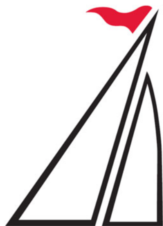

WINDWARD CAPITAL

Risk Averse Asset Management

2021 Third Quarter Review

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Source: Bloomberg

The Weak That Was

"You can observe a lot by just watching."

— "Yogi" Berra (1925 – 2015)
American Baseball Legend

The major U.S. equity market indices continued to advance to new, historic highs during the Third Quarter of 2021 before retreating in the final four-to-six weeks. As a result, the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) returned +0.58%, –1.46%, and –0.22%, respectively, for the period. For 2021 Year-to-Date, the S&P 500, DJIA, and NASDAQ have returned +15.91%, +12.12%, and +12.67%, respectively.

The latest political theatrics in Washington, D.C., has increased the uncertainty regarding the outcome of the Biden Administration's spending initiatives, as well as the timing of an increase in the U.S. debt ceiling—thereby contributing to the recent financial market volatility. This volatility may persist until these issues are ultimately resolved.

Despite the most recent declines, however, the overall positive financial market trends appear to be intact. The bullish sentiment among investors seems primarily related to optimism regarding the outlook for the U.S. economy and continues to be predicated upon strong monetary and fiscal policy support amid significant uncertainties regarding the extent and speed of the overall global macroeconomic recovery due to the lingering, and uneven, regional and international geographic impacts of the coronavirus pandemic.

As COVID-19 transitions from pandemic to endemic status, it is becoming increasingly clear regarding the path forward: vaccinated people will access boosters whenever immunity wanes, and they (and businesses) will take other precautions necessary to protect themselves so as to resume normal activities—whereas the unvaccinated will continue to risk their health. In our view, competent business owners and the vaccinated majority will increasingly have little tolerance or empathy for the societal disruptions caused by the unvaccinated minority. As a result, we believe that these set of circumstances will enable the global macroeconomy to continue to move forward, exceeding its pre-pandemic trend as the negative impact of the coronavirus, on the margin, continues to wane.

Predictably, some of the factors providing underlying support to the U.S. economy have also had the unintended consequence of creating speculative excesses in specific areas of the financial markets. Recent examples include trading activity in near-bankrupt companies, microcaps, penny stocks, cryptocurrencies, non-fungible tokens (NFTs), special purpose acquisition companies (SPACs), and thematic ETFs, among other financial instruments. Liquidity effects, excessive leverage, and momentum "investing" have combined with high-frequency trading, algorithms, the pervasive use of ETFs, and a variety of social media-driven commission-free retail trading platforms to exacerbate this trend. In addition, economic sectors with generally-suspect long-term business fundamentals (e.g., Energy, Materials, and Financials) have traded significantly higher based upon an unwinding (via higher yields) of the extraordinary bond market rally of mid-2020, projections of substantive and sustained inflation, and expectations regarding a renewed commodity supercycle.

The ultimate unwinding of these speculative excesses and rotational sector moves may result in increased volatility and, potentially, a near-term market correction. We do not believe, however, that these factors represent a systemic risk to the overall financial markets. In addition, we believe that the risk associated with any resultant financial market volatility is mitigated in *Windward* portfolios—especially over the long run—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.

Historically, periods of excessive ex-ante savings, combined with demand that is too weak to justify investment, cause certain areas of the financial markets to become driven by the speculative rearranging of portfolios rather than by the underlying business fundamentals (like return on capital investment). We are not "traders;" we are investors. As such, it is irrelevant to us whether or not "the market" agrees with us over the short term. For speculators, on the other hand, daily market affirmation remains essential.

As discussed in detail in our *Windward Capital 2020 Fourth Quarter* and *2021 First Quarter Review*s, we do not subscribe to the current assumptions being made by financial market participants regarding the outlook for inflation or a commodity supercycle. As a result, 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 speculative financial market trading. We believe, however, that we will continue to be successful in making profitable long-term investments for *Windward*'s portfolio strategies.

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.

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. 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.

Not Smooth

Eighteen months have passed since the U.S. economy faced the full force of the coronavirus pandemic. This shock led to an immediate and unprecedented decline as large parts of the economy were shuttered to contain the spread of the disease.

Unprecedented fiscal and monetary policy support has fueled a vigorous, but uneven, recovery—one that is, in many respects, historically anomalous. In a reversal of typical patterns experienced during a downturn, aggregate personal income *rose* rather than fell, and households massively shifted their spending from services to manufactured goods while *increasing* their personal savings to record levels. Pent-up demand and the strength and speed of the reopening have led to shortages and bottlenecks, leaving the COVID-constrained supply side unable to keep up. The result has been a near-term rise in prices.

The unevenness of the recovery is further demonstrated by the sectoral shift of spending into goods—particularly durable goods, such as appliances, furniture, and cars—and away from services—particularly in-person services in areas such as travel and leisure. Even today, with overall GDP and consumption spending more than fully recovered, services spending remains about –7% below its pre-pandemic trend. Total employment is now 5 million below its February 2020 level, and 4.4 million of that shortfall is in the still-depressed service sector. In contrast, spending on durable goods has boomed since the start of the recovery and is now running about +20% above the pre-pandemic level. With near-term demand outstripping pandemic-afflicted supply, rising durables prices are a principal factor lifting inflation well above the U.S. Federal Reserve's (Fed's) average inflation target of +2%. We believe that, in a free enterprise profit incentive-driven market economy, these price pressures should continue to moderate over time as supply eventually catches up to demand.

The pandemic recession was the briefest, yet deepest, on record. The decline in total U.S. Real Gross Domestic Product (GDP) in the Second Quarter of 2020 from its previous peak was *triple* the full decline experienced during the Great Recession of 2007–2009. However, the pace of the recovery has exceeded expectations, with U.S. Real GDP now achieving record highs after only four Quarters—less than half the time required following the Great Recession. We expect this trend to continue—albeit at an increasingly moderate pace.

In terms of employment, the pandemic recession displaced roughly 30 million U.S. workers in the space of two months. As is typically the case, the recovery in employment has lagged the recovery in output; nonetheless, employment gains have also come faster than expected. The economic downturn has not fallen equally on all Americans, however, and those least able to bear the burden have been the hardest hit. In particular, despite progress, joblessness continues to fall disproportionately on lower-wage workers in the service sector and on minority ethnic groups.

The outlook for the labor market has brightened considerably in recent months. Despite recent volatility in the monthly employment reports, the pace of total hiring is faster than at any time in the recorded data before the pandemic. The levels of job openings and quits are at record highs, though, and employers report that they cannot fill jobs fast enough to meet returning demand. These favorable conditions for job seekers should eventually help the U.S. economy cover the considerable remaining ground to reach maximum employment. Although the unemployment rate has declined to 4.8%, a post-pandemic low, it is still much too high compared to the pre-pandemic level—especially considering that the reported rate *understates* the amount of total labor market slack in the economy. Long-term unemployment

remains elevated, and the recovery in labor force participation has lagged well behind the rest of the labor market compared to previous recoveries.

However, with vaccinations rising, schools reopening, and enhanced unemployment benefits ending, some factors that may be holding back job seekers are likely fading. While the Delta variant of the coronavirus created a significant recent risk, the marginal impact of this variant now appears to be waning, and the prospects are good for continued progress toward maximum employment and continued economic growth.

Bark Worse Than Bite

The combination of extraordinary fiscal support and the prospect of households unleashing substantial pent-up demand have highlighted the possibility of increased inflationary dynamics as a potential market risk. In the U.S., consumer demand is strong, vaccine coverage is expanding, and pandemic-affected sectors are reopening. As with the ebbs and flows of the onset of the pandemic shutdown, the scale of the economic reopening is similarly unprecedented—and it is generating near-term supply/demand mismatches in a variety of economic sectors. Separating signal from noise in the high-frequency economic data is therefore challenging: the supply/demand mismatches are making it difficult to precisely assess inflationary developments and the amount of resource slack from month-to-month.

Given year-over-year base effects, pent-up demand, and short-term supply chain disruption, at this juncture it seems more likely that the U.S. economy could experience a transitory inflation "scare" rather than a sustained period of "real" inflation.

The rapid post-pandemic reopening of the U.S. economy has brought a sharp run-up in price pressures. Over the 12 months through August, measures of headline and core personal consumption expenditures inflation have run at annualized rates of +4.2% and +3.6%, respectively. Businesses and consumers widely report upward pressure on prices and wages. Although inflation at these levels—if sustained—would be a cause for concern, in our view a number of factors continue to suggest that these elevated readings are likely to prove temporary. This assessment is a critical and ongoing one, and we are carefully monitoring incoming data for any change to our forecast in this regard.

As we have discussed in the past, because the dynamics of inflation are complex, we assess the inflation outlook by analyzing a variety of metrics. Some of the results of these analyses currently include:

Absence of broad-based inflation pressures

The recent spike in inflation is, so far, largely the product of a relatively narrow group of goods and services that have been directly affected by the pandemic and the reopening of the economy (e.g., durable goods, energy, semiconductors, hotel rooms, airline tickets). A range of measures meant to capture whether price increases for particular items are spilling over into broad-based inflation—including "trimmed mean" measures and measures excluding durables and computed from just before the pandemic—generally show inflation remains at or close to the Fed's +2% longer-run objective. We would be concerned at signs that inflationary pressures were spreading at higher levels more broadly throughout the economy.

Moderating growth in prices of recent higher-inflation items

We directly monitor the prices of particular goods and services most affected by the pandemic and the reopening, and are beginning to see a moderation of some of these as shortages ease. This dynamic of upward inflation pressure dissipating and reversing seems likely to play out particularly in durable goods because of historical precedent: over the 25 years preceding the pandemic, durables prices actually *declined*, with *de*flation averaging –1.9% per year. As supply problems begin to resolve, inflation in durable goods should, therefore, slow and start to fall. As a result, it seems unlikely that durables inflation will continue to contribute meaningfully to overall infla-

tion, over time. Similarly, the recent run-up in the highly-volatile commodities sector remains unsustainable over the long term, in our view, unless it is accompanied by a fundamental underlying secular change (such as a renewed commodity supercycle)—a prospect which we deem unlikely given that the second derivative of a primary economic driver of such a dynamic (i.e., Chinese infrastructure demand) remains negative. In addition, there is no greater historical supply/demand truism in the commodity markets than "the cure for high prices is high prices." While it may take time for these market dynamics to unfold, we continue to look for evidence that supports or undercuts these expectations.

Moderate broad-based wage increases

Wage increases are essential to support a rising standard of living and are, generally, a welcome development. But if wage increases were to move materially and persistently above the levels of productivity gains and inflation, businesses would likely pass those increases on to customers, a process that could become the sort of "wage–price spiral" seen at times in the past. Currently, we see little evidence of wage increases that might threaten excessive inflation. Broad-based measures of overall wages that adjust for compositional changes in the labor force, such as the Employment Cost Index and the Atlanta Fed's Wage Growth Tracker, show wages moving up at a pace that appears consistent with more moderate longer-term inflation. Remember, in the U.S., unemployment ran below 4% for approximately two years before the pandemic, while inflation ran at or below +2%. Although wages did move up across the income spectrum during that time, it was not enough to lift overall price inflation consistently to +2%. Given current volatile employment dynamics, however, we continue to monitor these data carefully.

Anchored longer-term inflation expectations

Monetary policymakers generally believe that, as long as longer-term inflation expectations remain "anchored," policy can and should look through temporary swings in inflation. The Fed's monetary policy framework emphasizes that anchoring longer-term inflation expectations at +2% is important for both maximum employment and price stability. We carefully monitor a wide range of indicators of longer-term inflation expectations (including both the 5-year and 10-year breakeven inflation rates). Currently, these measures are at levels broadly consistent with the Fed's +2% objective. Longer-term inflation expectations have moved much less than actual inflation or near-term expectations, suggesting that households, businesses, and financial market participants also believe that current high inflation readings are likely to prove transitory.

Global disinflationary forces remain intact

As we have discussed numerous times in the past, it is important to remember that, since the 1990s, inflation in many advanced economies has run consistently below +2%—even during periods of sustained economic growth. This pattern of low inflation likely reflects sustained disinflationary forces, including technology, globalization, and demographic factors, as well as a stronger and more successful commitment by central banks to maintain price stability. With regard to global inflation dynamics, from a long-term investment perspective, the most important development is the secular deflationary trend that we have discussed in detail over the past several years. Namely, from a global macroeconomic perspective, there remains a surfeit of supply and dearth of demand which is serving as an overall constraint on any secular inflationary dynamic. While underlying global disinflationary factors are likely to evolve over time, there is little reason to believe that they have suddenly reversed or abated because of the pandemic. Indeed, we believe that the same structural forces that have driven this dynamic over recent decades (e.g., the global savings glut, demographic aging, etc.) should continue after the pandemic wanes.

Although continued vigilance is warranted, in our view the inflation and employment data thus far appear to reflect a temporary misalignment of supply and demand that should fade over time as the demand surge normalizes, reopening is completed, and

supply adapts to the post-pandemic environment. It remains uncertain, however, how long it will take for this realignment to occur.

"Tapering is Not Tightening"

Central banks have always faced the problem of distinguishing transitory inflation spikes from those that are more secular and pernicious, and it is sometimes difficult to do so with confidence in real time. At such moments, there is no substitute for a careful focus on incoming data and evolving risks. If sustained higher inflation were to become a serious concern, we believe that the Federal Open Market Committee (FOMC) would certainly respond and use their tools to assure that inflation maintains levels that are consistent with their average inflation targeting goal.

The period from 1950 through the early 1980s provides two important lessons for managing the monetary policy risks and uncertainties that the Fed currently faces. The early days of stabilization policy in the 1950s taught monetary policymakers not to attempt to offset what are likely to be temporary fluctuations in inflation. Indeed, responding may do more harm than good—particularly in an era where policy rates are much closer to the zero lower bound (i.e., 0%) even in good times. The main impact of monetary policy on inflation can come after a lag of a year or more. If a central bank tightens policy in response to factors that turn out to be temporary, the main policy effects are likely to arrive after the need has passed. An ill-timed policy move unnecessarily slows hiring and other economic activity and pushes inflation lower than desired. Today, with substantial slack remaining in the U.S. labor market, fiscal policy support waning, and the pandemic continuing its transition to endemic status, such a mistake could be particularly harmful. Extended periods of unemployment can impose lasting harm to workers and to the productive capacity of the economy.

History also teaches, however, that central banks cannot take for granted that inflation due to transitory factors will fade. The 1970s, for example, witnessed two periods in which there were large increases in energy and food prices, raising headline inflation for a time. But when the direct effects on headline inflation eased, core inflation still continued to run persistently higher than before. One likely contributing factor was that the public had come to generally *expect* higher inflation—a reason why it is important to monitor inflation expectations so carefully.

As you may recall, the Fed previously indicated that it would continue its pandemic-related $120 billion in monthly asset purchases at that pace until it saw substantial further progress toward its maximum employment and price stability goals. As we predicted, at the Fed's August 27 Jackson Hole symposium, Fed Chairman Jerome Powell indicated that the "substantial further progress" test had been met for inflation and that there has also been clear progress toward maximum employment. Subsequently, at its September 22 meeting, the FOMC signaled its intention to slow the pace of their asset purchases while splitting its decision on whether to begin raising the short-term Federal Funds interest rate late next year or in early 2023. The Fed has not yet announced any details regarding the scope of its tapering of bond purchases, so its magnitude and duration remain uncertain. As always, however, all future Fed actions remain data dependent and, therefore, subject to change.

As we have discussed with you over the years, the last decade has challenged the Fed's operating framework with issues such as: a falling natural rate of inflation, policy rates near the zero lower bound, a weakened relationship between unemployment and inflation, questionable estimates of the natural rate of unemployment, and a heightened awareness of the cost of unemployment. Remember, excess savings relative to intended investment has driven the global equilibrium rate of interest (the real rate of return required to keep the economy's output equal to potential output) well below zero. In response, global monetary policymakers responded appropriately by maintaining nominal short-term interest rates near the zero lower bound for an extended period. At the moment, we do not foresee any material change in this dynamic. In our view, the Fed's decision to initially focus on tapering its asset purchases (rather than raising short-

term interest rates) is a bullish sign of confidence in the U.S. economy—despite the risks surrounding the evolving pandemic, the direction of future fiscal policy measures, the looming showdown over raising the nation's debt ceiling, and the recent financial challenges in China (see discussion below).

Unbalanced

Policymakers in Beijing are in a tough position on what to do about *Evergrande*, the Chinese property developer whose slow collapse has transfixed the financial markets. *Evergrande* is China's second-largest property developer, with an estimated $355 billion of assets across 1,300 developments. It has around 200,000 employees, and usually hires 3-4 million laborers a year for construction work. It is also the most-indebted property developer in the world, with on-balance sheet liabilities equivalent to nearly 2% of China's annual GDP, and off-balance sheet obligations equal to another 1%. Among its liabilities are $37 billion in bills and trade payables owed to suppliers and contractors, and an estimated $6 billion in high-yielding wealth management products, which it has sold to more than 80,000 retail investors.

For the past several years, Chinese regulators have worked hard—if unsuccessfully—to reduce the economy's overreliance on debt. As part of this regulatory push, regulators last year implemented what became known as the "three red lines" for property developers. These consist of hard limits on a company's debt-to-asset ratio, its debt-to-equity ratio, and its cash-to-short-term debt ratio.

The three red lines almost immediately began to affect the operations of highly-indebted developers. Because they were no longer able to borrow, and in many cases were forced to pay down debt, they had to liquidate assets, often in fire-sale conditions, and were sometimes forced to cut back on their operations. The resulting losses often only worsened their reported debt ratios and put further pressure on them to cut back. Although *Evergrande* is the most visible of these large property developers, and perhaps suffers from greater financial distress than any other, the impact of the three red lines on Chinese property developers has not been limited to *Evergrande*: of the country's 15 biggest developers, only one is fully compliant with the new rules.

It is easy to understand why policymakers have been so worried about real estate debt—and debt in general. China's official debt-to-GDP ratio has soared by nearly 45 percentage points in the past five years, leaving it with among the highest debt ratios for any developing country in history. The property sector is notorious for its addiction to debt. This addiction has expressed itself not just in borrowing from banks and bond markets but in a variety of other ways. Property developers regularly presold apartments to homebuyers many months or even years in advance, for which they received the full price or at least a substantial deposit. They paid off contractors and suppliers with commercial paper and receivables instead of cash. Their financing arms even sold credit products known as "wealth management products" to retail investors—mainly, it seems, to employees of the borrowing companies, their banks, and their suppliers.

All this borrowing has enabled the property sector to become one of the main engines of economic activity for the Chinese economy, accounting for as much as 25% of the country's GDP (considerably higher than is typical in other countries). But this borrowing spree has also helped stoke a substantial real estate bubble in a country in which housing prices are several times higher, relative to household income, than they are in the United States or other major economies. Perhaps worse, the property bubble has resulted in a lot of empty homes and apartments—between one-fifth and one-quarter of the total housing stock, especially in more desirable cities—owned by speculative buyers who have no interest in either moving in or renting out. Empty housing creates no economic value, even as it incurs a significant economic cost.

Chinese regulators have decided to have a showdown with creditors over *Evergrande*. By convincing lenders that they will no longer stand behind large Chinese borrowers, they are trying to transform the country's financial system by making Chinese lenders more reluctant to fund nonproductive investment projects.

These projects generate what Chinese leader Xi Jinping, in an important recent essay for *Qiushi* (the leading official theoretical journal of the Chinese Communist Party [CCP]) disparaged as "fictional growth," in contrast to the "genuine growth" he called for.

Regulators are right to worry about the important role moral hazard plays in generating overall leverage within the Chinese economy, but it is not an easy problem to resolve. If they intervene to support creditors, they will reinforce moral hazard and lose credibility. If they do not, and effectively force the borrower and its creditors to work out their disputes using just *Evergrande*'s internal resources, there are at least three important subsequent problems the regulators would face. These include roiled credit markets, widespread financial distress, and the role of debt in propping up China's nominal GDP growth.

Of these three, the role of debt in Chinese GDP growth is probably the most fundamental problem of all. As we have explained for many years, China's ability to achieve politically-determined GDP growth targets requires moral hazard, and the country's financial regulators cannot eliminate moral hazard until Beijing scraps the growth target and allows growth to fall to whatever underlying rate the economy can accommodate.

This is because what Xi referred to in his *Qiushi* essay as "genuine growth" cannot generate enough economic activity to allow China to hit its GDP growth targets. This high-quality growth consists mainly of consumption (driven by increases in household income rather than rising household debt), exports, and business investment. By our estimates, high-quality growth has probably accounted for barely half of China's reported GDP growth rate in recent years. Until Beijing learns to accept much lower—but healthier—GDP growth rates, it will not be able to stabilize the country's growth in debt.

Policymakers have discussed the urgent need to rebalance the economy from investment- to consumer-driven at least since 2006-2007, after which they have made various attempts to resolve China's economic imbalances by controlling the rise in debt, by structural supply-side reform, by insisting that "homes are for living, not speculation," by focusing on dual circulation, and, most recently, through a revival of the decades-old "Common Prosperity" ideology—all within the context of renewed nationalistic fervor. Indeed, the most recent manifestation of these efforts has revealed the progressively ambitious authoritarian nature of the CCP regime as it continues to promulgate strategic, geographic, and competitive hegemony. Despite these measures, however, Chinese demand remains as unbalanced as ever, debt and malinvestment continue to surge, and (at least until now) home buying is still driven primarily by speculation. In our view, this will remain the case until the vested interests of the Chinese oligarchy are willing to confront the reality of what a true rebalancing would entail: a transfer of power.

While income inequality *within* the household sector is the primary distortion in income distribution in countries like the U.S. and Europe, where households retain 70-80% of GDP, this is not the case in China, where households retain only 55% of GDP. The primary distortion in income distribution in China is the disproportionate share of China's GDP that the government retains. As we have discussed in detail several times in the past, the logical alternative to the Chinese economic growth model requires a substantial transfer of income—and power—from local governments and vested interests to households. We continue to argue that, until Beijing recognizes that this is the transfer that matters, they do not really have a coherent alternative towards which they should be directing the economy.

We continue to monitor both the resolution of the *Evergrande* situation, in particular, and the ongoing efforts to rebalance the Chinese economy, in general, as they evolve over time.

Carry On

As detailed in our *2020 First Quarter Review*, on an overall basis, our investment strategy during the pandemic crisis remained consistent with the investment strategy that we have followed in the past—

essentially: to invest in high-quality businesses at the right valuations and hold them for as long as they remain high-quality businesses. In fact, the competitive strengths of these businesses, in many cases, *increased* as a result of the pandemic as lower-quality businesses failed to survive. As a result, this dynamic drove the valuations of companies held in *Windward*'s portfolios dramatically higher than previously seen.

Similarly, crises usually accelerate real, pre-existing trends in society and technology—they do not create or destroy them. Subject to constraints, therefore, we believe that there is a deep underlying propensity for human habits to persist over time, and that, human nature being what it is, individuals will have a strong inclination to return to their former way of life as soon as reasonably practicable. As a result, we did not make changes in *Windward*'s strategies to invest in those companies that were deriving benefits from near-term coronavirus trends (e.g., telecommuting, media streaming, etc.) because we believed that those trends would not persist. In addition, we did not invest in any speculative Healthcare companies involved in the discovery of a therapeutic or vaccine because we believed that the benefit to be derived from this discovery would primarily accrue to the existing businesses held in *Windward*'s portfolios. In other words, we continue to believe that the long-term secular investment themes that we have previously identified remain intact.

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

Information Technology regulation, Healthcare reform, Infrastructure investment, 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

Our goal, as always, is to identify those companies and invest in them for your *Windward* portfolio. Our risk averse approach to managing your investments causes us to take a more measured and unemotional view of extremes in bullish or bearish sentiment and find ways to outperform the market with less volatility by focusing on specific companies' fundamentals. Our results over the course of various market cycles demonstrate our success.

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, speculators, 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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U.S. White House
World Health Organization

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 website.

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 at 8:00 pm 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 or Form CRS 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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