Oakwood Outlook

& Quarterly Review

Volume 9, Number 2 April 2006

A Word

From the Advisor

Staying Power

Whether the equity market is going up or down, it will always be full of short-term distractions – the direction of interest rates, inflation, commodity prices, and geopolitical events, to name but a few that create market volatility. It is difficult at times to look beyond a short-term horizon and remain comfortable holding your equity investments for a minimum period of several years, as you ride out the inevitable bumps that will occur during that time period. The challenge for us at Oakwood Capital Management LLC is to look beyond the noise and short-term distractions and continue to find investment ideas for our clients that have staying power, but also remain ready to respond to any **fundamental** change in an individual investment or industry outlook.

Our equity investment approach begins with an understanding that it may take years for a company to create global distribution networks, build infrastructure and forge brand identities. We continuously evaluate management's strategies and execution and their potential impact on a company's long-term profitability. Our view of each company as an ongoing business, rather than as a current stock price or a quarterly earnings projection, keeps us focused on promising long-term investment opportunities.

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Economic Outlook

Not Too Cold, A Little Too Hot?

The first quarter of 2006 ended with all US equity market indices in positive territory. The two major broad equity market indices, the Dow Jones Industrial Average and the S&P 500 Index, both gained 4.2% for the quarter. The Lehman Brothers Intermediate Bond Index, which gauges the overall bond market, returned -0.4% for the quarter, with the Merrill Lynch Government Corporate Bond Index returning -1.0% for the same time period.

A view most widely held by economists, investors and Wall Street pundits is that the US economy is in a "Goldilocks" phase, that is, it is not too hot, not too cold, but just right. To be sure, the Federal Reserve (Fed) has successfully checked any fears of an increase in core inflation, while implementing a remarkably orderly moderation in economic activity. Up to this point, judging Fed policy has been relatively easy. Back in June, 2004, the Fed essentially told the markets it was going to lift its target rate from the highly stimulative 46-year low of 1.0%, to a more neutral level historically consistent with healthy growth and low inflation. The patterns in the economic data, to this point, have played only a small role in the Fed's actions to raise rates. With the Fed's target interest rate now at 4.75%, following its fifteenth quarter-point hike in as many meetings, its ability to determine whether the 4.75% rate is high enough to insure that inflation will stay under control has more uncertainty surrounding it, and this uncertainty

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We are pleased to announce that Donald L. Carter has joined Oakwood as a Senior Vice President in our Marketing and Client Services Group.

Don comes to the firm with an impressive background which includes over 25 years of experience in Banking and Financial Services. He has served as a senior officer and manager of Trust and Wealth Management departments, where he provided investment services to a broad base of private and institutional clients.

Please join us in welcoming Don to the Oakwood team.

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TAXABLE FIXED INCOME

Strategy

As bond investors enter the second quarter of 2006, many are wondering "When will interest rates stop going up and begin to once again move lower?" They note that newly appointed Federal Reserve Chairman, Ben Bernanke, at the Fed's latest March 28th meeting, picked up where Alan Greenspan left off in January. The Fed pushed up its main rate a quarter-point higher for the fifteenth time, to 4.75%. Furthermore, those who were looking for signs that the Fed would stop raising rates were disappointed that Bernanke, in his accompanying statement, left the door open for further rate hikes. This implies that a Fed Funds rate at 5.0% is practically guaranteed, with the potential for additional rate hikes beyond that level.

As pointed out in previous editions of the Oakwood Outlook, we feel that it is important to differentiate "future inflation expectations" from "current inflation reporting" as the key to understanding monetary policy and, more importantly, to projecting changes in market expectations. For example, clearly, to date, inflation has remained under control. A widely watched ***current*** *inflation report*, the Commerce Department's personal consumption expenditures (PCE) core index, rose only 2.1% on an annualized basis, during the last quarter. Given this benign reading, why are bond investors concerned? For one thing, central bankers have said they would be comfortable with a 1.0 to 2.0% inflation level. While this initial 2.1% level is only modestly above their range, the report was later revised upward to 2.4%. **This revision can focus the attention of the Fed to the fact that *future inflation expectations* may soon trend even higher.**

Adding to concerns is the state of the economy. As you are aware, the economy remains quite strong despite the headwinds of higher energy and commodity prices and higher interest rates. Despite earlier evidence that employment growth may be slowing, new data suggests that the economy is expanding at a 4.7% pace in the first quarter. This is consistent with factories running at 81% of capacity, matching a five-year high, in December. The Fed may be concerned that the level of growth will further drain the pool of available workers who will then demand higher wages. This, combined with the run-up in commodities prices, hints that inflation trends may indeed move higher. **Therefore, we feel it is important for the economy to slow as a prerequisite to an end in rate hikes.**

Not all of the news is negative for bond investors. The graph shown in Exhibit A on page 7, demonstrates confidence that the Fed will be successful in its efforts to curb this inflation threat.

Since the start of the interest rate tightening in June 2004, the Fed's targeted fund rate has increased 350 basis points, to 4.75%. Concurrently, the yield spread separation between Fed

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TAX EXEMPT FIXED INCOME

Strategy

In an otherwise difficult interest rate climate, municipal bonds provide a somewhat bright spot. In fact, our recent decision to selectively extend shorter maturity positions into the 10 to 17 year maturity area has helped to stabilize market values. As an example, a 15-year municipal bond generated enough income to overcome a modest market decline. This occurred as the demand for longer securities remain strong, especially in the face of two additional rate increases by the Fed since the beginning of 2006. The following graph shows yield changes in municipal versus taxable securities since year-end 2005.

Taxable vs. Municipal Yield Change
1st Quarter 2006

		Change in Yield Curve (BPs)	Taxable change vs. Municipal
2 Year	Taxable	+42	+8
	Municipal	+34	
3 Year	Taxable	+42	+8
	Municipal	+34	
5 Year	Taxable	+46	+21
	Municipal	+25	
10 Year	Taxable	+46	+24
	Municipal	+22	
15 Year	Taxable	+47	+30
	Municipal	+17	
30 Year	Taxable	+36	+28
	Municipal	+8	

Source: Bloomberg L.P., Oakwood Capital Management LLC

Although both taxable and tax-free yields have moved higher, the magnitude of increase is less for municipals, especially in longer maturity areas.

A review of Oakwood client fixed income portfolios essentially reflects flat returns for the first quarter. Nonetheless, client portfolios enjoyed good cash flows from interest payments on their bonds, and we are pleased with our ability to retain market value during this difficult environment. **In fact, we feel the municipal bond sector continues to provide an inherent degree of market protection, for the following reasons:**

- **Based on quality, while municipals have more risk than government securities, the historical default rate is less than 1.0%.** This provides comfort to investors even under the weight of ongoing Fed actions.

- **The demand for municipals is driven by a tax advantage to those investors in higher tax brackets.**

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EQUITY MARKET STRATEGY

Opportunities Ahead

In our last Oakwood Outlook, we published our short list of market-defining items for 2006, which included the end of the Federal Reserve tightening cycle and the continuing instability and underlying secular increase of oil prices. As the first quarter of the year has come to a close, we see these same items at the top of our list, and add to that the high rates of resource utilization and elevated commodity prices that could boost inflation. Despite these lingering uncertainties, stocks picked up in the first quarter of 2006 where they left off in late 2005, potentially setting the stage for a fourth straight year of equity gains following the brutal bear market from 2000 through 2002.

We see continuing, though slower, US economic growth, steady or moderately higher price-to-earnings ratios (P/Es), a slowing in housing activity and moderate increases in core inflation. The corporate earnings outlook remains positive with elevated wage pressures being positively balanced with solid productivity trends, respectable earnings growth expectations, and increased corporate spending. **Corporate net cash flows grew by a strong 18.5% on an annual basis.** The historically high $2 trillion level of cash on corporate balance sheets has to date been utilized fairly conservatively, but as we progress further into 2006, yielding to shareholder pressure, companies are becoming more aggressive in terms of acquisitions, capital spending, hiring, dividend increases and share buybacks.

Much of the character of the 1980s and 1990s bull market is still in evidence today. Valuations are reasonable, yields are lower, profits around the globe are growing at a rapid pace, excess liquidity is prevalent, productivity still remains strong, innovation continues at a healthy pace, and capitalism is spreading at an accelerating rate around the world. **The continuing acceleration of global economic activity this year, as the US economy settles into a more modest rate of growth, will benefit the multinational nature of many of the holdings in Oakwood client portfolios.**

Our focused research effort has identified companies that have competitive advantages that will create long-term opportunities for shareholders. We buy when the fundamentals of the company and the price of the stock dictate a buy, and we view the stock as having the potential to add value to the overall portfolio.

A company poised to capture the explosive growth in the Information Technology sector is the king of cell phones, capitalizing on its economies of scale and powerful branding to introduce new phones. This company's brand has been rated as one of the most valued in the world. Thinking like a consumer goods company, it has segmented the market by targeting different phones to different consumer niches. It has made significant strides in the Code Division Multiple Access (CDMA) market, the one major protocol it doesn't dominate. Having a strong portfolio of CDMA products will provide entry to the key markets of China, India, and the US. The overall financial position of this company is outstanding. It generates generous free cash flow, much of which it is returning to shareholders via dividends and share buybacks. It also has more than $12 billion in cash and investments on the balance sheet, with almost no debt.

An excellent opportunity we have uncovered in the Healthcare sector is a very well positioned medical device company that has been a going concern since 1906. We like the company's very high return on equity, return on capital, stable free cash flow, and strong competitive position. The exceptional management of this firm has had the foresight to reinvest cash flow from its mature businesses into value-added products. Over the past two decades, management incurred sizable research and development costs to make long-term commitments to safety-engineered products—which prevent workplace hazards such as needle-sticks—and expand into high-margin, fast-growing areas such as medical devices for diabetes, including blood glucose monitors and flow cytometry. Those investments are paying off, as these products are less than one-third of total sales, but accounted for half of 2005 revenue growth. **International markets for safety-engineered medical devices represent its biggest sources of growth. International conversion rates to safety-engineered products from older-generation products are as low as one third the level of the US. This firm's international safety-engineered sales grew 34% in 2005, to $273 million.**

As highlighted in the Word from the Advisor, world energy production is approaching its peak, and reserves are declining each year without replacement. **Responding to this reality, we have selectively overweighted the Energy sector. Examples of the types of companies in client portfolios include:**

- **Domestic production companies with significant reserves and exploration potential**. These undervalued companies may be acquired at premiums to their current prices, as major energy companies compete to add reserves as fossil fuels become increasingly scarce.

- **North American natural gas companies.** We like these companies because we believe:
  - They have more price leverage than oil oriented companies over the next 5 years, when adjusted for supply/demand conditions;
  - Gas is currently undervalued on a BTU basis versus oil;
  - Gas is the premium, preferred fuel as its burns much cleaner than oil and coal.

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Equity Market Strategy
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- **US and Canadian-based companies.** Companies based in North American have a margin of geographic safety, given world geopolitical problems. Foreign oil companies' assets are at increasing risk due to the instability of their geographic locations.

An example of an energy company widely held in client portfolios is one of the world's largest independent oil and gas producers. Primarily consisting of natural gas, its US properties constitute 72% of the firm's overall reserves. Natural gas is the clean, preferred fuel, in general selling at about 20% of current oil prices. Sizable American reserves limit the firm's political risk and put it in the middle of the world's largest energy market. We purchased this stock at what we believe to be 60% of its current intrinsic value, and expect its value to increase with rising energy prices. **Owning these assets protects our clients from energy driven inflation and from devaluation of the US dollar as well.**

We have deliberately sought out and bought companies that will benefit client portfolios by adding value in these more challenging times of global uncertainty. An example of this type is a company that explores for and produces gold, silver, and copper in the Americas and Australia. Gold companies tend to be countercyclical. They also provide an excellent hedge to inflation and geopolitical risk. This particular mining and production company does not engage in the forward selling of gold. This unhedged position allows the company to benefit when gold prices rise. With nearly 2 million probable tons of ore at one of its larger facilities, it has many years of high-grade production ahead of it. Gold has recently run up to $600 per ounce.

We have recently added to client portfolios a world class multinational, multi-industry, media and financing giant that has excellent growth prospects. Corporate managers, especially those who captain conglomerates, must shine at asset allocation, and this company, throughout its long history, ranks among the best. **This company invests heavily in research and development ($12.5 billion over the past five years) and has evolved into a technology company with an unmatched breadth of products and services. This company's genuine competitive advantage is that it is able to use various technologies across business segments.**

Another fine company recently added to client portfolios is the most global of the US-based packaged-food companies. It has a strong international presence, with sales outside the US accounting for more than 60% of annual revenue. This company's brand, which is placed on everything from ketchup to baked beans to baby food, is a $3 billion global powerhouse, accounting for one third of the firm's total revenue. Having been manufactured and sold in the United Kingdom for more than 100 years, this brand has become a national icon, with many Britons actually believing that it is an English firm. Dominating the ketchup market in the US, garnering more than 60% of retail and food-service sales each year, this firm also controls around 70% of the available market in Western Europe. This company enjoys very stable, high free cash flow in all economic environments. We purchased the stock at a fraction of its intrinsic value and have been pleased to see its market price increase significantly in the last month.

As always, we will continue to look for opportunities to invest in companies where the stock is currently priced at a material discount to the long-term intrinsic value. Our focus continues to be on identifying attractively priced companies with high returns on capital, positive free cash flows and solid earnings prospects with shareholder oriented management. ■

Tax Exempt Fixed Income
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Unlike taxable bonds, where demand can be distorted by foreign buying, a shift away from US securities would be less onerous to this market sector.

- Taxable equivalent yield levels on municipals are favorable versus taxable alternatives even after adjusting for inflation. As an example, investors can capture a 4% tax-free yield by investing in a 10-year bond. For higher taxed individuals, this equates to over 6% on a taxable equivalent basis, well above both a comparable high quality corporate bond yield of around 5.65%, and of core inflation at around 2%.

Overall, the quality level in municipalities is improving as the economy remains strong. However, we still prefer to scrutinize each investment choice as a protection against a slowing economy. Our fixed income investment process is dynamic, and is a process in which we continually strategize. As such, we have postponed our goal to extend portfolio durations from 5.0 to 5.5 years. And as previously mentioned, on a limited basis we will continue to seek value in the 10 to 17 year maturity area. For California clients, we continue to invest in local level municipalities and avoid purchases on a State level, even with some financial improvement at the State level. This avoidance will not change until policymakers focus more on expense reduction than on a tax revenue bailout from the bustling economy.

While this remains a difficult period for bond investors, we believe we are nearing a time when markets will become more stable. The higher yields have adjusted to market concerns and now provide an acceptable yield over inflation. As pointed out earlier, municipal investments provide a way to squeeze out more after tax-income. As the Fed nears completion of its mission to curtail the threat of inflation, the higher level of yields should provide investors with growth opportunities and a solid flow of tax-free income for years to come. ■

Word from the Advisor
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This long-term view also has positive effects on a fixed-income portfolio. We seek to give our clients a relatively high and stable long-term income stream, rather than merely trying to generate returns by capturing short-term price fluctuations.

We buy stocks of companies that we believe are well-managed, that are growing, and that generate above-average free cash flow on our investment, at reasonable prices, and hold them for the long term. We ask, "Where will this *company* be in three to five *years*?" instead of "Where will this *stock* be in three to six *months*?" It may seem to be oversimplifying to say "Look for good long-term investments", but the basics are often overlooked when investors and markets are caught up with short-term distractions.

What follows are three investment themes that Oakwood believes in for the long term. We have identified the underlying industry, sector and economic trends that we believe will generate respectable returns for our clients over time:

Information Technology Sector

Everyone, it seems, is going wireless. Statistics from the wireless world seem almost unbelievable for those of us not working in the field – like the billion cell phones shipped in the past two years, or the projection that the US market for all wireless services and products is expected to be $190 billion by 2007, up from $145 billion in 2004.

Keep in mind that the US consumer wireless industry is rapidly approaching key turning points, with subscriber growth and continued voice average revenue per user (ARPU) slowing, with total voice revenue expected to decline in the 2008-2009 timeframe. In this environment, the next wave of explosive growth will be fueled by continued second generation (2G) internet capabilities for cell phones, like messaging, e-mailing and transmitting pictures; and third generation (3G) services like video on demand. **Effectively mapping internet content to mobile wireless devices requires not only new technologies and standards, but also innovative solutions that minimize cost and maximize efficiency to the benefit of both content providers and consumers.** We have identified companies that innovate and lead in the areas of:

Network and Service Technologies

- Equipment providers that produce the devices and the infrastructure to support wireless data networking.
- Application platform solutions from vendors that contribute the middleware infrastructure such as wireless application protocol (WAP) gateways.
- Leading wireless and mobile communications companies that develop the wireless application protocol for transmitting and presenting wireless information and telephony services on mobile handheld devices.

Energy Sector

All of Oakwood's investment professionals have successful results investing in the Energy sector, and positioning portfolios for opportunities during times of great change. Regardless of the volatility in energy prices, we see a long term secular bull market in energy stocks. **The underlying thesis that drives our investment approach in the energy sector is the ongoing major transition from the current cheap fossil resource-intensive global economy to a more expensive energy environment where virtually every business and consumer purchase, and investment decision is driven by its energy efficiency.** The increasing scarcity of oil, gas, and other fossil resource mineral fuels will necessitate an economic restructuring as we transition into a diminishing resource environment. This transition, already underway, will continue over the next decade or two, and will create profitable opportunities for the perceptive investor and losses for anyone who does not anticipate its impacts and who fails to change their portfolios.

The pressures of supply and demand are in force in magnitude for both oil and gas production. Global oil and natural gas in the US are already in very tight supply versus demand worldwide, with production and refining capacity straining to meet demand. This, along with geopolitical uncertainty and reductions in production – as in Nigeria, for example - is leading to increased price volatility in oil and natural gas, overlaid on a secular increase in prices over the next ten years.

Approximately 40% of global energy consumption is petroleum. About 70% of existing oil production is from oil fields discovered 25 or more years ago. With 4% to 5% of world crude production being depleted every year, an additional 2% in crude production must be found and developed to meet growth in global demand. **In 2005, the world consumed 6 barrels of oil for every one discovered, one of the signs that world oil production is nearing its peak while demand continues to climb. We focus on identifying those companies that will succeed in this challenging environment, and on owning energy assets, in safe countries, which we believe will ultimately increase in value.**

Healthcare Sector

The aging of the US population brings with it an increase in demand for healthcare related products and services. A recent report released by the federal government estimates that within a decade 1 out of every 5 dollars spent in the US economy will go for health care, with annual spending consistently growing faster than the overall economy. The nation will spend $4 trillion on health care — or about $12,320 per person annually — by 2015. Increased spending on hospital care, home health services, drugs and public health programs will help push total health care spending from its current 16.2% of the Gross Domestic Product (GDP) to 20% in 2015.

While the demand for healthcare products and services is on the rise, our society's cultural norms are such that we cannot accept the notion of an entity making a profit from someone's misfortune of ill health. Because of this, there will

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Economic Outlook
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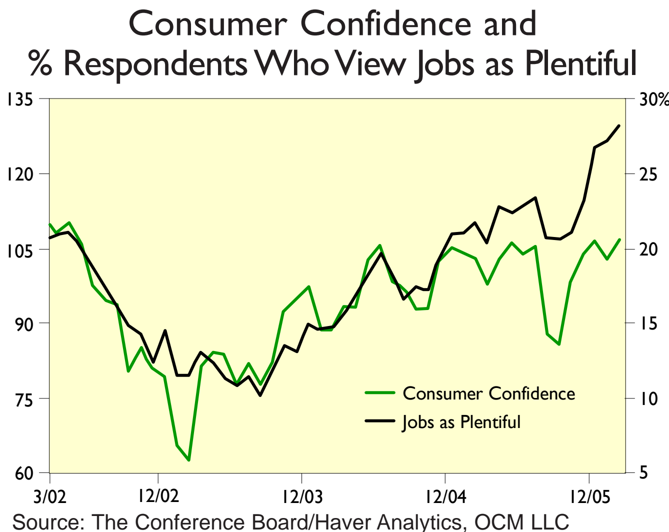
will translate into more volatility in the coming year.

There are several factors that lead us to think that the economy may be heading to a point where it is a little "too hot", which we believe will lead to increased inflationary pressures and continuing action from the Fed.

While the fourth quarter GDP measure of 1.7% was the slowest growth in nearly three years, the Fed said that it "reflected temporary or special factors." To prove this point, despite a meager 0.1% increase in February, inflation-adjusted consumer spending, which accounts for about two-thirds of the GDP, remained on track to grow at a pace of nearly 5.0% annually, a definite snap-back after a slim 0.9% advance in the fourth quarter of 2005.

The Conference Board's Index of Consumer Confidence jumped to its highest level in nearly four years during March 2006. Over the last ten years, there has been a 66% correlation between the level of consumer confidence and the annual change in real consumer spending. As can be seen in the following chart, the percentage of respondents who viewed jobs as plentiful jumped to 28.4%, the highest since 2001.



Source: The Conference Board/Haver Analytics, OCM LLC

If all factors remained status quo, we would agree with the "Goldilocks" view of the economy. However, we see two more rate hikes to ward off inflationary pressures that we see coming from the following areas:

- **As we mentioned in the last Oakwood Outlook, we view the surprising uptick in the US dollar in 2005 as an interruption of a longer-term decline in the dollar. The strength of the dollar has been a key ingredient in the easing of inflation.** A strong US dollar has the effect of lowering import prices, with the overall pace of nonfuel import prices easing, on average, from 2.7% down to 0.8% in the past twelve months. However, the underpinnings for the stronger dollar are set to fade. The European Central Bank is continuing to sound hawkish and the Bank of Japan is ending its accommodative easing. Global economic activity is expected to accelerate this year even as the US economy settles into a more modest rate of growth. As a result, the demand for the US dollar should wane, eliminating the inflation-dampening effects of lower import prices.

- Another pressure on prices is the inability of US manufacturers to keep up with orders. Output is already outstripping the growth of new production capacity. This is pushing up operating rates and giving companies more leeway to lift prices.

- Labor markets are stretched thin, and with ongoing efforts at Gulf Coast rebuilding, we look for a strong rise in payrolls and an unemployment rate around 4.8%.

What we envision for the remainder of 2006 is a market that is glued to the numbers. The Fed and investors alike will be attuned to each new squiggle in the charts to try to identify trends in economic growth and inflation. The upshot of this focus will be that each economic report will take on increased significance for the markets for the balance of the year. Data surprises may pack more punch than they have to date. **Our experienced and knowledgeable investment professionals will monitor and interpret the data along with everyone else, but as we outlined in the Word from the Advisor, the main approach at Oakwood is to identify themes that will provide our investors with excellent long-term investment results for the "long haul".** ■

Word from the Advisor
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always be pressure on profit margins in this sector. While healthcare companies can and must make a reasonable profit in the accounting sense, society will not accept the notion of a healthcare provider making excessive profits. **That being said, adherence to our strict investment discipline of identifying companies where the stock is priced at an attractive discount to the firm's long-term intrinsic value is crucial to long-term success in this sector.** There will be opportunities to make money in the healthcare sector. The key is to remain patient in order to obtain the price we are *willing* to pay for the stock.

We are focused on these sectors for the "long haul", and will remain diligent in our search for the highest quality companies within these and other areas that we feel will provide our clients with solid, low risk long term investment results. We look forward to continuing to serve your investment needs. ■

Taxable Fixed Income
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Funds and 30-year Treasury bond yields has declined to zero. This means that long bond yields rose only modestly in the face of relentless Fed tightening. If inflation were indeed systemic and not a short-term issue, long bond yields would increase well beyond current levels, despite strong demand from overseas investors.

We believe this persistent Fed policy will ultimately reward bond investors. This is not to suggest that it's time to turn completely bullish in the fixed income market. Our goal remains to preserve capital and position ourselves for an upcoming bond rally. Therefore, we continue to maintain a modified barbell structure in client portfolios. As an example, because yields levels in the shorter maturity areas match the yields in the 4 to 7 year maturity area, we hold a large weighting in shorter securities. This strategy produces similar coupon cash flow while providing valuable protection against further Fed rate hikes. In addition, we hold a market weighting of securities in the longer 7 to 10 year area. This is in response to the previous graph which suggests a degree of market stability and growth potential. Our preference is for corporate bond holdings with strong quality trends. Examples include:

- HSBC Holdings, one of the largest banking and financial services organizations in the world;
- J.P. Morgan, a global financial services firm, under the direction of well respected CEO Jamie Diamond;
- Black and Decker, a global manufacturer and marketer of power tools and accessories, hardware and home improvement products, and technology-based fastening systems; and,
- Lockheed Martin Corporation, which researches, designs, develops, manufactures, integrates, operates and sustains advanced technology systems, products and services, and whose corporate bond holdings have recently been upgraded.

We expect Chairman Bernanke to err on the side of caution in order to establish credibility. The decision to raise interest rates at the latest meeting marks the first attempt by Chairman Bernanke to shape monetary policy. We view a continuity of monetary policy as an essential ingredient to a continued strong economy and low inflation. **Therefore, we remain committed to preserving capital and look forward to a better bond market ahead. We believe fixed income will soon reward investors for their patience and to even consider abandoning the bond market with 15 rate hikes behind us is a huge mistake.** ■