Oakwood Outlook

& Quarterly Review

Volume 8, Number 1 January 2005

A Word

From the Advisor

Managing the Complexity of Change

The financial markets are intricate and complex, and if there is one word that characterizes them, it is change. **Change is what makes active money management challenging.** Oakwood's active research process in both the equity and fixed income areas is designed to unearth how changes in the economic, market, and company-specific environments affect individual stock and bond prices. We continuously review the short and long-term prospects of these stocks and bonds in order to determine how they alter the overall risk/reward profile of client portfolios. **Change is what makes active money management rewarding.** ***All Oakwood strategies for the year 2004 surpassed their respective benchmarks and have enjoyed longer-term success as well.***

The goal of our active management process is to produce for our clients a positive return over a market cycle and to accomplish that with reduced risk. The positive return over a market cycle is easy to measure. One way that we measure the risk is to compare our strategies' performance and

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Economic Outlook

Accentuate the Positive

The 2004 stock market posted a gain of +10.9%, as measured by the S&P 500 Index, which along with 2003's positive results, gave us the first back-to-back yearly gains since 1999. Most of the index's return for the year occurred in the fourth quarter, which garnered +9.2%. The Dow Jones Industrial Average, another measure of the US stock market, had a lower annual return of +5.3% and +7.5% for the fourth quarter. The bond market, as measured by the Lehman Brothers Intermediate Bond Index, returned +3.0% for 2004, with a fourth quarter return of +0.4%.

To prepare ourselves for the New Year, let's do some housecleaning. **First, let's get rid of our "fear of the Fed".** Through the past several decades, when the Federal Reserve has started on one of its interest-rate-raising campaigns, it has been bad news for the markets. In a typical business cycle, the Fed steps in because the economy has become overheated and inflation starts to pick up. The Fed starts to hike rates in an effort to force the economy to slow by boosting borrowing costs. Businesses must pay more for their cost of capital and profits decline. Consumers get hit with higher costs, too, as mortgage rates rise, and people stop buying new homes and cars. The typical result is a declining stock market.

The current cycle of Fed rate moves has not followed the old pattern. The Fed cut rates from 2001 through 2003 to fight deflation and recession, which provided much-needed stimulus in the economy and stock markets. However, because the economy had been so weak, it did not spark an uptick in inflation. In that case, the Fed isn't fighting inflation; it is moving to normalize interest rates from their abnormally low levels. **The Fed is doing its job, by all indications is doing its job well, and the financial markets like the job it is doing.** The Greenspan Fed has achieved an unprecedented degree of credibility as an inflation-fighter. The key will be whether the Fed can continue to guide the economy between the obstacles of inflation and recession. The Fed has several more tightenings before it moves the Federal Funds rate back to "neutral," a level that no longer stimulates growth, which is currently in the neighborhood of 3.0%, given our current low inflation. And with inflation likely to edge only slightly higher, long-term rates, which are crucial to housing demand and corporate finance, probably won't rise as much as short-term rates and will remain at comfortable levels. We feel that the Fed will continue to hike the Fed Funds rate from its current level of 2.25% to a level of 3.0% by June of this year, and may then pause, depending on the inflationary environment.

Secondly, let's adjust our perception of the trade deficit. There is an abun-

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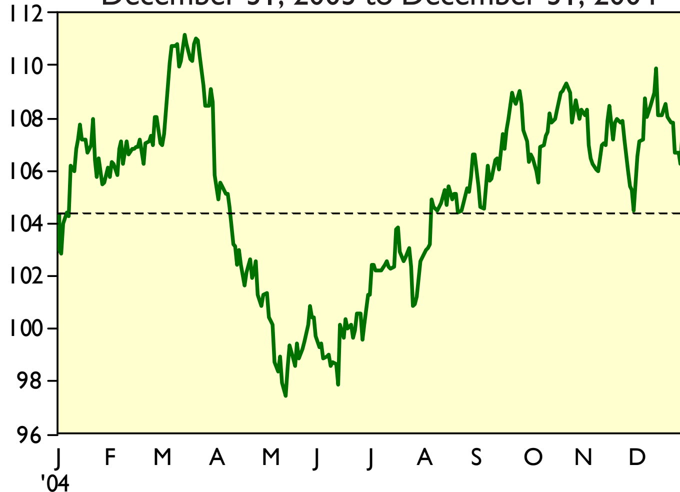
TAXABLE FIXED INCOME

Strategy

An appropriate word to describe the behavior of the bond market in 2004 is "unsettling". To support this, we have illustrated below the price swings in the 30-year Treasury bond throughout the year.



Source: Bloomberg, Oakwood Capital Management LLC

As shown, this price sensitive benchmark started the year at a premium price of $104.375, or $1,043.75 for each $1,000 par bond. By mid March, its value increased 6.75 points to a price of $111.125, as escalating oil prices and a perceived erosion in economic fundamentals favored bond investing over stock investing. During the two months following this rally, market conditions turned decidedly negative. **It became clear that concerns pertaining to the economy were superceded by fears that escalating commodity prices would propel inflation higher in the months ahead.** The market price of this long Treasury security plummeted 13.75 points or 12.4%, to a yearly low price of $97.375. This realignment of market priorities led to an immediate call on the Federal Reserve to tighten monetary policy and raise short-term interest rates, even if it meant the economy would suffer.

In response, the Federal Reserve demonstrated its commitment to fighting inflation pressures by embarking on a measured pace of interest rate hikes in its target Federal Funds rate at every meeting since June 2004. With five consecutive 25 basis point increases to date, the rate now stands at 2.25%, over twice the June 30, 2004 rate of 1.0%. As investor confidence returned, the 30-year Treasury bond reversed direction again and rallied to beyond the price level shown at the start of 2004.

To reduce the negative effects of price volatility and to gain comfort in the overall structure of client portfolios, we established a conservative duration target based on each client's risk versus return parameters. We then established a high coupon

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TAX EXEMPT FIXED INCOME

Strategy

We are pleased with Oakwood's 2004 investment results. **Returns in fully discretionary accounts were solidly positive and exceeded their established benchmarks.** Similar to the taxable markets, the municipal bond market is experiencing a number of crosscurrents with the bulls and the bears interpreting economic data differently. On one hand, the bears point to solid economic growth, plaguing budget deficits, ratcheting commodity prices and US dollar weakness as reasons to avoid bonds. On the other hand, the bulls point to subdued producer and consumer prices, a diligent Federal Reserve policy, strong investor demand for municipal securities and sub-par job growth as reasons to favor bonds.

Some bearish individual investors may be avoiding this investment sector, but far more continue to purchase substantial amounts of tax-free bonds, especially in short and short/intermediate maturity areas. While these investment preferences may seem somewhat inconsistent with the Fed's current trend of raising short-term rates, the price sensitivity of short maturities is considerably less volatile than longer maturity investments. This demand is exacerbated by a need to reinvest the proceeds of large numbers of previously issued bonds that are being called away prior to their stated maturity.

Currently, short maturity tax-free yields are low in comparison to taxable alternatives and offer little or no after-tax yield advantage. By contrast, if an investor were to purchase a 10-year tax-free bond at a yield of 4.0%, the after tax advantage versus investment quality taxable bonds would exceed 1.0%, even for those clients in a modest 28% marginal tax bracket. **We feel this yield advantage is appealing to municipal bond investors and should become more appealing during 2005.**

As the Fed continues to address the fundamentals surrounding inflation, market confidence should return, prompting investors to invest new cash or lengthen existing positions, in favor of longer higher yielding bonds. Independent of this decision, the demand for tax-free bonds should remain strong, as new supply is managed. In fact, the overall holdings of municipal bonds grew in 2004, while taxable Treasury and corporate sector holdings actually fell. Statistics show there was an influx of money market fund holdings at the expense of permanent assets, as taxable corporate bond yield spreads narrowed to less appealing levels.

Our goal in 2005 is to remain patient and await an attractive opportunity to lengthen the profile of client portfolios. To accomplish this, we will reduce an overweighting in short-maturity bonds, in favor of 10 to 20 year investments. However, we intend to maintain our preference for higher coupon securities. In fact, an above market or premium coupon security has several distinct advantages during periods of mar-

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EQUITY MARKET STRATEGY

A Stock Picker's Market

We at Oakwood take very seriously the profound responsi bility that we have in managing our clients' wealth. If we posted the rules we live by on our mirrors to remind us first thing every morning of that responsibility, they would read, in the following order:

Rule 1. Preserve our clients' capital.

Rule 2. Generate positive returns for our clients.

The key reason we strive for positive returns is that down years damage the long term compounding effect on net worth, and counter what we are trying to do for our clients: safely compound their assets over the long term to increase their wealth. We seek to outperform the S&P 500 Index as well – over the long term, say 5 to 10 years. Wall Street speaks of "alpha" as the excess return over the index in any year. Alpha can be generated with lots of risk by gunslingers and lucky momentum players, but achieving long term results for our clients requires a proven methodology, discipline, and low risk.

Using the S&P 500 Index as a proxy for the market, the 2004 year ended with a +10.9% return. Most of this return, +9.2%, happened in the fourth quarter, which acted like a rising tide that lifted the annual returns of active managers, as well as index funds. **While all Oakwood equity strategies ended 2004 by outperforming the S&P 500, it was during the earlier part of the year, through September 30, where the Oakwood methodology and discipline demonstrated superiority by outperforming the market.**

Oakwood's full spectrum of equity strategies share the same investment discipline. The margin of safety in the intrinsic value we buy versus the purchase price that we pay diminishes risk, and helps to avoid the possibility of loss of capital employed. For those strategies at the value end of the spectrum, the lower the purchase price compared to the intrinsic value, the greater the margin of safety and the greater the potential for reward. Put in simple terms, if you invest in an asset that is worth $1.00 and you pay only 50 cents for that asset, your risk of loss of capital is lessened. The key is the ability to recognize quality values of $1.00, when everyone else thinks it is 50 cents, because it is priced at 50 cents. If we buy a company for half its intrinsic value, and for example 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 gap between price and value closing; only one-third comes from the business value growing. For those strategies at the growth end of the spectrum, we put more emphasis on growth potential and may be willing to pay more for that potential. For each Oakwood equity strategy, we continue to buy well managed high return on capital, high return on equity businesses below their intrinsic value, and that continues to generate low risk returns over the long term. We know that the market can misprice in the short term, but sooner or later, it recognizes the intrinsic value of stocks.

One of many examples of adhering to our discipline occurred in the second quarter of 2004. During this period, the market reflected concerns about rising interest rates, and many financial services companies suffered from the perception. One of our holdings, a diversified financial services company, experienced a short-term decline in price, due to this market concern. Because we know the company and its business so well, after a discussion with the management, we correctly perceived this sudden undervaluation as a buying opportunity, and bought at a fraction of the intrinsic value while others were selling. In addition to adding to this position, we took the opportunity to buy some other financials at bargain prices that were affected in the same way. **The 2004 "market panic" didn't differentiate between companies that are interest rate sensitive and those that are not.**

We begin the 2005 year with many uncertainties, among them the direction of both inflation and oil prices. We currently believe a reasonable set of expectations is for earnings to grow by approximately 8%, which is a more modest earnings growth rate than 2004. With dividend yields currently at 1.6%, the market has the potential to deliver returns in the high single digits in 2005. Impacting that return will be changes to the market's P/E multiple, changing expectations for earnings growth and the potential for rising dividend payouts.

The continued contraction of P/E multiples in 2005 is a possibility, as forward earnings growth expectations moderate in 2005 and 2006, relative to 2004. While inflation is not a problem at this time, inflation expectations could change as a result of the Fed's accommodative monetary and fiscal policy. The falling dollar and rising commodity prices could also put pressure on P/E multiples, thereby reducing stock returns. **While we view stocks in general as being fairly valued at this time, neither cheap nor expensive, we do believe that opportunities to add value through stock selection will emerge in the year to come.**

Net profit margins on S&P 500 stocks have risen from a decade low of 6.2% in 2001 to a 20-year high of 8.5% in 2004. As a result, the S&P 500's returns on equity have risen from a decade low of 15.1% in 2001 to a respectable 17.4% in 2004. **Correspondingly, corporate free cash flows have risen to over 2.5% of US GDP, a level not seen since 1964.** Cash, at 11.5%, as a percentage of total assets for the S&P 500, has never been higher. **With rising cash balances on corporate America's balance sheets and the potential permanence**

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variability to those of a market index like Standard & Poor's 500 (S&P 500).

While many investors believe that a broad market index like the S&P 500 reflects an equal weighting of US industries, and that by indexing they are participating in this broad market, the fact of the matter is that sectors often become highly imbalanced. For example, in 1980, at the height of the energy crisis, stocks in that sector comprised approximately 27% of the index. Today it is approximately 7%. And in 1999, during the dot.com craze, technology shares made up about 28% of the index. Today it is about 16%. The index gets distorted by those companies that are doing the best from a price standpoint. Currently, the financial services sector comprises approximately 20% of the S&P 500 Index, up from about 13% ten years ago. Certainly, many of these financial companies are subject to interest rate risk - their recent upsurge in profits has been tied to the huge boom in mortgage refinancing due to extremely low rates, and capturing a nice spread between the interest rate charged to borrowers and the low cost of capital required to make those loans. Now that rates are on the rise, these ballooning profits become vulnerable.

Our investment methodology and discipline have led us to currently have an overweighting in financial services companies in our client equity portfolios. The difference in the quality of our holdings and the index's holdings is the selectivity we have employed in the companies we own. Rather than owning all the financial services companies, and hoping that the good ones will offset the bad ones, we focus on a handful of companies that have excellent fundamentals from the following standpoints:

- Superior financial strength, including an underleveraged balance sheet, with high return on equity and capital;
- Limited product and/or interest rate risk which makes for a predictable business;
- Predictable free cash earnings, with limited cash requirements for growth;
- Franchise or cost advantage, a "good" business, with long term competitive advantages.

Oakwood's discipline has led us to select only what we believe are the highest quality US financial companies. One of these companies concentrates in issuing only variable rate mortgages which makes it interest rate insensitive. In addition, this savings and loan's experienced credit analysis is unparalleled, its return on equity is approximately 20%, and its insider ownership is also around 20%, signifying high conviction from management. A high degree of insider ownership also reflects a high degree of alignment with shareholders who bought and paid for their shares, as opposed to companies whose management has options on the stock which typically cost them almost nothing. Companies whose management owns a high percentage of their own shares want to

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Tax Exempt Fixed Income
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ket uncertainty.

- **Premium bonds tend to be less volatile and help to protect market value.** As an example, for a given change in interest rates, a premium bond has less par or market exposure. Therefore, mathematically they will experience a smaller percentage price change than current coupon or discount type issues.
- **Premium bonds provide a higher cash flow yield.** This is especially important during periods of rising rates or during range bound markets.
- **Premium bonds often offer a yield advantage, which can improve the likelihood of a higher return over the life of the investment.** In the secondary market, a good trader can buy these bonds cheaper, as many investors avoid this sector.

In previous editions of the Oakwood Outlook, we noted our resistance to owning California State specific debt. This proved to be a good decision, as these bonds underperformed most local obligations. However, we have now begun to purchase select state issued bonds, if backed by specific sales tax revenues. Unless there is a new supply of bonds with a direct cash flow backing, we are likely to avoid further purchases at this time. California's estimated budget deficit continues to widen, even in the face of an expanding economy and strengthening tax revenues. The State will find it difficult to grow its way out of the problem where severe cutbacks are needed. Unfortunately, California now has the lowest credit quality ranking among US states.

As an alternative, there are countless well-managed municipalities within the State of California available for investment consideration. In fact, in-state yield levels are quite attractive versus out of state municipalities. As this yield advantage begins to return to a more normal historic relationship, we expect California tax-free bonds to outperform other states. Our focus in 2005 will be to canvas all the markets for good investment opportunities. There will be many choices, as US voters approved billions in new bonds at the November 2004 election. Also, there will be future bonds issued as new communities surface throughout the country. They will need to borrow for new schools, firehouses and numerous other services. It seems clear that the municipal bond market will thrive for many years to come. **Because we own only the highest quality bonds with excellent liquidity characteristics, we can exercise maximum flexibility in the management of accounts. Furthermore, because we are content with our current structure, we can afford to be patient.** ■

Economic Outlook
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dance of press and chatter (mostly negative) about the size of the US trade, or current account, deficit, now at 5.6% of Gross Domestic Product (GDP). If Americans buy automobiles from Japan, and have no other transactions with Japan, the Japanese must end up holding dollars, which they may hold in the form of bank deposits in the United States or in some other US investment. The payments from Americans to Japan for automobiles are balanced by the payments of Japanese to US businesses and institutions, including banks, for the acquisition of dollar assets and dollar-denominated raw materials. **Said another way, trade or current account deficits are offset by capital account surpluses—that is, the purchase of US assets by foreign businesses and institutions such that net flow of receipts and payments is in balance. By definition, this means the capital account surplus is 5.6% of the GDP as well, not a bad thing.**

Whether you are a US or foreign investor, the US is the best destination for capital. That is why the trade deficit, and, in turn, the capital surplus, are so large. The US is the only growth country of all the developed countries, and as such, attracts capital investment. The only way non-US investors can guarantee a dollar cash flow to invest in the US is if they export more goods to the US and import less. Viewed this way, the trade deficit is not a sign of a structural economic flaw, but is instead a sign of a country that has the ability to attract capital because of its potential for growth, its free market, and an economy that regulates the relationship between the government and the market through legal institutions so that economic development is both possible and sustainable.

Third, let's dispel the notion of a complete free-fall of the dollar. Changes in exchange rates have limits. Without a corresponding rise in domestic dollar prices, US goods and assets become relatively more attractive to both foreigners and Americans when there is a fall in the foreign-exchange value of the dollar. Eventually, the dollar would be so cheap that there would be more buyers than sellers, therefore limiting the dollar's fall.

As the dollar decreases relative to other currencies, foreign goods become more expensive by the same percentage as the dollar decrease. While in the past a dollar depreciation of the magnitude that we have been experiencing over the past two-plus years would have been a precursor to much higher inflation and interest rates, we are not currently seeing that higher inflation. The reason for that is that the Fed is not accommodating the higher inflation with faster monetary-base growth. The Fed, while monitoring the valuations, believes there is no reason to intervene. When foreign economic policies improve, and the foreign attractiveness of capital increases as a result, the first impact is a lessening of the US terms of trade, followed by a fall in the trade deficit.

Fourth, let's look beyond the ups and downs in the economic data, oil prices, and the price indexes to understand the bond market. Despite the drop in November housing starts, builders in early December were upbeat, as the National Association of Home Builders' survey rated market conditions the best in more than a year. Some reasons for builders' optimism are the current low level of long-term interest rates and the long-term secular demand for housing. At the end of 2004, the yield on 10-year Treasury bonds (a proxy for mortgage rates) was slightly lower than it was a year earlier, despite the backdrop of solid economic growth, an uptick in inflation, and five interest rate hikes totaling 1.25% by the Fed. A unique difference in this expansion is that the Fed has given the bond market an unusually clear road map for future Fed actions and inflation. First, through a new openness of communicating policy, the Fed has put its pattern of interest-rate hikes on a gradual and predictable path. Ever since the Fed began lifting rates in June 2004, the market has come to expect a quarter-point increase in the Federal Funds rate at almost every meeting, an expectation that should remain in place in the first half of 2005. **This certainty reduces volatility.**

Looking Ahead

We feel that the US economy will continue to improve in 2005, with modest growth, contained inflation and predictable rises in short-term interest rates. This outlook is based, most notably, on the assumption that oil prices will stabilize, after running as high as $55 a barrel in 2004. That should help restrain inflation and strengthen the purchasing power of households that surrendered disposable income to high gasoline and home-heating costs in 2004. Businesses should feel some relief as well. Global economic growth is poised to slow from close to 5.0% in 2004 to below 4.0% in 2005. In addition, although there remains robust demand for raw materials, as the global economy grows moderately in 2005, non-energy commodity prices are likely to moderate as well. ■

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increase the share price prudently over the long term.

Indices are a reflection of what is happening and what has happened in the marketplace. Passive investment products merely aim to mimic a given index. When investors choose to index, they are surrendering themselves to the whims of the marketplace, buying the good with the bad. Oakwood, as an active manager, operates with acuity in finding and holding onto the gems of the marketplace.

At Oakwood, all our years of experience are focused on the issues that affect client portfolios and we remain carefully attuned to developments that will provide outstanding investments for our clients. Looking forward to 2005 and beyond, we as always remain vigilant in our effort to pinpoint economic developments, company-specific and geopolitical events that affect our goal of building and maintaining our clients' wealth. ■

Taxable Fixed Income
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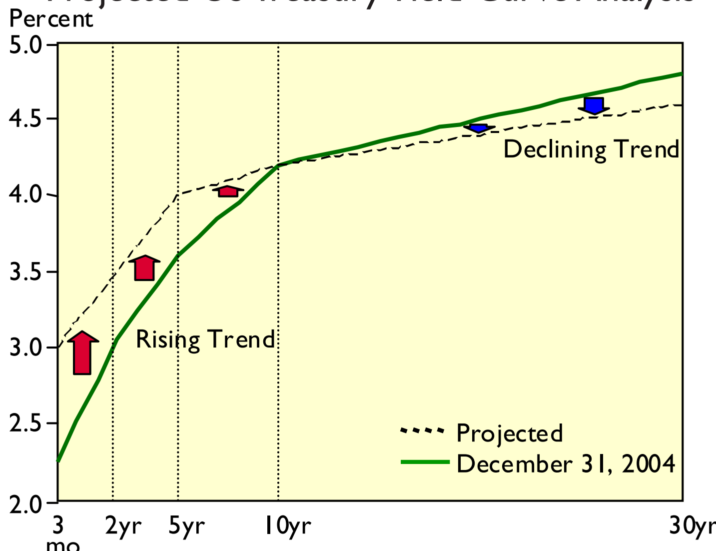
profile in portfolios, in order to generate above market coupon cash flow. This strategy was designed to place more emphasis on cash flow generation and less emphasis on market appreciation. In addition, we maintained an over-weighting in higher yielding corporate securities with a history of strong earnings growth. As yield levels compressed to outperform their higher quality Treasury counterparts, this strategy added performance to the portfolios. As a result, we are pleased with the investment results in 2004. **The returns for fully discretionary accounts were solidly positive and exceeded their established benchmarks for the year.**

Looking ahead, we remain somewhat sensitive to the potential for additional price volatility. **Our goal is to continue to provide a level of market stability to accounts and at the same time generate respectable returns.** Until the bond market senses an end to Fed tightening, the yield curve should flatten further, as bond yields in the shorter maturity area move modestly higher. We agree with the consensus of market forecasters that expect the Fed to raise rates at least three more times to 3.0% by mid 2005. As shown below, this means that the yield level on 2-year Treasuries could approach 3.50%, up from the year-end close of 3.07%.



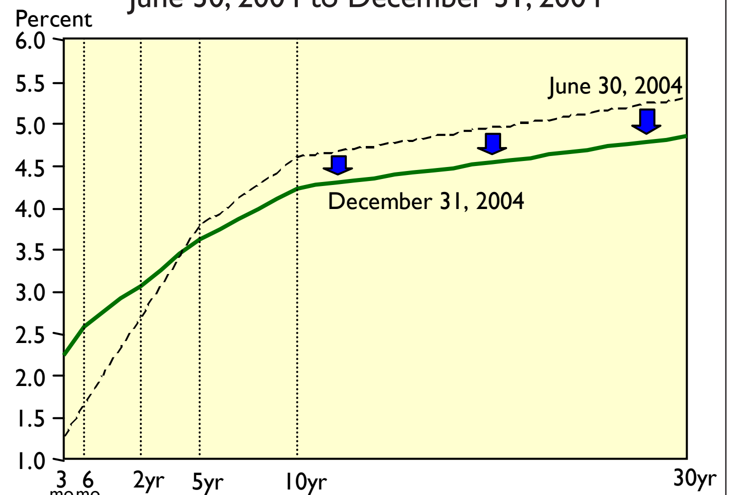
Source: Bloomberg, Oakwood Capital Management LLC

Similarly, as shown in the yield curve comparison chart to the right, since the Fed began raising short-term rates in June 2004, yield levels on 5-year and longer Treasuries have not moved higher and have actually fallen.

As a result, we will continue to underweight the vulnerable 2 to 4-year maturity areas, in favor of a "barbell" type structure. This strategy combines very short investments (less than 1 year) with 10-year or even longer bonds, where permitted, to achieve our desired duration target.

We begin the New Year as cautiously as we did in 2004 and stand ready to switch to a more aggressive posture as inflation fears are dismissed and interest rates throughout all areas of the yield curve peak. Until then, we are likely to reduce certain corporate bond positions as the return benefit in the sector is no longer attractive. We will then focus on strategic **yield curve placement and duration management** as tools to generate valuable return in 2005.

We believe a strong basis for an improvement in market fundamentals centers on the dynamics of Federal Reserve policy. Their stated mandate is to orchestrate a sound, steady economy with low inflation. **The Fed is raising short-term interest rates in anticipation of inflation pressures, but well in advance of inflation that would become embedded in the system.** As their success becomes apparent, the bond market should become less volatile and provide bond investors with the potential for even more favorable risk adjusted returns. ■



Source: Bloomberg, Oakwood Capital Management LLC

Roth IRA Changes

For retirees seventy years old and above who do not depend on withdrawals from their IRA's for living expenses, it is now possible, due to recent changes in the tax laws, to defer the mandatory withdrawals through conversion to a Roth IRA and continue to amass untaxed financial earnings that can be passed down to their heirs. Further, the new change in the law allows those who make $100,000 or less, excluding IRA withdrawals, eligible to convert to a Roth IRA.

Instead of paying taxes on money withdrawn from a traditional IRA (based on the holders', or the heirs', ordinary income tax rate), Roth holders pay taxes immediately on money transferred out of an IRA based on their current income tax rate. Roth holders, or most likely their heirs, are then able to withdraw tax free in the future and keep more money growing for a longer period of time.

For those that meet the requirements, a Roth IRA may be the appropriate investment vehicle. This new law may be worth discussing with your CPA or tax advisor. ■

Equity Market
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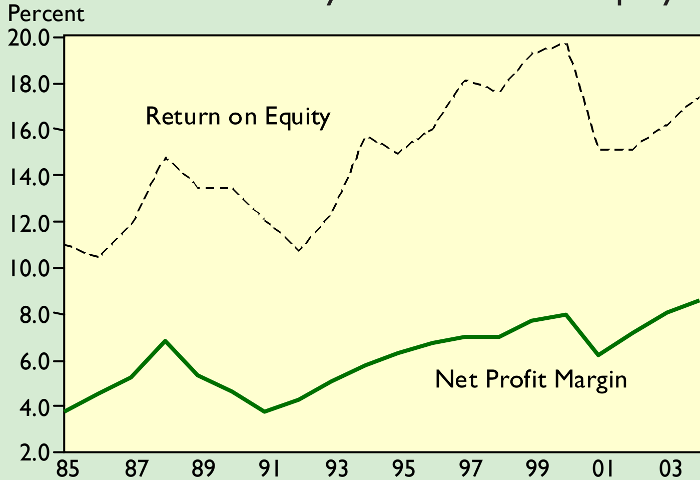
of dividend tax relief, we expect to see higher dividend payouts in 2005. This potential for continued increases in dividend payouts is an important positive for stocks in the coming year. Dividend payouts increased by 12% in 2004 and we expect more of the same in 2005. Evidence of our ability to stay ahead of the curve was our recognition, prior to the preferential tax treatment of dividend income, that this was an important future return opportunity area in which to actively participate.

S&P 500 Profitability and Return on Equity



Source: Thomson Financial, Oakwood Capital Management LLC

With record profit margins and levels of cash flows, one would expect to see returns on equity much higher than the respectable 17.4% mentioned earlier. The reason we're not seeing higher returns on equity at this point is that corporations have been paying down debt. **Debt ratios are at the lowest levels in more than two decades.** Debt repayments may lower a firm's interest expense but the process of reducing debt can reduce returns on equity in many instances. With the S&P 500's long-term debt to total capital ratio at 33%, we believe we are reaching a point where corporations may slow down or stop paying down debt. This will free up additional cash for other purposes such as dividend increases, stock buybacks, sound mergers and acquisitions, and higher levels of capital investment, all of which are positives for stocks.

An important part of Oakwood's methodology and valuation of companies is not only how much free cash flow is generated, but what the companies do with their free cash flow. We like to see companies that utilize their free cash to benefit their shareholders. Some examples of how we like to see management spend free cash flow include share buybacks and increased dividend payments to shareholders, (which most financial services companies in client portfolios regularly do), or reinvest cash flows at high rates of return (as a certain natural gas company does). We tend to avoid companies that spend cash on dubious acquisitions, as in many cases the returns are poor. We sold an otherwise high return financial company in the third quarter, when an ill advised and overpriced acquisition severely hampered the future ROE of the combination.

Given high free cash flows, rising cash balances and the more modest earnings growth expectations for the next couple of years, we would also expect to see a continuation of the increase in corporate merger and acquisition activities that we witnessed in the second half of 2004. We will continue to scrutinize each acquisition for economic sense.

Corporate cash balances and cash flows are sufficiently high that companies can fund somewhat higher capital expenditures. Many sectors of the economy that severely lacked capital investment during the 1990's are now the sectors experiencing pricing power. These sectors include energy and basic materials, such as steel, lumber and paper as well as industrials. By contrast, the technology sector is still awash in capacity, being characterized by too many players doing the same thing. This is one reason why we continue to be underweighted in technology. The primary reason is based on fundamental individual company research and valuation.

The energy price shock we experienced last year modestly depressed US and global economic and corporate earnings growth. The modest energy price declines we've experienced of late will partially diminish this headwind. About 40% of global energy consumption is based on petroleum. About 70% of existing oil consumption comes from oil fields discovered 25 or more years ago. Approximately 4% to 5% of world crude production is depleted every year and an equivalent amount must be found and developed to maintain production volumes. An additional 2% in crude production must be found and/or developed to meet current growth in global demand. This means that an additional 6% to 7% of oil production must be saved through increased efficiency and/or must be found, developed and brought to market each year to meet global energy demand. Regardless of the short-term volatility of energy prices we continue to see this as a favorable area, which explains our overweighted positions in oil and gas energy stocks during the course of 2003 and 2004, which continues into 2005.

Even though we don't see runaway inflation on the immediate horizon, we are ever mindful of the consequences of an inflationary environment. Our criteria for stock selection, the end result of owning only the highest quality, highest return on capital companies that have pricing power and the ability to pass on inflation costs, positions us to weather a higher inflationary environment, should this become a reality.

Although many quality companies are fairly priced in today's market, we continue to find some "gems" to add to our portfolios. We continue to demonstrate our ability to maintain our discipline, and use our methodology to find these gems. While there are challenges in the current market, we believe that on balance the outlook for stocks in the year ahead is positive. In managing our client portfolios we will continue to focus on owning companies with positive cash flow characteristics, strong returns on capital, healthy balance sheets, increasing dividends and healthy earnings growth prospects trading at attractive valuations. ■