

# Oakwood Outlook

## & Quarterly Review

Volume 9, Number 1 January 2006

### A Word

#### From the Advisor A Roadmap for 2006

As we begin the journey into the New Year, we would like to take this occasion to thank our clients for the opportunity to serve as your investment adviser. To begin the year with a solid foundation, we feel it would be helpful to include a roadmap for investors to navigate through all the news, noise, and data that we are faced with on a daily basis regarding the markets and the economy. Sometimes just knowing the right questions to ask can go a long way in helping to understand the various dynamics that affect the stock and bond markets. Some of the questions that investors have been struggling with would include:

#### Can I make money on my investments in 2006?

At Oakwood Capital Management LLC, we like to establish reasonable expectations for our clients. **We expect both the 2006 stock and bond markets to provide positive results** while experiencing volatility, given the components of an unstable oil market, an active Federal Reserve, a softening housing market, and an unpredictable midterm election. Like the majority of investors, we are not counting on a replay of 2003, a bright spot that lit up the first full year of the latest bull market, with the S&P 500 Index, a representative index of the broad

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### Economic Outlook Entering the New Year with Remarkable Resilience

**The US economy showed remarkable resilience in 2005.** Despite a major natural disaster and an intensified energy shock, growth accelerated from 3.5% in the first half of the year to an estimated 4.2% in the second half of the year. In part, this is a typical reaction to disaster: **recovery spending typically offsets the damage to growth almost immediately, and in this case, much has yet to be spent. However, the picture also reflects underlying strength.**

As we move into the New Year, a brief review of 2005 performance for the equity and bond markets shows that the S&P 500 Index, a measure for the broad equity market, returned a positive 4.95% for the year. Another widely used measure of the market, the Dow Jones Industrial Average, returned 1.86% for the year. The Lehman Brothers Intermediate Bond Index, a representative measure of the fixed income market, returned 1.58% for 2005.

We expect the US economy to show continued strength into the year 2006, particularly in the first six months of the year, with a slowing in the second six months, with the overall pace more modest than 2005. We forecast that the nation's gross domestic product (GDP) will grow at an annual rate of 3.3% in 2006, certainly a respectable rate, but falling short of the average of the past two and a half years.

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*We have recently added two new members to complement our existing professional team. John L. Graves, CFA has joined Oakwood as Senior Vice President, Chief Investment Officer of the Equity Investment team. John comes to the firm with an impressive history of successful investment management experience, most recently as the principal of a major West Coast investment management company. David N. Goldberg, who joins the Marketing & Client Services Group as a Vice President, most recently was an officer and financial advisor at a major international financial services company, with whom he was with for nearly thirty years, where he provided investment counseling to a broad base of private and institutional clients.*

*We are also pleased to announce the promotion of Watt W. Webb III to Senior Vice President, Director of Research.*



**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

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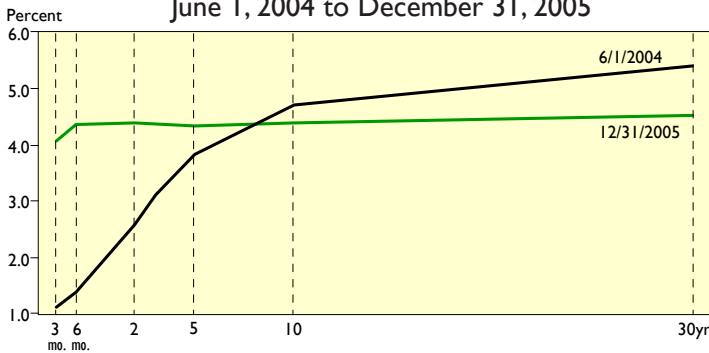


TAXABLE FIXED INCOME

Strategy

The year 2005 has been an exciting and challenging year for taxable fixed income investors as the Federal Reserve pledged to keep the economy and inflation in check. In fact, at each of its eight scheduled policy meetings, Fed officials opted to raise the key overnight lending rate by 25 basis points. When combined with the five prior rate increases that started in June 2004, the Federal Funds rate now stands at 4.25%. The following graph compares the changes in US Treasury yield levels throughout this process.

US Treasury Yield Curve Comparison June 1, 2004 to December 31, 2005



Source: Bloomberg, Oakwood Capital Management LLC

The left side of the graph depicts the direct impact of these interest rate hikes in the short maturity areas. We believe the significantly higher yield levels should begin to slow the economy as well as calm inflation worries. The far right side of the graph shows a very different yield pattern. In sharp contrast to the short area, yields in long Treasuries actually fell. In fact, because short-term yields moved higher and long term yields moved lower, all yields regardless of maturity area are almost identical. In our view, for this "curve flattening" event to occur, foreign and domestic investors must be confident that the Fed will be successful in its mission to halt inflation concerns and contain economic growth. As a comparison, normal yield spreads between 2 and 10-year Treasuries on a historic basis have averaged around +90 basis points. Typically, there is inflation risk as investors await repayment of their initial investment. The absence of this "risk premium" implies that inflation is expected to moderate and a change in monetary policy is near. This may further imply a possibility that the Fed may even begin to lower interest rates later in 2006 or in early 2007.

At Oakwood, we are pleased with the performance results in client portfolios. In spite of rising short term interest rates and market naysayers who forecasted doom in the bond market, client portfolio returns were positive throughout all Oakwood bond strategies. While market observers continue to debate the significance of a flat or in-

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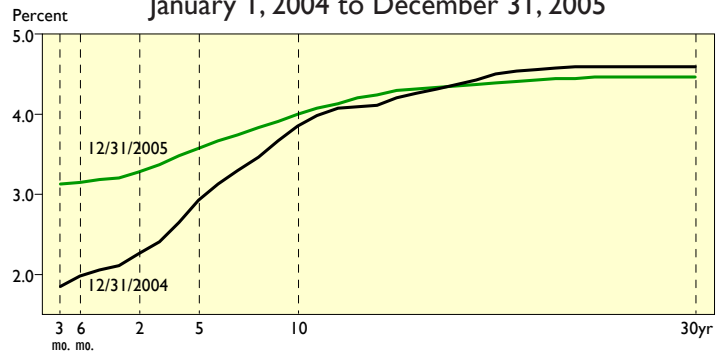
TAX EXEMPT FIXED INCOME

Strategy

Municipal bond markets enjoyed a good finish to 2005, as yield levels either held steady or trended lower. History shows that unlike the taxable bond markets, high quality municipal securities seem to sidestep much of the daily emotion from conflicting economic data, and instead are more affected by underlying market fundamentals and overall trend direction. In our current environment of interest rate uncertainty and stock market fluctuations, municipal bonds continue to provide investors solid tax-free income and a necessary level of market protection. This is evident in Oakwood client portfolios as returns were positive for the year.

Similar to our forecast on the taxable markets, we believe municipal yield levels will begin to trend lower in all maturity areas during 2006. As shown below, longer municipal rates have already begun to respond to favorable inflation news.

Municipal Yield Curve Comparison January 1, 2004 to December 31, 2005



Source: Bloomberg, Oakwood Capital Management LLC

As we near an end to Federal Reserve monetary tightening, we expect short yields to follow the direction in longer yields. As a result, for your review, the following reflects recent changes to maturity in our portfolio structure. These changes are reflective of an overall average maturity of 7.50 years and a duration target of 5.75 years.

MUNICIPAL BOND MODEL table with columns: Effective Maturity, Allocation 2005, Allocation 2006. Rows include maturity ranges from 0 to 1 to 10+.

As shown, we increased our allocation in the 10+ year maturity area to 25% while lowering holdings in short maturities.

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## EQUITY MARKET STRATEGY

## Sustainable Growth

We believe US equities can continue to generate positive returns into 2006. **Despite strong economic growth, the US equity market experienced a lackluster year in 2005, with very modest positive returns on the whole.** Not surprisingly, particular sectors—notably oil and natural gas exploration and energy—diverged sharply and significantly outperformed other sectors of the market in large part due to high energy prices. Related to this phenomenon has been a dramatic underperformance by the auto and consumer discretionary sectors, which are most affected by high prices of oil and gasoline. We began the year 2005 with many uncertainties, among them inflation and oil prices. As 2006 begins to unfold, these same inflationary pressures seem in check due to a proactive Fed. **On our short list of market-defining items for 2006 are the end of the Fed tightening cycle, the continuing instability of oil prices and corporate and personal income growth.**

There are several reasons to support our conviction for a positive US equity market this year. First, **US investors are feeling that inflation is under control.** We are encouraged that inflation remains stable despite significantly higher oil prices. Interest rates have risen, but in a very gradual and transparent fashion which has translated into a well-engineered slowing of the economy. We believe investors may increasingly reward higher quality companies, particularly large-cap entities that generate good quality cash flow, such as the companies that comprise Oakwood client portfolios. Overall, we see quality coming to the forefront with corporate earnings growth coming in slightly above trend.

**Corporate profits should continue to rise, albeit at a somewhat slower pace this year.** We project that operating profits on the S&P 500 will advance approximately 11% for 2006. A larger portion of those profits will benefit shareholders via increased dividends and stock buybacks. Cash on the balance sheets of nonfinancial companies in the S&P 500 hit another record high in late 2005, at \$638 billion. This has enabled companies to increase their share buyback programs. **In past years, some companies used buybacks to offset shares issued in conjunction with exercised options. Now that options have to be expensed, we are seeing less of this activity, and buybacks are actually reducing the shares outstanding. This has positive implications for per-share earnings and, therefore, stock prices.**

From a historical valuation basis, the equity markets are not cheap, but seem fairly priced. The price-to-earnings ratio (P/E) of the stocks in the S&P 500 Index, for instance, was 16 times estimated 2006 earnings as of the end of 2005. Some analysts interpret that to mean that stocks are cheap, although the ratio is just really returning to its long-term historical average, with the average P/E ratio approximating 15 times estimated twelve-month forward earnings. The P/E ratio ratcheted toward 40 times estimated forward earnings at the height of the 1990s excess and has

been sliding downward since.

While all strategies at Oakwood Capital Management are driven by individual company fundamentals, considerations regarding macro-economic, geopolitical and industry dynamics drive long-term investment decisions for holdings in client portfolios as well. The depth and experience of Oakwood's equity team has enabled us to identify industry shifts and to advantageously position ourselves well ahead of the curve to benefit our client portfolios. As an example, we identified the peaking of the Energy sector in the late summer, and subsequently took profits at the appropriate time.

**A major transition that we believe will inexorably change our world is a shift from the current fossil resource-intensive global economy to sustainable, more regional economies.** The increasing scarcity of oil, gas, and other fossil resource mineral fuels will necessitate an economic restructuring to function in a diminishing resource environment. This transition, already underway, will take a decade or two, and will create opportunities for the perceptive investor and losses for those who do not anticipate its impacts and fail to change their portfolios.

**Oakwood is extraordinarily equipped with the expertise to manage this transition for its clients, and has begun to do so.** All of Oakwood's investment professionals have successful histories investing in the Energy sector, and positioning portfolios for investment success during times of great change, and great opportunity. Mineral deposit geologic characteristics, extraction costs, location, transport access and political and military stability, among other criteria, play critical roles in the investment success of each company selected for investment. Some recent additions to client portfolios that capitalize on this knowledge are independent energy companies that acquire, develop, and produce oil and gas reserves located in the United States. Some common characteristics of these companies are the long life (an average of 15 years) of the oil and gas reserves, and the undervaluation of their share price. This undervaluation provides significant value protection, and these companies carry near zero geopolitical risk.

Another holding in client equity portfolios that is poised to capture opportunities in the Energy sector is a company that has an outstanding shareholder management extremely focused on increasing cash returns. This company is an operator in commercial real estate, with power generating subsidiaries encompassing two alternative energy sources, hydroelectric power operations and biomass operations (ethanol).

A company in the Industrial Services sector that is held in some client portfolios is a service company that provides pest and termite control to residential and commercial customers throughout North America. This industry is highly fragmented with numerous small mom and pop and medium size companies. The company we hold is a highly disciplined acquirer, looking to create

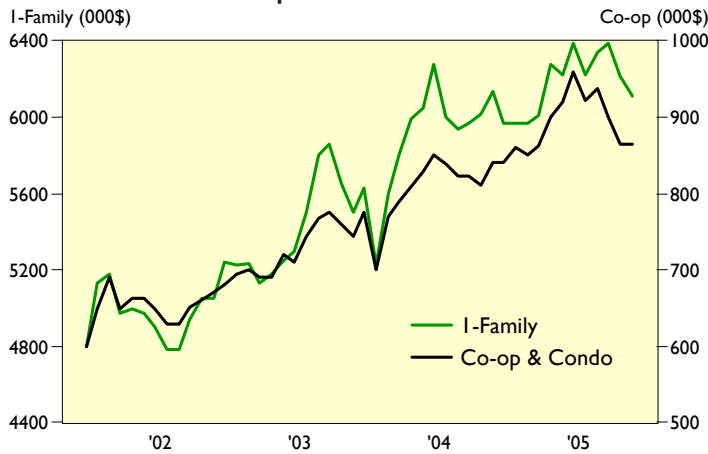
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Economic Outlook  
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Real estate wealth, supporting the economy by providing consumers with cash to buy everything from designer kitchens to second homes, appears to be experiencing what looks like a slow-motion soft landing—as can be seen from the following chart, sales are slowing, with a subsequent building in inventories, with price inflation cooling, but not collapsing.

US Existing I-Family Home Sales  
and US Co-op & Condominium Sales



Source: Haver Analytics, Oakwood Capital Management LLC

As interest rates rise, the ingredients of rising home values and consumer cash extraction from refinancing and home equity loans that provided economic growth are being displaced with a new growth mix. **Businesses will lead the way with strength in capital spending, inventory rebuilding, supported by post-Katrina government outlays and exports that are expected to pick up the slack from weakened consumer spending and housing.**

The economy's rebound from 2005's natural disasters and costlier energy have left companies with solid balance sheets and the cash available to afford their capital spending plans and to increase hiring. Even though interest rates will likely continue to rise in the early part of 2006, and labor costs should continue to increase, businesses are sufficiently flush with cash to withstand these pressures. **With currently healthy balance sheets and extremely manageable corporate debt, companies are in such good shape that there is a negligible need to borrow to meet the needs for the year's new buildings, equipment, inventories and payroll.** Corporations' ability to either reduce their borrowing or not borrow at all reduces their interest expense, thereby improving net margins.

Stronger growth in non-US economies will be a plus, as major economies abroad maintain forward momentum. Economic growth abroad leads to solid US export growth, a trend which, along with slower import growth, should stabilize or perhaps even narrow the growing trade deficit. The two major contributors to this foreign economy strength are the Euro

zone and Japan, reflected in the new attitudes of both central banks. The European Central Bank lifted rates in December of 2005 for the first time in five years, and the Bank of Japan is contemplating ending its zero-rate policy that had begun in 2001, as it appears that its long hard battle with deflation is ending. **The multinational nature of many of the holdings in Oakwood client portfolios will benefit from these improving non-US economies, as well as the healthy effect of an increase in US exports.**

The US dollar enjoyed a rally in 2005, primarily due to several factors. US interest rates, higher than non-US counterparts, attracted foreign capital, while the repatriation of billions of dollars in profit by US multinationals added support to the currency. In addition, China's modest revaluation of the yuan did not spark the broader rally expected in Asian currencies, maintaining the appeal of the US dollar. Despite the current strength of the dollar, many see the present situation as an interruption of a longer-term decline in the dollar. With the US trade deficit growing, many investors say that at some point the dollar must weaken considerably to address this imbalance.

**An interesting recent development that could put heavy downward pressure on the dollar is the indication from China during the first week of January 2006 that it could begin to diversify its rapidly growing foreign exchange reserves away from the US dollar and government bonds – a potential shift with significant implications for global financial and commodity markets.** Economists estimate that more than 70% of China's reserves are invested in US dollar assets, which has helped to sustain the recent large US deficits. If China were to stop acquiring such a large proportion of US dollars with its reserves – currently accumulating at about \$15 billion a month – the dollar could potentially lose its strength. A fall in the US dollar may heighten inflationary expectations in the US and force the Fed to constrain them. Stronger global growth would put upward pressure on global real interest rates. In addition, it could affect international capital flows, another factor contributing to weakness in the US dollar, particularly if Japan becomes significantly more attractive to global portfolio managers.

A precipitous dropoff in housing activity and home prices and/or a sharp shift in oil prices are the major threats we see to continued US economic growth. So far, the Fed has done its job with controlling rates to allow growth for the economy and keep inflation at bay, with the current Federal Funds rate at 4.25%. An overtightening policy could severely damage housing, and possibly the overall economy. The ups and downs in the price of oil could either be a positive or negative for growth. Any sharp swing out of the range of \$45 to \$70 a barrel would affect growth and overall inflation. ■



Word from the Advisor  
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market, returning 28.69% in that year. **Normal bull markets settle down after their early gains, and that has been the pattern for this current one as well.** The average annual change in the S&P 500 Index for the past 50 years is an increase of 10.40%.

Oakwood's expertise is based on in-depth research and fundamental analysis that allows us to pinpoint and select those stocks and bonds that will appreciate in all types of market environments. We also focus on risk management. For stocks, we control price risk and, to the best of our ability, identify and control operating risk. For bonds, all security choices are subjected to a rigorous array of fundamental and quantitative modeling to validate rate of return expectations, including return variance and horizon analyses. Oakwood's strict investment discipline and carefully defined investment philosophy for all investment strategies provide our clients with security selection that allows for the maximum total return potential with the minimum amount of risk. **We feel that the coming year provides many opportunities for capital appreciation through cautious security selection in our clients' portfolios.**

### **Why is there so much attention in the media regarding the present shape of the yield curve?**

Normally, the yield curve, the graph of interest rate levels across all the various maturities, from the overnight Federal Funds rate to the 30-year Treasury bond, slopes upward, showing long-term rates that are greater than short term rates. This "positive" yield curve typically rewards investors who must wait for the return of their money with the uncertainty of inflation and is usually reflective of economic growth. However, as the Federal Reserve raises interest rates to calm inflation rate fears and to moderate economic growth the yield curve "flattens" and short term and long term rates have little difference between them. **If and when short term rates become higher than long term rates, also known as an "inverted" yield curve, it implies the market is beginning to become more confident that the Fed will be successful through its tighter monetary policy, short term inflation is being controlled and an economic slowdown, even to the point of recession, is possible.**

Taken in this context, the Federal Reserve, whose primary responsibility is to ensure maximum economic growth with low inflation, must balance economic and inflation barometers to achieve a proper balance. To date, we have seen favorable signs of low inflation, and the Fed's opinion is that the economy is continuing to growth without moderation. Therefore, we feel that the Fed should be reluctant to lower rates for fear of sparking inflation. At Oakwood, we advantageously position our client portfolios to benefit from the current higher interest rate environment, and just like the Fed, monitor new information to determine future trends.

### **Why are the housing market and housing prices so important to the US economy?**

**Approximately one-third of the growth in the economy during the past year is a direct or indirect result of the boom in home construction, sales, and prices.** The housing wealth

Equity Market Strategy  
Continued from page 3

economies of scale through its acquisitions, as well as leverage a well known brand name.

Areas in which we have scaled back are mainly in the Consumer Discretionary sector, where the stocks sold have much lower potential returns and significant risk, particularly in light of an economy with a deteriorating housing market and unstable energy costs leading to decreased consumer discretionary income.

We are currently underweighted in the Financials sector, particularly wary of those companies that are sensitive to fluctuating short term interest rates. There are several regional banks that from a fundamental perspective are very attractive; however, their prices are too lofty at this point for serious consideration.

Companies in the Healthcare sector have been beneficial to all client portfolios, and we look for positive performance going into 2006 in this area as well. In this sector, our client portfolios have prospered with the ownership of a regional healthcare provider which owns its own healthcare services organizations, including doctors. This structure gives them control over the quality of healthcare delivered to a network of patients, resulting in much higher patient satisfaction and 15-20% lower costs than any competitor. We have recently done some profit taking in the Healthcare sector, where some of our names had fully appreciated.

At Oakwood, our fundamental investment approach is based on achieving superior long-term performance by acquiring equity securities of financially strong, well-managed companies run by capable managements trading at market prices significantly below our assessment of their business, or intrinsic value. **Our focus is on companies that sustain high return on equity, high return on capital, and predictable free cash flow.** ■

effect operates with long and variable lags. When demand slows, most of the impact is initially felt through rising inventories, not falling prices. After the remarkable run-up of the past several years, homeowners will be reluctant to slash prices. Inventories were remarkably lean at the beginning of 2005, and the rise thus far has only brought them back into rough balance with the current level of sales. There are also long lags from the end of the pricing boom to the weakening of consumer demand. **The growth in housing wealth and equity extraction accelerated in the past year. It will probably take some time for the funds already extracted to wash out of the system.** Models of the wealth effect typically assume that it takes three years for household spending to respond fully to an increase in wealth. In addition, homebuilders are still reporting large backlogs, so it may also take time for residential investment to slow.

We realize that these are just a few questions that may be on your minds as investors. **We invite you to freely communicate to us any questions, comments or concerns that you may have regarding the stock or bond markets, the economy, or any other investment questions as frequently as they come up. We invite you to send your questions to [questions@oakwoodcap.com](mailto:questions@oakwoodcap.com), where a member of our team will be available to respond to your inquiries.** ■



**Taxable Fixed Income**  
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verted yield curve, we expect interest rates to move lower, as consumers lose the huge boost to discretionary spending from home refinancing and as the flattened curve penalizes banks, finance companies and other investors who try to profit from borrowing short to lend long.

In the most recent edition of the Oakwood Outlook, we alluded to the difficulties in pinpointing a change in interest rate direction and its effect on yield levels throughout the curve.

**We prefer to adjust portfolios in gradual steps, based on prevailing return opportunity, market risk assessment, and as the early signs of a change in market sentiment surface.** As an example, we feel there is a developing opportunity to extend some of our 10-year Treasury investments to the 12-year maturity area. This swap provides an ability to improve yield and gain generous coupon cash flow while providing a potential to add more return as the yield spread advantage disappears. Pending the end of Fed tightening, we continue to add zero coupon positions that compound at a purchase yield level. Complementing this strategy, we hold market discount callable Federal Agencies in the 2 to 3-year area. This segment of the agency sector adds comparable yield with only a slim chance of early redemption, especially as many of these holdings pass their one-time-only call date.

Because we are forecasting a slowing of the economy, we have tightened quality standards on approved corporate holdings. While the credit cycle has not turned decidedly negative, many companies are beginning to lose earnings momentum. As a result, we have completed a review of all existing corporate holdings with the intent to extend only issuers that pass our very stringent quality standards. This select extension program is designed to enhance portfolio yield and shift overall duration on discretionary portfolios to a modestly aggressive posture.

**As you are aware, at Oakwood we are active and opportunistic bond managers and remain prepared to alter our forecast and portfolio strategies should market conditions warrant. At this time, we believe 2006 will be a good year for bond investors. ■**

**Tax Exempt Fixed Income**  
Continued from page 2

These changes are designed to improve the overall yield in client portfolios and provide dependable tax-free cash flow from future coupon payments. Furthermore, we continue to emphasize investments that have good call protection and to avoid bonds that are subject to alternative minimum tax (AMT). It is estimated that 20 million taxpayers will be affected by AMT and even a minor tax restructuring by Congress to eliminate this broadening tax consequence seems unlikely.

As you are aware, the economy has been able to handle the seemingly endless round of Federal Reserve interest rate hikes which have resulted in higher tax collections. As a result, tax receipts are running ahead of schedule for most state and local municipalities. This provides support for their outstanding debt obligations. **Despite this, we will continue to own only the highest quality investments with an emphasis on issuer diversification.** This entails a conscious effort to diversify both geographically within each state of client residency, and to diversify the various revenue sources backing the payment structure of each holding.

As previously stated, we are forecasting a good year for tax-free bonds as strong demand for this investment class continues. New bond sales during 2006 should top \$400 billion as the infrastructure needs of this country are expected to grow exponentially. We note that many individual investors have become wedded to very short bonds and we expect to see a move to lengthen these holdings. This process should begin to materialize as investors respond favorably to the continued Federal Reserves efforts to keep inflation and the economy in check. ■

*We wish you and yours  
a healthy and prosperous  
new year.  
Please feel free to contact us should  
you have any questions or needs. We  
always stand ready to provide you  
with high quality investment advice  
and client service.*