

# Oakwood Outlook

## & Quarterly Review

Volume 7, Number 2 April 2004

### A Word

From the Advisor

*The Oakwood Fixed Income mission is to produce excellent relative performance in all interest rate environments.*

**The results of the first quarter of 2004 show that bonds as an asset class outperformed equities on an absolute and risk-adjusted basis, with the Lehman Brothers Intermediate Government/Corporate Index returning 2.5%.** After a strong start, the major stock indexes ended almost unchanged for the first quarter of 2004. The Dow Jones Industrial Average finished the quarter down -0.4 %, with the broad S&P 500 Index returning 1.7%, held up by its many household-product stocks. The more volatile NASDAQ composite, whose many technology stocks led last year's gains and this year's declines, was down -0.5% for the quarter.

With optimism fighting anxiety, stock market investors are staying the course despite some mixed economic data, higher stock valuations and geopolitical tensions. The fixed income market sees bond loyalists maintaining their portfolios, as new supplies of issues are being absorbed and foreign demand remains strong.

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### Economic Outlook A Balanced Scale?

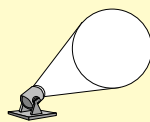
We could envision the measure of the economy's health (the Gross Domestic Product (GDP)) and other economic factors as the unknown weights on an equal arm balanced scale. To use an equal arm balanced scale, objects of unknown weight are placed on one of the pans, and objects of known weight are placed on the other until the bar holding the pans is in balance. The Federal Reserve, led by Chairman Alan Greenspan, continuously monitors this economic scale, and judiciously uses its counterweights of adjusting the legally required reserve requirements for banks, buying or selling US government debt, and setting the Fed's discount rate to attempt to maintain long-term sustainable growth.

When the economy is fully employed (generally considered to be when the unemployment rate is around 5.0%) real GDP growth (that is, adjusted for inflation) of 2.5% has traditionally been considered to be the long-term achievable growth rate. This range is determined by adding the historical population growth of 1.0% and the historical productivity improvement of 1.5%. Recent technological advancements, however, have led to significantly improved productivity, which in turn has led Chairman Greenspan and others to conclude that 3.0% to 3.5% may be the new long-term achievable growth rate.

After years of productivity drought, the floodgates have indeed burst open. The statistics show the US economy is awash in productivity gains, with an astounding 4.6% annualized rise in output per hour since the start of the recession in March, 2001, far outpacing the 1.8% productivity growth of the previous recession and recovery in the early 1990s. These gains have taken their toll on jobs for Americans, but have at the same time generated real benefits. **The rapid growth in productivity over the past three years has added an additional \$320 billion to the nation's GDP compared to what the GDP would have been had productivity gains followed the slower pace of the previous business cycle.**

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**Oakwood's Concentrated Value Strategy**  
Positive performance in each year of the most recent bear market.  
Read the full article on page 7.



**Oakwood**

Capital Management LLC

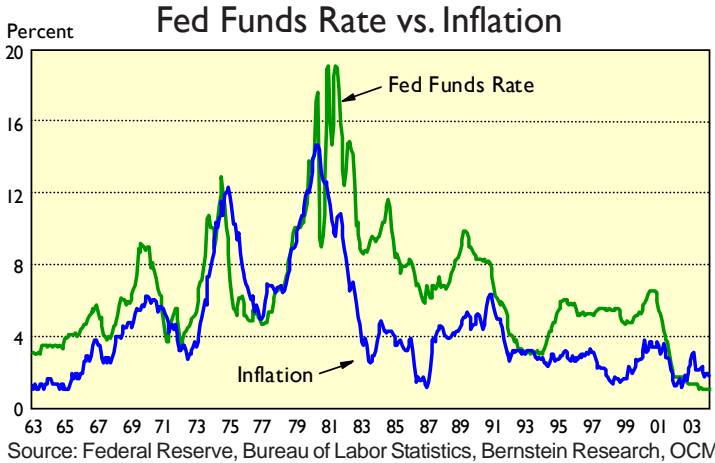
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A Word From the Advisor  
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A constant topic is the level of interest rates, in particular the Federal Reserve's target short-term rate of 1.0%. Concerns are that today's unusually low interest rates will spark inflation if they aren't raised before long. For literally decades, the direction of inflation and interest rates has been the same, and while there are indications of inflation in the economy, it has yet to meaningfully filter down to the consumer level.



It is true that the occurrence of a rise in rates does hamper total return for bonds, but price changes represent only part of bond returns. Income is the other critical component. Many bondholders fall into the trap of monitoring the market value of their bond portfolio, when one of the main reasons for investing in bonds is for the income component. As coupon levels rise, it is easier to maintain desired income levels. Income generation is perhaps the biggest advantage over other assets.

For those that are dependent on a stable income to live on, a rise in rates and the ensuing higher income component is a very positive occurrence. A higher interest rate environment can help more conservative investors avoid the trap of chasing inordinately risky, seemingly high returning assets and keep their money in the more stable, conservative asset choice of bonds while earning respectable returns.

The prospect of rising interest rates can be a welcome event to income-seeking bondholders who make full use of Oakwood's active management strategies. **The tendency to chase yields will lead inexperienced investors to intuitively position themselves at the longer end of the yield curve, which may cause them the most damage should interest rates move higher. However, we at Oakwood become more defensive by implementing market protection strategies. This allows us the flexibility to take advantage of an upward move in rates.** We use daily volatility in the market to advantageously position the duration of client portfolios to benefit from these moves, rather than to react to them.

Today's improving economic conditions have another implication for bonds: Stronger economic growth should improve credit quality. Profit and cash flow are picking up for US corporations, and the expectations are for this trend to continue as the pace of economic growth strengthens. These factors have begun to affect how credit agencies are rating corporate debt.

Since the beginning of 2003, credit downgrades have begun to fall relative to upgrades. The market has recognized this improving trend in credit quality, as the extra yield available for buying corporate bonds has fallen. **Again, the value of Oakwood's active bond management is brought to light as the selection process for corporate securities for client portfolios includes rigorous research and continuous review.**

**The Oakwood Fixed Income mission is to produce excellent relative performance in all interest rate environments.** Our active-management approach is designed to accept only the amount of risk necessary to achieve your goals. Risk is managed by using only investment grade securities and by employing rigorous sell disciplines to preserve market value.

**Oakwood offers both taxable and tax-free portfolio management. A review of Oakwood's fixed income strategies covers the spectrum of active bond portfolio management in all categories.**

**Short-Term US Governments Fixed Income.** This diversified fixed income strategy invests in all types of US Government securities with a maturity limitation not to exceed five years. The strategy is actively managed around a target duration and seeks higher return potential than that obtained from money market securities without the risk of longer maturity issues. This strategy is suitable for investors who seek moderate income and growth consistent with participation in the highest quality fixed income securities.

**Intermediate Fixed Income.** This diversified fixed income strategy may own all types of US Government securities and investment grade corporate bonds. The portfolio will generally not hold bonds with maturities beyond ten years. The strategy is actively managed around a target duration. Using the Lehman Brothers Intermediate Government/Corporate Index as a benchmark the goal of the strategy is to generate good returns relative to the benchmark in all interest rate environments. This strategy is suitable for those who seek moderate total return.

**Full Maturity Fixed Income.** This diversified fixed income strategy makes use of all taxable investment grade fixed income securities. There are no maturity or sector restrictions and the portfolio is actively managed around a duration target. With the Lehman Brothers Government/Corporate Index as a benchmark the goal of the strategy is to exceed the return of the benchmark. This strategy is suitable for those who seek total return in a fixed income portfolio.

**Tax-Exempt Municipal Bonds.** This fixed income strategy invests in tax exempt securities, both state-specific and general market obligations, depending on client residency and/or market opportunities. The strategy is actively managed and may use the full maturity spectrum for both state-specific and general market bonds. The goal of the strategy is to generate good after tax returns.

**Research and active management can generate return where it doesn't seem readily available.** In addition, it is important to remember that bonds play an important role in any portfolio, both as a reliable, income-producing asset and as an anchor for those times that equities underperform. ■



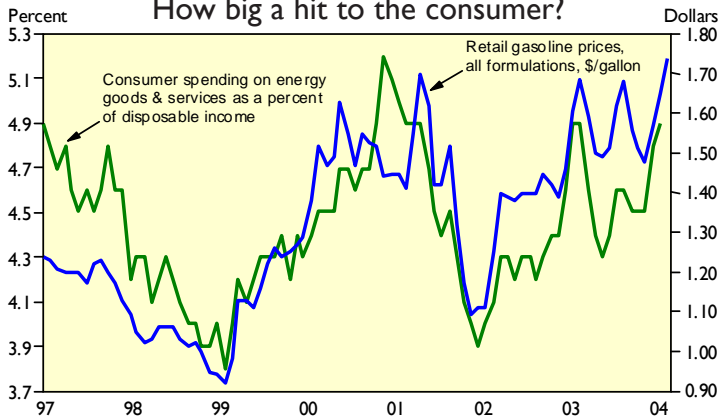
Economic Outlook  
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Winners			Losers		
Corporations	Operating Profits	+24.9%*	Unemployed Workers	Job Growth	+0.1%*
Consumers	Consumption Price Index	+1.4%*	Professionals/Tech Workers	Real Wages	+0.6%*
Managers/Executives	Real Wages	+2.6%*	Blue Collar Workers	Manufacturing Jobs	-3.1%*
Homeowners	Real Housing Prices	+6.5%*	Poor Households	Benefit little from rising home and stock prices	
Investors	S&P 500	+39.2%*			

\* Change over 12 months ended March 22, 2004  
Source: Dept. of Labor Statistics, Commerce Dept., Oakwood Capital

As shown in the chart above, the benefits of productivity gains have shown up primarily in corporate profits. With the first-quarter earnings season upon us, Oakwood’s analysts expect profits of companies in the S&P 500 Index to increase 16.7% from the previous year. One recent plus for profits is the dollar’s decline, but that is far from the most important factor. Fourth-quarter net receipts from non-US operations were up 23% from the year before, but earnings from US domestic operations alone rose by a larger 30%. Profits are flowing, mainly because demand is accelerating at the same time that businesses are able to cut costs. During the past year, overall demand has grown 4.4%, more than double the 1.8% pace the year before. At the same time, productivity growth has reduced labor costs, the result of which is more of each sales dollar going straight to the bottom line.

Energy Prices and Consumer Spending  
How big a hit to the consumer?



Source: Dept. of Energy, Bureau of Economic Analysis, Oakwood Capital

The final revision of the fourth quarter 2003 GDP indicates economic growth increased by 4.1%, which was below analyst expectations but still considered strong growth. We expect first quarter 2004 GDP growth to be in the 4.5% range. As consumption (that is, consumer spending) comprises approximately 68% of the GDP, it is considered the most important component. Higher gasoline prices and other energy prices are behaving like a pseudo-tax on both consumers and businesses, threatening the recovery’s longevity. With crude oil quotes up 10-15% since December, the filtering effect to gasoline and other energy prices, along with a combination of low

inventories, tight domestic refining capacity, stringent environmental requirements and stronger demand as we enter the summer driving season could drive prices up to new records. Based on the assumption that nationwide gasoline prices hit \$1.95/gallon, up from the \$1.74/gallon at the end of March, the consumer will face a pseudo-tax hike in the first half of 2004 of approximately \$20 billion. Put more simply, each \$0.01 rise in gas prices takes approximately \$1 billion directly out of consumers’ pockets.

To be sure, rising tax refunds and other tax reductions will offset the impact of this scenario. The estimate for the retroactive features of last year’s tax cuts should reduce individual taxes by approximately \$37 billion between February and May of 2004. Tax cuts and low interest rates are typically government responses when the economy is in need of help. What makes the current policy somewhat extraordinary is the aggressiveness of both the Bush administration and the Federal Reserve. The Federal Reserve has been busy over the past few months, decreasing the counterweight of the discount rate in the attempt to keep the recession shallow. The federal funds rate remains at 1%, after hitting a 46-year low nine months ago.

Further envisioning a mini-balance scale with inflation in one pan and deflation in the other, we recall that since the Federal Reserve began its interest rate cuts from the 6.5% rate at the beginning of 2001, these two pans have been undulating. Now we are seeing the factors between the forces that promote lower and higher inflation tilting toward the latter. Most prominently, “core” consumer prices rose by 0.2% for the second month in a row and by 1.7% at an annual rate over the past three months. This is a change from the November 2003 report of flat core consumer prices for the first time in more than four years. This change in pricing power is showing up in goods prices first. Core consumer goods prices, accounting for about 23% of the CPI, rose 0.3% in the past three months – a tiny change when looked at in isolation, but when compared to the 2.5% decline over the past year, not so tiny. As well, inflation in other forms, such as higher commercial insurance and health care costs, is filtering its way into the economy.

This evidence of the return of inflation isn’t ironclad, but outward signs are accumulating that point in that direction:

- **Cyclical prices are booming.** The prices that US companies pay for nonenergy commodities have increased 7-40% in the past year. This is shaping price expectations among manufacturers and some are passing through these increased costs.
- **Inflation expectations are rising.** The University of Michigan’s consumer polling indicates both one- and five-year expectations have risen. Consumer inflation expectations are important because they

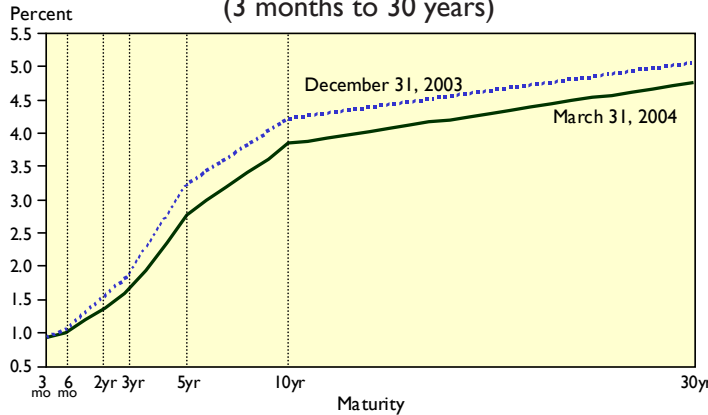


TAXABLE FIXED INCOME

# Strategy

We continue to generate positive fixed income results for Oakwood client portfolios in the first quarter of 2004. As shown in the following chart, yield levels throughout all maturity areas moved modestly lower during the quarter, with the five and ten-year area capturing the largest decline.

Historical Yield Curve  
(3 months to 30 years)



Source: Bloomberg, Oakwood Capital Management LLC

**This downward trend in interest rates suggests that the fundamentals governing the economy, inflation and monetary policy, remain somewhat favorable for the fixed income markets.** As an example, corporate productivity gains continue to bolster company profits with only a limited need to raise prices. A stable Federal Reserve monetary policy is helping to keep mortgage rates low and the demand for housing strong, with low monthly interest expense counteracting the inflationary aspects of escalating housing prices.

The current bond market environment is somewhat reminiscent of year-end 2002, a period when oil was also trading above \$30. Ironically, US Treasury yields at that time were almost identical to present levels. As highlighted in previous Oakwood Outlooks, one preeminent factor in keeping interest rates and inflation low is the impact these high energy prices have on the economy, and, in turn, on a company's ability to demand higher prices for products. Another factor is a shortfall in confidence that the economy can sustain strong growth. In fact, even though currently strong, there is a growing concern that the recovery may be slowing, as conflicting economic reports begin to surface. For example, while fourth quarter Gross Domestic Product (GDP) grew at 4.1% and exceeded market forecasts, factory orders rose at only 0.3%, well below predictions and the Chicago Purchasing Manager Index fell from a reading of 63.6 last month, to 57.6. Furthermore, stubbornly high

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TAX EXEMPT FIXED INCOME

# Strategy

The municipal bond market showed modest improvement over the quarter, as cash generation from coupon flows accounted for most of the performance gains. Compared to this period last year, new bond issuance is strong as municipalities use this low interest rate environment to shore up weak balance sheets. **While the demand for the added supply is robust, there is a certain amount of "rate shock" as investors move to the sidelines or switch to the equity markets.**

For California residents, even modest positive performance is quite commendable, considering the huge State deficit financing scheduled to start in June. In fact, during the quarter, California actually outperformed many other states. This, however, may change as the State floods the market with the biggest (\$15 billion) municipal bond deal ever, easily eclipsing the recent \$10 billion deal in Illinois. The deal is already beginning to affect the supply/demand balance of municipal bonds throughout the country at the same time other state and local governments are tapping the municipal bond markets for their own needs.

Although the California situation may continue to draw money away from other states, the extra pressure placed on the municipal market should be manageable. One widely used measure to identify attractive maturity areas is the yield relationship of tax-free bonds to their taxable counterparts. Historically, a yield relationship of 80% for intermediate bonds and 90% for bonds maturing beyond 10 years is attractive. **Because we are even more demanding, we are able to find high quality intermediate bonds with a yield relationship of 85%, and longer maturity bonds with a yield relationship of 95%.**

Looking forward, we believe interest rates are likely to move modestly higher. As pointed out in the Taxable Fixed Income Strategy, low yield levels have factored in an ideal climate of moderate economic growth and subdued inflation, and even small market disappointments can exaggerate price volatility. However, a rebound in yields should begin to attract investors again.

Meanwhile, we are allowing the average maturity in client accounts to shorten through the passage of time. Furthermore, despite the inherent tendency to "chase yield" by extending bond positions to higher yielding longer-term fixed income investments, we maintain only limited representation beyond 10 years. **To keep accounts from becoming too short, we are able to take advantage of the steep yield curve through the select selling of shorter holdings, in favor of six- to eight-year investments, for generous yield gains of +100 basis points**

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Taxable Fixed Income  
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energy prices continue to erode airline profits, despite high passenger volume. Finally, consumers are being forced to spend more of their discretionary income to fill up their vehicles.

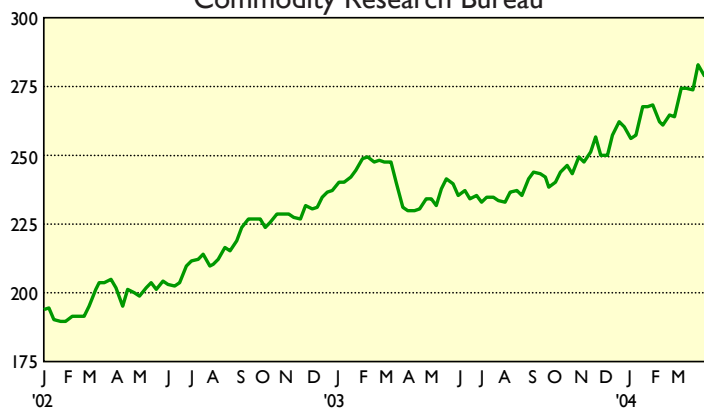
Clearly, since the start of this latest economic cycle that began in 2001, the lack of new manufacturing jobs is keeping interest rates low and bolstering the bond market. Future changes may be the key to interest rate direction. Most economists along with Federal Reserve Chairman Alan Greenspan say that patience is needed, as they expect gains in corporate productivity to moderate soon and translate into a need to add jobs. **While it is intrinsically difficult to accurately predict the future direction of interest rates, it is even more difficult with bond rates near historic lows. As a result, changes in the economy, world events and small adjustments in inflation can heighten price volatility and easily alter return expectations in bonds.**

Therefore, we are initiating several changes in client portfolios. First, we are beginning to reduce the average maturity of our Treasury holdings. While similar maturity corporate bonds are also subject to erosion of principal, their inherently higher yield and potential to be upgraded should provide a market buffer. This is especially true if the catalyst for higher interest rates is an expanding economy, modest inflation and better corporate profits.

Second, the use of short-maturity, high coupon, callable securities provide additional yield versus non-callable alternatives, with an emphasis on the early call dates. Because we insist on a very generous yield to the final maturity, market protection is guaranteed if the security is not retired early. Regardless of the outcome, the high coupon generates above market cash flow, which is an essential part of investment performance.

Finally, concerns over inflation have prompted us to prepare programs to shorten portfolio duration. All precious metals which include gold, copper, platinum and silver, along with oil, are sending commodities prices to multi-year highs.

CRB Index  
Commodity Research Bureau

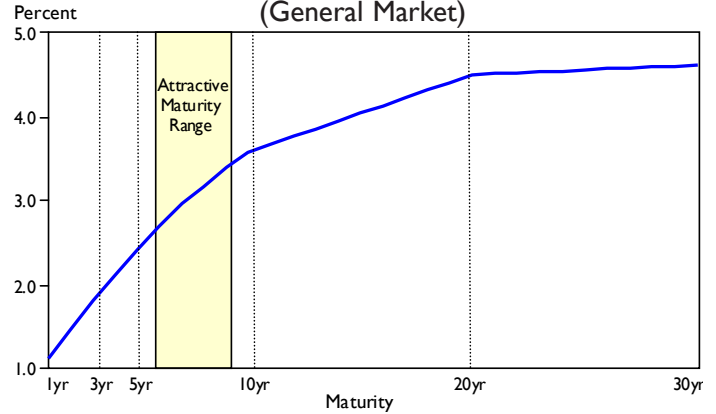


Source: Bloomberg, Oakwood Capital Management LLC

Tax Exempt Fixed Income  
Continued from page 4

**or more.** California clients receive an additional tax benefit as previously purchased out-of-state bonds are shifted back to in-state municipalities and are modestly extended.

Tax-Free Yield Curve  
(General Market)



Source: Bloomberg, Oakwood Capital Management LLC

Continuing our investment posture, our above-market coupon preference is designed to generate high cash flow and protect against a rising interest rate event. Regardless of the ultimate outcome, we will continue to use daily market changes to identify other attractive areas of investment. For national accounts, under consideration are states like Florida, where yields have adjusted upward in response to a reduction in the intangible tax on residents. Also, pre-refunded and escrowed to maturity bonds that normally offer lower comparable yields due to their government collateral support are now trading at comparable levels to other sector choices. **Finally, we believe the key to success in this uncertain environment is market discipline and patience, a quality that Oakwood is well known for.** ■

As the worldwide demand for commodities continues to grow, manufacturing companies are being forced to pay higher prices. In fact, the latest Institute for Supply Management report reflects a sharp increase in respondents who report paying higher prices for raw materials. Unless the situation changes, we intend to initiate duration-shortening beyond our current market neutral stance.

At the same time, we will remain flexible and will be able to easily shift back to a more aggressive posture. We are mindful that the long-term downward trend in interest rates that begin over 20 years ago remains intact. During this period, there have been numerous times when we were able to take advantage of short-term price fluctuations to add value to client portfolios. Because we hold only high quality securities that are highly liquid, we can respond quickly to future moves. For now, we feel our shift to a somewhat cautious structure is a better match for the potential risks. ■



EQUITY MARKET STRATEGY

# A Return to Rationality

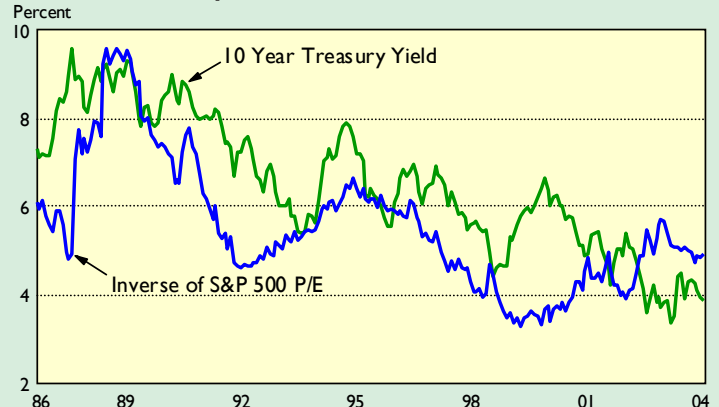
With the close of the first quarter of 2004, it is quite clear that a level of rationality has come back to the market. The 2003 rally, which featured smaller-cap, technology, telecommunications, and Internet companies with dubious balance sheets, whose stock prices were doubling or tripling in value, seemed to lose momentum toward the end of the first quarter of 2004. The long-awaited rotation into the shares of larger, high-quality companies with proven records of earnings growth which comprise Oakwood's equity universe has begun to materialize. **This rotation translated into outperformance in all of Oakwood's equity market strategies for the quarter compared to the S&P 500 Index. This outperformance is particularly compelling in light of the fact that the beta coefficients of client portfolios are at the lower end of their normal range.** (Additional information is available upon request. Past performance is not indicative of future results.)

Despite a strong start in January, most major indexes closed the first quarter of 2004 very near their starting points. Stocks moved unevenly during the quarter with investors considering higher oil prices, a bundle of political issues, and continued reminders of geopolitical risk. The outlook for corporate earnings, while still respectable, is not as robust as it was in the second half of 2003. At that time, earnings were poised to surge on the wave of an economy that was, by most points and measures, finally recovering from a recession. Now, with the recovery in a more mature stage, increases in earnings are likely to become more modest. As earnings gains slow, stock gains are likely to follow suit.

Our outlook for stocks for the year remains positive. We expect corporate earnings to grow in the range of 10% to 14% in 2004 and 9% to 12% in 2005. Other positives for the stock market include the expectations for economic growth of 4.0 to 4.5% this year, a pickup in business investment, an improving job market, rising incomes, larger than normal tax refunds and yet another round of mortgage refinancing. Weighing on these positives is the prospect of inflation, gradually higher interest rates and political uncertainty in this election year which could affect future tax policy.

**Modest increases in inflation and interest rates are traditionally signs of economic strength and thus would be a positive for stocks.** On the other hand, significant increases in interest rates due to an inflation scare could represent a risk to price-to-earnings (P/E) multiples. Using the inverse relationship between the yield on the ten-year Treasury bond and the current P/E multiple of the stock market to gauge valuation in the market, we see the current yield on the ten-year Treasury bond of about 4.2% implies a market P/E of about 23.8 times earnings.

10 Yr. Treasury Yield vs. Inverse of S&P 500 P/E



Source: Baseline, Bloomberg, Oakwood Capital Management LLC

The P/E on 2004 earnings is currently about 19, implying a yield on the ten-year Treasury bond of about 5.25%. These relationships clearly indicate that the stock market has already priced in some expectations for an increase in inflation and interest rates. We believe we will see some contraction in P/E multiples in 2004 and perhaps in 2005. The magnitude of the contraction and its impact on stock returns depends on the strength in corporate earnings, changes in earnings growth expectations, and changes in inflation expectations and interest rates. **So while changes in interest rates and inflation are a factor in stock price movements, they are just part of a wide range of fundamental and economic factors that impact these prices.**

One sector that is perhaps most sensitive to changes in interest rates is the financial services sector. We are modestly overweighted in financials and have evaluated interest rate sensitivity, among other fundamentals, for each of our holdings in this sector. Our equity investment process and discipline has led us to a selection of high quality companies with strong fundamentals and excellent free cash flow generation. A rise in interest rates for these financial intermediaries means that cash flow generated will be reinvested at higher yields, allowing for more attractive spreads between their assets and liabilities. As well, many of the companies in Oakwood client equity portfolios are global in nature, which lends them some immunity to the ebb and flow of country-specific events.

Given the rate of improvement in the economy, the continued increase in corporate earnings, higher dividend payouts and a probable contraction in P/E multiples, we envision an environment of stock returns in the range of 9% to 11% per year. In the first quarter, no one sector or industry dominated the performance of the major stock indexes (although noteworthy is the fact that the financial sector and the energy sector were the top-performing sectors). There are currently many "ifs" in

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Spotlight on Concentrated Value Strategy

Positive Performance in Each Year of the Recent Bear Market

If we lived in a monochrome financial universe, we would, as investors, all have the same financial goals and attitudes about risk. This would lead us to all choose the same types of investments. The truth is that we live in a richly colored world, and know that one-size-doesn't-fit-all. At Oakwood, our array of equity strategies reflects that knowledge. As an Oakwood client, you have the benefit of choice from four very well defined equity strategies that complement our fixed income and balanced strategies.

Oakwood Capital Management Equity Portfolio Strategies

Equity Income	Concentrated Value	Large Cap Equity	Capital Appreciation
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Since its inception in 1997, where it outperformed the S&P 500 Index, the Concentrated Value Strategy has an annualized return of more than double that of the S&P 500 Index. It is noteworthy to add that the annual returns of the Concentrated Value Strategy not only outperformed the S&P 500 Index in each year of the 2000, 2001 and 2002 bear market, it also generated positive returns in each of these three years. The Concentrated Value Strategy continued to outperform for 2003, as we began to pull out of the bear market. (Additional information is available upon request. Past performance is not indicative of future results.)

A basic goal of portfolio management is the desire to limit risk and maximize return. Achieving this goal is not always easy, largely because risk can be difficult to define and measure. The traditional risk measurement tools used by investment professionals include beta (the relative movement of an investment versus a benchmark) and price volatility. Theoretically speaking, the more risk that we take on, the more payoff we should receive in terms of higher returns. In Oakwood's Concentrated Value Strategy, risk is defined somewhat differently. Risk is defined as the possibility of long-term loss of capital employed. The Concentrated Value Strategy over the short term can be volatile. Because of its concentrated nature, changes in the market value of a single issuer could cause greater fluctuations in the value of the portfolio than would occur in a more diversified portfolio.

Investment philosophy

In the Concentrated Value Strategy, we seek to achieve superior long-term performance by acquiring equity securities of financially strong, well-managed companies, at market prices significantly below our assessment of their business, or intrinsic value. A guiding principle is the view that common stocks are units of ownership of a business, and we as investors are

becoming owners of the business, not just holders of a stock certificate. We are patient investors, not market timers. We believe that, over time, the price of a stock will rise to reflect the value of the underlying company. The Concentrated Value Strategy, as its name implies, is non-diversified, and as such, will own a minimum of four equity securities and a maximum of fifteen equity securities. While the strategy may incur short term paper losses, the focus is on avoiding long-term loss of capital employed. This is achieved mainly from the margin of safety in the price paid for the stock, and the quality of businesses in our investment choices. Under normal market conditions, the strategy will remain fully invested.

Investment process

Because we seek to identify undervalued companies, the investment process is not solely based on such macro-economic factors as the performance of the economy or the direction of interest rates. We employ an intensive, in-house research process to identify companies that meet our value criteria. The equity research process for the Concentrated Value Strategy starts with an analysis of a company's financial reports to determine its value. The balance sheet and earnings history and prospects of each investment are extensively studied to appraise fundamental value. We establish contact with and hold numerous conversations with company management. We are looking for companies where the appraised (or intrinsic) value exceeds the current stock price by a significant margin.

We look for those companies that display the following characteristics:

- High return on equity, on capital, and on reinvested capital, with distribution of excess capital to shareholders;
- A management that is shareholder driven, that are preferably shareholders themselves, and who spend shareholder money prudently;
- Financial strength in terms of cash flow and an underleveraged balance sheet;
- Predictable free cash earnings with limited cash requirements for growth; and
- Strong franchise or cost advantage - these businesses tend to have a wide "moat".

The next step in our analysis is to select the companies that are capable of delivering greater than a 15% probability-adjusted compound annual return over a 5- to 10-year time horizon. The price of the stock, its Free Cash Flow [FCF] growth rate, its FCF growth rate predictability, its Return on Equity [ROE] and its ROE Retained to Common Equity [RTCE] play a large role in our proprietary valuation methodology. We adjust our projected 5- to 10-year forward rate of return by the



## Economic Outlook Continued from page 3

often anticipate measured inflation changes and because they also reflect behavior, especially in the wage-setting process.

- **The long slide in the dollar has begun to slowly but significantly lift import prices.** While US prices of Asian imports fell by 1.9% over the past year, this accounts for just 12% of the US total. On the other hand, the prices of imported goods from the European Union (EU) which account for 21% of US imports, have risen by 3.5% over the past year, thanks to a 15% depreciation of the dollar against the euro.

We have not achieved equilibrium in our disinflation-inflation scale, as neither the data nor analytics yet point uniformly to higher inflation. Unit labor costs are still falling, and there is ample slack in the US and global economies. However, as labor markets firm, unit labor costs will rise, as compensation mildly accelerates. The most recently released employment report astounded Wall Street with the reported addition of 308,000 jobs in March, with January and February numbers revised upward as well, strengthening the precept of a firming labor market. These employment numbers took many observers by surprise, but seem to be the missing counterweight for our growth scale, finally aligning with other economic indicators that have been signaling robust economic growth.

Consumers will remain the key to the recovery's stamina, who by all measures seem to have the wherewithal to keep spending. Higher than usual tax refunds are starting to boost after tax income, and mortgage rates were recently back to near-record lows, which should add another lift to refinance money. These two factors, coupled with the good news in the labor market, should in turn boost consumer confidence. However, the economy is at an inflection point as new forces are acting upon it. Outsourcing looms as a potential threat because no one knows how many jobs and which industries are vulnerable. Productivity is problematic because the lines between the pros and cons are blurred. Meanwhile, the next revolution that is supposed to propel the economy and job growth forward after the Internet boom isn't obvious.

The US is now experiencing the brunt of pain from outmoded jobs while still awaiting the innovations that will generate the jobs of the future. History has shown us, however, time and time again, that jobs follow growth, but not necessarily in a linear fashion. The US economy is and always has been an innovative economy. With the economic scales nearing a balance needed for sustainable growth, we feel the economy will deliver the jobs and prosperity that it has in the past. ■

## Equity Market Strategy Continued from page 6

the investment world, the outcome of which is uncertainty, an environment that isn't likely to establish a consistent direction. In this type of environment, Oakwood's proven investment process and discipline and its end result, superior stock selection, becomes paramount.

**Our focus in managing client portfolios has always been on investing in higher quality companies. Although quality can be defined in many different ways, our definition of quality companies includes those that have positive cash flow characteristics and attractive free cash flow yields, strong returns on capital, increasing dividends, healthy earnings growth prospects, and positive economic returns on capital, coupled with capital spending discipline. ■**

## Concentrated Value Strategy Continued from page 7

probability of achieving it, to determine an expected, or probability adjusted, rate of return. Qualitative and quantitative estimates factor into our probability analysis, based on many years of investment experience. All calculations are post-stock option expense calculations, an adjustment that radically changes the expected return of many popular companies.

The construction of the Concentrated Value Strategy portfolio is the result of a collective effort of Oakwood analysts and portfolio managers to identify the best values in the market. Equities purchased at prices substantially below their intrinsic value protect capital from long-term loss and can also appreciate substantially once the market recognizes the company's economic value. For example, if we buy a company for half its intrinsic value, if the value grows 12% per year through retained earnings, and if the share price rises to reflect corporate worth in the fifth year, the investment will compound at 29% per year. Two-thirds of the return comes from the narrowing of the gap between the purchase price and the intrinsic value, while one-third comes from the business' value growing.

We are long term holders of stocks even if fully priced as long as the intrinsic value grows at an average of 15%. Generally, we will sell if the business materially deteriorates, if we disagree with substantive management actions, if we find we have erred in our evaluation analysis or if new unfavorable material facts come to light.

**In the Concentrated Value Strategy, investors enjoy the benefit of a well-defined fundamental investment strategy that leads to the construction of a focused equity portfolio comprised of a small number of only the highest quality stocks. ■**