

# Oakwood Outlook

## & Quarterly Review

Volume 9, Number 3 July 2006

### A Word

From the Advisor

#### Wealth Building through the Management of the Asset Allocation Decision

Wealth building entails a viable plan that encompasses setting your objectives, assessing the level of risk you are willing to take, estimating the time that it will take you to reach your goals, and then sticking with your plan. There are a dizzying variety of investment vehicles available to help you achieve your plan: stocks, bonds, real estate, gold, commodities, to name but a few. **What many investors, novice and veteran, find to be one of the greatest challenges in devising and maintaining their plan is the difficulty in predicting economic trends and their effects on different investment choices, over even a relatively short time horizon.** There are so many variables that can alter the economy's performance, and even when one's prediction is correct, the markets' reactions may be completely different from the expected outcome.

The Federal Reserve Board (Fed), in a key phrase from their most recent statement, said that their next move will depend on, to a large extent, incoming

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### Economic Outlook A Changing Backdrop

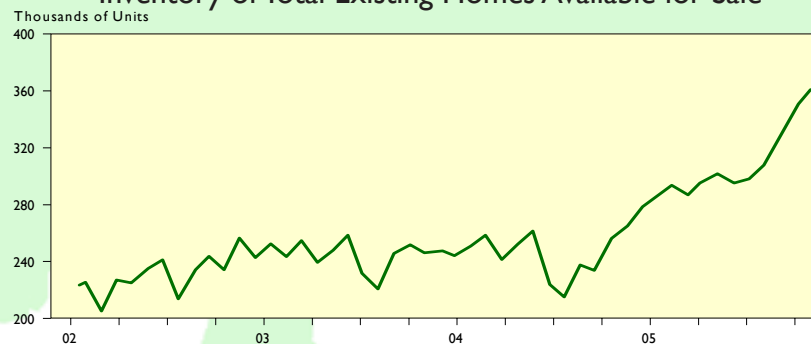
The end of the second quarter of 2006 witnessed a rally in both the stock and bond markets for three reasons: first, the markets approach Fed meetings with the same trepidation as we treat a visit from a cranky relative - both of us are just happy to get it over with. Secondly, there was relief that the interest rate hike was 25 basis points, not 50 basis points. And third, the nature of the comments from the Fed was slightly more dovish than expected, and much more dovish than any recent Fed comments. Despite this rally, which helped to bolster the quarter, the S&P 500 Index ended in negative territory, with a -1.45% return and a year-to-date return through June 30, 2006 of +2.69%. The broad bond market, as represented by the Lehman Brothers Aggregate Bond Index, on the other hand, returned -0.08% for the quarter, with a year-to-date return of -0.72%. The Lehman Brothers Intermediate Bond Index fared slightly better, returning +0.21% for the second quarter, with a slightly negative return year-to-date of -0.17%.

Interest rates continue to dominate the psychology of financial markets. Concerns over inflation still have investors anxious about economic growth going forward. Leading economic indicators, the durable goods report, and housing permit activity shows that the US economy is indeed slowing from its brisk first quarter pace. The persistent concern is that the Fed will raise rates so high that it will stunt economic growth and bring the housing market to a harder landing than expected.

US housing market activity, which has been one of the main supports of the economy, continues to weaken, with confidence in the industry at its lowest level since 1995, according to the National Association of Home Builders. The following chart shows the inventory of existing homes for sale in the US, which rose 5.5% at the end of June, and is up 41.0%

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Inventory of Total Existing Homes Available for Sale



Source: National Assoc. of Realtors, Haver Analytics, OCM LLC



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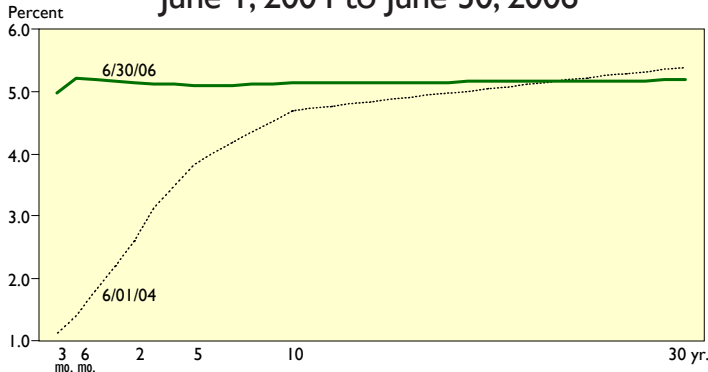


TAXABLE FIXED INCOME

# Strategy

As expected, the Fed raised its overnight lending rate between banks by another 25 basis points to 5.25%. This latest move reflects the ongoing equal 25 basis point rate increases at each of the 17 previous meetings. In an accompanying statement, the Federal Open Market Committee “judges that some inflation risks remain,” and states “the extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth as implied by incoming information.” While on the surface this statement could be interpreted as a negative to bond investors, a closer view of the Treasury curve reaction since the first rate hike in June 2004, shows a level of confidence on the part of investors.

**Historical Taxable Yield Curve  
June 1, 2004 to June 30, 2006**



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

Clearly, the repeated rise in the Fed Funds rate has had a direct impact on shorter maturity yields as evidenced by a 200 basis points increase in 3-year Treasury yields. However, an investor seeking a safe haven by investing heavily in this maturity area found little protection. By contrast, to the surprise of most market experts during this same period, there was a remarkable amount of stability in longer maturity areas. Oakwood correctly saw the opportunity in this area, and took advantage of it for client portfolios. In fact, the yield level on 30-year Treasuries actually fell by 21 basis points. This suggests that, at least to this point, investors view inflation as a short-term condition and endorse the Fed’s efforts.

We are pleased with the year-to-date investment results in client portfolios and the significant cash flows that our bond investments have provided. While it has been difficult to entirely avoid the effects of interest rate tightening, our decision to combine very short investments with longer investments, best known as a barbell structure, has provided market protection. **By next year, we expect the Fed to begin cutting rates. In fact, well in advance of any Fed action, a change in market sentiment should ignite a bond rally.**

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TAX EXEMPT FIXED INCOME

# Strategy

Similar to the taxable bond market, the tax-free bond market continues to search for a clear direction. From month to month, security values are either up or down depending on shifts in market sentiment, even though year-to-date returns are nearly unchanged. Oakwood has protected value through generous tax-free cash flow. Adding to market confusion is a tug-of-war between strong and weak economic reports and conflicting reports on inflation.

**During this year, we have tried to avoid overmanaging portfolios by reacting to short term trends in market data and overreacting to data releases.** As a result, we continue to hold an overweighting in short investments due to the passage of time and the avoidance of temptation to invest aggressively. In fact, sector comparisons show that intermediate 2 to 7 year tax-free yield levels versus taxable counterparts are at narrow spread levels not seen since the 1990s. Recently, we have witnessed some return to more normal ratios and spreads, as municipal yields adjust to continuing Fed tightening and as newly issued bonds set future yield levels.

For your review, we are beginning the second half of the year with the following maturity structure.

Model	
Average Coupon	5.40%
Effective Maturity	5.85 years
Effective Duration	5.05

Effective Maturity	Model
0 to 1	40%
1 to 3	0%
3 to 5	10%
5 to 7	5%
7 to 10	20%
10+ years	25%

As shown, we are limiting new money purchases in the 2 to 7 year maturity areas, unless yield levels reach 75% to 80% of taxable Treasury yields. Fortunately, because the municipal yield curve is abnormally flat, there is little yield loss by staying short. In addition, we feel there is good value in the 7 to 15 year maturity areas with levels between 4.20% and 4.65%. For investors in highest tax brackets, this tax-free yield equates to a taxable equivalent of 6.46% and 7.15%, respectively.

For the first time in over two years, we are beginning to invest in State of California specific general obligation issues

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EQUITY MARKET STRATEGY

# Looking for Opportunities

There are still ample opportunities for disciplined investors, despite developments in the economy that represent a substantial change for investors that are accustomed to a backdrop of strong economic growth and low inflation. The current valuation and earnings picture remains mixed with:

- Elevated wage pressures, but solid productivity trends that offset higher input costs;
- Decent earnings growth expectations, but mounting margin pressure from energy prices and interest rates; and,
- Solid corporate spending but multiple headwinds facing consumer spending.

All of this adds up to a more cautionary stance and a shift to more defensive portfolio construction. As always, our research effort is focused on identifying undervalued companies that have competitive advantages that will create long-term returns 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. Adhering to this discipline, we have been emphasizing undervalued companies with strong free cash flows, which can outperform in the face of a slowing economy.

We remain overweighted in the Energy sector, which waned in the second quarter, declining mainly in the lower quality gas-related companies, companies not held in Oakwood client portfolios. We remain committed to this sector, as the long-term macroeconomic and political variables have not changed. The ever-increasing global energy insecurity evidenced in virtually all the major producing countries – Iran, Iraq, Nigeria, Venezuela, Russia and Saudi Arabia - remains pervasive. The long term demand/supply equation for oil and natural gas remains drastically imbalanced, as the supply of oil in particular is constrained by the world’s inability to produce and refine enough product to meet demand.

During the quarter, natural gas prices disconnected from their historic relationship to oil prices, creating huge discounts in certain stocks. We added a leading North American gas producer late in the quarter, at its price bottom and the stock is up strongly. This company not only has excellent long term natural gas reserves which should produce superb cash flows in the rising price environment we foresee over the next 10 years, but also is an attractive candidate.

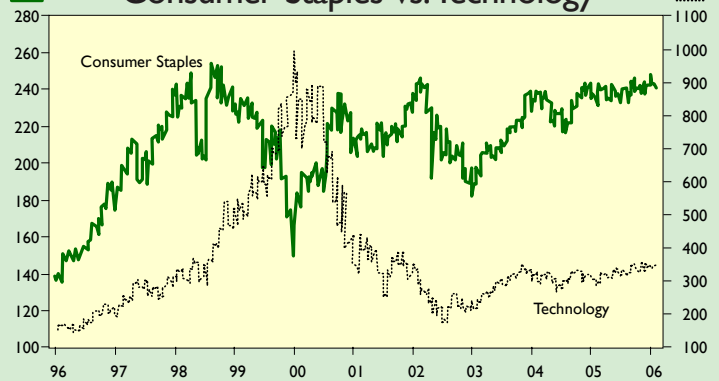
We have added positions in the Consumer Staples sector, which includes companies that sell food and beverages, household items, and other goods that consumers continue to buy even in a less than robust economy. A global marketer of beverages with 17 of the top 20 brands, strong free cash flow and a solid dividend was purchased at a discount from its intrinsic

value during the second quarter, as was the dominant marketer of sports footwear with the same characteristics. Both firms have strong share buyback programs in force, and managements that have clearly demonstrated their alignment with shareholders’ best interests.

Although we have been underweighted in Technology for some time, as it is difficult to find companies that provide long-term investment opportunities for clients on a risk-adjusted basis, we believe the avoidance of technology-related companies makes particular sense at this time. Technology companies’ fortunes tend to rise and fall with the prospects of the economy, and in a slowing economic environment, they vastly underperform the market.

The chart below depicts the relative performance of the Consumer Staples and Technology sectors going into, and coming out of, the “tech bubble.” As shown, if you owned Technology but no Consumer Staples in the late 1990s, you’d have little reason for immediate concern. But by the early 2000s, rising Consumer Staples stocks provided an updraft to your portfolio, helping weather the sharp downdraft in Technology stocks.

Sector Comparison  
Consumer Staples vs. Technology



Source: Standard and Poor's, Oakwood Capital Management LLC

Although we do look at various sectors and their historical performance during different phases of the economic cycle, our main research effort focuses on a company’s fundamentals, which includes their business model and their management. A result of this effort has unearthed several companies which we like not only for their underlying financial quality, but also for their managements’ attempts to reduce their cyclicality, despite being categorized in a traditionally cyclical industry.

One example of this is a media company which has grown to become one of the biggest companies in its industry on the planet. Today, its businesses include newspapers, movie and television studios, television stations, cable networks, and satellite television providers, just to name a few.

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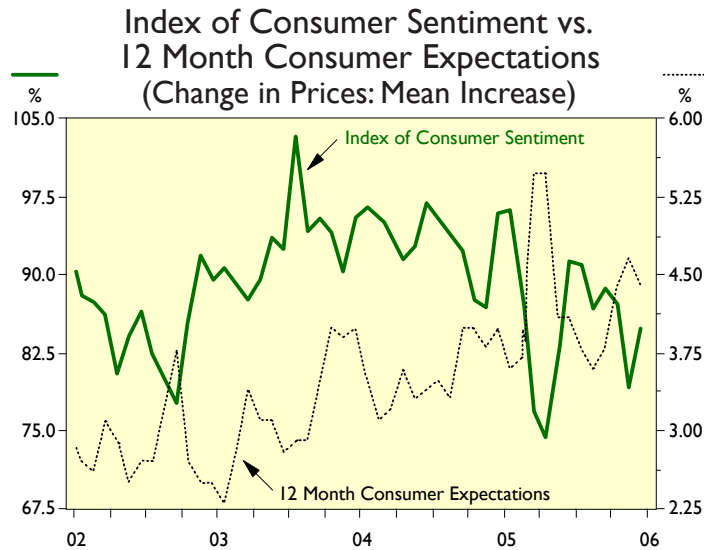


Economic Outlook

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from one year earlier. These rising inventories reflect the slowdown in the US housing market; however, it is important to remember that the measurements come from a period of an historically frothy housing market, and vary from month to month. In a typical down cycle, housing starts drop to half of their peak value and the share of residential construction in the Gross Domestic Product (GDP) drops by two percentage points. If that were to happen at this point in time, GDP growth could easily dip below 2%.

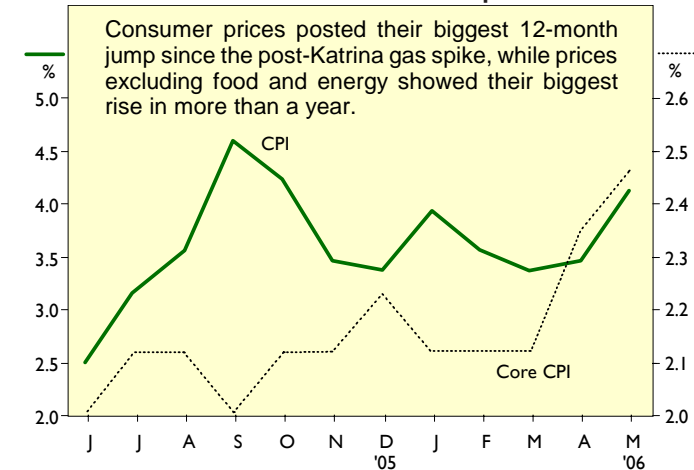
Despite this weakness in the housing market, consumer sentiment bounced back slightly in June after the index dipped in May, as can be seen from the following chart.



Source: University of Michigan, Haver Analytics, OCM LLC

While consumer sentiment improved, consumer expectations about changes in prices took a dip. The single most important contributor to a heightened state of concern in recent weeks has been the release of worse-than-expected US consumer price data. Higher oil and gas prices have been a contributor to accelerating price pressures, given the tight supply/demand balance in global energy markets.

Pressures Pick Up



Source: Labor Dept., Oakwood Capital Management LLC

Core CPI, which excludes often volatile food and energy prices, increased 2.4% year-over-year, the highest increase since February 2005.

Potentially adding to inflationary pressures is a weakening US dollar. The dollar is down about 6.0% so far this year versus other major currencies, and many are forecasting further declines, particularly if the Fed stops raising rates while other central banks around the world raise rates. But so far there's been little sign that exporters overseas are raising prices, which could boost the price of imports.

Currently, consumers are struggling with over \$3-per-gallon gasoline. Retail sales in May edged only 0.1% above April. The broader message from sales is that weak consumer spending is going to be a big drag on overall economic growth, although business spending is expected to offset the decline in consumer spending. We feel that the US economy will moderate through the remainder of 2006, with the threat of increasing inflation and persistently high commodity costs. ■

Equity Market Strategy Continued from page 3

**Its business and geographic diversification—with assets in Asia, Europe, South America, Australia, and North America—puts this company in a position to weather challenging economic times relatively well.**

While the market in general has soured on “old media” assets, this company in particular generates generous cash flow from its newspaper businesses and television stations.

In the Consumer Cyclical sector, we reduced position sizes in a superb energy-efficient automaker when its stock price ran up, although we continue to hold a smaller position for the long term, and in a dominant retailer. A Hispanic Television network we purchased some time ago was partially sold, delivering a superb realized return to Oakwood clients.

To further address risk management in our client portfolios, we have, in certain instances, decreased position sizes and are in the process of increasing the number of positions in client portfolios. This greater diversification, by definition, decreases volatility.

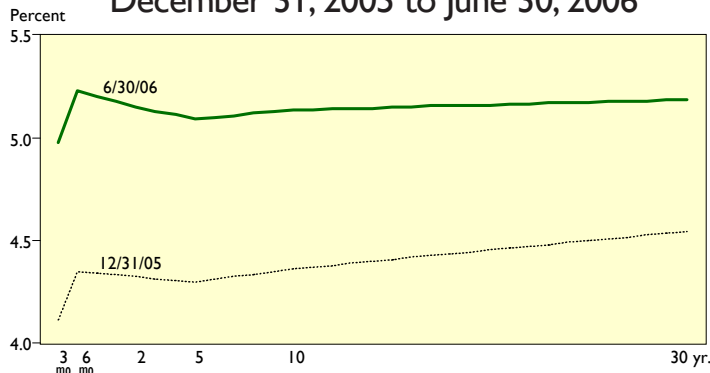
**While there are challenges in the current market, we believe there are positive opportunities for the rest of the year ahead.** In managing our client portfolios we will continue to focus on owning companies with positive free cash flow characteristics, strong returns on capital, healthy balance sheets, increasing dividends and healthy earnings growth prospects which are trading at attractive valuations. ■



Taxable Fixed Income  
Continued from page 2

Because a reverse in the interest rate cycle is difficult to time, we will unwind our barbell strategy in incremental steps. Yield levels in the long end of the maturity curve have not ratcheted up to the same extent as intermediate maturities. Hence, we see more opportunity for yields to fall in the 2 to 5 year maturity areas. We recognize the fine line between unacceptable inflationary trends and the dampening effect of a slowing economy on its future path. However, if inflation gains inertia, it will be difficult for the Fed to stop and reverse its direction, even with a slowing economy. To illustrate this point, we again show an historic yield curve comparison, this time using a shorter time frame.

Historical Taxable Yield Curve  
December 31, 2005 to June 30, 2006



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

As shown, in the face of relentless Fed monetary tightening, yield levels throughout all areas have recently moved noticeably higher because of new inflation concerns. This occurred despite a housing slowdown, deceleration in consumer spending, rising energy costs and substantial hikes in adjustable loans. **As a further slowdown in the economy accelerates, we expect the upward trend in interest rates to stop.** This will provide us with an opportunity to extend short maturities and lock in the higher income levels and allow for future growth potential. To augment the yield portion caused by a flat yield curve, we continue to find additional yield in Federal Agency mortgaged-backed securities and high quality corporate bonds that have a demonstrated build up in free cash flow. Although free cash flow does not directly correspond to a higher coupon for corporate bonds, it does provide corporations with the flexibility to decide how to invest or distribute this cash.

In our view, inflation concerns remain too high, although as the economy shows more signs of slowing in the second half of 2006, fixed income investors should be rewarded. **Meanwhile, we remain steadfast in our mission to protect capital and mindful that even with all of its resources and experience, the Fed is not prepared to claim victory on inflation at this time. This may be why the Fed has remained diligent in the face of pundit criticism that they are overreacting to only a small increase in inflation.** ■

Tax Exempt Fixed Income  
Continued from page 2

with insurance supplement in the short maturity areas. California, like most municipalities, has enjoyed the benefits of a strong economy and improved tax receipts. These factors, coupled with reductions in new issue supply and strong demand, have favored municipals. Strong demand for this sector should continue; however, we remain mindful that the trend in interest rates remains currently upward. As a result, we continue to emphasize an above market coupon, 5% or higher, in order to focus on income.

**We believe that patience is the key and endorse the Fed's stated objective to monitor ongoing data for signs that the economy will slow and inflation will trend lower.**

Our strategy is designed to take incremental steps toward preparing for a lower interest rate environment. This means that we will only hold bonds with maximum liquidity and maintain flexibility to extend maturities as opportunities surface. ■



## Family Wealth

Even the closest families can feel uncomfortable talking about money. It makes us uneasy. You know you should find out whether your parents have enough money to support themselves as they get older and whether they have made arrangements to pass on any assets that are left over, but you don't want to come across as nosy or, worse yet, as if you are just itching to get your hands on your inheritance. And if you are the parent of adult children, perhaps you have held off broaching the topic because you figure it is none of your business.

**Today's longer life spans make this sort of intergenerational conversation especially crucial.** In a recent study of 3,250 affluent families, a well-respected consulting group found that only a third had managed to transfer the family fortune to the next generation and grow it. Lack of communication, not financial ineptitude, was the big reason. So, whether you are an older parent or an adult child, the time to start talking is now.

If you would like to discuss family wealth or have any other questions, please feel free to call us at (800) 586-0600 or e-mail questions@oakwoodcap.com.



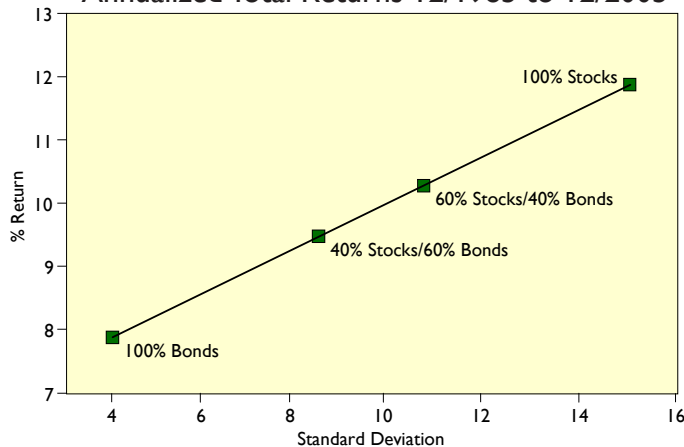


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economic information. This information takes the form of housing market and unemployment figures, inflation measures such as the Consumer Price Index (CPI), manufacturing orders, and additional data. The Fed's interpretation of this data, notwithstanding an exogenous "shock" to the system like a natural or geopolitical occurrence, will be an important factor for the markets' direction for the remainder of 2006. We don't pretend to know the outcome of the Fed's next meeting in August, or the meeting thereafter. This is why we believe it is critical to adhere to a plan that incorporates risk and expected return objectives, using either equities or fixed income or a blend of each.

Clients' goals and expectations change over time, and so do markets and opportunities. Each investor is unique, and as such, has their own individual profile and ability to weather the volatility that accompanies different investments. The graph below plots annualized total returns versus volatility over 20 years for various asset allocations of stocks and bonds, using market indices, and illustrates the range of returns and volatility of a portfolio of 100% bonds, 100% stocks, and blends using different percentages of both. As can be seen from this illustration, stocks have historically provided the potential of a higher return but also have a higher level of volatility, while bonds focus on diversifying risk, generating income, and preserving wealth, with low volatility. Over the 20-year period starting in December 1985, a portfolio containing 60% stocks tracking the S&P 500 and 40% bonds tracking the Lehman Aggregate Bond Index provided 89% of the returns of an all-stock portfolio, with 36% less volatility. Add in the potential that active management provides, and you have the opportunity to significantly increase the returns.

The Balance of Risk and Return  
Annualized Total Returns 12/1985 to 12/2005



Source: Thomson Financial, Oakwood Capital Management LLC; Bonds represented by Lehman Brothers Aggregate Bond Index; Stocks represented by the S&P 500 Index.

Oakwood offers the ability to establish a portfolio using equity and fixed income strategies and blends of those strategies that will fit clients' risk tolerances and expected return

objectives. **Wealth building now becomes a controlled plan as opposed to an endless prediction of outcomes and the effects of those outcomes without discipline.**

While many investors have the time horizon and risk tolerance that makes the choice of 100% Equity Strategies the best fit for them, other investors are at the stage in their particular investment situation that makes the choice of 100% of Fixed Income Strategies the best. For many others, however, it makes sense to choose a balanced portfolio, which is a blend of these strategies. **Two of Oakwood's strategies, the Balanced Growth Strategy and the Balanced Income Strategy, provide our clients with the ability to tailor their portfolios to their long-term investment return and risk objectives.**

**The Balanced Growth Strategy** places greater emphasis on equities than fixed income instruments, and is suitable for clients seeking long-term growth that is consistent with preservation of capital. Typically, the Balanced Growth Strategy will be comprised of 60% equities and 40% fixed income.

**The Balanced Income Strategy** places greater emphasis on fixed income instruments than on equities, and is suitable for clients seeking preservation of capital, moderate income and moderate growth. Typically, the Balanced Income Strategy will be comprised of 60% fixed income and 40% equities.

**At Oakwood, we are proactive in the management of fixed income and equities in these and all of our strategies in order to identify quality opportunities for investment.** Oakwood's investment approach for both fixed income and equity securities encompasses the following basic tenets:

- Both fundamental and quantitative disciplines are employed to identify attractive securities;
- Diversification is used to control risk; and
- Sell disciplines are an integral part of the investment process.

**Changes in markets can lead to opportunities.** As market results are periodically reported and assessed, each investor must carefully examine long term objectives, determine whether or not sensitivity to risk has been further heightened or lessened by current volatility or market action, then ensure that the portfolio reflects the appropriate mix of stocks and bonds. Oakwood is committed to client service and client communication. We invite you to share with us your questions and concerns regarding your asset allocation, or any other investment topic. ■