// Oakwood Outlook
& Quarterly Review
Volume 10, Number 1 January 2007

A Word
From the Advisor

Throughout our existence, our goal at Oakwood Capital Management LLC has been to provide our clients with cost effective portfolio diversification throughout all markets, and comprehensive allocation throughout all asset classes. We have searched for an ideal solution that would span across asset classes, from small-cap to large-cap, from value to growth, from emerging markets to international, to real estate.

We are pleased to announce that Oakwood Capital Management LLC has established an alliance with Dimensional Fund Advisors (DFA)[1], pioneers in the field of the science of investing, to bring the ideal solution to our clients. The philosophies of Oakwood and DFA are aligned: to deliver the performance of the capital markets and increase returns through state-of-the-art portfolio design and trading. We both see markets as an ally, not an adversary. Rather than trying to take advantage of the ways markets are wrong, we take advantage of the ways markets are right—the ways they compensate investors. ***We are fortunate to be able to offer these strategies to***

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Economic Outlook
The Big Picture

Both the US bond and stock markets ended the year with respectable returns. The US bond market had very strong returns for the quarter, with both the Lehman Brothers Intermediate Index (LB/INT) and the Lehman Brothers Government/Corporate Index (LB/GC) both returning 1.0% for the quarter. The annual return for the LB/INT ended at a respectable +4.1%, with the LB/GC returning +3.8% for the year. Two measures for the equity market, the S&P 500 Index (+6.7%) and the Russell 1000 Growth Index (+5.9%) had robust quarterly returns. For the full year 2006, the S&P 500 Index (+15.7%) outpaced the Russell 1000 Growth Index (+9.1%).

A mild and brief deceleration of global economic growth is anticipated in 2007 due to the lagged effects of tighter global monetary policy and still-high raw materials prices. The slowdown will be most marked in the US. Steady investment and consumption growth in much of Europe, Latin America and Asia, not to mention continuing years of strong growth in the major emerging markets, will ensure that the overall numbers remain healthy.

The US dollar will remain weak and is likely to slide lower. Certainly any weakness in the US economy and the huge US trade deficit won't help, but the dollar's slide in 2007 is almost guaranteed by the international interest-rate cycle. The US Federal Reserve (Fed) has stopped raising interest rates for now, but the central banks of Japan, the European Union, India and China are still in rate-increase mode. As these rate increases close the yield gap that currently favors the US dollar, the dollar becomes relatively less attractive to global investors.

Oil prices will remain high by historical standards. We can't say when or if oil prices will spike back toward $80 a barrel. We can say with reasonable certainty that oil prices will stay high enough in 2007 to keep oil-company exploration and drilling at high throttle and to attract capital to high-cost projects ranging from Alberta's oil sands to Qatar's liquefied natural gas plant to windmills in Spain and ethanol plants in Iowa.

Some data suggests slower growth for the US economy, and some data suggests faster growth. For example, factory orders and durable goods orders had recent

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TAXABLE FIXED INCOME

Strategy

2006 was a very good year for Oakwood fixed income clients. Bond returns exceeded reported levels of inflation and comparable performance benchmarks, after enduring a string of 17 consecutive interest rate hikes by the Federal Reserve. Additionally, on a risk adjusted basis, our high quality bonds provided a less volatile alternative to high yield bonds, commodities and other investments.

We are pleased with our ability to produce these solid results, especially during this period of relatively low yields. The keys to our success are as follows:

1. ***A mathematical advantage*** – The advantage was due to a careful placement of investment choices throughout the entire maturity spectrum. As an example, we know that most taxable indices have a sizeable representation of Government securities in the shorter 1 to 3 year maturity areas. To provide this mathematical advantage, we utilized market discount callable Federal agency investments with higher return characteristics, regardless of interest rate direction. **Going forward, as we near a shift to a more accommodative Fed policy, we will take gains and avoid a risk that price performance will lag as the ability to call these bonds before maturity becomes a consideration.** At that time, we will consider the use of non-callable Federal agencies owing to favorable changes to their accounting methods that have bolstered their appeal. They offer improved liquidity, respectable yield and good performance potential.

2. ***Corporate bond decisions*** – During this period of interest rate uncertainty, cash flow yield from coupon payments and market stability are essential ingredients to capital protection and relative performance. When combined with solid liquidity features and an improving quality trend, the return profile is optimal. **We are careful to only own bonds issued by corporations with a solid earnings trend and to avoid those that could be negatively affected by an unexpected leveraged buyout.** As a safeguard, we prefer financial obligations where the maintenance of high quality is crucial to the daily management of company operations.

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TAX EXEMPT FIXED INCOME

Strategy

Municipal fixed income clients enjoyed a good year as after-tax returns in 2006 exceeded rates of inflation. Looking ahead, we expect an even better year as the supply of new bonds is met with strong demand and stable tax rates, with the potential for members of Congress to call for higher tax rates on wealthy individuals. However, we are concerned that while tax receipts in California exceeded 2006 projections, the current lack of fiscal discipline will lead to large deficits. Therefore, we intend to avoid State level bond obligations unless the maturity is less than 5 years. Furthermore, we will demand insurance backing or pre-refunded issues with the implicit guarantee of the US government.

In fact, throughout Oakwood client portfolios we already own many issues that are pre-refunded. This resulted from the prior year's rush to refund existing debt prior to maturity in a very low yield environment or from an effort to seek out these universally accepted bonds. However, despite their highest AAA quality rating, the inundation of supply tempered our return expectations. This year, we expect this to change as the supply of available bonds dwindles due to less issuance and growing demand.

Because of a minimal yield difference between higher and lower taxed states, we have effectively used local level tax advantaged California bonds for both California and out-of-state general market portfolios. As yield levels realign to reflect the proper yield relationship, we see a performance benefit to both in-state and general market residents.

In general, municipal securities out-performed their taxable counterparts last year. As a result, municipal versus taxable yield ratios have become less attractive, especially in 7 year and longer maturities. This provided us with an opportunity to take select gains and reinvest in shorter more conservative securities. This, combined with the passage of time, shortened overall durations from a target level of 5.4 to less than 5 years. Because we are now going through a period in which economic data is conflicted or distorted, we are comfortable with our more conservative stance.

As you are aware, the Fed has openly stated its concerns that inflation could become a problem. The market reacted negatively by pushing yield levels higher. As stated earlier, our shortened maturity profile has provided a level of protection against this event. **As interest rates reach peak levels and as yield relationships readjust to more attractive levels, we see an opportunity to again lengthen holdings.** The fol-

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EQUITY MARKET STRATEGY

Global Opportunities

As we enter 2007, we are positive on the outlook for global equities. We may be entering the latter stage of the US equity bull market, which is in its fourth year, but history tells us these time periods can be very profitable for shareholders. When a significant buyer of stock is the corporate buyout sector itself, future returns tend to be good.

Liquidity remains the story behind 2006's strong market and the prospects for 2007. The increasing utilization of financial leverage and record corporate cash flow are supplying an abundance of liquidity. International equities are riding the liquidity wave, too. Earnings growth around the globe is strong, valuations remain near or better than longer-term averages, and the cost of capital is quite attractive. Europe's economy is exhibiting the benefits of long-term restructuring through stronger domestic demand. Japan's domestic growth is uneven, but we see continued strong growth in China and other emerging markets.

Investors have been witness to areas of market and global economic stability and growth, but this disguises huge underlying forces that are reshaping the world in vast ways. These include booming commodity prices as the world uses up finite resources, and the resulting colossal transfer of wealth to resource-rich nations (accompanied by a commensurate movement of capital to developed nations). Consuming nations are jockeying for control of scarce resources both economically and militarily.

On the domestic side, with a shift in Congress, aside from some early successes, we anticipate gridlock in Washington, DC in 2007 and 2008. Until the 2008 elections, we expect the current federal income tax brackets and qualified dividend and capital gains tax brackets to remain essentially unchanged. We expect limited economic impact beyond an increase in minimum wage, and removal of subsidies for oil and gas. Also, there is a possibility that certain industries, such as healthcare and drugs, may be affected by initiatives from the new Congress. We have lightened up our exposure to these industries.

A central process in Oakwood's equity strategies has been identifying and investing in undervalued, high quality multinational companies and non-US ADRs. In addition to their excellent investment characteristics, these Oakwood companies with large non-dollar operations help insulate client portfolios from the falling dollar. We recently added a premier beverage company, trading at a ten-year low P/E ratio with profound international franchise strength, strong and growing free cash flow, strong dividend growth and frequent share buybacks.

Another international company that we hold in client portfolios was originally the wireless side of Telmex, the incumbent telephone operator in Mexico. It is the largest wireless operator in Latin America, with more than 70% of the wireless market in Mexico, in addition to millions of wireless customers in the US and Central America. It has positive free cash flow and is internally funding its growth. This company has experience dealing with the vagaries of the Latin American market, and introduced the first prepaid phone system, which has been the key to expanding wireless telephone service in many markets.

A world class pharmaceutical company based in Switzerland provides another component of client portfolios. In addition to manufacturing and marketing a variety of branded pharmaceutical, generic and consumer-related products, it has strong franchises in oncology and cardiovascular products, among others. Recent acquisitions should help to more than double its presence in generic drugs and add new growth platforms, such as vaccines. This high quality firm follows the European tradition of conservative financial management, with little debt and ample cash reserves. It is one of two AAA-rated nonfinancial firms in Europe, and generates free cash flow that exceeds 15% of sales.

While our conservative approach of owning premier companies with positive free cash flow, strong returns on capital, increasing dividends and healthy earnings growth that trade at attractive valuations will not always nominally outperform a high flying market, we believe it almost always outperforms on a risk-adjusted basis — and it helps our clients sleep well knowing they are well protected from downside volatility. ■

Word from the Advisor
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capture what the market offers in all its dimensions. These strategies are only available to clients of qualified and select registered investment advisors, such as Oakwood, and are not available to the general public.

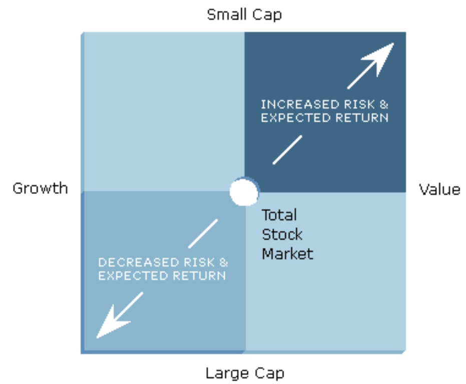
The Oakwood/DFA portfolios are designed to provide substantial diversification ranging from small-cap to large-cap, from value to growth, from emerging markets to developed international markets, to real estate. Increased diversification will reduce investment concentration and the resulting increased risk caused by the volatility of individual companies, asset classes or indexes. Portfolios are monitored and rebalanced, taking into consideration risk exposure consistency, transaction costs, and tax ramifications to maintain target asset allocations established by Oakwood for each client's unique risk profile.

The investment strategy of Oakwood and DFA is based on the principles of Modern Portfolio Theory (MPT)[2] and the Fama and French Three Factor Model for Equities[3]. An important part of MPT is the Efficient Market Hypothesis, which says that market prices are fair; that they fully reflect all available information. This does not mean that prices are perfect; some prices may be too high and some too low, but there is no reliable way to tell. In an efficient market, investors cannot expect to earn above-average profits without assuming above-average risks.

Fama and French's Three-Factor Model is an extension of another important part of MPT, the Capital Asset Pricing Model (CAPM). Put simply, the CAPM says that an investor's expected return is proportional to a single factor, the stock's risk relative to the entire stock universe. The expansionary Three-Factor Model is based on the following:

- **Market**: Stocks have higher expected returns than bonds.
- **Size**: Small company stocks have higher expected returns than large company stocks.
- **Price**: Lower-priced "value" stocks have higher expected returns than higher-priced "growth" stocks.

Everything that has been learned about expected returns in the equity market can be summarized in three dimensions. **First, stocks are riskier than bonds and have greater expected returns. And, relative performance among stocks is largely driven by the two other dimensions: small versus large, and value versus growth.** Many economists believe small cap and value stocks outperform because the market rationally discounts their prices to reflect underlying risk. The lower prices give investors greater upside as compensation for bearing this risk.



Successful investing means capturing risks that generate expected return and reducing risks that do not. Financial science-based portfolio design identifies the risks that add value, and then minimizes the costs imposed by traditional approaches, such as "indexing".

We look forward to discussing this new opportunity with you. Please call us at 800-586-0600 to discuss the benefits of an Oakwood Structured Portfolio. ■

[1]Dimensional Fund Advisors, headquartered in Santa Monica, California, inaugurated its strategies in 1981 with early research into the stronger performance of small cap stocks. Later, a comprehensive analysis of stock prices worldwide broadened the strategy repertoire and set a new standard for portfolio design options.

[2] MPT is generally accepted as the combination of the pioneering works of Markowitz, Sharpe and Miller who have all been awarded the Nobel Prize.

[3] Eugene Fama of the University of Chicago (father of the Efficient Market Hypothesis) and Ken French of Dartmouth College wrote the paper on the Three Factor Model for Equities which 'expands' our understanding of both MPT and the capital markets.

Economic Outlook
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substantial drops in their numbers, pointing to slower growth. However, numbers from the Institute for Supply Management (ISM) Services Index came in much higher than the consensus expectation, indicating that the service economy is expanding.

The Fed has recently made a concerted effort to convince the financial markets that its next move will be to raise rates again. This is, in large part, due to its focus on the level of US inflation, with the core rate, which removes volatile food and energy prices from the index, now at 2.9%, its highest rate for the decade. We are not convinced and, in fact, our interpretation of all the data leads us to believe that the Fed will hold off until the second half of 2007 and could actually cut rates at that point in time. ■

Taxable Fixed Income
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3. ***Duration control*** – Duration control entails the proper positioning of investments along the maturity curve in order to control price changes from numerous interest rate factors. Because predicting interest rates and yield curve movements can be difficult, we rely on a systematic investment approach that has been successful for several decades. This is especially important during this confusing interest rate climate. As yield levels now appear to be moving higher, we are implementing swaps designed to shift very short holdings into the 2 to 5 year maturity areas, with a minimal impact on our desire to remain near term market neutral.

4. ***Flexibility in our investment process*** - Possibly the most important feature to a well managed portfolio is proper security placement and the ability to recognize and adapt to changing market conditions. This involves the initial process of selecting securities that best suit client investment objectives. We then seek out opportunities based on return benefit, or sell securities that reach performance benchmarks, or that have deteriorating fundamentals. We take pride in our ability to adapt to market changes that affect portfolio decisions. Because we are inundated with information on a daily basis, we are careful to identify indicators pertinent to our market forecast. We then monitor these indicators to validate or challenge our expectations. As an example, Fed Chairman Bernanke repeatedly stated the critical importance of monitoring inflation expectations. As a possible offset, the housing sector has weakened as well as other select economic variables. With the potential for confusion, we prefer to stay focused on the Fed's clear priority to contain inflation.

Looking further ahead into 2007, we expect bond returns to reflect coupon generation and modest market price growth. While we are unsure of the timing of a bond rally, we have a growing sense that a strained consumer may lead to a period of below trend line growth in the economy. **Consequently, the Fed may find it difficult to reignite the economy, without cutting interest rates in the second half of 2007.** We are hopeful that the Fed will be slow to reverse its current restrictive monetary policy stance. While this may seem counterproductive to bond performance, the longer they remain focused on fighting inflation, the more potential for solid price appreciation. As their success becomes apparent, we intend to extend duration targets versus respective benchmarks. ■

Tax Exempt Fixed Income
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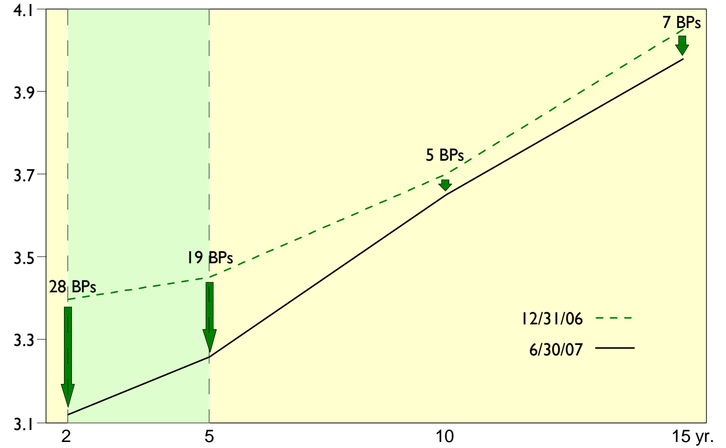
lowing chart reflects current yield levels and our forecast for the first half of 2007.



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

Shown is a modest decline in yields throughout the maturity curve. Specifically, most of the decline is reflected in the shorter 2 to 5 year areas, as the expected adjustment in municipal to federal taxable ratios will mute the yield decline in longer maturities.

As you are aware, forecasting the precise timing of a rally can be unreliable; nonetheless we are confident that yields will ultimately fall well below our forecast. Currently, market participants remain somewhat skeptical that the economy will slow enough to prompt Fed easing. On a short term basis we agree, however, we stand ready to act quickly. **History often shows a directional change in interest rates is commensurate with a change in market fundamentals and sentiment. Therefore, we encourage clients in the higher marginal tax brackets to remain invested in tax-free bonds.** ■