

Oakwood Outlook

& Quarterly Review

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A Word

From the Advisor

The Federal Reserve (Fed) followed a tight script on the last day of the second quarter, raising the Federal Funds rate a quarter of a point to 1.25% in a widely expected move. The Fed's goal is to gradually taper the economy and financial markets off their dependency on "cheap" money without extinguishing the recovery or allowing inflation to rampantly reignite. It's not as if the Fed is saying the economy is overheated and we have to slow it down; it's simply saying that the economy no longer needs the stimulus of inordinately low rates. **It is worth remembering that, with inflation in the 2.0 to 2.5% range, the Federal Funds should trade in a similar range for Fed policy to be considered neutral, a case in which policy neither helps nor hinders economic growth.** If policymakers hike rates by a quarter of a point at every meeting, the funds rate would reach a neutral point in early 2005.

Other things being equal, a climb in interest rates would be cause for concern for the stock market, because the higher rates add to businesses' borrowing costs and can slow the pace of economic growth. **The Fed's policy makers do not raise interest rates in a vacuum, and intend to use this action**

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Economic Outlook Measured Change

The Federal Reserve has raised the Federal Funds rate for the first time in over four years, as the economy is coming off an extended period of massive monetary and fiscal stimulus that has allowed easy and inexpensive credit to support consumer and business spending. Recently, the economic pendulum has been kept in motion by the deflation-inflation dialogue. Currently, economic momentum and its longevity have replaced deflation as a conversation partner. Opinions are divided as to the effect that the timing, size, and appropriateness of the recent rate hike and those that may follow will have on our current recovery process.

The current unemployment rate suggests that there is still slack in the labor market. Although the US economy has added approximately 1.2 million jobs since January of this year, employment growth slowed in June, as the government reported 112,000 new jobs in the US economy last month, well short of many Wall Street forecasts. The gain was about half of May's revised gain of 235,000 jobs, and after three straight months of strong reports, marked the weakest jobs report since February. The lackluster growth in June may set the tone for the second half of 2004, as many companies, particularly small ones, may be hesitant to hire in what they consider to be a fragile economy. Persistent violence overseas and uneasiness ahead of the November presidential election have created a tense environment in which inaction is becoming the watchword among hiring managers. Looking beyond the June payroll report and continual monthly statistical "noise" however, the trend in job growth has been positive, as are rising income levels. According to the Commerce Department, wages and salaries are now rising at an annual rate of 5.00%.

We see productivity as a key variable in determining how fast the economy will grow and whether that growth is sustainable. New technology and improved business practices helped squeeze more output from fewer workers, and pushed the current productivity rate well above the historic fifty-year average. With average productivity growth of 4.5% since the beginning of 2001, uncertainty looms over just what rate of productivity growth is sustainable, or, indeed, how far it might drop. This is worrisome because, should these productivity gains decelerate, companies will have to boost prices in order to maintain their profit margins.

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As we enter the season of corporate earnings announcements, the focus will again be on a primary determinant of equity prices: future earnings. The past few years have been especially kind to US companies. **Profits are rising at a double-digit pace while tax-law changes have created generous depreciation allowances. Companies as a whole have seen their cash flow surge by 24.2%, and have spent over half of that on capital expenditures and have reduced debt as well.** Businesses will most likely keep up the pace of capital goods spending through the remainder of the year, as the tax credits for this business investment activity expire at the end of 2004.

Certainly, rising short-term interest rates can impact profit growth. At this point, however, short-term rates are artificially low, both from an historical standpoint and relative to inflation. Assuming by late 2005 that short-term rates rise to a level closer to their long run average (between 3.00% and 4.00%), very few projects that are currently viable would be cancelled because the cost of borrowed funds becomes too high. The economic and stock market boom of the 1990's saw yields on the 10-year Treasury ranging between 5.00% and 6.00%. The 4.50% current yield on the 10-year Treasury, or even an increase in the yield to as high as 5.50%, would have only a modest effect on capital expenditures.

For consumers, who hold the bulk of the nation's wealth and represent two-thirds of its spending, high debt coupled with rising interest rates is not a palatable combination. In addition, the effect of last year's tax cuts is waning. However, while some consumers will face higher interest rate costs on floating-rate debt, many have locked in low cost, fixed rate mortgage financing. The rise in housing prices will likely decelerate over the next 18 to 24 months as interest rates rise, crimping consumer wealth, but not deflating it.

Oil prices have jumped 30 percent this year due in part to supply-and-demand problems. China, now the world's second largest oil market, has been a huge driver of oil demand, with import growth up about 40 percent so far this year. The weaker US dollar is another factor in the rise in oil prices. A 10 percent drop in the dollar against currencies of other oil-consuming countries means a 7.5 percent rise in the dollar price of oil. Although oil — and natural-gas — prices have risen sharply, they will likely have only mild effects on overall economic activity, making the Gross Domestic Product (GDP) only about 0.9 percent lower than it would otherwise be. Businesses also have more experience with energy price shocks; they understand how to manage the shocks that affect them and how other

segments of the economy will respond.

The scale of the current US budget deficit, projected to be \$477 billion in 2004, can cause a fundamental shift in market expectations and a related loss of confidence both at home and abroad. The era of large and lasting deficits can lead to decisions by international investors to shift out of dollar-based assets, thereby sparking a fall in the dollar and a more ratcheted rise in interest rates.

Does the latest Fed move signify a major change in our economy? The recent less-than-expected job number suggests that the economy is still growing, just with less momentum. Despite the slack in the labor market, we are seeing increasing pressures for inflation, with the Commerce Department's most recent report stating that the Personal Consumption Expenditures Index had its largest increase in 14 years. In the June Chicago Purchasing Managers report, the inflationary expectations were confirmed as the Index of Prices Paid rose to 84.5, from 80 in May. This is a huge month-over-month increase of 5.6%. **However, neither the Fed nor others can be sure if the recent surge in inflation is an isolated event or a return to the era of rising prices.** Fed Chairman Greenspan is expected to be cautious in increasing rates too quickly in order to avoid one of the rare blunders of the Greenspan years — a string of increases in 1994, which followed a long period of low rates, that caught the financial markets by surprise. The subsequent financial chaos contributed to the Mexican peso crisis and the bankruptcy of Orange County, California.

The downwardly-revised final release of the first quarter GDP indicates economic growth increased by 3.9%, a solid pace but lacking the verve we experienced entering 2004. The downward revision reflects the drag created by the yawning trade deficit and moderated consumer spending. The advance estimate of second quarter GDP will be released this month which we predict to be in the 4.0% range, modest but not meek. Notwithstanding any shocks on the geopolitical front or dramatic moves on the pricing front, the Fed has room to raise rates in digestible increments. **While financial conditions will likely tighten more, we feel that the gradual pace, and the continuance of the economy's momentum, will mean a measured change on the consumer and corporate front, not a fundamental change.** With this likely to be Greenspan's last term, many feel he wants to leave on a high note to secure his legacy, and to do this, he can't lead the Fed in an overly aggressive way. ■



TAXABLE FIXED INCOME

Strategy

At the end of the last quarter, we noted the difficulty in predicting the future direction of interest rates. For the bond market overall, the second quarter of 2004 was the worst in 10 years, with the Lehman Aggregate bond index down 2.4%, almost exactly offsetting the first quarter's gain. Changes in the economy, inflation and world events can heighten price volatility and easily alter return expectations in bonds. **As a result, we shifted away from lower yielding, more price-sensitive Treasuries, to an over-weighting in higher yielding corporate bonds.** The strategy proved to be a benefit for client portfolios, as yield and spread contraction has helped to preserve market value during this unstable period.

Furthermore, we noted that concerns over inflation favored some maturity shortening. During the quarter, there was evidence that corporations were beginning to raise prices, which can be a sign of inflation. This development weighed in on the Federal Reserve's decision to halt the string of monetary easing that began four years ago. However, despite a 25-basis point hike at its latest policy meeting, Fed Chairman Alan Greenspan repeated that inflation is **"not a serious concern"** and reiterated that future rate changes are likely to be **"measured"** over the quarters ahead.

We agree that the recent Fed action was justified and believe that they will be diligent in their efforts to contain inflation, which must be done to maintain a long period of economic expansion. As a result, **we are changing our current structure by adding to Treasury positions, primarily in the 3 to 5 year maturity area.** However, we will continue to maintain an overall emphasis on higher coupon securities and remain duration-neutral to identified benchmarks. To accomplish this, we are reducing our over-weighted position in select corporate holdings, at attractive price levels. This return to more price-sensitive security choices should not imply that we feel further interest rate increases will not occur. Instead, our strategy is based on expectations of the occurrence of a notable increase in new corporate bond issuance with attractive yield levels and historic evidence that current corporate bond issuance lags the rate of GDP growth.

We must remain mindful, that even with the Fed's access to endless data, it conducts monetary policy on a best effort basis in an ever-changing environment of unknowns. **While it may appear obvious that additional tightening is likely, we believe that current yield levels throughout the maturity curve are in balance with current economic conditions and inflation evidence.** As the Fed steers its way through these factors, they remain attentive to the ben-

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TAX EXEMPT FIXED INCOME

Strategy

Municipal bond yields moved modestly higher through the first half of 2004, reflecting both sound economic growth and the concern that inflation may return. The following chart shows that despite higher absolute yields in the longer maturity areas, rate levels in the short and intermediate areas had a greater basis point increase from year-end.

Maturity	Yield		Basis Point Change
	12/31/03	6/30/04	
3 Yr	1.90	2.70	+80
5 Yr	2.55	3.35	+80
7 Yr	3.15	3.80	+65
10 Yr	3.75	4.25	+50
20 Yr	4.65	4.95	+30

Source: Bloomberg, Oakwood Capital Management LLC

These comparisons help to point out the effect of yield movement on price changes. Bond prices are susceptible to change with interest rate fluctuations, with prices moving in the opposite direction of the move in interest rates. Typically, those bonds with longer duration experience more fluctuation. As a result, investors with longer duration investment structures lost more market value during this period of rising rates than did investors with shorter duration investment structures, even though the yield is higher and the year-to-date rate of change is less. This cause-and-effect partially explains the ability of shorter duration Oakwood client portfolios to withstand the upward move in interest rates. Our more cautious investment stance, i.e. shorter duration, provided good market protection during this difficult period of rising interest rates. For more than a year, we have allowed our overall maturity structure to shorten with the passage of time and restricted our purchase of longer securities. By avoiding the tendency to "chase yield", price sensitivity was reduced. Expressed another way, longer maturity municipals may seem more attractive on a yield basis, but shorter maturity municipals are more defensive when interest rates rise.

We believe the current shift in Fed policy should be viewed as a positive sign to the markets. An effective Fed policy is designed to maintain an orderly economic recovery and the Fed stands ready to raise rates in order to assure stability. Federal Reserve Chairman Alan Greenspan, over his 17-year tenure, has repeatedly stated that controlling inflation is the best way to guarantee economic success. Knowing this first increase in over 4 years is unlikely to be the

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EQUITY MARKET

Strategy

The current challenge facing all stock market investors is how to react to a stock market in a trading range, such as the one the stock market is currently experiencing. The comparatively smooth solid uphill one-year run of the S&P 500 Index from March 2003 to March 2004 has given way to choppy waters, with the index trading in a 5.5% range, between 1090 and 1150. The biggest contributors to these short-term movements have been oil prices, inflation, and interest rates. On days with higher oil prices or more aggressive comments from Fed officials, inflation and interest rate fears have driven stocks lower. On days when oil prices have retreated or the inflation outlook has seemed benign, stocks have gained. The ending tally shows the S&P 500 Index's return of the second quarter exactly matching the first quarter's 1.7%, with a year-to-date return of +3.4% through June 30, 2004. The Dow Jones Industrial Average returned a positive 1.2% for the second quarter, giving it a year-to-date return of +0.8%.

The S&P 500 Index Caught in a Trading Range?



Source: Bloomberg, Oakwood Capital Management LLC

Investors have been treading water, holding back ahead of the widely anticipated June 30th interest rate hike and worries about inflation. With this rate hike over, investors continue to hold back, focusing intently on economic and corporate announcements. Although few major companies have predicted bad earnings, the warnings that have come from several small and midsize technology companies regarding disappointing sales and earnings in the second quarter have dampened investor enthusiasm. Compounding this is the constant stream of news flow that stems from terrorist threats and geopolitical concerns based in part on a continued US military presence in Iraq and Afghanistan. All contribute to investor uncertainty, which in turn impacts the stock market.

While a number of exogenous factors may figure in the securities markets' performance for the rest of this year, it is important to take a step back and evaluate the underlying fundamentals that drive stocks over the long term. **The most**

significant change we have seen year-to-date is the upward revision in earnings. Earnings, which exert a powerful force on valuations and prices, are not only rising at a healthy rate, but the rate of growth has been increasing as analysts have upwardly revised their estimates for 2004 and 2005. At the beginning of the year, the estimate for earnings growth in 2004 by Wall Street strategists was 12%, now strategists are projecting a 16% increase. Likewise, earnings estimates for 2005 have risen from 7% at the beginning of the year to 9% now.

Oil prices, after rising from about \$29.00 per barrel a year ago to a high of \$42.32 per barrel in early June, have now settled into a range between \$36.00 and \$41.00 per barrel. While higher energy prices can act as a drag on profit growth, the growth in oil prices in the last year has primarily been driven by global demand, an indication of increased business activity. **We found good value in some great energy companies last year. We continue to overweight, in client portfolios, the energy sector versus the S&P 500 Index, given the higher oil prices and healthy refining margins, as well as a significant increase in earnings estimates in energy companies.**

In the financial sector, we are seeing upward, although more modest, earnings revisions as well. The financial sector can be sensitive to near term changes in interest rates, so we've been slightly underweighted with the exception of the Equity Income Strategy, which focuses on dividend paying stocks trading at attractive values. Our carefully selected issues in the healthcare industry display the characteristics that define our investment approach: very attractively priced companies with good earnings growth prospects that are not sensitive to near-term economic events. This allocation in the second quarter added to the positive return in client portfolios. In the Consumer Cyclical and Industrial Products and Services areas, we have a positive outlook for the companies we own because of our favorable outlook for the economy, consumer spending and capital investment. Technology is one sector where we are underweighted versus the index, and our decision has been confirmed, based on valuations and recent earnings guidance.

It's important to keep in mind that all strategies are driven by individual company fundamentals as well as macro-economic and industry considerations. At Oakwood, our fundamental investment approach is based on achieving superior long-term performance by acquiring equity securities of financially strong, well-managed companies run by capable managements at market prices significantly below our assessment of their business, or intrinsic value. **Our focus is on companies that sustain high return on equity, high return on capital, and predictable free cash earnings. This results in portfolios constructed of companies with financial strength that can maintain their profit**

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Taxable Fixed Income
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efits that a strong economy has on government needs, deficit management and job growth.

Since the Fed is expected to broadcast changes in monetary policy well in advance, our forecast calls for a subdued bond market this summer. This means that interest rates should trade in a narrower range than the past year. **Just as the Fed used the words “measured moves” in its recent policy statement, we are likely to manage changes in the portfolio in a “measured way”.** However, we expect to actively buy and sell a predetermined Treasury holding, concurrent with short-term market fluctuations. This strategy is designed to enhance portfolio returns within a somewhat cautious framework. Given the current situation, we anticipate waiting until the fourth quarter to become more aggressive. By then, the Fed should have a clearer view of inflationary forces. ■

Tax Exempt Fixed Income
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last, we remain prepared to reenter the longer maturity area on a limited basis. We will start by extending certain shorter holdings into call-protected 10 to 15 year investments. Our initial target for this maturity range is 10%.

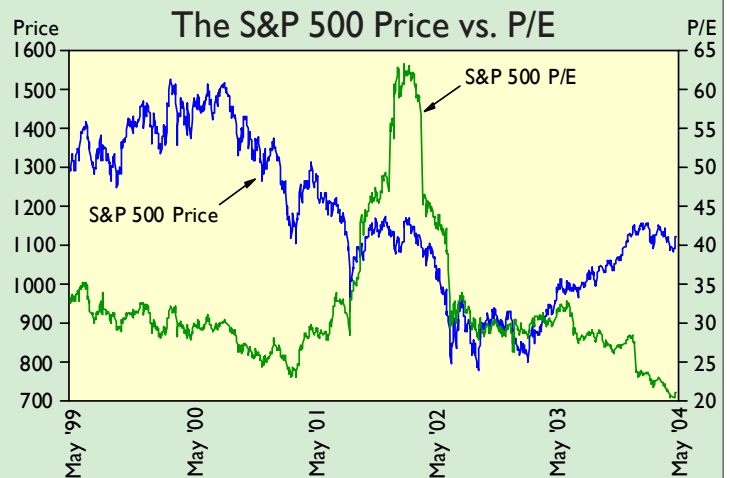
One measure in determining the attractiveness of municipal bonds is the yield ratio of tax-free investments versus taxable Treasury securities. Currently, 10-year municipals are yielding approximately 90% of their counterpart Treasury yield, well above the historic norm of approximately 82%. In addition, several developments within California may be beneficial to all clients. After months of underperformance relative to other states, California is beginning to compete again. Led by the new governor, this change started with California’s proactive approach in solving its budget crisis. Proposition 57, which allows for up to \$15 billion in “Economic Recovery” bonds, received overwhelming support by voters. Although this solves the near-term liquidity crisis, the state will be running a \$7 billion budget gap for some time. Nonetheless, this first step was greeted by a ratings increase from Baa1 to A3 from Moody’s. This event, combined with relatively high yields, makes municipalities within California attractive to both resident and non-resident clients. However, we will continue to avoid California-specific bonds until state deficits are reduced.

On balance, we continue to view tax-free bonds as an excellent investment choice for clients seeking risk reduction, investment diversification and a tax shelter. We have maintained market value during this rocky period, providing a sound basis for future growth as stability returns to the market place. ■

Equity Market
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margins, in the presence or absence of inflation. These companies, due to the strong franchise nature of their businesses, have the ability to pass along cost increases to their customers in the form of higher product prices.

In this world of uncertainty, the higher quality and lower historical volatility of the stocks that comprise Oakwood client portfolios provide a sound foundation for the remainder of 2004 and beyond. Although the market is digesting concerns, continued improving earnings and valuations will provide strong footholds for a positive stock market in 2004. Stocks have historically performed well in the months following a trough in the Fed Funds rate. In addition, the S&P 500 Index is already trading at its lowest price-to-earnings level in five years, as shown in the following chart.



Source: Bloomberg, Oakwood Capital Management LLC

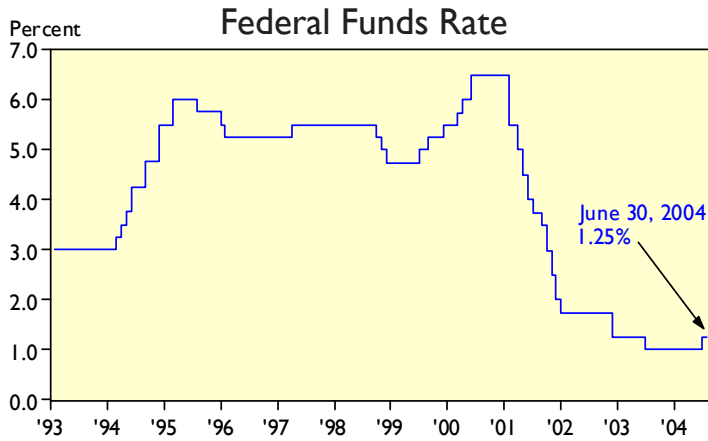
Robust top-line growth, as well as strong productivity gains, could push earnings growth further. If stocks remain in a trading range for the near future, continued growth in earnings will lead to more price-to-earnings ratio compression, setting the stage for the next leg up in the market. **The better performing stocks this year are companies with long-term track records of delivering actual earnings-per-share growth, many of which are owned in Oakwood equity portfolios. In contrast, recent past periods have favored more speculative companies with high potential for earnings growth versus actual growth.**

We will carefully manage through the current environment by continuing to focus on owning companies with positive cash flow characteristics, strong returns on capital, increasing dividends and healthy earnings growth prospects trading at attractive valuations. **We are long term holders of stocks even if fully priced as long as the intrinsic value grows at an average of 15%. We will sell only if the business or management materially deteriorates, if we disagree with substantive management actions, if we find we have erred in our evaluation analysis or new unfavorable material facts come to light.** ■



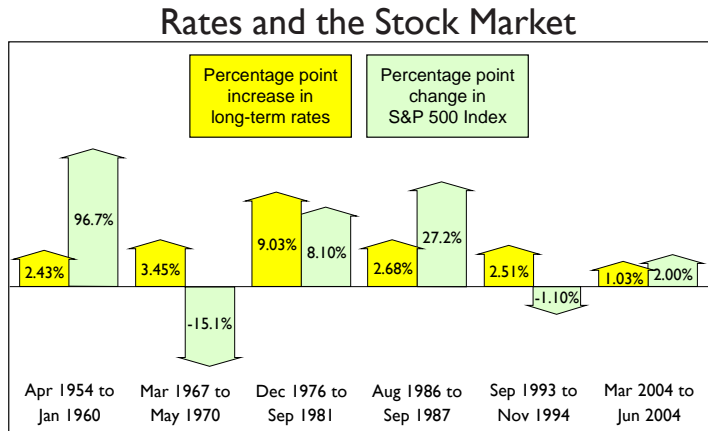
A Word From the Advisor
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as necessary to contain inflation. In this set of circumstances, moderation of interest rates has only a small net effect on the average company.



Source: Federal Reserve, Oakwood Capital Management LLC

History shows that the average company's earnings have grown faster when inflation is relatively high. In other words, the stock market is a good long-term hedge against inflation. The following chart shows the change in the index over longer periods of rising rates.



Source: Citigroup, Oakwood Capital Management LLC

We believe a sound investment approach is to own carefully chosen companies that have the ability to raise prices in the face of their own increasing costs, thereby protecting against inflation and retaining the potential to create real value over time. Oakwood's equity research process unearths sound businesses with high returns on equity and high returns on capital, which generate real returns, that is, adjusted for inflation. These high quality types of companies have the pricing power to offset inflationary pressures, thereby securing the ability to maintain profit margins. 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. 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. As a result, our equity portfolios are constructed of high quality companies

that should provide respectable returns independent of the macroeconomic environment.

On the bond side, the impact of a rise in rates is fairly straightforward. As interest rates rise, the principal value of an existing bond trends lower. However, at Oakwood we employ a defensive fixed income approach, 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 in order to benefit from these moves, rather than react to them.

We at Oakwood constantly challenge ourselves to find better ways to serve the needs of our clients. We are well-equipped, informed, and able to focus our attention on the issues that affect client portfolios, and remain carefully attuned to developments that will provide opportunities in the market. ■

Opportunities for US Multinational Companies in a Thriving Asian Market

- China's 1st quarter 2004 real GDP was 9.8% and the preliminary official guess for the 2nd quarter is 11.3%.*
- Foreign direct investment into China in the second half of 2004 is running at a \$68 billion annual rate, a new record, versus \$57 billion in 2003.*
- China's crude oil imports were up +39% a year ago. China's oil demand increase in 2004 should account for 25-30% of the world's growth of 1.82 million barrels a day.*
- India's economy grew 8.2% in the first quarter. New PM and Finance minister is still reform and growth minded. Not quite China but a second best.*
- Singapore's economy grew at a 9.1% rate in the first quarter of 2004, far exceeding forecasts. The Government is predicting 5.5 to 7.5% growth for the year. This is the fastest in 4 years and is driven by exports AND domestic demand. China is helping more than hurting her Asian neighbors.*

* Straszheim Global Advisors



**SENIOR VICE PRESIDENT
MARKETING & CLIENT SERVICES**

Spotlight on William F. Klepper

At its core, a company is the sum of the efforts and energy generated by a group of people in pursuit of a common goal. At Oakwood Capital Management, that group includes 16 educated and highly motivated men and women, whose common goal is to provide Oakwood clients with top quality investment management and superior client service. Bruce Mandel, President and CEO of Oakwood, shares his thoughts on client servicing. "Our business has two parts. Managing money is one part. The other part is explaining how we do it and why. We have a duty to communicate effectively with our clients – to help them be as knowledgeable as possible and to set proper expectations. Our Marketing & Client Services team works diligently to accomplish this efficiently and effectively." Recently, Oakwood welcomed Bill Klepper to its ranks.

In his role as Senior Vice President of Marketing & Client Services, Bill helps with business development as well as interacting with the firm's clients. When Bill sits down to discuss Oakwood and its capabilities, he looks upon himself as a problem solver. He takes the time to analyze an individual's complete financial situation, and determine what is the best overall investment strategy for his or her particular needs.

Caring, concerned and protective describe the approach that Bill takes with Oakwood clients. "The money our clients have entrusted to us represents a lot of hard work, and we are its guardian." Bill, a Certified Financial Planner, says "I like to think of myself as our clients' central point of information for all aspects of their financial lives, and help them answer questions they may have. When appropriate, I refer clients to experts in other areas."

Bill's 22 years of experience has not dulled his energy or his enthusiasm for the financial services industry. Says Nick Mamaril, Oakwood Senior Vice President and CFO "I've known Bill for more than fifteen years, and his always positive, enthusiastic attitude and creativity enhance the Oakwood approach to servicing its clients. His warm and friendly personality permeates not only the marketing team but the entire organization."

Bill joined Oakwood from Union Bank, where he served as a Vice President/Manager in the institutional trust department. At Union Bank, he interacted with over two hundred money managers and he states, "I always enjoyed working with my friends at Oakwood the most. I respected how they handled themselves and their clients,

always with a high degree of professionalism and integrity. I have dealt with the principals of the firm for fifteen years, and it is a pleasure now to work on the same side of the fence."

Although Bill spends a lot of his time on the road, meeting with prospective and current clients, he tries to be in the office at least some part of each day. This allows him to interact with others in the company. He works with the Operations Department to monitor the initial transition of a new client, ensuring that the client experiences a "seamless transition". Bill also works hand in hand with Portfolio Management in order to provide all-encompassing professional financial advice.

Bill's caring nature carries over into his personal life. He serves as a board member for Wise Senior Services, which offers vital support services and programs to preserve the independence and dignity of older adults. He is also a member of the California branch of Rotary International, a worldwide organization of business and professional leaders that provides humanitarian services and encourages high ethical standards in all vocations.

Bill is one of those people of which others comment "I don't know how he fits it all in". In addition to his busy work and community service schedule, he teaches financial planning and analysis, marketing and algebra at several local universities. Bill says he can relate to the students that he teaches. "I enjoy teaching at night because I was a 'night schooler' myself. I studied for both my bachelor's and master's degrees at night, while working full time. I understand the challenges only too well." Bill received his bachelor's degree in Business Administration from California State University, Northridge, and his Masters of Business Administration from Pepperdine University.

After a long day of working and teaching, Bill makes the drive to his home in Simi Valley, where he is greeted by his wife, Susan, his sixteen-year-old son Timothy, and his daughter Sophie, age 8. When not involved in golf or family activities such as camping and movie-going, Bill enjoys collecting movie posters, currently concentrating on posters from the 1970s. He also collects signed editions of hard copy books, his favorite genre being murder mystery. ■