Oakwood Outlook

& Quarterly Review

Volume 9, Number 4 October 2006

A Word

From the Advisor

We are continuously searching for ways to improve the risk/return profile of your portfolio. Stocks with excellent investment potential may come from anywhere. As seen in Exhibit A on page 4, US-listed stocks account for only 28% of the world's stock, and over half of the world's largest public companies are located outside of the US. On occasion, allocating a percentage of your portfolio to investments in other markets helps reduce long-term volatility and allows you to capitalize on some great non-US companies. Oakwood Capital Management LLC has a long history of investing in multinational companies and ADRs.

We have found that currently, the most efficient, cost effective and flexible way to achieve a direct investment in the international marketplace is through the use of exchange traded funds, also known as ETF's. At the most basic level, an ETF is just what its name implies: a basket of securities that is traded, like an individual stock, on the American Stock Exchange. An ETF allows us to buy an interest in an entire portfolio of international securities by purchasing a single security. It trades

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Economic Outlook

Moderating Growth with Room for Opportunity

The US economy is fortunate to have many positive influences affecting it, among them strong employment figures, the ongoing benefits of a period of low interest rates, a relief in gas prices, and a forecast for a relatively mild winter. These influences contributed to a third quarter of 2006 that witnessed decent returns in both the stock and bond markets. The intermediate bond market, as represented by the Lehman Brothers Intermediate Bond Index fared well, returning +3.20% for the third quarter, with a year-to-date return of +3.02%. The broad equity market, as represented by the S&P 500 Index returned +5.66% for the quarter, bringing its year-to-date return to +8.50%. The Russell 1000 Growth Index, consisting of those companies in the Russell 1000 Index with higher than average price-to-book ratios and forecasted growth, returned +3.94% for the quarter, bringing its year-to-date return to +2.97%.

Most economic releases from the third quarter point to continued health in the US economy, with only a moderation in growth. Inflation and housing were prominent stories during much of the quarter. Recent data show inflationary pressures heading in a favorable direction. Though consumer prices, excluding food and energy, remained elevated, wholesale prices at the core level declined in both July and August, which could suggest some easing in retail inflation in the coming months. Many on Wall Street expect this trend towards moderation to continue, particularly given the pullback in commodity prices.

The verdict is still out on how much the housing market will soften before it's all said and done, but weaker than expected permit data shows further declines in housing supply on the way. Year-over-year existing home prices declined for the first time in 11 years. With plenty of inventory on the market and buyers hesitant to make moves at the current time, it may still be some time before demand stabilizes. Mortgage rates have been relaxing. This couldn't come at a better time for the housing market which could desperately use help to lure potential homebuyers back to the bargaining table.

Even though oil prices have more than doubled over the past three to four years, it surprises some that this increase hasn't caused more damage to the economy. The lack of a more averse reaction is caused by several factors, including:

1. Oil is a smaller share of the economy than it used to be. The US uses half as much energy per dollar of output (constant dollars) as it did in 1970.

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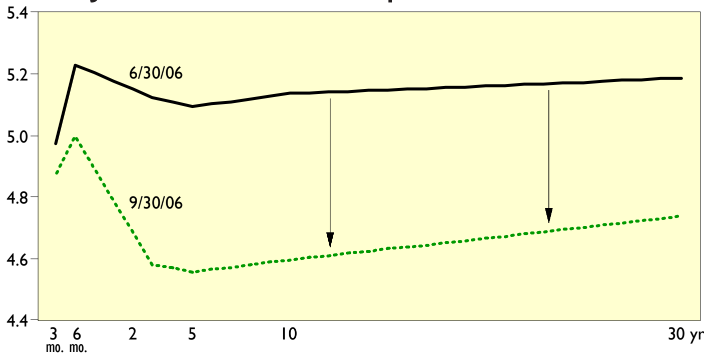
TAXABLE FIXED INCOME

Strategy

After two years of repeated monetary tightening, the Federal Reserve (Fed) recently ended its streak of 17 consecutive rate hikes which subsequently spurred a rally in the bond markets. Additional factors bolstering demand for fixed income securities were an unexpected decline in the widely watched Philadelphia Fed business survey, weakness in housing sectors, and favorable inflation reporting. As shown in the following graph, during the third quarter, yield levels throughout most areas across the Treasury yield curve fell by approximately 50 basis points. This provided a 2.5% price gain (excluding income) on a typical 5-year Treasury investment.

Historical Taxable Yield Curve
June 30, 2006 to September 30, 2006



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

At Oakwood, we were well-positioned in advance of this rally. As noted in the last edition of the Oakwood Outlook, we began to unwind our inherently defensive barbell maturity structure in favor of more investments in the intermediate (4 to 7 year) maturity areas. Because yield levels in the long end of the maturity curve did not increase to the same extent as intermediate maturities, from a return versus risk perspective, it was a favorable move. In addition, as the Fed continued on its program to fight inflation, **we viewed the higher yielding instruments as an opportunity to lock in higher income levels by extending short holdings.**

We have highlighted the effect of escalating energy prices on the economy, inflation and interest rate direction numerous times. While many observers chose to focus on the inflation implications surrounding the production, transporting and price of goods, we instead viewed the sharp rise in energy prices as a detriment to economic growth and consumer spending patterns. **Therefore, as people became more negative on the bond market as oil prices increased, we became more bullish as consumers were forced to reprioritize discretionary spending. As you know, the markets supported**

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TAX EXEMPT FIXED INCOME

Strategy

During the quarter, the municipal bond markets kept pace with taxable markets by registering impressive gains. The following graph shows that yield levels fell almost equally throughout all maturity areas.

Quarterly Municipal Yield Curve Change

	6/30/06 (%)	9/30/06 (%)	BP's Change
2 Year	3.85	3.55	-0.30
5 Year	4.02	3.59	-0.43
7 Year	4.14	3.67	-0.47
10 Year	4.31	3.86	-0.45
20 Year	4.60	4.20	-0.40

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

For this behavior to occur there must be a belief that the Fed has been successful in its efforts to fight inflation and that it will likely start to cut interest rates in 2007. **Similar to our taxable portfolios, we were prepared for this tax exempt bond rally.** In fact, as the Fed continued on its program of scheduled interest rate increases, **we engaged in swaps designed to lengthen short and intermediate holdings, in favor of higher yielding longer holdings.** This strategy has been successful.

Looking ahead, we are aware that the present yield levels reflect a significantly weaker economy, declining inflation, and upcoming Fed ease. The markets may not be factoring in the recent decline in energy prices and lower interest rates that show signs of rekindling consumer confidence. Furthermore, the Fed has openly stated that they will remain on inflation watch and stressed a need to monitor upcoming economic and inflation data prior to reversing their restrictive policy.

Therefore, we are altering our current maturity structure which affects the investing of new cash and changes in our overall weighting of longer positions. We will now focus on the intermediate maturity area. It is important to note that the recent decline in yield levels and taxable yield comparisons also impacted 3 to 7 year investments. However, for highly taxed individuals, yields still represent good value owing to the high 5.40% plus after-tax yield and return potential versus inflation.

Along with our goal to reduce longer bond holdings, we are establishing a 15% liquidity reserve by holding cash equivalents and securities that mature within one year. This will provide

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EQUITY MARKET STRATEGY

The Global Economy in Transition

The stock market's behavior in the third quarter of 2006 provided more drama than investors have experienced in some time. **As major US stock indices all neared or hit lows for the year in mid-July, Oakwood's client portfolios were defensively positioned and outperformed the market.** After the Fed decided in early August to pause in their two-year-plus campaign of raising interest rates, a narrower stock market rally proceeded in earnest through the end of the quarter.

Meanwhile, commodity prices, accentuated by the speculative debacles of prominent hedge funds, continued to fall during much of September amid signs of slowing economic growth worldwide. These price declines, while certainly tangible, are an antithesis to the natural supply/demand dynamics of scarce resources whose need is increasing. In particular, the decline in energy prices accelerated during the month with crude prices losing over 10%, wholesale gasoline falling more than 15%, and natural gas plunging over 29%. **Although good news for the consumer and businesses, this caused stock prices in the energy sector to soften. Our longer term commitment to these areas caused our portfolios to underperform in September. In response to this, we pared back holdings in this area, taking some nice profits in our positions.**

If, as we expect, the economy slows to 2.5% growth in 2007, there will be many benefits. Reduced inflationary pressures will give the Fed the flexibility to stay on hold or even reduce rates if economic growth seems to be stagnating. The Fed's actions have stabilized consumer confidence and spending, and seem to be ensuring that the housing-led slowdown won't accelerate into a hard landing for the US economy. Corporate profits growth will slow in tandem with the economy, but still manage gains. As investors feel more confident that profits are sustainable and inflationary pressures are abating, then the market price-to-earnings ratios should rise. **We think this should set the stage for a good year for investors who are willing to look past some of the current uncertainties and stay focused on the positive forces within the economy and the capital markets.**

Despite our recent lightening up in the energy sector, we are still believers in owning high quality companies in this area for several reasons: the geopolitical dynamics surrounding OPEC, their support of the current price level, and the fact that peak production levels have been or are near being reached. From a valuation standpoint, oil and gas stocks produce 25% of the S&P 500 earnings but only have 10% of the market capitalization, which indicates that these stocks as a whole are undervalued.

A company which we recently added in the energy area is one of the largest US-based independent oil and natural-gas companies. With about 90% of its reserves and production in North America, this company has a lower risk profile than some of its more internationally focused competitors. **We purchased this position near its bottom during a recent downswing in energy stocks, at less than half its true value.** Soon thereafter, better than expected results from its deep-water Gulf of Mexico drilling program were announced, and among independent exploration and production companies, it is the largest leaseholder in the promising deep-water Gulf of Mexico market. Energy prices will remain volatile in the short term but inexorably increase over time, due to demand exceeding supply. We accept the volatility and gain strong strategic value from these wonderful assets located in the US, free of all geopolitical risk.

We are also still favorable on the healthcare industry, buying great companies on a price dip. A company we recently added to client portfolios is a top performer in the managed care area which recently suffered a major price drop in reaction to media hype regarding the company's treatment of options. It has taken advantage of recent opportunities in Medicare, and has market leadership positions in Medicare Part D and Medicare Advantage. It has been acquisitive in its growth, potentially a risk, but we believe the consistent and strong returns on invested capital during this time are evidence it has made good acquisition choices and integrated them successfully. The company continues to yield significant free cash flow which is growing strongly, giving it ample capital to reinvest in the company, to repurchase shares, or from which to pay dividends.

Another quality healthcare company recently added to client portfolios is a leading provider of orthopedic devices, surgical equipment, and medical furniture. This company generates excellent returns on invested capital, and we especially like the way it pursues attractive niches within the healthcare industry. It dominates the highly profitable orthopedic implant market, which possesses difficult entry barriers and sticky customer relationships. The firm sent its bone-growing protein, OP-1, to the Food and Drug Administration in an important spinal indication in 2006. If approved, the company could enjoy a little growth spurt starting next year from this high-margin orthobiologic.

Another recent addition to Oakwood equity portfolios is in the rail transport industry, again opportunistically purchased on a depression in price. Long-term rail trends are favorable, as highway congestion, high fuel prices, and a shortage of drivers cast a shadow over the trucking industry, boosting demand for rail transportation. This company's second quarter earnings report caused the market to take an incredibly short-sided and negative view, thereby creating an excellent buying opportunity for us. The company reported a solid 11% revenue increase in the quarter, driven by a 4% increase in volume. Its free cash flow and operating ratio are among the best in the

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Word from the Advisor
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like a stock, is continuously priced throughout the day, and is highly liquid.

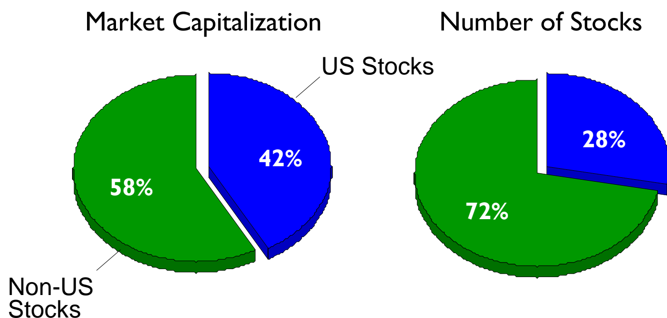
International ETF's are one of the many tools available to us as a professional active money manager, and, from time to time, we will choose to include them as one position among many in a well-diversified equity portfolio. We have singled out, in particular, the Morgan Stanley Capital International (MSCI) Europe Australasia Far East Index Fund, or EAFE Index, which is the second largest ETF overall with about $31.2 billion in assets, and the MSCI Emerging Markets Index Fund, with about $12 billion in assets. They provide diversification into both the developed and emerging economies of our increasingly globalized world.

Companies contained in the MSCI EAFE Index Fund, in general, are domiciled in countries that are considered developed, and would be the equivalent to "blue chip" companies in the US. The MSCI Emerging Markets Index Fund contains companies from countries whose economies vary from very big to very small, and are usually considered emerging because of their developments and reforms. Hence, even though China is deemed one of the world's economic powerhouses, it is lumped into the category alongside much smaller economies with a great deal less resources, like Hungary. Both China and Hungary belong to this category because both have embarked on economic development and reform programs, and have begun to open up their markets and "emerge" onto the global scene. You can learn more about ETF's at www.ishares.com.

As we enter the fourth quarter of the year, we encourage you to take the time to review your third quarter statements, and the information contained therein regarding your tax situation. Let us know if you have experienced any significant taxable events outside of your Oakwood accounts. We would also like to discuss any changes in your investment goals. Should you have questions regarding this or any other investment matter, please feel free to call us at (800) 586-0600. ■

Exhibit A

World Market Opportunities



Source: Oakwood Capital Management LLC, Factset

Equity Market Strategy
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railroad industry, despite stiff fuel-cost headwinds which are completely passed on to customers in fuel surcharges. **We are continuing to increase our weightings in the consumer staples, healthcare and financial sectors.**

As we move into the fall season, **we feel there are potentially a number of circumstances that could take a market that has reached new highs and correct it mildly downward. We are poised to make quality long-term investments when prices become more attractive.** In managing our client portfolios we will continue to focus on owning premier 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. We value the opportunity to work with you and to build your wealth. ■

Economic Outlook
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2. Oil is a smaller share of energy (35% compared with 44%) than it was in 1970, diluting the impact of oil prices on growth.

Let's keep oil prices in perspective. Recently, prices fell below the $60 level, which earlier this year was considered high, and is now considered low. The Organization of Petroleum Exporting Countries (OPEC) is now adjusting production to defend the current price level of around $60 a barrel. **A steep drop in oil from current levels may over stimulate the economy and force the Federal Reserve (Fed) into more interest rate tightening. This may not be good for either the stock or the bond market.** Though fears surrounding potential supply disruptions have subsided, it doesn't take much to reignite these concerns. In the meantime, oil's dip below the $60 per barrel level and prices at the pump falling across the country helped to boost consumer confidence late in the quarter.

In each of the four full years of this economic expansion, a widening trade deficit has subtracted anywhere from 0.3 to 0.7 percentage points from overall growth. Two factors may provide some relief to these perennial downbeat reports. First, growth outside the US is picking up even as domestic growth is moderating, causing real exports to pick up. Second, there has been a broad decline in the dollar, after a period of strengthening last year. The lower dollar represents a *de facto* rise in the competitiveness of American products in the overseas marketplace. These factors may make 2006 the first year in a decade that the trade deficit stops being a drag on economic growth.

Overall, the US economy seems to be healthy, and is transitioning to a slower, more sustainable growth rate. We are mindful, however, that challenges remain in the months ahead, and are continuously monitoring data from both consumer and business sectors to identify areas of weakness that represent opportunities for our clients. ■

Taxable Fixed Income
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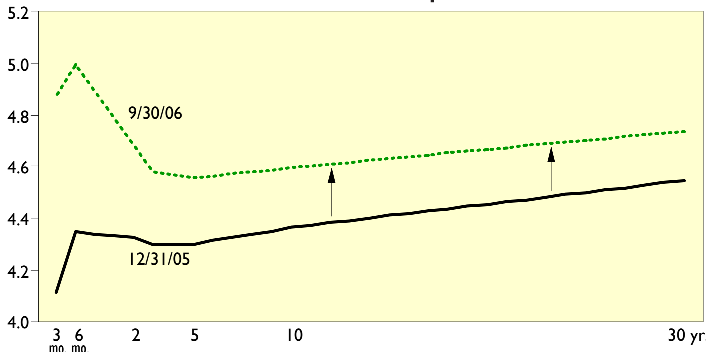
our position.

Since reaching a high of around $75 for a barrel of oil, prices have fallen back to around $60. We observe that consumers are becoming confident again, especially as gas prices continue to fall. **We are watching this situation closely because a precipitous fall in energy prices from current levels could reignite the economy and predispose the Federal Reserve to additional interest rate hikes.**

It is nearly impossible to predict the short-term direction of energy prices due to numerous supply/demand factors. Therefore, we only react to actual moves by altering our duration targets more or less aggressively in relation to respective benchmarks. Currently, we are somewhat constructive on the markets and, as shown, Treasury yields remain above year-end levels, even with the recent rally.

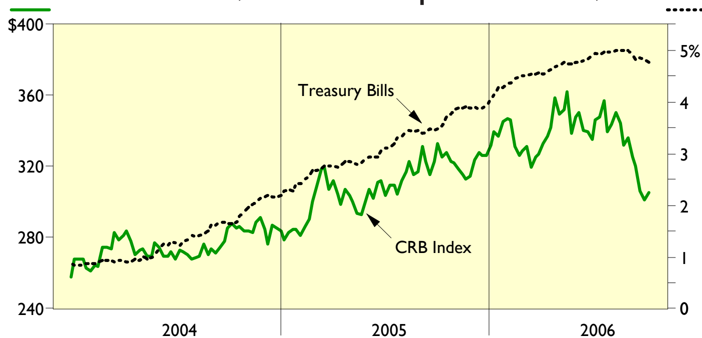
Historical Taxable Yield Curve December 31, 2005 to September 30, 2006



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

In addition to energy, we monitor price movements of other essential commodities. As shown, commodity prices, as measured by the Commodity Research Bureau Index (CRB), have moved substantially higher over a three-year plus time frame. This is in conjunction with a rise in short-term interest rates and repeated Fed tightening.

CRB Index vs. 3-Month Treasury Bills December 31, 2003 to September 30, 2006



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

Commodity prices have now begun to fall from recent peaks while short-term Treasury bill rates remain high. If this favorable trend continues, we expect inflation expectations to subside further, which calls for a Fed ease. This would propel short-term interest rates lower and large sums of capital would flow into more permanent longer security areas.

To augment yield in portfolios, we continue to invest in corporate securities on a selective basis. While we agree with those economists that predict a soft landing in the economy, the huge build-up of excess cash on balance sheets is prompting private investment groups to recommend "leveraged buyouts." Typically, this action is to the benefit of stock holders by retiring all outstanding equity and to the detriment of bond holders by draining cash reserves and by issuing large quantities of bond debt. While the goal is to position a company for future growth opportunities, the market value of outstanding bonds is hurt by quality downgrades and yield spread widening. **To enhance protection, we are reducing more vulnerable industrial and energy holdings, in favor of financial holdings, which must maintain high quality ratings in order to access capital at favorable rate levels.**

While many challenges remain for bond investors, the price behavior of the markets is as we expected. Our disciplined investment approach is paying off with returns on a steady path to continue to year-end. As always, we are sensitive to market surprises. **As you are aware, our active management process is designed to both preserve capital and seek out investment opportunities.** ■

Tax Exempt Fixed Income
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sufficient flexibility to become more aggressive, as future market conditions are better understood. These changes will bring our overall target duration on portfolios down to around 4.5 years from over 5.25 years.

We feel this desire to become more cautious is appropriate at this time especially because of the quickness and magnitude of the recent rally. The yield pickup from 1 to 20 years is only 73 basis points. **We believe there is a good chance the yield curve will return to a more positive slope, as longer yields adjust modestly higher.** Therefore, it is our goal to preserve our year-to-date gains which continue to exceed inflation as we look to the end of the year. ■