WINDWARD CAPITAL

Risk Averse Asset Management

2011 Fourth Quarter Review

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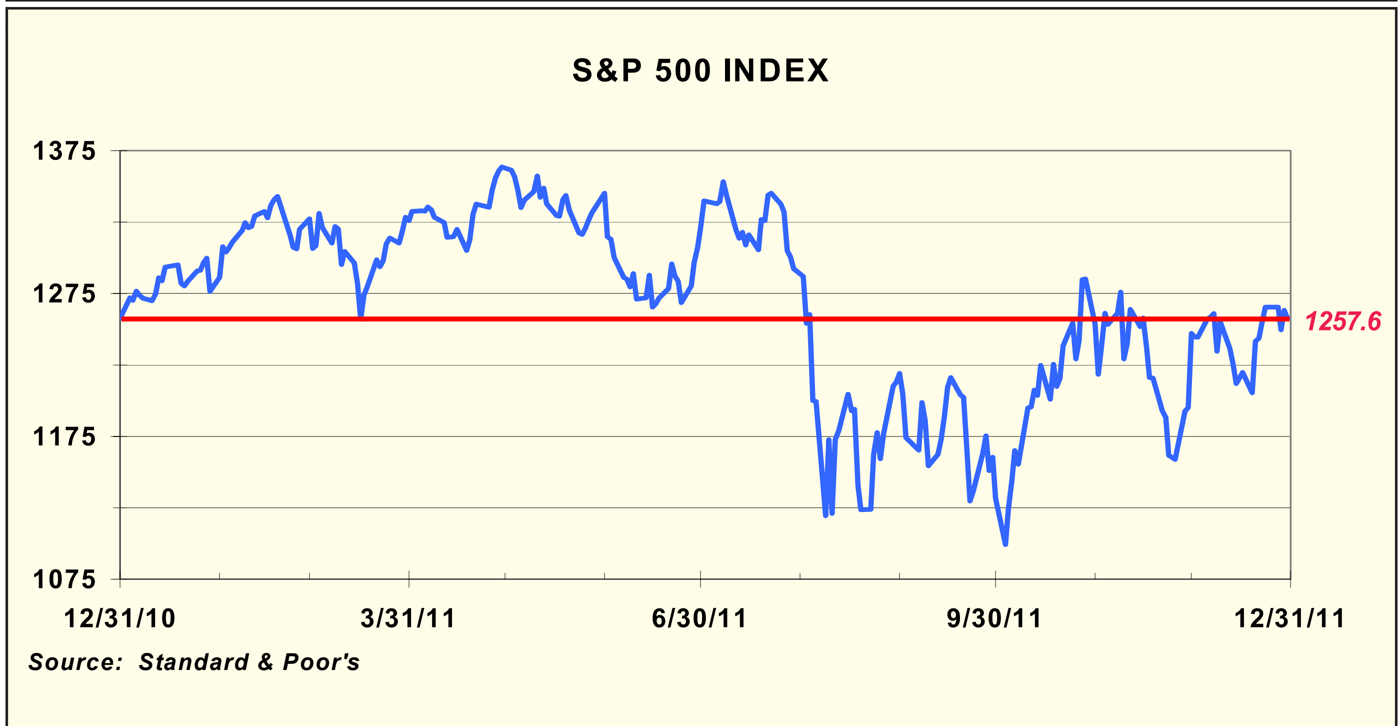

Start Over

"Complex problems have simple, easy to understand, wrong answers."

— *H. L. Mencken*
American journalist and satirist

The U.S. equity markets turned in a strong performance during the Fourth Quarter of 2011, with the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) up +11.8%, +12.8%, and +8.2%, respectively, for the period. However, returns for the full year proved mixed, with the S&P 500, DJIA, and NASDAQ returning +2.1%, +8.38%, and –0.8%, respectively, for 2011.

2011 started out strongly, and equities rose—along with optimism about the global economy—with the market peaking on April 29. Subsequently, Europe's turmoil and uncertainty about the U.S. recovery triggered a 5-month, 20+%-down, correction. The sell-off became serious, and in early August the markets experienced a selling climax. The climax was retested several times with historic degrees of inter- and intra-day volatility, and a final low was established on October 3. Since then the market has recovered robustly and broadened.

Remarkably, after having been up by as much as +9% and down as much as –14.5% from the start of the year (and down –21.6% from the April 2011 peak), the S&P 500 (excluding dividends) ended 2011 at exactly the same price as on December 31, 2010: 1257.6. A flat year for the market is a relatively rare occurrence: in the 82 years since 1928 (when S&P data was first accumulated), the S&P 500 was unchanged in only one year (1947)—and in only three of the 82 years was the annual change in the S&P 500 under 1% (1947, 1948, and 1970). Since stasis is not the norm, we expect the

market to provide more decisive direction in 2012.

As noted above, however, the market's ending the year exactly where it started belies the extreme volatility exhibited *within* the year—particularly during the Third and Fourth Quarters—as investors continued to grapple with uncertainty regarding the global macroeconomic outlook. Specifically, ongoing issues related to the fate of the European Union, doubt about the health of the Chinese economy, and these regions' potential impacts on the U.S. were of primary concern. Continued unrest in the Middle East and North Africa region, a petulant Iran, transition of power in North Korea and in Russia, and ongoing U.S. political dysfunction added negatively to the mix. The resultant equity market volatility was exacerbated by non-dedicated market participants—including high-frequency traders, algorithmic/quantitative trading strategies, and hedge funds—who accounted for an extremely high percentage of the markets' daily trading volumes. This during a period of continued equity fund outflows.

Needless to say, this was one of the most difficult periods in some time for dedicated, long-term, fundamentals-based equity investors to navigate. As a consequence, Windward's equity strategies underperformed their benchmarks for 2011. This underperformance occurred primarily during the Third and Fourth Quarters, as our stockpicking ability became irrelevant in an environment in which "risk-on/risk-off" asset allocations increased correlations dramatically, leading to extreme sector rotation, regardless of company-specific fundamentals. Of the 10 economic sectors in the S&P 500, only two of the sectors (Health Care and Consumer Staples) that were in the top five contributors to index performance (on a weighted attribution basis) during the first half of the year were also in the top five during the second half of the year. For the Russell 1000 Growth Index, the sector rotation was even worse, with only <u>*one*</u> of the economic sectors (Consumer Staples) being in the top five during both halves of 2011.

Given the nature of our low turnover, long-term investment approach, we were handicapped by a trading-oriented market environment that was focused primarily on the short-term. Within this context, it is important to remember that Windward's portfolio strategies generated substantial outperformance in 2010 and that, even after accounting for 2011's results, our longer-term track record retains its significant outperformance relative to relevant benchmarks, confirming the validity of our investment approach.

As always, over the course of a market cycle we strive to add value to Windward's client portfolios by remaining disciplined, focused, and unemotional investors. We believe that maintaining these attributes is even more critical during what has proved to be an historic and challenging investment environment. Our conviction in owning the businesses that meet our definitions of quality, growth, and value is what has ultimately allowed us to generate such an impressive long-term track record. On the margin, we have made some changes to the portfolios in order to take advantage of what we believe are very compelling investment opportunities and, given our macro/micro analyses, will continue to re-test our investment theses, as we always do, on an ongoing basis.

Although we expect financial market volatility to continue over the near term given the potential for additional headline risk and the (currently) unresolved nature of several underlying global macroeconomic issues, we believe that, at current levels, the equity markets have significantly discounted a variety of dire outcomes, and that the valuations of specific companies remain compelling. Of course, as we have discussed over the last few years, the world's economies remain subject to structural headwinds that continue to act as governors to growth. In addition, this relatively weak trajectory of growth is at risk from a variety of exogenous shocks. However, in our view, the stock market has discounted the bulk of these fears and is expecting little, if any, positive news.

With investors either materially in cash or heavily skewed toward low-yielding fixed income, any market recovery could feed on itself in an environment where individuals are uninvolved and hedge funds have multiyear low (i.e., bear-market low) net long exposure and run the risk of being caught offside. Stock "renters" and others lacking conviction have reduced their commitments to equities, as the sentiment of the most

dominant investor classes (retail, institutional pension plans, and hedge funds) has soured. The reappearance of a growing list of market Cassandras, who see the sky falling and an imminent global meltdown of monumental proportions, feeds this bearish sentiment. Low expectations and an underinvested investment community are all conditions that have historically formed the foundation for a better market setting, as bull markets typically emerge out of periods of bad news.

We believe that 2012 will be a surprisingly good year for the U.S. stock market. We anticipate that domestic economic and profit growth will surprise to the upside and are of the view that market valuations will expand (after contracting in 2011). If Europe muddles through, then the "flight to safety" trade of the last couple of years should unwind, and fixed income investments could take the brunt of the damage in a potentially large reallocation out of bonds and into equities.

Necessary, but Insufficient

Clearly, the most important market catalyst during the Fourth Quarter was the ongoing situation in the Eurozone. Actions taken by monetary policymakers and political authorities during the period were necessary first steps toward resolution of the Eurozone crisis, in our opinion. These steps included the following:

> *Global coordinated overnight lending facility*

On November 30, the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank (ECB), the Federal Reserve (Fed), and the Swiss National Bank announced coordinated actions to enhance their capacity to provide liquidity support to the global financial system. These central banks agreed to lower the pricing on existing temporary U.S. dollar liquidity swap arrangements by 50 basis points so that the new rate would be the U.S. dollar overnight index swap (OIS) rate plus 50 basis points. Under the swap line program, first launched in late 2007, the Fed lends dollars to other central banks, which in turn make the dollars available to banks under their particular jurisdiction. The action taken in late November made these emergency Fed loans less expensive. Lower rates of dollar swap lines buy time for the Eurozone to grow out of its existing debt overhang, giving banks time to raise additional capital and shore up their equity.

When the Fed originally launched these swap lines four years ago, it saw them as critical to its efforts to address the financial storm sweeping the globe during the *Lehman Brothers* crisis. Banks in Europe and elsewhere hold U.S. mortgage securities and other U.S. dollar securities. They get U.S. dollars in short-term lending markets to pay for these holdings. In 2008, when dollar loans became scarce, foreign banks were forced to dump their holdings of U.S. mortgages and other loans, which in turn pushed up the cost of credit for Americans, creating an environment for a liquidity crisis to occur.

The latest action was at least in part an attempt to head off a repeat of such a spiral. Borrowing costs in some mortgage markets and other U.S. lending markets had been rising in the months preceding November's action—a sign that forced selling by Europeans might be occurring as their own dollar borrowing costs rose. Global investors have become worried about the health of European banks because of their exposure to Eurozone government debt.

It is unclear whether the latest steps mark a prelude to even bolder actions by central banks to ease financial strains. Although they are not in a position to jointly push short-term interest rates lower (because rates are already at or near zero), central banks still have other tools at their disposal—chief of which is additional quantitative easing. During the Fourth Quarter, top Fed officials indeed made clear that they are open to launching a new round of quantitative easing to bring down long-term U.S. interest rates further, but they have not yet taken this action. Additionally, we fully expect the ECB to engage in quantitative easing at some point as a stopgap measure to address the Eurozone situation.

Also on November 30, the Fed made clear that it would funnel short-term credit to strained markets in the U.S., if needed. As you will recall, during the 2008 crisis the Fed designed multiple programs to support commercial-paper markets, money-market funds, and other corners of the financial system when panic led to shortages of short-term loans.

Although the recent coordinated central bank action does not directly address Europe's government-debt and budget problems, it is aimed at alleviating the impact of those troubles on global markets by facilitating additional liquidity. In essence, the message being sent by monetary policymakers is that central banks representing the entire capital structure of the world have cut rates and stand ready to take additional action to support the global financial system at all costs.

> *European Union summit*

Although highly anticipated as a watershed event by market participants, the December 9 European Union (EU) summit served to do what Eurozone leaders do best: buy time. However, as with previous summits, a number of details were not agreed, and the ECB did not respond with an expected announcement that it would step in to support peripheral countries in the markets as a lender of last resort.

To stem the immediate crisis, it was agreed that national central banks would provide bilateral loans to the IMF in the amount of €200 billion. At least some of that funding, together with unearmarked money in the European Financial Stability Facility/European Stability Mechanism and bond purchases from the ECB, will comprise a bailout package for Italy and Spain. Unfortunately, this will only partially mitigate Italian and Spanish funding needs. Continued implementation of strict austerity measures by these countries will serve to constrain growth and render their fiscal dynamics even more difficult. Absent other measures, Italy and Spain could ultimately face a debt restructuring.

To address the fundamental structural imbalances in the Eurozone, treaty changes were also agreed upon among most EU member states—with the notable exception of the UK, Sweden, Hungary, and the Czech Republic. The reforms introduced a "golden rule" into legislation to ensure that budgets are roughly balanced over the business cycle and that public debt does not exceed 60% of GDP. Sanctions for countries that miss their targets will be imposed unless 85% of the votes oppose it. This essentially reiterates limitations set forth in the original Stability and Growth Pact, which in itself did little to address the political or financial aspects of the Eurozone crisis. Instead, it institutionalizes the asymmetrical adjustment in the Eurozone, whereby peripheral countries retrench to undergo internal devaluation and core countries do very little to adjust their current account imbalances. This virtually ensures that growth will remain elusive in the region over the next few years.

Importantly, there was no announcement from the ECB after the summit to indicate its willingness to become a lender of last resort. In fact, after the December ECB governing council meeting, ECB President Mario Draghi indicated that the central bank would *not* play a greater role in alleviating the crisis even if EU leaders agreed to a fiscal compact. Many investors hoped that this was just posturing to maintain pressure on politicians to find agreement at the EU summit and ensure that peripheral countries commit to additional austerity measures. In any case, the ECB—for the moment—has clearly continued to resist becoming a lender of last resort.

Ultimately, Eurozone leaders bought themselves additional time with the reforms they agreed to at the EU summit, but they have not fully resolved the crisis. In fact, if the goal of this summit was to reinforce the EU's "fiscal union," as indicated by Angela Merkel (Germany's Chancellor) and Nicolas Sarkozy (France's President), then this meeting can be viewed as disappointing: there will be no joint debt issuance, no EU treasury, no shared budgets, and no fiscal transfers to regions in trouble. To the contrary, the agreement cements pro-cyclical fiscal austerity into the institutional framework of the Eurozone, with no quid pro quo to move gradually to debt mutualization. Nor was there

any change in the mandate of the ECB—not even a movement toward stimulative measures, nor a hint that financial stability (not manipulating short term prices) is the ultimate duty of a central bank. EU leaders still refuse to correct the most dangerous single failure in the construction of a monetary union: the lack of a lender of last resort.

Certainly, this will by no means be the last EU summit to "save" the Eurozone—the only question is how quickly the bond market will force the next one.

> *ECB LTRO*

On December 21, the ECB pulled out all the stops to save the Eurozone's €23 trillion banking system by extending unlimited credit to banks for three years by implementing a Long Term Refinancing Operation (LTRO), halving the reserve ratio to 1%, and relaxing collateral rules to allow banks running out of eligible assets to pledge a wider-than-usual range of collateral. Since the interbank lending market in Europe was experiencing strains, the ECB had to step in as an intermediary to do the lending that the banks would not do for each other.

This ECB action is the closest yet to being a potential "game changer" in two years of the rolling Eurozone crisis. By taking advantage of the "carry trade" (borrowing at 1% from the ECB until 2015 with leverage to buy Italian debt at 6.4%, for example), the European banking system could be rebuilt. More importantly, we believe that Europe's politicians had hoped that lenders would use a portion of the ECB funds to carry out a backdoor rescue of peripheral Eurozone governments without breaching the ECB's legal mandate: Italian, Spanish, and French banks have all been under political pressure to buy their own governments' debt and take advantage of the wide yield spreads. Unfortunately, although the magnitude of the operation was considered "successful" in that the ECB loaned banks €489 billion, the level of fear remains so high that the banks have, in effect, loaned the money back to the ECB at just 0.25% for a small loss.

The operation *was* successful in lowering short-term Eurozone bond yields, however: Italy and Spain, for example, sold bonds with maturities ranging from 3 months to 2 years at yields that were half the rates paid in near-panic conditions during November. However, although short-term bond yields came down dramatically, long-term yields (10+ years) remain elevated. Even bankrupt countries like Greece can sell bills (i.e., short-term paper)—what matters is the long end of the credit curve, and this has unfortunately not moved much.

This liquidity facility will be available again in February. In addition, we expect the ECB is likely to continue to lower its official interest rate from a current 1% over the coming months.

Although all of these actions are significant in terms of stabilizing the European financial system, they address *liquidity* concerns, not *solvency* issues. In our view, Eurozone structural issues remain unresolved.

Crossing the Rubicon

Europe's underlying problem is not budget deficits or even unsustainable debt. These are merely symptoms. The real problem with Europe is the huge divergence in costs between the core and the periphery: in the past decade costs between Germany and some of the peripheral countries have diverged by anywhere from 20% to 40%. This divergence has made the latter uncompetitive and has resulted in massive trade imbalances within Europe.

Trade imbalances, of course, are the obverse of capital imbalances, and the surge in debt in peripheral Europe in the past decade—debt owed ultimately to Germany and the other core countries—was the inevitable consequence of those capital flow imbalances. While European policymakers despair over fiscal deficits, surg-

ing government debt, and collapsing banks, there is almost no prospect of their resolving the European crisis until they address the divergence in costs. (Of course, if they do not resolve this problem, the problem will be resolved for them in the form of a break-up of the Euro.)

The best resolution is that Germany takes steps to reverse its trade surplus. It could boost disposable household income and household consumption by cutting income and consumption taxes, and as German household income grows relative to the country's total production, the national savings rate would automatically drop and the trade surplus decline and eventually become a deficit. Or, Germany could engineer a massive increase in infrastructure spending.

If Germany does not do either—and especially if it imposes austerity on the peripheral countries—there will be a surge in unemployment for many years within Europe as German excess capacity meets dwindling demand in peripheral Europe. This surge in unemployment will force the peripheral countries into the unenviable choice of either absorbing that surge in unemployment themselves, or of forcing the unemployment back onto the core countries by abandoning the currency that is at the heart of their lack of competitiveness; i.e., the Euro.

Much of the commentary coming from German officials suggests that they will not take steps to reverse the trade surplus willingly. Historically, countries that run large and persistent trade surpluses never seem to understand that their surpluses are mainly the consequences of domestic policies that generate additional domestic growth by absorbing foreign demand. On the contrary, they usually insist that the surpluses are the consequences of domestic virtue, and they see no reason to give up being virtuous. Surpluses, they seem to believe, are a reward for their behavior, and as their surpluses decline—an inevitable consequence of the stagnation affecting their trading counterparts—they actually try to limit the decline and do all they can do to prevent it from becoming a growing trade deficit.

But this violates simple arithmetic: trade deficit nations have received capital inflows for many years from surplus nations as the automatic counterpart to their deficits. If the surplus nations ever hope to get repaid—i.e., to reverse those capital flows—then it must be obvious that the trade imbalances must also reverse. Countries cannot run surpluses forever, just as they cannot run deficits forever. For debt not to build up to unsustainable levels in the deficit countries, both deficits and surpluses must ultimately be reversed.

At this point, then, everything hinges upon Germany.

Germany entered monetary union and gave up the Deutsche Mark reluctantly under French and Italian pressure as the price for their acquiescence to Germany's East/West Reunification. They entered at an overvalued rate after the Reunification bubble, leaving them in semi-slump for half a decade. They slowly clawed back competitiveness the hard way: by squeezing wages and driving up productivity. Although it is entirely understandable that Germany now thinks that the peripheral countries can and should do the same, they are wrong for several reasons. Germany was able to lower relative wages during: (1) a global boom, (2) against other monetary union states that were inflating, and (3) with benchmark borrowing costs that stayed low. These circumstances do not currently apply to the peripheral countries.

As we have said in the past, beyond adjusting the economic and competitive imbalances noted above, a true monetary union leads inevitably to full fiscal union because an orphan currency cannot endure without a Treasury and government to back it up. Full fiscal union leads to debt pooling, shared budgets, and loss of sovereign powers to tax and spend: in essence, to the abolition of individual nation states.

This is the choice Germany now faces: it must either immolate itself and dismantle the state for the cause of European monetary union, or prepare to finance an orderly withdrawal from monetary union (along with Finland, Denmark, and Austria, et al) so that the Southern countries can breathe again and hope to recover. That is why there is so much seeming prevarication with regard to a "solution" for the Eurozone crisis: these are clearly decisions of epic proportions, and there is no painless solution. All other choices are illusion,

wishful thinking, can kicking, denial, obfuscation, muddle, and self-delusion.

In our experience, most politicians are incapable of making difficult, and unpopular, decisions—especially ones of this magnitude. As a result, we fully expect ultimate resolution of the Eurozone crisis to be deferred for as long as possible. As a stopgap measure, we believe that the ECB will ultimately change course and unleash massive quantitative easing.

With most of Europe currently in economic recession, drastic fiscal austerity measures—combined with upcoming bank deleveraging due to mandates for European banks to raise their core Tier 1 capital ratios to 9% by June—are making matters worse: two-thirds of the Eurozone cannot be pushed into fiscal and monetary contraction without consequences. The Eurozone economy is in imminent danger of experiencing significant deflation, bringing down the whole structure of sovereign debt and distressed lenders.

This crisis can be stopped by monetary policy using open market operations to expand the quantity of money and reflate nominal GDP in the peripheral countries. Although this does not solve the structural monetary union issues noted above, it does prevent insolvency for Italy and Spain. Unfortunately, this would result in higher inflation for Germany—anathema to memories of the Weimar Republic. Although Article 123 of the Lisbon Treaty makes it illegal for the ECB to purchase government bonds directly, we believe that President Draghi is slowly combining an alliance of ECB "doves" ready to spring a trap on the German Bundesbank, with interest rate cuts close to 0% imminent and signals of forthcoming quantitative easing—most likely by playing the deflation card and blaming impaired monetary transmission channels. It remains to be seen how this game of brinksmanship plays out.

From an investment perspective, the crisis surrounding the Eurozone is fully acknowledged by market participants, and we have yet to find an optimistic view regarding its resolution. The consensus view is that structurally-swollen debt loads and the disparate legal, political, and economic interests of the 17 members of the EU preclude a near- or intermediate-term solution. There is near unanimity that the timid and tame policy responses will never be capable of or willing to adopt the necessary shock and awe resolution that the U.S. provided in 2008-2009.

Our view is that the consensus is too pessimistic. Although it appears that European authorities will postpone the inevitable Eurozone restructuring to an unknown later date where they will be forced to decide whether to go "all in" or engineer some sort of breakup, we believe that the world's stock markets have ignored some near-term positive liquidity actions which, though slow-moving, appear to have measurably taken "tail risk" off the table as well as set the stage for what we believe will be an inevitable aggressive monetary policy response by the ECB.

For now, the moves by the EU have not resolved the crisis, and the associated uncertainty, along with additional economic and fiscal data points, will create the potential for continued short-term volatility. Nevertheless, with tail risk in Europe reduced, an improving U.S. economic recovery, weak investor sentiment, reasonable equity valuations, decent corporate profit and dividend growth, and market-friendly global central bankers, we believe that markets can move higher until more aggressive European policy is introduced.

The Year of the Dragon

The Chinese economy charged ahead at an unsustainable +10.5% pace in 2010, sparking concerns of rising inflation and the risk of speculative bubbles, particularly in the housing sector. Chinese policymakers responded with more than a year of restrictive policies that slowed the economy and created a credit crunch that has been particularly severe for medium and small firms and that only recently has led to a moderation of inflation.

In 2011, global, as well as Chinese, investors appeared to fear that these restrictive policies would push the Chinese economy into a sharp slowdown (i.e., a hard

landing). Adding to those fears was the evident global downturn in manufacturing, the ongoing financial crisis in Europe, and the predictions of some that the U.S. would also experience a return to recession. The Chinese economy has been affected more significantly by developments in Europe than has the U.S. economy because of the greater importance to China of manufacturing and trade with Europe (20% of China's exports are to Europe). Investors are well aware of this and appear to have priced into Chinese equities a European recession—a development that we believe is currently happening.

The Chinese economy is clearly slowing. GDP growth eased to a +9.1% annual rate in the Third Quarter of 2011, following a +9.5% rate in the Second Quarter. The widely watched Purchasing Manager's Index hovers around 50—the demarcation point between expansion and contraction. We expect the slowdown to continue into the first half of 2012, with annual GDP growth in 2012 falling to a still-global-leading rate of around +8%. There are downside risks to this forecast—a collapse of the Eurozone, a recession in the U.S.—but neither of these is in our base-case projections.

Our forecast of a soft landing for the Chinese economy is based on the increasing evidence that Chinese economic and financial policies are becoming less restrictive and will likely become expansive in the near future. Importantly, declining inflation is giving the monetary authorities some room to maneuver.

In fact, on November 30, authorities moved to cut the required reserve ratio of large banks by 50 basis points, followed a week later by the lowering of the reserve ratio for 20 smaller, rural banks. This move was likely intended to give several signals. To markets, it signaled a move toward easing the credit crunch and supporting domestic liquidity. Moreover, it was not a coincidence that China made its announcement on the same morning that the other major central banks of the world announced their coordinated action to head off a liquidity crunch for European banks. (China could not participate in the swap arrangements directly because its currency is not convertible.) Its coincident move to support liquidity in China can be seen as complementary to the efforts of the other central banks. China places great importance on the objective of easing the crisis in Europe due to the significance of its trading relationship. The recently-released increase in China's December 2011 trade surplus bolsters our expectation for additional easing measures.

We of course remain cognizant of the risks associated with China, including its real estate bubble, highly export-driven economy, and opaque reporting, among other issues. Consequently, we always retain healthy skepticism with regard to near-term expectations. However, we balance these concerns with the long-term secular growth dynamic of the emerging economies (including Brazil and India) as well as China's particular ability to exercise greater control over its economic policies, given that it is a command economy. As a result, we are cautiously optimistic regarding the outlook for China in 2012.

Keep On Truckin'

One of the primary reasons for the equity market correction in 2011 was concern regarding a renewed U.S. economic recession—primarily related to the impact of the Eurozone crisis and an economic slowdown in China.

Contrary to consensus expectations, a U.S. recession did not materialize, and the economy proved resilient and self-sustaining as Real GDP grew at an annualized rate of +1.8% in the Third Quarter—an acceleration from the first two Quarters of 2011: Real GDP rose at an approximate +1% annualized rate in the first half of 2011 and should increase at near a +2.5% rate in the second half of the year. For 2012, we estimate that Real GDP will continue to grow at approximately +3%, with the potential for additional upside—absent an exogenous shock to the global macroeconomy from Europe and/or China.

Although employment conditions are improving, consumer spending remains steady, confidence is returning to both consumers and businesses, business investment

is increasing, and construction spending is showing signs of life, there is no reason to expect an economic boom any time soon, however. Moderate U.S. economic growth continues to be our baseline assumption: a slow recovery that is really more of an adjustment to what appears to be the economy's new equilibrium path—one that is decisively lower than the pre-recession trend. We continue to believe that many structural issues (housing, unemployment, etc.) will continue to serve as headwinds to a more robust recovery. Certain of these issues remain severe and have serious implications for long-term U.S. competitiveness.

On the margin, though, there is no denying that there has been a gradual improvement in a variety of recent domestic economic data—jobless claims, employment, manufacturing indicators, housing, auto sales, etc.—and that the investment punditry have virtually ignored it. As a result, in our view the underlying trends in U.S. economic data do not present a substantial risk to the U.S. equity market during 2012 because, although corporate profits as a percentage of GDP are higher than historical norms, we do not expect margins to contract materially given the slack in the labor market, the low interest rate environment, and benign inflation.

Certainly, the state of flux in the U.S. political and regulatory environment, along with potential disruptions caused by Europe or China, remain risks. However, we believe that the market has already discounted (with a –14% decline in price/earnings ratios in 2011) a diminished profits outlook that we do not currently believe will occur.

Possibilities

The stock market outlook always encompasses a range of possibilities. Prudent investing involves assessing those possibilities, assigning probabilities, and establishing positions for potential trade-offs. Our outlook is that the U.S. stock market has a high probability of posting strong gains in 2012.

U.S. equities currently present tremendous value relative to both historical norms and to alternative investments.

The S&P 500 is trading at only 12.5x projected 2012 profits—an 8% earnings yield—compared to less than a 2% yield on 10-year U.S Treasury bonds. This compares to a 50-year average of over 15x during a time in which the yield on the 10-year U.S. Treasury bond approached 6.7%. Moreover, U.S. equities have historically been valued at 17-18x when interest rates and inflation (and inflationary expectations) are around current levels. Risk premiums (the earnings yield less the risk-free cost of capital) are now elevated and back to levels last seen in 1974; following that last spike in risk premiums 37 years ago, the S&P 500 returned +35% and +19% in 1975 and 1976, respectively.

Earnings for the S&P 500 rose +14% in 2011, but the market ended flat. If earnings rise +10% in 2012, as is the recently-lowered consensus forecast, then the S&P 500 would have to rise +24% just to maintain the already-low valuation metrics that existed at the end of 2010, when stocks were considered cheap. **To repeat: the S&P 500 could rise by +24% in 2012 just to keep pace with 2011 and 2012 earnings growth. In fact, the S&P 500 has lagged earnings growth over the past 10 years. If the relationship between expected earnings and the S&P 500 had held over the past two years as it had over the first eight years of the decade, the S&P 500 would currently be near 1500. This does not even account for the possibility of price/earnings multiple *expansion* to 17-18x in a historical revaluation, asset reallocation trade. Under that scenario, the S&P 500 would approach 1800.**

Of course, these valuation scenarios are merely hypothetical but are worth considering given the very real price/earnings multiple compression that occurred during 2011 and the currently high level of negative investor sentiment.

Given the current surfeit of negative investor sentiment, it is worth remembering that, over the long run, consensus thinking (in any endeavor) rarely delivers outperformance. Within that context, we believe it is

important to think about some alternative possibilities that may occur over the coming year. What if:

- With its back against the wall and taking a lesson out of the U.S. playbook, Europe's tame and timid policy response to the debt contagion becomes one of shock and awe, with massive ECB intervention that stabilizes sovereign bond yields?

- The Eurozone's fiscal integration goes smoothly, as does the implementation of a massive banking industry recapitalization?

- Europe only experiences a modest economic dip?

- China successfully engineers a soft landing and growth exceeds expectations?

- U.S. 2011 Fourth Quarter Real GDP exceeds +3%?

- U.S. corporate revenue growth improves more than expected during a period when inflation and wage growth remain subdued, thereby sustaining profit margins and leading to increased earnings expectations?

- Consumer and business confidence rebound dramatically, paving the way for pent-up demand to be unleashed?

- Merger and acquisition activity explodes in an unprecedented manner?

- A Republican party resurgence sweeps the Democrats from the White House and from the Senate, leading to complete, one-party Executive and Legislative control?

- The political parties put aside their differences and introduce a proactive economic plan—a business-like agenda of thoughtful, intelligent, and radical pro-growth fiscal policies which address the housing market, fiscal situation, employment, energy policy, overseas corporate profits, and the tax system?

- U.S. bond yields rise rapidly, causing a massive reallocation trade out of fixed income and into equities?

It is important to note that these outcomes are not intended to be predictions, nor are they what we expect will actually happen. However, we do find it useful to consider that these events have a reasonable chance of occurring—and that they remain clearly out of the consensus zeitgeist.

We appreciate your confidence and encourage you to feel free to contact us should you have any questions or concerns.

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 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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