WINDWARD CAPITAL

Risk Averse Asset Management

2023 First Quarter Review

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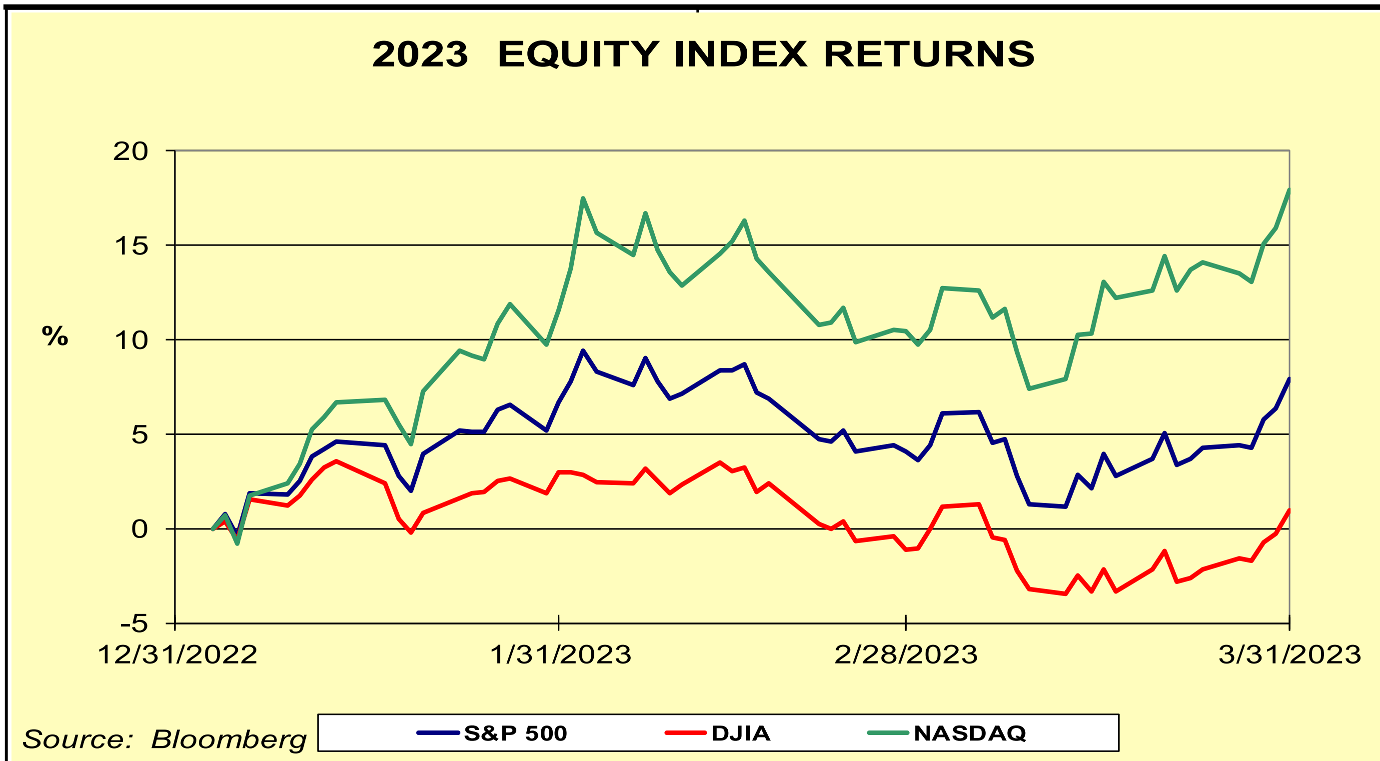

Tricksy Markets

"The essence of strategy is choosing what *not* to do."

— Michael Porter (b. 1947)
American Economist and Business
Management Strategist

After posting annual declines in 2022, the major U.S. equity market indices continued their positive Fourth Quarter 2022 momentum into the First Quarter of 2023, with the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) returning +7.48%, +0.93%, and +17.05%, respectively, for the period.

After posting three successive years of positive returns from 2019 through 2021—which culminated in a cumulative total range of returns of +66% to +142% during the period—the major U.S. equity market indices corrected in 2022. Despite last year's declines, however, as of March 31, 2023, the major U.S. equity market indices are still anywhere from +56% to +91% higher than December 31, 2018, from +83% to +93% above their 2020 coronavirus pandemic lows, and from +21% to +28% above their pre-pandemic highs, demonstrating significant resilience given the historic—and unprecedented—global events of the last few years.

Among other things, the current ongoing financial market volatility appears to be related to significant uncertainty regarding the impacts of tighter monetary policy, inflation, and geopolitical conflict on the global macroeconomy and the resultant effect that these issues could have on the corporate revenue and earnings outlook. Although the extent and duration of these impacts remain unknowable, based upon recent economic data it seems that at least some of these issues may either be in the process of moderating or have peaked. Until there is greater clarity regarding the ultimate resolution of these uncertainties, however, we believe that the current inter-, and intra-, day financial market volatility may persist. It is important to remember, though, that financial markets usually discount any positive (or, conversely, negative) outcomes before they actually occur.

Fortunately, despite expectations for a near-term tightening of financial conditions and concomitant slowdown in growth, the U.S. economy remains in a relatively strong position and continues to be supported by factors that we have discussed in the past, which include: employment-driven increases in household income, substantial net worth of the household sector, and a high level of savings accumulated during the course of the pandemic.

Predictably, some of the factors providing underlying support to the U.S. economy over the last few years 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 in and out of favor 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.

As we have noted in the past, 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.

Although 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 that we will continue to be successful in making profitable long-term investments for *Windward*'s portfolio strategies. In our view, one of the best ways to accumulate wealth over the long term continues to be by investing in high quality businesses—especially during periods of financial market volatility when investors can take advantage of valuation discounts to purchase such businesses "on sale."

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.

Rockets and Feathers

Several recent economic and industry-specific indicators suggest that U.S. inflation may have peaked in the near term as a result of tighter financial conditions, ongoing progress in matching supply/demand imbalances, a moderation in economic growth, and demand destruction, among other factors:

- ✓ Declining global freight rates (as well as other measures, such as excess retail industry inventories) indicate that global supply chain disruptions continue to resolve. The Federal Reserve Bank of New York's Global Supply Chain Pressure Index—which is based upon global transportation cost, delivery time, backlog, and purchased stocks data—has recently turned *negative* and is now at its lowest reading since August 2019, indicating that global supply chain conditions have largely normalized.

- ✓ Although crude oil prices have recently bounced somewhat, they are still down –20% from last year's peak, and many other commodities (e.g., natural gas, copper, aluminum, lumber, cotton, wheat, etc.) still remain approximately –15% to –80% off of their previous Spring/Summer 2022 highs (with several now trading at 2021 levels).

- ✓ Higher mortgage rates have slowed U.S. home price growth and eased housing industry supply chain shortages/imbalances. Over time, this should contribute to lower Owners' Equivalent Rent (OER), which is a significant component of certain inflation statistics.

- ✓ Despite ongoing strength in U.S. employment, Nominal Average Hourly Earnings growth has moderated on a year-over-year basis, and the rate of change in 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 no indication of a "wage-price spiral."

Although many components of inflation appear to have peaked, overall inflation remains well above the U.S. Federal Reserve's (Fed's) +2% longer-run goal: over the 12 months ending in February 2023, total Personal Consumption Expenditures (PCE) prices rose +5.0% (down from the June 2022 peak of +6.8%); excluding the volatile food and energy categories, core PCE prices rose +4.6% over the same period (down from the February 2022 peak of +5.4%). Price pressures remain evident across a broad range of goods and services. Importantly, however, the trend rate of price growth is no longer accelerating but is, in fact, *moderating*.

Despite elevated levels of current inflation, longer-term inflation expectations appear to remain well anchored, as reflected in a broad range of surveys of households, businesses, and forecasters, as well as measures from financial markets. This indicates an expectation that the Fed will be successful in its efforts to ultimately control inflation.

In November 2022, Fed Chairman Jerome Powell discussed how the Fed monitors inflation by breaking core inflation into three component categories: (1) core Goods inflation, (2) Housing Services inflation (which measures the rise in the price of all rents and the rise in the rental-equivalent cost of owner-occupied housing, or OER), and (3) inflation in core Services other than Housing (the so-called "supercore" inflation).

- ✓ *Goods*
  Core Goods inflation has moved down from very high levels over the course of 2022 and into 2023 as supply chain disruptions and other related supply/demand imbalances have mostly been resolved, post pandemic. If current trends continue, goods prices should begin to exert downward pressure on overall inflation in coming months, in our opinion.

- ✓ *Housing Services*
  While Housing Services inflation has risen rapidly, this type of inflation tends to lag other prices around inflation turning points because of the slow rate at which the stock of rental leases turns over. The market rate on *new* leases is therefore a more timely predictor of the direction of overall Housing inflation over the next year or so. Because measures of 12-month inflation in new leases rose significantly during the pandemic but have been falling sharply since about mid-2022, we would expect Housing Services inflation to begin falling sometime during 2023.

- ✓ *Services ex Housing*
  As the largest of the three categories (constituting more than half of the core PCE index), this may be the most important category for understanding the future evolution of core inflation. This is a large spending category that covers a wide range of services—from health care and education to activities as varied as travel and recreation, legal services, and hospitality. Because wages make up the largest cost in delivering these services, the labor market holds the key to understanding inflation in this category.

Over the coming months, the Fed will continue to be dependent upon the incoming data and the evolving outlook for the U.S. economy as it looks beyond the recent peak in inflation for compelling evidence that inflation is moving *down* toward their +2% longer-run goal.

Based upon our analysis, we believe that the Fed is near the end of this monetary tightening cycle. The Fed, though, through its rhetoric and policy moves, has indicated that it remains committed to holding rates at a restrictive level for an extended period of time to create sustained downward pressure on the labor market, in particular. And the guidance in their Summary of Economic Projections with regard to the unemployment rate and real GDP growth in 2023 and 2024 look very much like they are forecasting a recession as a result. If the current disinflationary trends that we are seeing in the recent economic data persist, the Fed's hawkish reaction function (i.e., commitment to driving the unemployment rate higher than necessary) may become less defensible and could become the key monetary policy concern of 2023.

We continue to monitor the economic data on an ongoing basis.

Higher for Longer?

As you know, the relatively rapid increase in monetary policy tightening witnessed during 2022 was in response to the emergence of global inflation.

As you will also recall, in response to sustained inflationary pressures and a strong labor market subsequent to the coronavirus pandemic, the Federal Open Market Committee (FOMC) of the Fed initiated the current monetary policy tightening cycle by raising the target range for the Federal Funds (Fed Funds) rate off of the zero lower bound to 0.25-0.50% at its March 2022 meeting. In addition, with regard to the Fed's balance sheet, the FOMC ceased net asset purchases in early March 2022 and subsequently began reducing its holdings of U.S. Treasury securities and agency debt and agency mortgage-backed securities in June, which has also served to tighten financial conditions.

Because of the ongoing persistence of inflation, the Fed continued this monetary policy tightening throughout 2022. In 2023, the Fed raised the short-term Fed Funds interest rate by an additional +25 basis points at both its February 01 and its March 22 meetings, to a current range of 4.75-5.00%. FOMC participants are now projecting a range of 5.1-5.6%

for the Fed Funds rate during 2023—the highest rate since the 2008 Financial Crisis.

As we have noted in the past, it is important to remember that monetary policy works with long and variable lags. At some point, therefore, it will be appropriate for global central banks to slow the pace of monetary tightening and assess how their cumulative policy adjustments are affecting their economies and inflation.

Unfortunately, central banks have moved so rapidly that, as they put these rate hikes in place, there really has not been enough time for them to judge what the feedback effects are on the global macroeconomy, and an increasing number of economists think that monetary policymakers have been excessive in their actions to raise interest rates and that the effect of all of this tightening will be a global recession.

Indeed, based upon real-time forward, rather than lagging, indicators, some economists believe that the Fed, in particular, has already over-tightened. For example, certain economists (e.g., monetarists) monitor current changes in the global money supply because they believe that such changes affect the price levels of securities, inflation, exchange rates, and the business cycle. Under the monetarist approach, the fact that several "narrow" and "broad" money supply indicators have been contracting for many months suggests that inflation risks are already fading fast and that further monetary policy tightening is unnecessary.

Certainly, a primary consideration for monetary policymakers is judging how responsive economic activity is to the rising level of interest rates. This responsiveness is likely to be dynamic, changing over time and with the state of the economy. In addition to domestic matters, the interplay of global macroeconomic and geopolitical factors must also be noted. Despite these uncertainties, we would not underestimate the Fed's commitment to restoring price stability.

Although we believe that we are near the end of the current monetary tightening cycle, it remains uncertain how long these current higher interest rates will remain in effect given the persistence of certain components of inflation. As a result, restoring price stability could require maintaining a restrictive monetary policy stance for some time because the historical record cautions strongly against prematurely loosening policy. This could increase the risk of an economic recession. Although reducing inflation is likely to require a sustained period of below-trend economic growth and softening of labor market conditions, restoring price stability is essential to set the stage for achieving maximum employment and stable prices over the longer run.

In addition to the risk of an economic recession, monetary tightening cycles also have other ramifications, including an increase in financial instability.

Moving Fast and Breaking Things

The rapid pace of global monetary policy tightening over the course of the last 12 months made it highly likely that there would be a commensurate increase in the risk of financial dislocations.

In the event, several financial institutions experienced distress during early- to mid-March 2023 due to a confluence of disparate factors, including mismanagement, loss of investor/depositor confidence, liquidity issues, internal control weaknesses, and specious business models, to name a few. These underlying issues were exposed—in some cases, indirectly—by the recent rise in interest rates.

Some of the entities involved include:

- ✓ *SVB Financial*
  Silicon Valley Bank failed because of a lack of risk management (an investment asset/depositor liability mismatch) that was revealed during a classic bank run initiated by social media and exacerbated by the lack of friction in moving large sums of money in the digital age.

- ✓ *Signature Bank* and *Silvergate Capital*
  The failure of these financial institutions was precipitated by a fall in cryptocurrency (crypto) pric-

es and the subsequent collapse of several crypto exchanges (such as FTX) and fraudulent crypto schemes in late 2022. Concerns regarding the credit exposure of these Firms from leveraged crypto derivatives resulted in a loss of confidence that ultimately doomed these institutions.

- ✓ *Credit Suisse Group*
  A series of decades-long scandals (most of them emanating from its executive suite and its unscrupulous investment banking unit), years of operating losses totaling billions of Swiss Francs, and an uninspired multi-year strategic review and delayed restructuring were all factors that eroded the Credit Suisse brand over time. A key investor's vote of "no confidence" for a capital raise after clients had pulled 110 billion Swiss Francs ($119 billion) of funds in the Fourth Quarter of 2022 ultimately sealed the Firm's fate. Credit Suisse was subsequently merged into its Swiss rival, UBS.

- ✓ *U.S. Regional Banks*, *Commercial Real Estate* (CRE), *Private Equity*, *Venture Capital/Startups*
  All of these entities have varying degrees of risk exposure related to any increase in their cost of capital, a persistently higher interest rate environment, and/or liquidity issues. For example, CRE loans account for a significant portion of smaller banks' loan portfolios and certain Private Equity investment trusts. Certain areas of commercial real estate are in distress due to higher interest rates and the pandemic shift to working remotely. As a result, the value of some of these loans is impaired, and this impairment could worsen during an economic downturn—which may ultimately result in significant writedowns. With regard to Private Equity, since these firms generally do not have to mark their assets to market, they may be able to delay realizing any losses on devalued assets in the near term in the hope that those assets will reflate some time in the future. If the value of these assets continue to fall, however—and/or if there are substantial redemption requests—these losses may have to be realized earlier than expected. Venture Capital (VC) firms are already taking longer to complete deals and are increasing their focus on due diligence of Startups. VCs are now prioritizing the profitability of their existing investments over making new ones. A sustained period of higher interest rates could also change the calculus of institutional investors on which VC firms rely for their capital, influencing the types of firms that they back. Startups will have to start taking money on less attractive terms; in many cases, this will mean accepting lower valuations than they received in previous fundraising rounds.

As a result of these dislocations, several companies in the Financials sector experienced a dramatic equity sell-off as investors rotated into the equities of higher-quality businesses (primarily in the Information Technology sector) and depositors sought safety in U.S. Treasuries or higher yield in money market funds. (Note: *Windward* had no investments in the above-mentioned financial institutions and, based upon our fundamental analysis of this sector, has been underweight Financials relative to the major U.S. equity market indices for several years.)

To restore calm, the Federal Deposit Insurance Corporation (FDIC), U.S. Treasury, and the Fed stepped in to guarantee all deposits at the affected banking institutions (not just those below the FDIC cap), created a new lending facility (the *Bank Term Funding Program*), and enhanced the existing discount window. These measures are designed to address any liquidity concerns/issues by stepping in as lenders of last resort—thereby, most importantly, restoring confidence in the financial system.

Notwithstanding any company-specific issues, in our opinion the current situation does not pose a systemic risk to the overall U.S. banking system, which remains sound and has strong capital and liquidity positions. The global financial system also remains resilient due to the significant reforms that nations took after the 2008 Financial Crisis.

Indeed, there are several key characteristics of the 2008 Financial Crisis that differentiate it from the current situation:

In 2008, a variety of highly-levered institutions owned complex and opaque derivative securities backed by home mortgages that turned out to be far less valuable than claimed. At its core, then, the 2008 Financial Crisis was primarily driven by the resolution of this divergence via a series of institutions either failing or being bailed out as the true value of those securities became apparent. This created a self-reinforcing downward spiral that ultimately led to a significant correction in the financial markets and a substantial economic downturn.

Part of what made the 2008 crisis so difficult was that many losses took place in lightly-regulated or unregulated corners of the financial system. By contrast, the majority of the current problems have taken place in traditional banks, which have an entire infrastructure of deposit insurance, access to emergency Fed lending, and oversight to reassure the public as to their solvency.

In addition, the post-crisis reforms contained in the 2010 Dodd-Frank Act overhauled financial regulation extensively and made changes affecting all Federal financial regulatory agencies and almost every part of the nation's financial services industry. Unfortunately, in 2018 the U.S. Congress rolled back part of the Act, easing rules for mid-sized and regional banks. Despite this, however, the most important provisions of Dodd-Frank remain intact. For example, regulators now have more authority to resolve even a large failed bank, which should enable swift, decisive action necessary to stem contagion. More importantly, capital ratio requirements are higher than they were in 2008—dramatically so at the largest institutions—giving banks a greater financial cushion.

In our view, then, the primary impact of the recent financial stability concerns will be to further tighten financial conditions via second order effects. Some of these may include higher bank lending standards and slower loan growth, stricter Private Equity investment hurdle rates and redemption limitations, more-discriminating Venture Capital funding rounds, and, ultimately, financial institution mergers/acquisitions.

As always, financial markets remain vulnerable to economic and monetary policy uncertainty and have whipsawed recently in an effort to digest both slower growth prospects globally, but also emerging financial stability concerns. While there have been some increased volatility and liquidity strains in financial markets lately, overall we believe markets are operating effectively. Actions by banks and financial regulators in recent years have greatly strengthened the financial system. Banks are well capitalized, and the functioning of the U.S. Treasury, equity, and commodity markets remains orderly.

Given the current state of the U.S. economy—with inflation near 40-year highs and the unemployment rate near record lows—moving expeditiously to a restrictive stance of monetary policy was appropriate, in our opinion. At the same time, monitoring risks and the responsiveness of economic activity to these interest rate changes is also important.

The resolution of pandemic-induced supply/demand disruptions and the lagging impact of tighter monetary policy should contribute to an easing of inflationary pressures via the resultant moderation in economic growth. In the meantime, a monetary tightening cycle is always fraught with challenges. However, the rationale for removing accommodation is obvious when inflation is high, demand is strong, and the labor market is tight. Under those conditions, an economic "soft landing" is probable but not guaranteed—and the risk of recession still exists. While an outlook of easing supply constraints and moderating demand growth is consistent with inflation stepping down even as the labor market remains strong, less favorable outcomes are certainly possible. In the event high inflation persists while demand turns down and the labor market falters, monetary policymaker resolve may be tested—but should never be doubted.

Get-Rich-Slowly Scheme

Our strategy during the current investment environment remains 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 addition, 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:

Bloomberg
Congressional Budget Office
Council of Economic Advisers
Federal Reserve Banks of Atlanta, New York, and St. Louis
International Monetary Fund
Organisation for Economic Co-operation and Development
Reuters
U.S. Bureau of Economic Analysis
U.S. Bureau of Labor Statistics
U.S. Congress
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 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.

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WINDWARD CAPITAL MANAGEMENT CO.

Risk Averse Asset Management

www.WindwardCapital.com

11111 Santa Monica Blvd, Suite 1200
Los Angeles, California 90025

(310) 893-3000
(800) WINDWARD
(800) 946-3927
(310) 893-3001 Facsimile
mail@WindwardCapital.com

Robert Nichols, PhD
CEO / Portfolio Manager

Donald R. Bessler, CPA
Chief Investment Officer / Portfolio Manager