



# WINDWARD CAPITAL

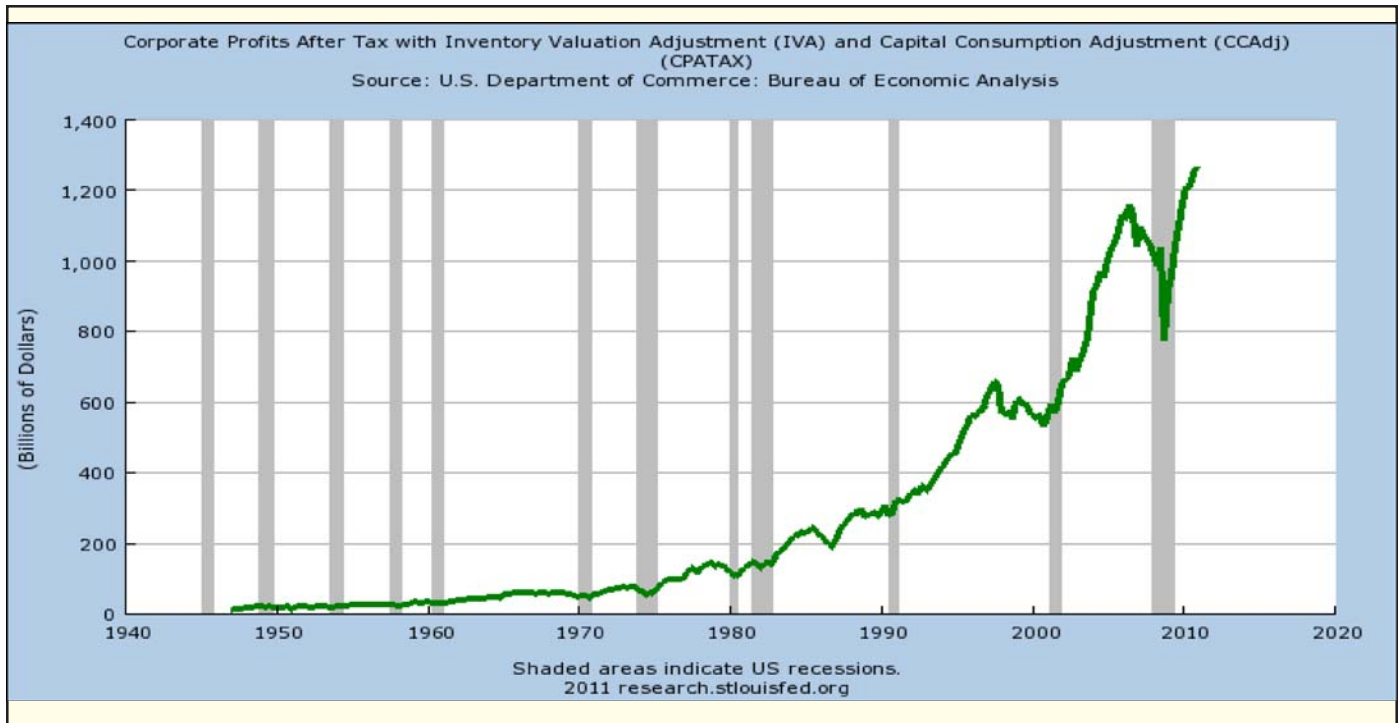
*Risk Averse Asset Management*

## 2011 Second Quarter Review



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### *Macro vs Micro*

The U.S. equity markets experienced significant volatility during the Second Quarter of 2011—increasing +4% at their high and decreasing -6% at their low—before ending the Quarter nearly flat: the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) returned +0.10%, +1.42%, and -0.03%, respectively, for the period. Year-to-date through June 30, however, the S&P 500, DJIA, and NASDAQ have increased +6.02%, +8.58%, and +5.01%, respectively. For 2011, Windward's portfolio strategies continue to outperform their relevant benchmarks on a risk-adjusted basis, adding to our clients' above-average long-term absolute and relative investment returns.

As we have discussed innumerable times over the last several years, in the aftermath of a financial crisis (especially one as severe as that currently experienced), there is usually an extended period of slow economic

growth, during which time those factors that precipitated the crisis take years to unwind and/or be resolved. These issues can be long-lived and may either be shortened or protracted by a variety of policy measures—whether they are fiscal, monetary, or political. Exacerbating the impact of the current crisis is its global scope—affecting nearly every one of the world's largest developed economies—thereby making it more difficult to achieve “normalization” in short order.

As a result of many factors, we anticipate that overall global macroeconomic growth will be moderate for some time as economies continue to grapple with the primary issues surrounding the aftermath of this financial crisis: a real estate collapse, high secular unemployment, and extensive private and public deleveraging. At various times, there will be country-specific pockets of economic strength and weakness, depending upon those countries' relevant exposures. In this type of

environment, financial market volatility should be considered the norm as investors remain uncertain regarding the pace of recovery and near-term outlook for the global macroeconomy and continue to be very sensitive to any signs that may indicate a renewed crisis.

Obviously, the consequent investment ramifications of the financial crisis are significant and generational in nature. We believe, therefore, that, in order to navigate this environment, the importance of both preserving *and* growing capital in the years ahead cannot be overemphasized. Within this context, a long-term investment approach that is focused on owning dominant, financially strong, leading companies with best-in-class managements, high incremental returns on invested capital, and business models with sustainable competitive advantages that have predictable and sustainable above-average growth in revenue, earnings, and free cash flow remains critical to achieving these financial goals.

Importantly, this is not about buying “the market.” Rather, this is about being able to specifically identify those companies whose businesses comprise those characteristics noted above that, by their very definition, will accrete long-term value to their owners—regardless of the overall economy’s moderate rate of economic growth. We believe that such companies will become increasingly viewed as having precious value in the years to come. As we “hope for the best, and prepare for the worst,” we attempt to mitigate any downside risk in our portfolios by, among other measures, owning these type of companies. We have successfully demonstrated our consistent ability to identify and invest in such companies for Windward portfolios. The result has been portfolio returns higher than that of the market, with less risk and low turnover.

Most of what the market has experienced this year has been in line with our previous expectations—the details of which we have described in earlier Quarterly Reviews. Rather than repeat those details, we would encourage you to re-read our past reports, which you can find at our website ([www.windwardcapital.com](http://www.windwardcapital.com)) or which we can send to you at your request.

From our perspective, the investment themes (both cyclical and secular) that we have developed over the last few years remain intact and continue to be validated by recent events:

- ✓ *Rise of The Rest*  
Globalization and the development of the middle class in emerging markets is a long-term secular trend.
- ✓ *Tech Haven*  
Select Technology companies are well positioned to withstand the current recession due to their strong balance sheets (high cash, low debt) and are uniquely poised to benefit from a rebound in global consumer spending—especially in emerging economies where standards of living are improving from subsistence levels.
- ✓ *Regulation*  
Financial Services re-regulation, Healthcare reform, and Climate Change policy are all currently areas of government focus, and the economic sectors within these areas may, therefore, be subject to challenges or opportunities based upon how successful the government is in implementing its programs.
- ✓ *Continued Deleveraging*  
Consumer deleveraging and the shrinking of bank balance sheets will be a multi-year process that will restrain the U.S. economic recovery (and the earnings power of those sectors affected).
- ✓ *Capacity*  
The specific industries that did not overexpand during the boom (Materials, Energy, and Industrials) are better positioned than those that did (Real Estate, Financial Services, Homebuilding, Automobile Manufacturing, and Retailing) to benefit from a global economic recovery—especially one that is led by emerging markets.

✓ *The Great Unwind*

The unwinding of current Federal Reserve policies has the potential to, at the very least, weaken the U.S. dollar.

We are invested accordingly.

***Like A Pig Through A Python***

The rate of global macroeconomic growth is slowing. The recent decline has sparked a debate regarding whether the weakness will become more pernicious and lead to another recession—potentially precipitated by such factors as a renewed European sovereign debt crisis, lack of additional government fiscal and/or central bank monetary stimulus measures, or the absence of political leadership and unity.

Global equity markets rallied in the final days of the Second Quarter as investors became increasingly confident that a default by Greece would not occur in the near term. This upturn reversed much of the Quarter's earlier losses that occurred in volatile markets buffeted largely by negative economic news and the significant tail risk of a financial market crisis in Europe. Ten days later, the equity markets corrected based upon concerns regarding Italy—Europe's third-largest economy. Recent weaker-than-expected Purchasing Manager Indices (PMIs) for many countries (China, U.K., the Eurozone) suggest that the bottom of the slowdown in global manufacturing has not yet been reached.

As always, however, markets look forward rather than backward. As such, the consensus outlook for the second half of this year is for a resumption of somewhat higher growth in both the U.S. and the global economy as it recovers from several transitory negative influences, including unusually adverse weather, high energy and food prices, and Japanese earthquake-related supply disruptions. Indeed, overall corporate earnings and some specific components of manufacturing data remain strong and indicate sustainable underlying growth dynamics. We continue to monitor economic data points very closely.

***Pushing On A String***

Although the degree to which the recent slowdown will continue remains unknown, we do not currently forecast another recession for the U.S. in the near term—absent an exogenous shock. Although elongated due to the nature of the credit crisis and somewhat distorted due to public policy measures, we do not believe that the business cycle is entirely dead: higher corporate profits have historically driven an inventory rebuild, which is followed by a capital expenditure cycle, that then initiates a wave of hiring. However, it is important to remember that the headwinds in this type of environment are non-traditional and much stronger than usual. This is the normal progression of an economic “recovery” after a credit crisis. Consequently, we do not expect a sudden economic rebound or short-term resolution of these headwinds. Instead, this recovery will be more extended: correcting structural issues takes time and patience—which is why we take the long view. (Perversely, although the aftereffects of the crisis were mitigated in several important regards, they have been protracted in other ways by a variety of policy measures enacted both domestically and abroad.)

In the U.S., although unemployment will remain high for some time and the housing market will take years to recover, we do not anticipate either one to worsen materially from current levels. The bulk of the declines have already occurred—there just will not be a “snapback” recovery because either the demand is not there or the normal market functioning process has been interrupted. Although the current inventory of housing stock (including unreleased “shadow inventory” held by financial institutions) will ultimately be cleared (at the right price), the unemployment issue has a more significant structural component that could severely impact a generation of workers and negatively affect U.S. competitiveness.

The failure to have designed a coordinated package of monetary and fiscal policy to engineer a V-shaped employment recovery looks increasingly like a massive lost opportunity. With that opportunity now lost, a return to something similar to the pre-crisis jobs trend seems essentially impossible. Elevated unemployment is being influenced by factors that include globalization,

austerity, the shedding of municipal jobs (associated with local, State, and Federal fiscal imbalances), technological innovation, and the use of part-time and temporary employees as a permanent part of the workplace (reflecting economic uncertainty, mounting healthcare costs, and the costs of regulatory burdens). Private employment is currently 2% below 2001 levels. This magnitude of job loss over a 10-year period is unprecedented since the advent of something resembling reliable data began being collected in 1890.

## Hostage Crisis

The “noise” of U.S. politics—whether it is related to the economy, the debt/deficit discussion, or to politics in general—will continue to drive the country (and financial markets) to distraction. We have already discussed our view regarding both parties’ elected officials’ lack of political will and inability to unite for the good of moving this country forward. If anything, the situation has become more partisan as rhetoric regarding the debt ceiling has intensified.

Although most everyone recognizes that the deficit is an increasingly important problem, no one seems willing to admit the basic facts:

- ✓ Discretionary spending alone is too small to solve the problem.
- ✓ The tax base is not large enough to solve the problem.
- ✓ Mandatory entitlement programs (Social Security, Medicare, Medicaid) are the real problem.

One way to think about the scale of this issue is the following: even if all discretionary spending were cut by -50%, there would still be a \$1 trillion deficit in 2011; even if all current taxes were increased by +50%, there would still be a \$1 trillion deficit in 2011.

As one wades through the deficit issues and searches for available funds, the stark reality is that the main problem is spending—specifically, spending on entitlement programs that are not adequately funded and destined to get worse due to aging demographics and rising healthcare costs. While both political parties pos-

ture with plans labeled as attacking the deficit, a plan that does not address mandatory entitlement programs should be viewed skeptically.

It is obvious to us that, at some point, a fiscal solution will require higher taxes on the middle class, not just the richest 2%. Likewise, entitlement reform will require means-testing the Social Security and Medicare programs, not merely squeezing the far smaller safety net in areas like Medicaid and food stamps.

Washington has a terrible budgetary habit whereby politicians continuously avoid concrete, but politically painful, near-term savings in favor of gimmicks like freezes, caps, and block grants that push purely paper cuts into the distant, foggy future. Such fiscal chicanery ignores the fact that the U.S. has experienced a recession every five years or so for the last six decades, that the budget is now exposed to even more frequent and amplified cyclical turbulence amid the aftershocks of the financial crisis, and that the U.S. does not have a “divine right” to issue any amount of interim debt that suits the ideological convenience of the two parties.

For decades, global central banks have been giving policymakers a false signal that sovereign debt is cheap and limitless, causing bond prices to be far higher (and interest yields much lower) than would be the case in an undistorted market. Indeed, the Fed and currency-pegging central banks in East Asia have absorbed nearly all of the U.S.’ multitrillion-dollar debt issuance. The risk is that, for a variety of reasons, these foreign holders become sated and are forced to disgorge their U.S. Treasury holdings to address internal issues, thereby driving bond prices lower and yields higher. Combined with the Fed’s ultimate unwinding of its balance sheet, this could result in an unanticipated, much more immediate, fiscal crisis.

At the eleventh hour, we suspect that an interim, stop-gap budget compromise measure will be reached. The details of that compromise will probably include a variety of politically-correct half-measures along with an increase in the debt ceiling. At some point, however, we believe that the (bond) market will be the ultimate force that will create a renewed focus on the long-term structural issues related to government revenue and

spending.

## ***Default Deferred***

Europe will remain a risk as long as the debt restructuring “can” continues to be “kicked down the road.” Although it appears to have been mitigated in the near term, sovereign default of the weaker (primarily Southern) European countries remains inevitable, in our view—it is only being deferred.

Our analysis indicates that the positive effects assumed from increased austerity measures are based off of unrealistic GDP growth expectations: Real GDP in Portugal, Ireland, Italy, Greece, and Spain (PIIGS) was weaker than potential for most of the 1990s during a time when each country could tailor monetary policy specifically for its own needs (i.e., before formation of the Euro). Now that monetary policy is out of their control and each country is facing weaker growth prospects from the implementation of fiscal austerity measures, the official growth forecasts from the PIIGS show growth is anticipated to be relatively *better* over the next two years than it was in the 1990s. If economic growth could not exceed potential when monetary policy was accommodative, it may be too optimistic to assume growth can exceed potential when monetary policy is tighter and fiscal spending is constrained. Any new bailout needs to take into account that GDP growth may be substantially weaker than official estimates; otherwise, there is a high probability that any new bailout will not be large enough and will postpone, not eliminate, an eventual default or restructuring.

As you know, a formal default by a European country such as Greece, Ireland, or Portugal would not just threaten bondholders—it would threaten the French, German, and Belgian banks (among others) that own so much of those countries’ sovereign debt. Because the Euro binds together the currency and banking systems of many countries, the European Union (EU), European Central Bank (ECB), and International Monetary Fund (IMF) have gone to great lengths to forestall default. Profligate governments have been pressed into passing austerity plans, slashing budgets, selling state-owned assets, and raising taxes. The ECB is guar-

anteeing debt and providing limitless liquidity and bailout funds—all so that Greece, Ireland, and Portugal can remain current on the financial obligations they have assumed on behalf of their citizens (Greece and Portugal) and their banks (Ireland). The bondholders are being protected at the expense of the taxpayers.

We believe that, at this point, a more drastic approach to mitigating the crisis is necessary. One potential option to consider would be a Brady Plan for Europe (a “Trichet Plan,” so to speak). The Less Developed Countries debt crisis in the 1980s was ultimately resolved by the Brady Plan in the early 1990s, whereby: (1) bank creditors were granted debt relief in exchange for greater assurance of collectability in the form of principal and interest collateral, (2) debt relief was linked to some assurance of economic reform, and (3) the resulting debt was more highly tradable, allowing creditors to diversify risk more widely. This type of proposal for Europe would be predicated on the notion that the borrowers and the lenders (and not outside parties) should take the losses, set terms of the restructuring, and design the instruments in a menu of options which best fits their needs: in other words, the consenting adults who created Europe’s crisis are the ones who should resolve it. There is no doubt that such a plan would be highly complex; however, it is interesting to note that Jean-Claude Trichet, President of the ECB, has previous experience with the Brady Plan.

How this situation ultimately unfolds is unknowable at this time given the strength of the vested interests involved and the current strategically-faulty structure of the EU (i.e., the lack of a fiscal union). Once again, we hope that some type of intelligent leadership emerges that will be able to unify the various interested parties and take the difficult steps necessary toward resolving the crisis in an orderly manner.

## ***Boiling Frogs***

The Federal Reserve’s recent Quantitative Easing measure (QE2) ended on June 30, almost seven months after the program was officially announced. QE2 was the U.S. central bank’s hotly-debated second round of

quantitative easing which was intended to prevent deflation and stimulate the economic recovery. The plan included the purchase of \$600 billion in long-term Treasury bonds, as well as the reinvestment of an additional \$250-\$300 billion in Treasuries with the proceeds of its earlier investments. The Fed has discontinued its Treasury purchases (for now) but will continue to reinvest the proceeds of maturing bonds.

It is interesting to look at the performance of various markets since the unofficial announcement of QE2 at Jackson Hole by Fed Chairman Ben Bernanke in August 2010: the U.S. equity market has risen by +23%, a basket of commodities has risen by approximately +29%, Treasury yields have risen by +17%, and the U.S. Dollar has declined by -10%. Were these market moves all due to the effect of QE2? Probably not. Corporate Operating Earnings, for example, rose dramatically during that period, and a lot of other global market events transpired.

While the merit and direct effect of QE2 will be debated for years, our view is that although QE2, in isolation, had relatively modest effects, such benefits as it provided should not evaporate with the end of bond purchases. It is important to note that, despite the Fed stopping its asset purchases, the net additional stimulus provided remains in the system: the Fed is not backing off of its desire to stimulate the economy; all it is doing is backing off of its policy of steadily adding to that stimulus. We think the main success of QE2 was that it helped the Fed signal convincingly that it had the ability and will to prevent deflation. Remember also that the Fed by itself does not have the ability to solve all of our current economic problems.

Looking ahead, there are widely divided views about what removal of this stimulus will mean for the markets—particularly the Treasury market. One strong argument is that bond yields will move higher (and prices lower) as the largest buyer of the past six months steps out of the market—a void which some do not think can be filled by private demand. An equally valid argument is that yields will remain low—and could possibly move even lower—due to a deterioration in the economy (as investors seek safety, they will purchase bonds, raising prices and keeping yields low).

It is impossible to know with certainty which direction the bond market will turn based upon the cessation of QE2. In the near term, the bond market may remain volatile, given the global macroeconomic slowdown and the significance of the renewed European debt crisis (which may have a larger influence on the movement of yields than the removal of Fed buying). Ultimately, we believe that, when the Fed unwinds its balance sheet, yields will ratchet significantly higher.

At the moment, however, interest rates are low, and Fed policy remains accommodative: the FOMC is officially on hold and is monitoring the state of the U.S. economy. In the absence of clear and convincing evidence that deflation is again a threat, they believe they have little traction over growth at this juncture. In their view, additional policy measures would yield no improvement on the employment outlook but could potentially add to an already uncomfortable inflation tradeoff.

The Fed interprets much of the current economic data flow as reflecting temporary factors: either the impact of higher commodity prices or the disaster in Japan. (Interestingly, though, temporary factors alone are not sufficient to fully explain the slowdown, as their recent 2012 GDP forecast was also downgraded.) With job gains slowing, housing prices sliding, and consumers spending cautiously, officials do not want to tighten financial conditions. This means that they will maintain short-term interest rates near zero for an indefinite time (in our opinion) and keep the central bank's \$2.6 trillion of securities holdings from shrinking. At the same time, because inflation has recently picked up, they are reluctant to embrace new initiatives aimed at boosting growth. For additional stimulus (i.e., QE3+) to be officially implemented, there would probably need to be a combination of a shift to deflation concerns, an additional dramatic downward revision in the 2012 growth forecasts, or massive financial contagion from the European debt crisis.

As has been clear over the past four years, we know that Chairman Bernanke will use every conceivable monetary policy weapon in his arsenal. At the same time, Bernanke claims no responsibility for the side effects of extraordinarily accommodative policy: He

claims it does not debase the dollar, it has not lifted commodity prices, and it did not reflate financial assets. (We disagree on all of these points.) Therefore, if he sees no negative unintended consequences of his policy (both past and present) and still believes cheap money will help, QE3 (and more) will always be an option—*if* things get much worse.

In our view, absent further asset purchases, the Fed could take the following additional steps to keep long-term yields low:

- (1) conditionally commit to keeping the current policy path for a specific period of time based on the evolution of economic conditions,
- (2) make explicit its implied inflation target of 2% to firmly anchor public expectations of prices if the committee chooses to formally commit to supporting the economy for a longer period than is currently anticipated,
- (3) impose a penalty on excess reserves (essentially taxing banks that choose to park money at the Fed), or
- (4) go “nuclear” by capping yields.

## ***Twist and Shout***

Since just about everything that has to do with the U.S. economy is either directly or indirectly priced off of the 10-year part of the yield curve, it stands to reason that this is the segment that matters most for the economy. The 10-year part of the curve is the oxygen tank for the market and macro backdrop, yet the Fed in its latest round of QE centered its efforts more on the front and mid part of the curve. Therefore, at the margin, if economic weakness becomes pernicious, it may well make sense for the Fed, in its next round of stimulus (whenever that may occur), to signal to the public its intent to take down (and hold down) the most critical interest rate of all: that of the 10-year Treasury bond.

Historical experience tends to support the proposition that a sufficiently determined Fed can peg or cap Treasury bond prices and yields at other than the shortest

maturities. The most striking episode of bond price pegging occurred during the years before the Federal Reserve-Treasury Accord of 1951. Prior to that agreement, which freed the Fed from its responsibility to fix yields on government debt, the Fed maintained a ceiling of 2 ½% on long-term Treasury bonds for nearly a decade. This was otherwise known as “Operation Twist.”

There is certainly nothing preventing the Fed from targeting the 10-year Treasury bond any more than the Fed Funds rate. But the Fed Funds rate is already near zero, and, as such, there is no incremental move there that can benefit the economy more broadly. Targeting the 10-year in much the same fashion is probably worth a try under a “nuclear option.”

While the Fed can either target its balance sheet (which it has been doing with its QE measures) or target interest rates, it cannot do both at the same time. So the next QE will probably not be called “QE” but something else—maybe “Operation Twist 2.” The Fed would buy up all the 10-year bonds needed to clear the market at the set target price (yield). So, depending upon supply conditions and demand from the private sector, the Fed would basically lose control of its balance sheet; but if, in return, this policy is the one that blazes the trail for a turnaround in the housing sector and initiates a durable revival in the economy, so be it. If the Fed were to be concerned about the impact that any further balance sheet expansion could have on the U.S. dollar, it could always hike the short end of the Treasury curve (short-term spreads matter more in the foreign exchange markets). By doing this, the Fed would also lend some much-needed support to the troubled money market fund industry. So much can be accomplished with such a policy—the upside potential could be worth the cost.

Although we do not expect the Fed to utilize interest rate caps anytime soon—especially given the recent market-driven downward trajectory in the 10-year bond yield, which may have more efficiently accomplished the same goal—we do believe that you may hear more discussion regarding Operation Twist if the economy were to fall into another recession (an outcome we do not anticipate). However, keep in mind that a QE3

needs to be bigger than QE2—the Fed would want to signal “shock and awe.” Both monetary and fiscal policy suffer from the same impediment: in order to be effective, the amounts necessary, in both size of the Fed’s balance sheet and the magnitude of the federal deficit, are so big that policymakers view them as potentially destabilizing, while the magnitude to which they might be willing to commit would leave them open to criticism if their policies are failures.

In addition, from a political standpoint, the Fed has to wait for the next downturn in economic activity and reversal in the stock market so that those on Capitol Hill that are lamenting the Fed’s interventionist efforts end up begging for more. The obvious fallback position is to embrace the devil you know: which, in this case, is an economy in a prolonged state of moderate economic growth punctuated by periods of short-term weakness.

### ***Happy Talk***

Corporate earnings growth has been incredibly strong off of the depth of the crisis: On a quarterly basis, starting in the First Quarter of 2010, Operating Earnings for the S&P 500 have increased +54%, +41%, +30%, +30%, and +19%, respectively, on a year-over-year basis. Led by the Materials (+49%) and Energy (+38%) sectors, the estimated S&P 500 earnings growth rate for the Second Quarter of 2011 is +14%, and revenues are projected to increase +11%. The forward 12-month consensus earnings estimate for the S&P 500 currently stands at \$106.25, compared to \$95.89 at the start of 2011.

Better-than-expected First Quarter 2011 earnings were driven by a pickup in revenue growth and continued cost cutting—this combination mitigated potential margin pressures stemming from rising input (i.e., commodity) costs. Companies have called attention to rising commodity cost pressures but have retained a positive earnings outlook, citing improved demand in the U.S., continued growth in emerging markets, and the ability to selectively raise prices. The earthquake in Japan impacted specific industries during the First Quarter (e.g., Technology and Automobile Manufacturing),

but the general impression is that any slowdown or supply chain disruption related to the earthquake will be short-lived.

The strength in corporate earnings and generally reassuring guidance have acted as primary sources of support for the equity market in the face of concern about Europe’s debt crisis, unrest in the Middle East and North Africa region, the earthquake in Japan, and China’s efforts to slow its economy. With consensus earnings estimates holding up and companies remaining confident in their outlook, the risk premium in equities looks like a marker of unsubstantiated fears about economic and earnings growth prospects that is creating a long-term buying opportunity. This is particularly true for large, high quality, multinational corporations.

We will be paying particular attention to the financial results and outlooks provided by companies during the Second Quarter reporting season. In general, we think companies will be somewhat conservative with their guidance—widening their estimate ranges around current consensus estimates to account for the macro uncertainty while also allowing for positive surprises. We also believe that those select companies with demonstrated relative strength in operations over the last several Quarters should be able to maintain their positive momentum and continue to provide leadership to the equity markets as a whole.

### ***Recency Effects***

U.S. stocks have struggled since the April 29 peak. Could this recent period have seen a bull market peak, with a new bear market now underway? Possibly. Or, could it be an interim peak, with the stock bull market going higher after a corrective period? Possibly. Ask four Wall Street professionals, commentators, investors, and media pundits and you will get five opinions. Simply put: we don’t know. Neither does anyone else if they are honest with you.

The long-term underperformance of the equity market during May through October relative to November through April is well documented. It would not be surprising to see this year trend similar to last year, when

the S&P 500 was very choppy through August with a prevailing negative bias. The equity market is following the seasonal pattern so far this year, and it has had a lot of headline help in doing so.

Confidence in the outlook is key right now, and confidence is lacking. Yet, if the concerns that have gotten us to this point can be checked off in the coming weeks and months—and there are real possibilities that they can—then a repeat of last year’s relief rally could be seen. However, our investment horizon is much longer than a few months.

Our research indicates that there is still good, relative long-term value in the equity market at the current price level. That is certainly true vis-a-vis Treasuries based on an equity risk premium that now stands at 525 basis points versus a 20-year average of 123 basis points. Interim weakness, therefore, should be thought of as a long-term investment opportunity predicated on relative value and supported by solid earnings growth, extremely low interest rates, strong cash flow, and healthy balance sheets. U.S. multinationals with solid financial positions and increasing exposure to emerging and developing markets continue to be an attractive investment option as the market digests a variety of unknowns.

The equity markets certainly appear to have no memory or, at the very least, are suffering from the “recency effect,” whereby they greatly overemphasize the most recent experiences at the expense of remembering what has happened over the long run. Have we truly forgotten how the global macroeconomy survived the financial Panics of 1819, 1825, 1837, 1847, 1857, 1866, 1873, 1884, 1890, 1893, 1896, 1907, 1929, 1933, 1938, 1973, 1987, 1998, 2000, and 2007-2009? Are our memories of recent events more vivid than those of older events that may have been considered equally, if not more, “cataclysmic” than the challenges currently being faced?

This amnesia results in significant short-term volatility and can be frustrating for the true, long-term investor. The summer months could see some irrational thinking that drives some emotional selling, which then leads to some common sense investment opportunities.

In our view, several factors should continue to support stocks over both the near- and the long-term:

- Corporate balance sheets and income statements continue to be strong.
- Valuations remain reasonable—especially relative to inflation and interest rates.
- An extended economic up-cycle still appears the most likely outcome. (Hopefully, more effective and productive public policy could extend the recovery further.)
- Individual investors remain uninvolved in the equity markets (and are overweight bonds).
- Statistically, over the long run, stocks tend to rise.
- The mass of the people has the weight of the money on its side, and the crowd is innately positive on the future and invests for the future.
- Corporations are generally managed by executives who want to succeed, not fail. Rising profits, expanding dividends, and opportunistic buybacks are general objectives of their management policies.
- Demographic growth (population increases and household formation) provides a gravitational pull toward economic and corporate profit growth.
- Governments will do nearly everything in their power (policy-wise) to advance economic growth, even in the face of economic tragedy or near-economic Armageddon.

As always, please feel free to contact us with your questions or concerns.

## NOTES

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### 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.

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### 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](http://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](mailto:spene@windwardcapital.com), or call Mr. Pene at our main number: (310) 893-3000.

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# NOTES

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