveals that a recession is already underway. That would virtually guarantee a move to zero interest rates.

The emerging story, then, is one of an insurance rate cut to reverse the mistake of December's hike. A 25 basis point cut at the July 31 meeting therefore appears likely, with future rate cuts still dependent upon incoming economic data.

Something's Gotta Give

Conceptually, global macroeconomic trade relationships usually result in a "win-win" situation for the countries involved. After all, peace and trade are the most positive of all foreign policy-related activities because parties enter into an agreement only if both expect to benefit.

However, as with any negotiated agreement, there are compromises and associated unintended consequences—this is especially true in the case of global-

ization. Although there are many approaches to dealing with these issues, we believe that protectionism is not a viable solution. Trade restrictions only address the symptoms and not the underlying causes of globalization dislocations, and they introduce other costs and distortions to the global macroeconomy.

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. 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 overall 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, while at the same time incentivizing and encouraging the development of new, competitive industries. (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.)

Recently, protectionist impulses are on display as the United States' trade negotiations with China have reached an impasse: tariffs are rising, rhetoric is heating up, and both sides are digging in. For all of the efforts at a trade resolution, however, this current phase will likely be remembered as merely the opening gambit in a longer-term strategic geopolitical confrontation that will outlast the current Administration.

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 2018 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 Report* 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 trade 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.

There is a possibility, however, that the U.S. and Chinese economies are so intertwined and interdependent that they simply must find ways of getting along in order to avoid the possibility of a severe economic downturn. 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 even be updated or improved upon.

But contentious issues may not remain quarantined forever. A key feature of Cold War foreign policy, at least in the 1970s, was "linkage"—rewarding cooperation in one area by relaxing tension in another, punishing bad behavior in one domain by imposing costs elsewhere. Linkage in the current U.S.-China context could turn a complex and difficult relationship into a more significant confrontation. As the stakes rise, both sides may try to gain advantage in one area by acting in another, and competition could cross into a variety of additional domains.

It is important to remember that China's trade practices are essential to its nationalist 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 es-

caping 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 Xi to abandon his commitment to the Chinese identity.

Chef's Kiss

Despite ongoing uncertainty (and resultant volatility), the U.S. equity markets have exhibited significant strength since 2009. To us, the greatest risk of future equity market declines 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.

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. In addition, recent dovish comments by the Fed, additional Chinese economic stimulus, as well as the potential for an interim U.S.-China trade resolution, could spark significant buying interest. 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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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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