Oakwood Outlook

& Quarterly Review

Volume 8, Number 4 October 2005

A Word

From the Advisor

Preparing for a Bond Rally

A vast amount of news about the stock market reaches our ears on a daily basis. Sometimes it is good news about the economy or a company which causes a rally, and sometimes it is bad news about rising oil prices or a company missing earnings, causing a subsequent decline in market levels. Recently, it seems that we are also being inundated by news of the negative effects that rising interest rates will have on our daily lives. These concerns include fears that mortgage rates will skyrocket, monthly payments will rise, and housing values will drop. In addition, investors are being led to believe that investing in bonds is a losing proposition with little or no likely return potential.

Just as a successful real estate expert knows how to manage the mortgage market in order to capitalize on changes in interest rates and housing values, **a successful fixed income manager knows how to position client portfolios in response to changes in market conditions.** For example, in a period of declining interest rates just two years ago, investors were pleased that their fixed income investments were generating attractive returns and providing stability against the volatility in the stock portion of their portfolios. **What might not have been apparent to these same investors, however, was that the same dynamic**

Continued on Page 5

Oakwood Capital Management LLC

1990 South Bundy Drive Suite 777
Los Angeles, CA 90025
www.oakwoodcap.com
310-772-2600 800-586-0600
FAX 310-772-2601

Economic Outlook

The Resilient US Economy

Equity markets were notably stable given the challenges the economy faced during the third quarter of 2005. The Federal Reserve's (Fed) interest rate hikes, US operations in Iraq, surging commodity prices, and the bankruptcy filings of Northwest Airlines and Delta Airlines had little negative effect on equities. **To date, the effect that the catastrophic hurricanes Katrina and Rita will have on the equity and fixed income markets is decidedly vague.** The sheer vastness of the destruction, the inability to determine accurate economic data, and the widespread instability these natural disasters have caused in so many sectors has left many companies in many industries unable to ascertain the true effect on their earnings. **As we move through the current earning season, we believe the ensuing market volatility from many earnings surprises will provide opportunities for seasoned investors like Oakwood.**

Year to date, the S&P 500 Index, a measure for the broad equity market, has returned a mere +2.85% through September 30, 2005, and the Dow Jones Industrial Average ended in negative territory, with a return of -0.14% year-to-date. The fixed income markets, as measured by the Lehman Brothers Intermediate Bond Index, returned +1.06% year-to-date. The yield curve remained rather flat, with shorter-term rates continuing to rise. The 10-year Treasury note stubbornly remains around 4.40%, after beginning the year at 4.25% and beginning the third quarter at approximately 4.00%.

Higher interest rates have helped the dollar to strengthen, reaching its strongest level in more than sixteen months against the Japanese yen and hovering near three-month highs against the Eurodollar, as investors are trading on expectations of still higher US interest rates. International interest rate differentials continue in favor of the US dollar, which is a factor in the dollar's strengthening. **Non-US investors are betting on more rate hikes by the Fed and widening spreads between fixed income securities of the United States and those elsewhere, attracting foreign investment. As stated, the US 10-year Treasury note is yielding around 4.30%, compared with around 3.18% for the Eurobond equivalent and around 1.56% for its Japanese counterpart.**

The US real estate market has been a relative pillar of strength, benefiting from below-6% mortgage rates and strong, although slightly decreasing demand, in the

Continued on Page 5

TAXABLE FIXED INCOME

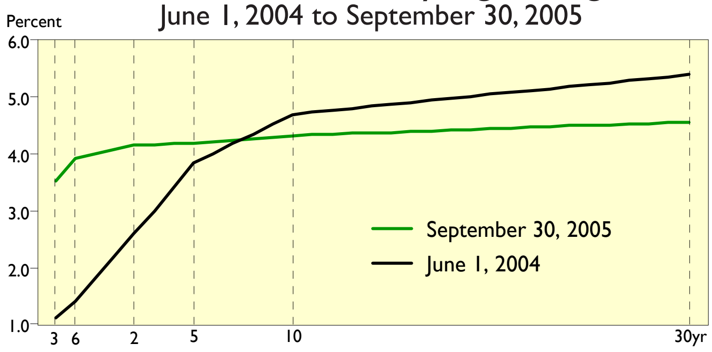
Strategy

Bond investors have endured the eleventh consecutive increase of the target Federal Funds rate which began on June 30, 2004. This pace of rate increases suggests that inflation remains at the higher end of the Fed's tolerance, and if so, one or two additional rate hikes by year end cannot be ruled out.

However, there is a risk that the Fed becomes overly obsessed with fighting inflation and causes the economy to slip into recession. In fact, many market experts believe the potential economic drain from recent natural disasters, accompanied by a decline in consumer confidence and a slowdown in home sales, are ample evidence that the Fed should stop the rate increases. A recession could trigger deflation, as overseas trading partners are forced to flood the United States with low priced goods in the face of slowing demand.

We suspect that we are approaching a time when overvalued housing will cause a meaningful drag on the economy and the Fed will stop raising short term rates. This should provide a benefit to short and intermediate maturity investments as the continuous decline in market principal is no longer a drain on the cash flows from coupon payments. The following chart shows the significant rise in short term yields over the last sixteen months.

Period of Monetary Tightening
June 1, 2004 to September 30, 2005



Source: Bloomberg, Oakwood Capital Management LLC

Our general level of optimism that the interest rate hikes will come to an end should not imply that we are shifting our market bias to a more aggressive posture. In fact, as long as inflation and economic forecasts remain clouded, we will continue to avoid making large market bets, either by overweighting non-government sectors or by significantly altering duration targets versus respective benchmarks. **However, in preparation for a more favorable market environment, we are enhancing liquidity in client portfolios, favoring longer maturity securities with more price sensitivity, currently in the 7 year maturity area. This involves a systematic reduction in overvalued corporate positions and the targeting of specific short maturity holdings, as we swap these**

Continued on Page 4

TAX EXEMPT FIXED INCOME

Strategy

During this past quarter, the municipal bond market remained surprisingly stable, in the face of another three Fed interest rate hikes since June 30, 2005, and two very destructive hurricanes. It appears that investors are confident that the Fed will be successful in its efforts to fight inflation. However, there is much uncertainty surrounding the impact that the storms will have on the economy and the bond markets. For example, prior to the natural disasters, it was easier to monitor the direction of the economy. Economic indicators, including the unemployment rate and consumer confidence, were on a steady path of improvement. Now, **market participants must decide the difference between short term disruptions and changes in longer term fundamentals.** Complicating this issue is a lack of understanding as to how the Fed will handle monetary policy in the future. Therefore, until the picture becomes more clear, the municipal bond market should remain near current levels with day to day shifts in market sentiment.

At Oakwood, we have repeatedly emphasized the importance of an individual security's underlying credit quality, independent of any supplemental insurance or credit support. While most analysts are in agreement that municipal insurance carriers will be able to handle interest payments in the event of defaults or cash flow disruptions, a financially strong municipality will retain both market value and liquidity. **History shows that tax exempt municipalities are more likely to avoid bankruptcy and to endure hardship than are taxable corporations.**

We also have encouraged all clients to diversify their fixed income investment choices. Heavy concentrations in a particular industry, sector or geographic area can expose portfolio holdings to regional mismanagement or natural disasters in an isolated region. We feel investors are not being properly compensated to take on more risk in these areas. Often, investors don't even notice that they are creating imbalances that can leave them vulnerable.

The markets should continue to trade in a somewhat narrow range for the balance of the year. Furthermore, the supply of new municipal securities should be manageable while yield relationships between tax-free bonds and taxable bonds favor municipals. As shown in Exhibit A on page 6, we like the 10 to 15-year maturity area, where the yield differentials are approximately 90% of their equivalent US Treasury.

While the yield curve (comparison of short rates versus long rates) in the taxable market is completely flat, in the tax-exempt market, investors receive added yield for the added risk of investing in longer maturities. In fact, at present, a 15-year tax free bond yielding 4.20% has a taxable equivalent yield, based on the highest tax bracket, of around 6.45%. By comparison, a

Continued on Page 6

EQUITY MARKET STRATEGY

The End of the Year Could Bring Opportunities

While significant challenges exist in the current market, we believe that, on balance, the outlook for stocks for the remainder of 2005 and into 2006 is moderately positive. Estimates of growth in corporate earnings for 2005 by Wall Street strategists have risen from the start of the year to over 10%, with the actual recent earnings growth averaging closer to 13.5% so far this year. Even in the wake of higher commodity prices and the damages from natural disasters, Oakwood's analysis of corporate earnings leads us to estimate that calendar year 2005 earnings growth may well exceed current Wall Street estimates. **Across all Oakwood equity strategies, the average weighted earnings growth rate of our stocks is decidedly stronger than the broad market, represented by the S&P 500.**

The multiplier effects on the billions that will be spent on rebuilding our energy infrastructure and the Gulf Coast communities will have a very strong and positive impact on growth in corporate revenues and profits in 2006 and 2007. Earnings forecasts by Wall Street strategists for 2006 have increased in recent months, and our expectation would be for further increases in earnings forecasts along with potential positive earnings surprises. A caveat to these expectations is the rate of inflation. Strategists are starting to write about the possibility of "stagflation" defined as the environment of slower growth and rising inflation. While the current environment of rapidly rising prices in raw materials, oil and gas may negatively impact corporate profitability expectations over the next twelve months, we believe earnings will increase over time. We will continue to monitor these factors to determine appropriate portfolio adjustments.

Another positive development is that the rate of growth in dividend payments is greater than the rate of growth in corporate earnings. Last year, dividends paid by S&P 500 index companies grew by 12% over the prior year, and so far this year, dividend payments have increased by over 16%. **In most Oakwood equity strategies, our client portfolios enjoy dividend income well in excess of the dividend income of the S&P 500 Index.** This income advantage will provide a cushion should we experience some short term volatility in the market and will contribute to clients' total return.

The important theme for all holdings in Oakwood's equity portfolios is that they have the following characteristics:

- Positive cash flow;
- Strong returns on capital;
- Healthy balance sheets;
- Increasing dividends;
- Good earnings growth prospects, and;
- Trade at attractive valuations.

Certainly, the upcoming earnings reporting season promises to be filled with many earnings surprises and will cause some market volatility. **In periods of market volatility, high quality companies that meet all of Oakwood's stringent investment criteria but have been overpriced may now be trading at valuations suitable for inclusion in Oakwood client portfolios. We make volatility our friend by using it to add excellent companies to our portfolios, when short term issues lower their prices.**

Rising interest rates increase borrowing costs for businesses and place pressure on net interest margins for banks and other finance companies. **Our decision to be underweighted in the interest-sensitive segment of the financial sector across all Oakwood equity strategies has been beneficial to client portfolios, as this area has been depressed due to rising interest rates.** The mortgage Real Estate Investment Trust (REIT) that we do own has minimal interest rate risk and extremely low balance sheet leverage. In addition, the one large bank we own is conservatively managed, and largely does not participate in the derivatives market, a major source of risk for most money center banks. The relative underweighting in this segment of the financial sector provides us with the flexibility to increase our exposure to this area, when we feel that the interest rate environment is more favorable to these types of companies.

During the third quarter, we continued to lighten up on energy holdings, as some of these stocks hit new highs. Oakwood's clients were richly rewarded by being overweighted in energy stocks about 18 to 24 months ago, based on our analysis. After enjoying the benefits of their significant run-up, we reduced our position sizes. We believe downside risk and high price volatility are latent in energy stocks, and prefer to be underweighted in this area at this time. The week ended October 7, 2005, showed a 7.4% pullback in the price of crude and a similar tumble for energy stocks, after their remarkable run-up.

Continued on Page 4

Equity Market Strategy
Continued from page 3

Our intensive search for undervalued growth and income stocks leads us to uncover investment gems in a variety of industries and sectors. Some examples are:

Consumer Cyclicals. Rarely do we find a company suitable for client portfolios in this industry; however, this restaurant stock has strong fundamentals and growth prospects that make it a standout. It is a well-run, high return on capital, high return on equity single-concept restaurant chain whose stock has been depressed by market negatives relating to the restaurant industry as a whole. It develops, franchises and operates casual dining restaurants located in 49 states and 12 countries outside the US. During 2004, the company launched a strategic alliance with Weight Watchers to offer Weight Watchers branded menu alternatives. The management owns 6.3% of its outstanding shares, and is very focused, innovative and shareholder oriented.

Consumer Staples. An excellent consumer staples company in client portfolios is the largest retailer in North America. Its low price leadership strategy in the US, continued expansion of its successful food business, additional refinements to its apparel selections, and inroads into international markets are key sales drivers. This company's expansion plans in 2006 include 240 to 250 supercenters and 145 to 155 international stores. A continued emphasis on small business customers, while maintaining price leadership, should boost results in its membership warehouse division. The free cash flow generated by this company promises to provide superb shareholder returns.

Financials. We have owned this dominant business development company in the US middle acquisition market since 2002. It provides mezzanine and senior debt financing for buyouts led by private equity firms, and financing to smaller private and small public companies to fund growth, recapitalizations and acquisitions. Many of its equity investments provide capital gains potential. Investors are richly rewarded by its significant dividend, which has compounded at 9% the last five years. It is hard to find solid dividends that grow, and this company has developed years of future potential by moving into the European acquisition market this year.

We have scoured the mortgage and real estate markets for an outstanding **REIT** whose primary focus is investing in real estate by acquiring and owning securities backed by high-quality real estate loans, particularly jumbo residential loans within the US real estate markets. This company has a brilliant strategy which it executes extremely well, generating a base dividend of over 5%. This company is a significant player in the small jumbo mortgages industry, issuing non-recourse securitizations and retaining only the credit risk which they can manage. If there are disturbances in the mortgage markets, this company is well positioned with excess capital to invest when opportunity arises.

Healthcare. A healthcare company in Oakwood's Capital Appreciation client portfolios is a dominant player in the wound-therapy industry, an industry with high barriers to entry. With its existing patents and innovative products which address a large under-penetrated market and wide coverage by third-party payers, this healthcare company should continue it prospects for 20+% top- and bottom-line growth. The company's primary business is advanced wound care, and its lead product is a proprietary system that promotes wound healing. Its secondary business includes selling surfaces that promote wound healing. This generates substantial free cash flow and gives the company valuable access to hospital decision-makers.

We are pleased to hold these excellent and growing companies purchased at a value price in our client portfolios. For the remainder of 2005, we expect the stock market to provide more opportunities for us. When we find under priced quality companies, we buy them, otherwise, we wait. In this environment, we particularly like our substantial dividend income which gives us a virtually certain cash return even in the event of a market fall. ■

Taxable Fixed Income
Continued from page 2

securities candidates into high quality liquid investments. At the present time, we do not feel that investors are properly compensated to tolerate a quality downgrade or to invest in complex bond structures. These strategies are best implemented when yield levels are more generous, or when quality trends begin to improve from the depths of recession.

Our primary goal is to maintain maximum portfolio flexibility, in advance of the end of Fed tightening. We believe bond investors will soon be rewarded for their patience. To date, we feel the diligence exercised on the part of the Fed has been the prescribed medicine needed to assure that inflation remains contained. This is an essential ingredient to an improved future bond market. Although bond returns have not been generous recently, we feel that our strategy of protecting capital has been invaluable to client portfolios, in the face of relentless Fed tightening. Fed Chairman Greenspan has repeatedly forewarned us of the dangers associated with "low risk premiums", which include overvalued housing, speculative security choices and low yielding long Treasury bonds. Recognizing this, our overriding focus is to isolate potential market risks and properly evaluate security choices, based on return expectations and capital preservation, which are consistent with our clients' goals and sensitivities. ■

Word from the Advisor
Continued from page 1

of lowering interest rates that created market value gains in their fixed income investments was pushing yields down to historic low levels, deeming them unattractive.

History shows that as interest rates decline, many investors become reluctant to invest in lower yielding bonds. Instead, they begin searching for higher yield at the expense of risk. This is particularly true for those investors who depend on fixed income as a means to generate needed income to live on. **However, those few extra basis points in yield come with a trade off – the inability to unwind the position quickly and to be poised to take advantage of more attractive opportunities created by a changing environment.**

That propensity to seek higher yield may seem reasonable until a period of rising interest rates, similar to the environment which we have been experiencing since June 30, 2004, causes investors to become trapped with their investment choices. Following the adage "It's best to own the best house on the street when the market turns down", a smart real estate investor knows to upgrade the quality of his real estate investments in order to preserve valuable capital and gain flexibility for future opportunities. At Oakwood, we use the same reasoning to build and manage client bond portfolios. Unlike those investors who searched for higher yield by lowering their quality standards or accepting complex bond structures during this period of rising rates, we were willing to accept a lower yield and focused on preservation of capital and future flexibility. ***The success of this strategy is shown by our ability to retain precious market value during this fifteen-month period of eleven consecutive interest rate hikes.*** *In addition, because we own only highly liquid investments, we maintain investment flexibility, in advance of better market conditions. Unlike the passive buy and hold investor, we view changes in market conditions as an opportunity to improve returns. This more active management strategy allows us to react quickly as interest rates begin to peak and to shift our attention to capital appreciation.*

Over two hundred years of experience in numerous economic cycles back up Oakwood's senior decision making team. The discussion of all current economic events at Investment Policy Committee meetings and the often differing viewpoints add a depth of insight and strengthen the fixed income team's ability to identify risk factors and return opportunities that are not apparent to less experienced managers. Oakwood's fixed income managers know that **liquidity and flexibility** are crucial in order to advantageously position client portfolios in this dynamic market. **Oakwood provides a highly disciplined quantitative approach to fixed income management that is necessary to evaluate individual security provisions, control portfolio risk in all interest rate market environments, address future changes in taxes and policies, all of which ultimately leads to properly structured portfolios based on risk versus return expectations.**

Well-defined investment processes are what distinguish Oakwood's strategies from our competitors. The ability to adhere to our investment disciplines and avoid the risky temptation to chase yields is what provides Oakwood clients with the reassurance that the objectives of the strategies will be met with the right balance between risk and reward. ■

Economic Outlook
Continued from page 1

midst of a storm of economic risk factors - including oil prices pushing well into the $60-plus a barrel range. The spread between long-term fixed rate mortgages and shorter-term adjustable rate mortgages has been narrowing, suggesting that at some point fixed rates will move to regain a more historically normal spread from their adjustable rate counterparts. We don't anticipate this to be a rapid move, which means the housing market will continue with favorable conditions through the end of this year, with slowly rising mortgage rates remaining in the "comfort zone" of most homebuyers for the time being. The downside of the hot housing market, of course, has been **the reliance of the US consumer on borrowing against the escalating prices of their homes, extracting nearly $600 billion from the values of their properties last year. This equates to a startling 6.9% of after-tax income and has contributed to relatively strong retail sales in the consumer discretionary sector.**

While the US economy has maintained moderate economic and job growth in the past year, continued risks such as rising oil prices will likely linger and persist, thereby exacerbating concern about the health of the economy. Oil prices have certainly dominated the headlines, and other energy prices, such as heating oil and natural gas, are beginning to cause concerns as well. **Since the beginning of the summer, the price of natural gas has doubled. Those companies with pricing power, such as many of the dominant high quality companies in Oakwood client portfolios, will be able to pass along these increased energy costs to their customers.** Those that can't will be suffering a reduced bottom line. It now appears that for the full year 2005, US energy expenditures are expected to rise to $1.08 trillion, up 24% from last year. That represents 8.7% of US annual gross domestic product (GDP), the biggest percentage share of GDP since 1985.

We believe that the impact of government spending related to the natural disaster recovery could add further inflationary pressures. The government has committed to spend $60 billion by the end of October, with plans in the works to funnel an additional $150 to $200 billion into the region over the next several years. **To give you a sense of the stimulative power, this is twice the size of the Bush administration's 2003 tax cuts.** In addition, the supplemental expenditures for US defense-related activities in Iraq, while certainly stimulative to the economy, are adding their own inflationary pressures. **The supply shocks from Hurricanes Katrina and Rita to sectors outside of energy add to potential core price pressures.** Supply shocks differ from demand shocks. Unless demand slows by as much as the loss of output, shortages and production bottlenecks will push up prices across a broad range of goods and services. A lasting slowdown in demand doesn't seem likely but we are continuously reviewing data from both the consumer and business sectors. ■

EQUITY PORTFOLIO ASSOCIATE & SECURITIES TRADER

Spotlight on Matthew W. Lauer

At Oakwood Capital Management, our goal is to provide our clients with top quality investment management. We welcomed Matt Lauer to our ranks about a year ago, where he has become a valuable member of the Equity Investments team. In his role as Equity Portfolio Associate and Securities Trader, Matt is responsible for the day to day trading in client equity accounts. He manages the trades when clients add funds to their accounts, as well as responds to client requests for withdrawals. He meets with the portfolio managers on a regular basis to discuss portfolio construction and individual stock positions. When the decision is made to make a change in a portfolio, he is responsible for executing those trades. Matt assists the portfolio managers on long term projects, helping in the creation of valuation models and in-house research reports. He coordinates closely with the fixed income department on asset allocation decisions for Oakwood's balanced client accounts as well.

Matt's keen eye for detail is a valuable asset when he is analyzing data and creating detailed quantitative reports on the companies that the Equity Investments team follows. His computer skills come into play on a regular basis as well. Matt says "I have been interested in computers and computer technology since I was in grade school, and have taken a lot of classes in programming. I understand the logic behind most software programs and that allows me to grasp new programs pretty easily."

Matt is a graduate of California State University, Northridge, (CSUN) where he earned his Business Administration Degree with a Concentration in Finance, graduating cum laude. Graduating with honors is a commendable task, but doubly so when it is accomplished while working full time. Matt was employed in various positions in the retail and insurance industries while completing his degree, bringing an attention to detail and a high quality of client service to these jobs. Most recently, Matt was with White and Company Insurance in Santa Monica, where he served as an Account Manager, fulfilling clients' complex insurance needs.

Matt enjoyed his classes at CSUN, particularly those that focused on the valuation of stocks and the stock market, and remains in touch with several of his finance professors. His introduction to the financial services industry came when he took an internship position at Merrill Lynch, where he analyzed client portfolios and made recommendations on appropriate investment strategies. Matt also has made it a priority to pursue his Chartered Financial Analyst (CFA) designation.

As busy as Matt is at Oakwood, he has been busy in his personal life, too. Matt got married this October to his fiancée, Jackie. The couple met at Moorpark College, where Matt started his college education. Jackie became enamored with Matt when their professor sprung a pop quiz on the class, and Jackie didn't have a pencil. Matt, already entranced by Jackie, broke his pencil in half and gave her the sharpened end. The couple enjoys mountain biking, going to movies, and going out with friends on the weekend. They wed in Calabasas, California, honeymooned in Italy, and will make their home in Agoura Hills, California, with their Chihuahua, Hank. ■

Tax Exempt Fixed Income
Continued from page 2

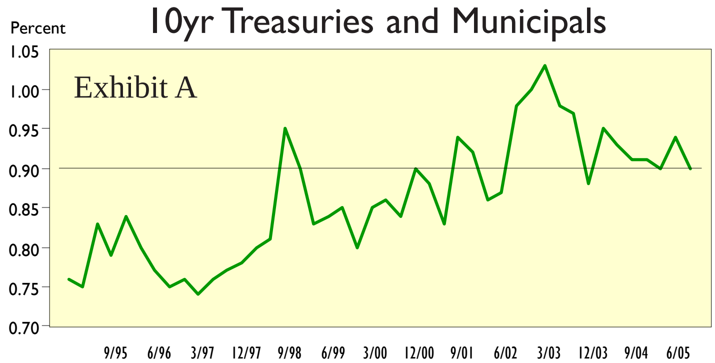
similar high quality taxable corporate bond yields 5.45%. For your review, we show current yield levels with taxable yield equivalents, throughout the maturity range.

	Municipal Yields	Municipal Taxable Equivalent Yields*		Taxable Corporate Yields**
1 Year	2.85	4.40	vs.	4.40
2 Year	3.00	4.60	vs.	4.60
5 Year	3.30	5.10	vs.	4.75
7 Year	3.55	5.45	vs.	5.05
10 Year	3.85	5.90	vs.	5.10
15 Year	4.20	6.45	vs.	5.45
30 Year	4.50	6.90	vs.	5.60

*Based on a 35% tax bracket
**Finance AA Corporate securities

It is important for investors to separate views based on short-term factors versus long-term trends. We believe the Fed will remain diligent and concerns over inflation should be resolved soon. Until the Fed calms these fears, returns will continue to be modest. We have been successful in protecting market value in client portfolios. Looking ahead, **our goal remains to hold only the highest quality securities with maximum diversification. On a daily basis, we are making modest changes in portfolio structure, in advance of a more favorable market environment. In this process, it is essential that we avoid overpaying for new purchases during short periods of market rally and maintain maximum liquidity in order to take advantage of opportunities as they surface.** ■

Historical Yield Ratio Between 10yr Treasuries and Municipals



Source: Bloomberg, Oakwood Capital Management LLC