

# Oakwood Outlook

## & Quarterly Review

Volume 8, Number 3 July 2005

### A Word

#### From the Advisor Control Your Future

The essence of building personal wealth is determining what your investment goals are, focusing on the best way to achieve them and identifying the resources that will be needed along the way. There are many factors that enter into these decisions, and as intangible and difficult to define as they may be, making these decisions is a mandatory step in attaining your investment goals. At Oakwood Capital Management LLC, we have the means to provide reasonable answers to concerns about your investment needs in a risk-sensitive, disciplined manner.

A useful tool to map your current financial situation is to analyze your assets and liabilities. The preparation of a personal balance sheet will clearly outline your net assets, defined as assets minus liabilities. As in a corporate balance sheet, the personal balance sheet is a snapshot in time, such as a calendar year end, providing a picture of your financial health. Assets that you would list might include your annual salary, expected Social Security benefits, your home and real estate investment property, along with your investment portfolio.

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### Economic Outlook

#### As Usual, the US Economy Adapts

After suffering broad losses during the first quarter of 2005, US stocks rebounded in the second quarter of this year, as widespread fears about inflation were somewhat abated. Meanwhile the economy continued to show signs of moderate but healthy growth. These and other factors led stocks to almost recoup their first-quarter losses, although they did give up some of these gains near the very end of the quarter. Bonds also enjoyed a surprising rally, due to a proactive Federal Reserve (Fed) and mild inflation news. The following table provides a summary of the returns of the Lehman Brothers Intermediate Bond Index (L/B - Int.), a proxy for the overall bond market, and the S&P 500 Index (S&P 500), a proxy for the broad US stock market. We have also included the narrower Dow Jones Industrial Average (DJIA), an index comprised of 30 large, mainly industrial "blue chip" stocks and the NASDAQ Index, whose composition includes mostly technology stocks.

Index	2005 Returns ending 6/30/05	
	2nd Quarter	Year-to-Date
Lehman Brothers Intermediate Bond Index	2.48%	1.59%
Standard & Poor's 500	1.37%	-0.82%
Dow Jones Industrial Average	-1.60%	-3.61%
NASDAQ	2.89%	-5.45%

Source: Bloomberg, Oakwood Capital Management LLC

The growth in both the economy and the labor market over the past months has been moderate enough that inflation has been milder than expected, especially considering the current volatility of energy costs. The Fed announced its widely-anticipated ninth consecutive quarter-point increase in its short-term interest rate target, to 3.25%, when its meeting ended on June 30<sup>th</sup>. The Fed said that pressures on inflation "have stayed elevated" but repeated a comment it has made in past statements that "longer-term inflation expectations remain well contained". Historically, as the economy has been in an expansionary phase and the Fed has been tightening its short-term Federal Funds rate, the long end of the yield curve has usually risen as well, creating a parallel shift in the yield curve. Currently, during this round of nine consecutive interest rate hikes, the long end of the yield curve has not shifted upward.

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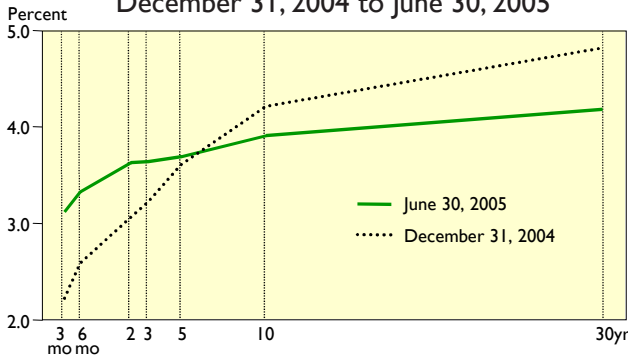
TAXABLE FIXED INCOME

Strategy

The future direction of Federal Reserve monetary policy appears to be the dominant issue facing the fixed income markets, as both market forecasters and investors try to predict the end to the Fed rate increases. Many point to a moderation in inflation pressures and conflicting economic data as reasons for the Fed to soon end its tightening. In fact, several Fed Open Market Committee (FOMC) policy makers, including Dallas Federal Bank President Richard Fisher, suggest that the central bank is in “the final innings” of its interest rate increase. Furthermore, the historic low level of long-term interest rates indicates that inflation is contained and the Fed should be nearing the end of tightening.

While this may prove to be correct, at Oakwood, we don’t necessarily see an urgency to stopping the string of the nine consecutive 25-basis point interest rate increases that began in June 2004. The economy, in spite of escalating oil prices, continues to grow at a solid pace with the latest reporting of GDP growth at 3.8%. The unemployment rate stands at 5.0%, its lowest level since September 2001, and weekly jobless claims continue to trend lower. Furthermore, policy-making is much more transparent than it was several years ago and has taken a lot of the risk-premium out of the market. This allows the Fed to conduct monetary policy without creating unwarranted gyrations in bond prices, consumer confidence and economic expectations. As shown, this factor alone may explain the pattern of declining long maturity US Treasury yields, in the face of repeated Fed rate tightening.

US Treasury Yield Comparison December 31, 2004 to June 30, 2005



Source: Bloomberg, Oakwood Capital Management LLC

Unfortunately, this unexpected drop in long term rates is causing a problem for the Fed, as home prices have been escalating at an unsustainable pace and consumers tap equity in their homes for spending. As discussed earlier, the US is not currently a “savings” country. Recent reports indicate that over \$200 billion of funds that could be invested into a hard asset or saved (actions the Fed would prefer to see) has not been utilized in this productive way. At some point, this alarming trend may be the catalyst for a drop in home values or even a recession.

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TAX EXEMPT FIXED INCOME

Strategy

During the first half of 2005, there was a seemingly endless discussion on the future direction of monetary policy and interest rates. Some have even concluded that bonds do not offer a good investment opportunity for investors. However, a review of the bond market returns for the first half of 2005, especially after adjusting for risk, does not concur with this viewpoint.

As mentioned earlier, investment returns on widely recognized indices such as the S&P 500 Index, the Dow Jones Industrial Average and the NASDAQ Composite are all negative year-to-date through June 30, 2005. Municipal bonds have produced modest positive returns for the same time period. However, on a taxable equivalent basis, the return difference between municipal bonds and the equity indices shows a greater margin of difference. Additionally, on a risk-adjusted basis, we believe that Oakwood clients achieved this positive return with lower risk.

This point is not meant to mitigate the role that the stock market plays. In fact, in contrast to the lower return potential of bonds, the stock market offers investors the ability to generate higher returns over time. After factoring in numerous market uncertainties, a risk management approach using asset allocation can be important to wealth building. Therefore, we believe municipal bonds will continue to play a vital role, for highly taxed investors who seek tax-free income generation, good after-tax total returns and protection of purchasing power. As you are aware, the Fed recently raised its Federal Funds target rate for the ninth time, to 3.25%. It is likely that they will continue to raise this rate at a “measured pace” until inflation is no longer believed to be a concern. When combined with the relentless rise in energy prices, it becomes difficult for both equity and fixed income investors to predict market direction with conviction. Regardless, tax-free yields ranging from 2.75% to 4.25% provide an attractive 4.2% to 6.5% taxable equivalent yield.

At the same time, we emphasize the importance of a strong underlying credit ranking, even if the bond has insurance backing. Recently, there have been numerous examples of municipality downgrades due to poor fiscal management and budgetary imbalances, to include the City of San Diego, California, which was recently downgraded to BBB+ from A. This pattern of deteriorating creditworthiness hurts liquidity and results in market loss. Oakwood client holdings have been completely unaffected by this trend in downgrades.

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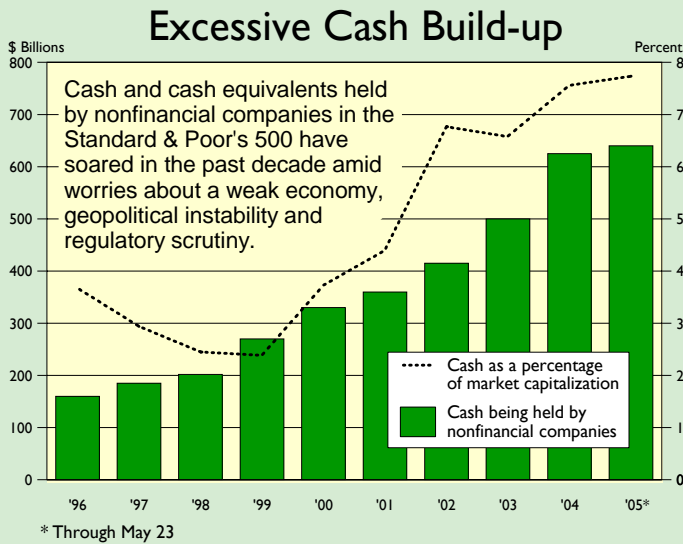


EQUITY MARKET STRATEGY

# We're Cautious and Selective

The positive economic backdrop that we are currently experiencing creates, in many respects, a favorable outlook for equity market performance for the remainder of the year, despite quite modest Wall Street earnings growth expectations for 2005 and 2006. The earnings per share (EPS) growth consensus among Wall Street strategists is 8% for 2005 and 5% for 2006. Oakwood's view is that the actual growth rates will likely be higher, in the low double digit range of 10 to 12%. Stock prices will get a boost as the lower consensus EPS growth estimates by Wall Street strategists are exceeded. **By and large, we expect positive EPS surprises for the remainder of 2005 to help move equity market performance into positive territory.**

An interesting phenomenon has been the build up of cash and cash equivalent balances on the balance sheets of non-financial companies. The following graph illustrates this occurrence:



Source: Standard & Poor's Quantitative Services, Institutional Investor

These high cash balances are muting returns on equity due to underleveraged balance sheets and are reducing asset turnover. Corporate managers have accumulated these cash balances over the last five years out of a sense of risk aversion and uncertainty in the wake of the bursting of the 1990's stock market bubble, the 9/11 terrorist attacks and the war on terror, as well the accounting scandals and incidents of corporate fraud in recent years. While, unfortunately, many of these negatives remain, we feel that confidence will build due to continued healthy GDP growth and corporate EPS growth exceeding expectations, and corporate managers will begin to put this cash stockpile to work.

Positive corporate liquidity could continue to boost merger activity, stock buybacks, cash dividends, and capital expenditures. Merger and acquisition activity has picked up slightly this

year; however, corporate managers have generally pursued smaller, safer, non-dilutive deals. Absent major product innovations, most capital expenditures are focused on expanding existing capacity to meet demand and will likely grow in line with revenues. This means that the bulk of the excess cash will be put to work buying back shares and increasing dividends. In fact, with such conditions, it is not surprising to find that the S&P 500 dividend yield has pushed above 2.0% for the first time since 1996. The end result will be a triple benefit of increasing returns on equity (ROE) due to increasing asset turnover as cash balances are drawn down to more normal levels, increasing dividend payouts and increasing earnings per share as shares are repurchased through buybacks.

Our clients recognize that we exhaustively search for undervalued growth and income wherever we can find it. Oakwood is beginning to see the emergence of attractive valuations in sectors and industries where, for some years, we had been unable until recently to find excellent companies whose prices had come down enough to meet our stringent criteria. For example:

- Pharmaceuticals:** A dominant drug company, whose valuation has suffered due to some patents that ended and to market concerns about the drug business as a whole, finally became cheap enough to meet our criteria. This company has massive balance sheet strength, strong and growing cash flows, a growing dividend and large reserves for any contingent liabilities. We expect its outstanding management to increase returns to investors via increased dividends and continued share repurchases. In fact, soon after our purchase, the company announced a large share buyback. In addition, well executed acquisitions and cost reduction programs and a strong research and development effort make this high return-on-capital firm an excellent long term investment.
- Entertainment:** Rarely do we find an investment that we find suitable for client portfolios in this industry, due to generally poor return on capital and giddy overpricing of most of the stocks. However, the shares of a dominant Hispanic broadcasting company, with a superb shareholder-oriented management that we deeply respect, traded lower and lower in price over the quarter, as the market negatively overreacted to concerns about a dispute with a programming supplier. The company announced its first ever share repurchases in 2004 and 2005 as management, which owns 36% of the shares, took advantage of the undervaluation alongside our purchases. The combination of a rapidly growing Hispanic market, superb op-

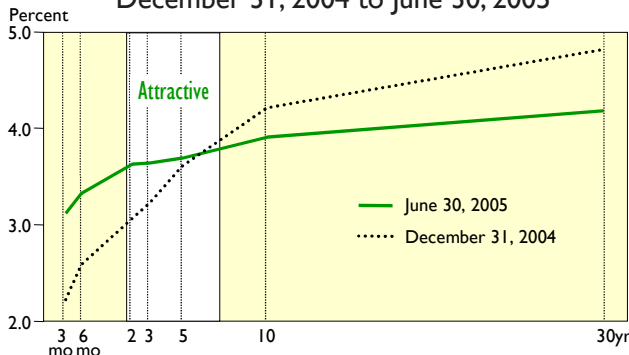


Taxable Fixed Income  
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Meanwhile, we will continue to focus on attractive areas of the yield curve as a way to capture valuable return. In fact, **in spite of significantly higher short-term interest rates, Oakwood clients enjoyed positive returns during the first half of 2005, throughout short, intermediate and longer investment strategies.** And, despite all the worries about higher bond yields, our full maturity investment strategy was able to produce even higher positive returns. We continue to favor higher yielding discount callable Federal Agencies in the 2 to 3 year maturity area. In addition, we plan to add a five-year zero-coupon Treasury holding. Benefits of zero-coupon holdings include market values that compound over time and the avoidance of a possible untimely reinvestment of coupon cash flows.

Recently, we have reversed our under-weighting in intermediate 4 to 10-year maturity areas, by shortening longer Treasury positions and extending very short holdings. As shown below, this decision is designed to improve yield and return potential in advance of market demand, as investors see the value of this maturity area. **Because we don't know the ultimate extent of Fed tightening, we remain duration neutral versus respective performance benchmarks.**

US Treasury Yield Comparison  
December 31, 2004 to June 30, 2005



Source: Bloomberg, Oakwood Capital Management LLC

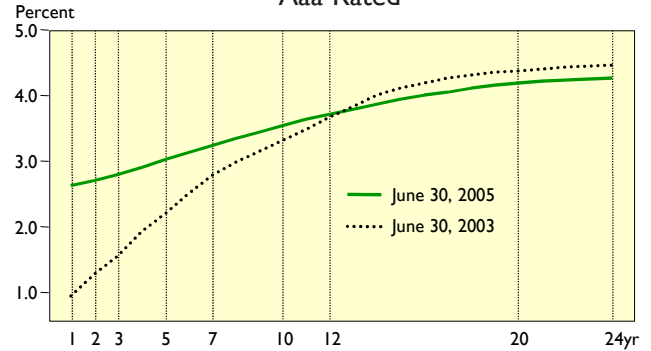
Finally, as a protection against the risks of negative financial news events, we reduced our corporate exposure and have made selective sales of corporate bond holdings which include Morgan Stanley and Valero Energy. Conversely, we continue to hold corporate positions with recent quality upgrades such as Occidental Petroleum, BankAmerica and Lockheed Martin, and positions that are pending an upgrade such as Black and Decker and Kinder Morgan.

Fed Chairman Alan Greenspan has repeatedly made clear that his approach to monetary policy aims to move against risks that may undermine the Fed's main objective of full employment and low inflation. We are certain that as the chairman nears retirement, which is expected early next year, that he will be slow to end the inflation fighting effort. **We continue to like the fundamentals in the bond market. Because we have reached a favorable balance of economic growth and inflation, interest rates could trend lower and even compress versus lower**

Tax Exempt Fixed Income  
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As shown below, there has been a notable flattening in the yield curve as long rates have moved in the opposite direction of short rates.

Two Year Municipal Yield Change  
Aaa Rated



Source: Bloomberg, Oakwood Capital Management LLC

It is important to point out, however, that on a taxable equivalent basis, tax-free bonds are considerably more attractive than similar maturity Treasury or corporate securities. As an example, a 15-year tax free California bond at a yield of 4% equates to a 6% yield for individuals in the highest tax brackets. This is why we will continue to focus on investing in this area.

Simultaneously, we are initiating a program that involves the selling of very short municipal bonds to be extended into the 4 to 6 year maturity area. However, we now see value in higher coupon callable type bonds, as municipals are trading at 82% of equivalent taxable treasuries. In addition, they offer generous yield versus a non-callable counterpart, with little risk of extending to their longer stated maturity.

While we continue to seek out attractive investment areas, the municipal market is facing several challenges. The first challenge is "rate shock." To overcome this, we are focusing our attention on quantitative risk/reward security placement. This provides maximum tax-free income, without subjecting portfolios to high levels of market risk. The second challenge is how to invest as the Fed continues on its program of fighting inflation. Oddly, we see this as an easier challenge. Only two years ago, a 4-year municipal bond was yielding 1.75%. Today, this same investment offers a tax-free yield approaching 3%, or on a taxable equivalent, 4.6%. **This provides Oakwood with the continued confidence that with today's yields, a municipal bond strategy can generate good returns and can provide a risk adjusted complement to other investment choices.** ■

**yielding European and Asian countries.** However, we are monitoring the price movement in oil on a continual basis for signs of a directional change. A precipitous drop in energy could prompt excessive growth in the economy and plant the seeds of inflation. Given the absence of this event, there is a decent chance that the Fed will begin to lower rates in 2006. ■



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in a parallel fashion. In fact, the long end of the yield curve has actually come down, creating a flattening of the yield curve, and narrowing the interest rate spread between short- and long-term rates.

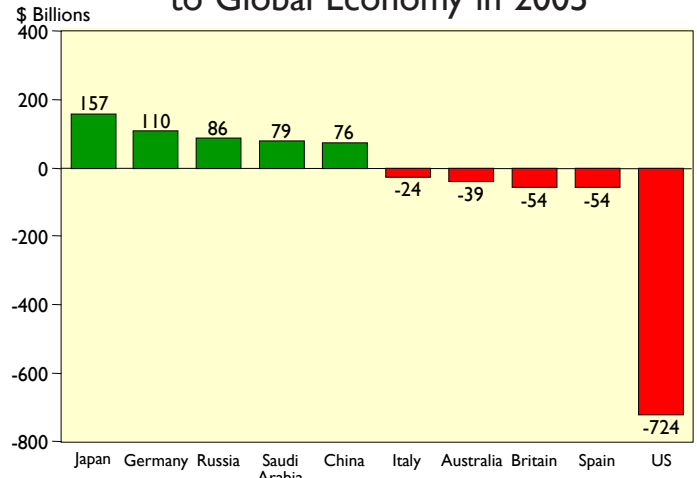
Investors, although encouraged by the decent growth in the economy, moderate job growth, and low inflation trends, have been confronted by the headwinds of skyrocketing energy costs. **In the current US economic expansion, the markets have shown that they can tolerate a price of \$50-plus per barrel of oil.** Despite these record oil prices, gross domestic product (GDP) grew 3.9% over the course of 2004, and the latest revision to GDP shows the economy grew at a 3.8% annual rate in the first quarter of 2005, when oil prices began their latest climb. **With crude prices breaching \$61 a barrel in the first full week of July, it remains to be seen what effect these sustained record prices will have on the economic expansion rate.**

Crude oil prices have increased more than 50% in the last year and have accounted for 85% of the rise in retail gas prices. The average price for regular grade gas in the week of July 4th was at \$2.26 a gallon. These higher prices have historically acted as a quasi-tax on the consumer, inhibiting economic growth. However, as shown in the healthy GDP numbers, the oil price spike and its corresponding filtering down to gas prices has not resulted in a significant slowing of the economy. **One possible explanation when talking about the lower impact of rising energy costs on our economy is that energy consumption per dollar of GDP has fallen. For example, energy consumption per dollar of GDP today, is only half of what it was in 1950.** Oakwood will continue to be vigilant in watching the effect of oil prices on the overall economy and the holdings in your portfolio.

This most recent round of oil price increases comes as the economy faces challenges such as a rising dollar and the likelihood of a less accommodative monetary policy. So far this year, the dollar has risen about 3.5% on a trade-weighted basis. The effect of the cheaper dollar is disappearing, dampening the export growth US manufacturers expected in the second half of 2005. As we correctly observed in the 2004 year-end edition of the Oakwood Outlook, changes in exchange rates relative to the dollar have limits. As the dollar decreases relative to other currencies, foreign goods become more expensive by the same percentage as the dollar decrease. 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 becomes so cheap that there are more buyers than sellers, thereby reversing the dollar's fall, which describes the current strengthening trend of the dollar and the corresponding reduction in the balance of payments.**

On the global front, we see Japanese corporations recording record profits, but not engaging in much capital spending. Chinese companies are pushing to invest wherever they can, but the country is getting so much money from exports that it has billions to spare, including \$18.5 billion that China National Offshore Corporation (CNOOC) bid for Unocal. The surging oil prices are giving oil producing countries such as Russia and Saudi Arabia far more money than they had anticipated. **The International Monetary Fund (IMF) predicts that in 2005 the worldwide savings rate should hit its highest level in at least two decades.** The following chart shows the expected level of savings for many countries that are big savers, in relation to the US, which is expected to remain an enormous borrower.

Expected Contributions of Net Savings to Global Economy in 2005



Source: International Monetary Fund

If global savings are channeled in the right ways, they can be a great catalyst to the world economy, enabling investments and risk-taking that fuel growth. However, instead of going into productive investment, cheap money may be overheating spending and sending asset prices soaring too high. Globally, investors are used to watching economic news and events in the US for use as economic signposts – for example, actions of the Fed and the levels of federal budget deficits – but in a global economy awash in savings, investors must increase their assessment of events outside the US and the implications for the companies owned in their portfolios. **Oakwood's global approach to research allows us to uncover those multinational companies that capture the advantages of such global economic trends.** ■



Word from the Advisor  
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lio. Liabilities would include your basic living expenses, any education or health care costs, and other discretionary living expenses.

Assets and liabilities change along with increases in age, a change in employment status, increased health care expenses, and other factors that may not be under your control. **The most critical asset under your control is your investment portfolio and, subsequently, its impact on your net assets.** As a client at Oakwood, you have already taken the first step in taking control of your portfolio by having your investment assets professionally managed.

When you first became a client, the assets that we initially managed for you may have comprised most of your investment portfolio. At that time, our recommendation of a particular strategy would have fit your investment time horizon and personal circumstances. However, since that time, your liabilities may have broadened or narrowed, your investment horizon may have lengthened or shortened, and your investment assets may have increased, and you may have added money to your Oakwood portfolio. All of these variables will have an effect on your net assets.

**Oakwood Capital Management takes very seriously the responsibility of managing the investment portion of your assets. We understand that for many of you, your Oakwood portfolio represents the majority of your liquid assets. As time passes by, this portfolio will become a larger and larger percentage of your total assets.** We employ sophisticated tools to continuously analyze your investments, which allow us to point out areas which leave you exposed to unnecessary risks. Our analysis shows how a potential reallocation of a portion of your current Oakwood portfolio to another Oakwood strategy might affect your income stream and, in turn, your ability to meet your liabilities, or how a change from one strategy to another might change the volatility or return potential. Please tell us if you have a change in your assets, or your liabilities outside of Oakwood's management. We can help you determine the best course of action in light of these changes. **We consider this type of ongoing analysis an essential part of the process in a successful relationship that allows us to achieve the common goal of building your personal wealth and your level of income.**

In the next issue of the Oakwood Outlook, we will take a closer look at the full array of Oakwood strategies and identify how they might fit into your existing investment portfolio. Until then, please feel free to contact us to talk about your investment portfolio. ■

Equity Market Strategy  
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erating execution, and owners as managers give us confidence in this company for the long term.

- **Technology:** For the last ten years, this technology distributor (unlike most technology companies!) has demonstrated consistently high return on capital, strong and increasing free cash flow and earnings, strong sales growth, and, since 2003, a growing dividend. This company has minimal technology risk, as it sells and installs all technology brands with the exception of Dell, which is a direct marketer. The client base of this company includes state and federal government entities that, in general, have longer and steadier sales cycles than the private sector. Its stock price had been depressed due to short term concerns regarding costs associated with its second warehouse opening to support annual US sales of \$6 billion.
- **Manufacturing:** The rising prices of steel and other raw materials and the deep malaise of US auto manufacturers drove the price of this superb, diversified, global manufacturer down into our value range. This well-managed firm markets some of the finest products in the auto, small engine and motorcycle markets and manufactures in local markets on a global basis. It holds very strong market share in the huge emerging markets of China and India. Its autos deliver very high gas mileage, an advantage in today's high gas price environment. The company is demonstrating a new commitment to cash returns to shareholders with substantial dividend increases and share buybacks, neither of which are cultural norms in its home country.

**We are quite pleased to find these excellent and growing companies at a value price. For the remainder of 2005, we expect the stock market to provide a few more opportunities for us as diligent seekers of undervalued growth.**

We have begun to pare back our overweighted position in energy. While our returns have been excellent, valuations reached such levels that our long term return projections, adjusted for risk, no longer meet our strict valuation criteria.

We will continue to seek to upgrade your portfolios in terms of projected returns and the quality of our holdings, a task that never ends. **Although many quality companies are fairly priced in today's market, we continue to find attractive opportunities to add to your portfolios. While there are challenges in the current market, we believe that on balance the outlook for stocks for the rest of the year ahead is positive.** In managing our client portfolios we will continue to focus on owning companies with positive free cash flow characteristics, strong returns on capital, healthy balance sheets, increasing dividends and healthy earnings growth prospects trading at attractive valuations. ■