Oakwood Outlook

& Quarterly Review

Volume 10, Number 2 April 2007

A Word

From the Advisor

A Managed Approach to a Targeted Focus

At Oakwood, we believe the definition of a *successful investor is someone who* captures expected return with the least amount of risk. As your advisor, it is our responsibility not only to fully understand your risk and return preferences, but to develop an optimal investment asset allocation, and then invest in those investment vehicles which we believe would accurately and consistently reduce risk and provide higher expected returns.

As an investor, there is always that temptation of "doing it yourself." It seems that with the wide range of trading options, information, and technology available, it is a matter of picking up a phone or a mouse, and making the trade. Many "do-it-yourselfers", overwhelmed with the wide range of offerings available, end up choosing an index fund or an exchange-traded fund, without fully understanding the underlying risk of such an investment. **But the most *successful investor* always evaluates the risk they are taking in relation to their expected returns.**

It is widely accepted that asset allocation is a major determinant of portfolio performance. Our ongoing role as a trusted advisor encompasses

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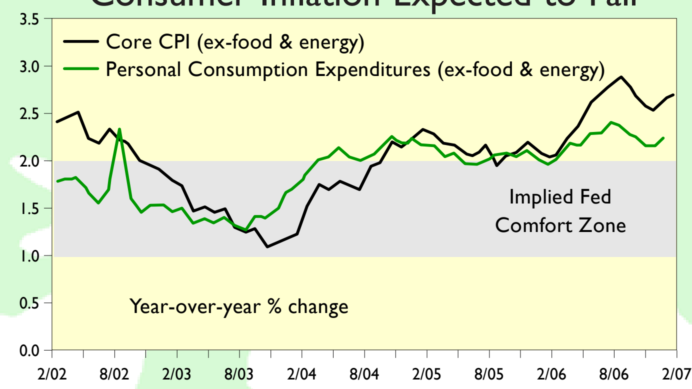
Economic Outlook

Globalization - Here to Stay

The US bond market outpaced the US stock market in the first quarter of 2007 with the Lehman Brothers Intermediate Index returning +1.59%, and the Lehman Brothers Government/Corporate Index returning +1.47%. In contrast, the S&P 500 Index, a broad measure for the US equity market, returned +0.63%, and the Russell 1000 Growth Index, returned +1.19% for the first quarter of 2007. The MSCI Europe Australasia Far East Index (EAFE), which measures the performance of international equity markets, returned +4.08% for the quarter.

The global economy has become increasingly more integrated, intensifying competition and placing downward pressure on prices. We have seen an improved flow of knowledge, capital and goods move more freely between countries. This has enhanced the development and spread of innovation and technology, thereby improving productivity growth. When it comes to keeping inflation in check, productivity is a virtue, no matter where you reside in the world.

Indeed, it appears that US inflation is in check, and inflationary pressures are set to recede later in 2007 as overall economic growth remains below potential. Favored core measures (excluding food and energy) have remained stubbornly above the Federal Reserve's (Fed) implied comfort zone of 1% to 2%, due in large part to elevated housing prices. However, the markets and the Fed broadly anticipate inflation to moderate going forward.



Source: Datastream, Bureau of Labor Statistics

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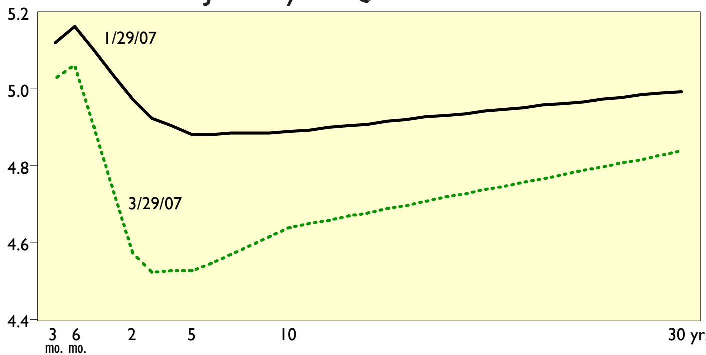
TAXABLE FIXED INCOME

Strategy

The first quarter of 2007 can be described as a transitional period for the taxable bond markets. Prior to February, market discussions centered on two questions:

1. To what extent will short term interest rates need to rise in order to meet the Fed's inflation requirements?
2. Is there enough yield curve inversion to stem economic growth?

The market's response to this dilemma is shown by comparing present Treasury yield levels to the January peak.



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

As shown, at the end of January, two-year Treasury yields approached 5% while inflation reports showed only sporadic signs of moderating. Furthermore, in comparing the 2-year Treasury to the 10-year Treasury, the yield curve inversion was at negative 9 basis points. A yield curve inversion is historically a precursor to an economic slowing or recession, and the 9 basis point margin seemed too narrow to be predictive of a slowing economy or a recession. Only two months later, there was a precipitous drop in yields and the curve inversion disappeared. So it leads to the current question - ***Why the dramatic change in market sentiment during the subsequent two months, as investors appear less concerned over the resilience of the economy and stubborn inflation?***

First, we know there is a time lag between an adjustment in monetary policy and its effect on the economy and ultimately, inflation. To date, the Fed has raised its benchmark short-term Federal Funds target 17 times over a period of almost 3 years. Past data shows a 9 to 12-month time lag between a Federal Open Market Committee policy decision and its flow through the system. Most experts could successfully argue that at least 12 of the 17 rate hikes were needed to reverse an

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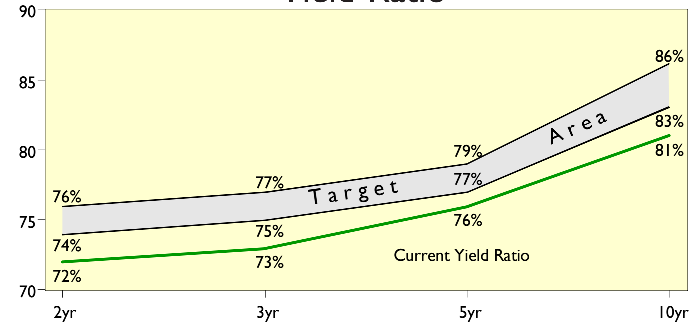
TAX EXEMPT FIXED INCOME

Strategy

Similar to the taxable bond markets, municipal bonds have entered a period of market stability after a long period of Federal Reserve interest rate tightening. In fact, on a tax adjusted basis, tax-free securities generated higher returns than their taxable counterparts. Because of this, yield ratios versus Treasuries are historically low. Therefore, investors must be careful not to pay too much for new purchases. As shown in the following graph, yield ratios are below our acceptable target range. As a result, we must continue to be diligent in our investment choices and careful to negotiate a fair price.



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

Furthermore, it is important now, more than ever, to continue to monitor the credit worthiness of existing holdings in client portfolios. During the past three years, in response to record tax collections and strong forward looking economic projections, many municipalities on both a state and local level ramped up spending plans. With home values now moderating or falling and defaults on the rise, those areas of the country that depend on high tax collections based on inflated home values will struggle to maintain their budget projections. Unfortunately, states, including California, have approved aggressive projects with an expectation that tax revenues will remain strong. As a result, credit rankings may fall and the liquidity of outstanding debt obligations will suffer. We will continue our intensive research efforts to validate the credit worthiness of our holdings.

Meanwhile, the growing supply of new municipal securities is being met with strong demand. Individuals have significant cash reserves as evidenced by large holdings in bank certificates of deposit and money market funds. Aging baby boomers continue to use municipal bonds as a shelter against taxes and as an alternative to riskier investment classes. **With the Fed's intense focus on inflation, it seems unlikely that yields will move much higher.**

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GLOBAL EQUITY STRATEGY

Going Global

T.S. Eliot once wrote that April is the cruelest month, but March 2007 was certainly no picnic for investors. After the markets surged to start the year, later in the quarter many Asian markets plummeted. The Shanghai Index, which is a measure of China's stock market, dropped 9% in one day, causing a rippling through all global markets, including the US. The US market bellwether, the S&P 500 Index, dropped 3.5% that day. It is a well-established fact that in times of "market shock", the correlation, or synchronization, of markets increases, and this "global selloff" was no exception. It is interesting to note, however, that since this event, the Shanghai Index has recovered, and actually reached new highs, while the US market continues to struggle. Markets' ability to recover varies by region for various reasons: the state of their economy, governments' willingness to intervene, investor psychology, to name just a few. This de-linkage of market performance by region after a shock provides a compelling reason to invest globally.

The "flight to quality" stocks held in Oakwood client portfolios demonstrated their value when the market took its downturn. Oakwood Equity Strategies held strong while the general market dipped, and are outperforming year-to-date. Oakwood's Structured Global Strategies held their strength through this tumultuous period, and are also outperforming to date.

The US equity market is wrestling with its economic outlook, and the subsequent potential impact on corporate profits and valuations. The door is open for a possible interest rate ease later this year, if the economy slows further and/or core inflation recedes in coming months. Stocks typically do well during midcycle slowdowns, as a pullback in demand relaxes inflation pressures and allows for lower interest rates. Knowing the stock market anticipates 6 to 9 months forward, the market may only have a modest correction as it anticipates lower interest rates to stimulate a pickup in the economy.

We continue to emphasize asset class investing in global markets, and on the domestic side, favor sectors and companies with consistent free and growing cash flow. We are well diversified, and are currently overweighted in the following US market sectors:

Energy. Over the past few months, the short-term outlook for North American natural-gas producers has improved. Last fall, a gas storage overhang resulting from a warm winter pulled the price of natural gas below our long-run estimate while drilling and service costs continued to rise. Both factors weighed heavily on gas producers' profit margins. Recently, these pressures abated as a frigid February helped draw down gas storage, and reduced activity helped stabilize drilling and service costs.

A large global player in the oil and gas industry in client portfolios is the third-largest energy company in the US. It is well positioned to benefit from a trend toward wider spreads between the cost of lighter, high-quality oil and heavier, lower-quality crude oil. Its investment in a well-established Russian oil giant grants this company access to significant hydrocarbon reserves with large upside potential.

Telecom. Mergers in the telecom world have exploded in the last couple of years. We expect the recent pace of merger activity to continue. Despite a slowdown in the fixed-line phone business from increased competition from other services, and pressure on wireless interconnection rates by government regulators, telecom firms continue to generate significant amounts of cash flow. Most firms have increased dividends but still have excess cash. In order to boost growth rates, these firms are looking at acquisitions to increase growth.

Rural phone companies similar to our Oakwood client portfolio holding have garnered attention in recent years as safe havens in the telecom industry. The revenue opportunity in small markets often isn't large enough to attract as much attention from rivals, and regulations can provide more insulation from competition than in urban areas. Wireless service is also sometimes spotty, making fixed-line service more attractive. As a result, this Oakwood telecom company has been and is currently generating steady cash flow, which it uses to pay a large dividend.

Industrials. We have been pleased in recent quarters by the resilience of many of our industrial holdings. By and large, raw-material and manufacturing production have remained strong, particularly in chemicals, building materials, metal products, machinery, and transportation equipment. On top of that, firms have enjoyed steady, and in some cases, improving pricing. Even with the potential for the US economy to slow further in 2007, international economic expansion keeps demand steady.

A portfolio holding in this sector has a strong global presence that has allowed the firm to weather sluggish domestic demand. Its products that have reached maturity in

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Word from the Advisor
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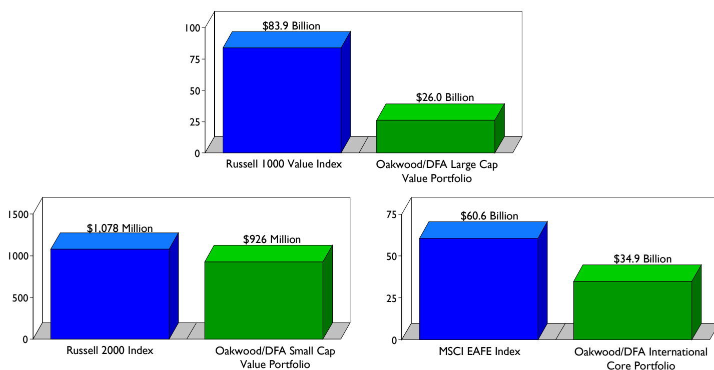
the following in regards to asset allocation:

- **Analyze** your risk/return profile.
- **Determine** the most appropriate asset classes for your personal investment goals.
- **Research** the optimal investments for each asset class.
- **Structure** your portfolio with the appropriate weights.
- **Invest** your portfolio in the most cost effective manner possible.
- **Monitor and manage** each investment and asset class, and make adjustments when necessary.

The best way for us to ensure that you receive the optimal portfolio risk and return characteristics is to utilize investment vehicles that *accurately and consistently* target the asset classes that we have identified as being the most appropriate for you, and the most rewarding over time. **Oakwood Capital Management's alliance with Dimensional Fund Advisors (DFA), through its institutional funds exclusively available through registered investment advisors such as Oakwood, has enriched our ability to manage and deliver the accuracy and consistency that is crucial in building your customized portfolio. The Oakwood/DFA structured approach may seem to some investors like passive management, or "indexing", but, in fact, it is far from that.**

The first difference between the two is the *structural benefit* of Oakwood structured and managed portfolios. The following table shows a side by side comparison of a simple portfolio characteristic, weighted average market capitalization, which defines size, between three widely used indices, and the Oakwood structured and managed portfolios.

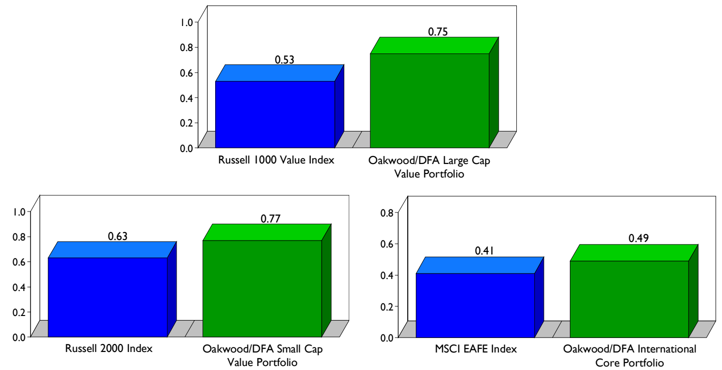
Weighted Average Market Cap



Source: Dimensional Fund Advisors, Oakwood Capital Management LLC

As you can see above, the Oakwood structured and managed portfolios' weighted average market capitalization is much lower, illustrating the **targeted focus** on smaller companies, which have generated historically higher expected returns. Taking it a step further, and examining another simple portfolio characteristic, the book-to-market ratio, shows another fundamental improvement of the Oakwood structured and managed portfolios in targeting value stocks. Research for the past eighty years has shown that a higher book to market ratio has provided higher expected returns.

Weighted Average Book-to-Market



Source: Dimensional Fund Advisors, Oakwood Capital Management LLC

Oakwood's portfolio construction method also begins with a wider net, by starting with *entire* markets, not just subsets of markets. In a traditional index fund, the fund manager seeks to replicate the performance of JUST the stocks in that index. Our portfolios are not dependent upon the stocks in the indices but rather designed to pinpoint the **targeted risk factors, size and value, which history has shown provide higher expected returns. These characteristics are evident in the above graphs.**

Another difference between traditional indexing and Oakwood's designed portfolios is ***the trading benefit***. The Oakwood/DFA approach allows for more flexible and patient trading because it is not restricted by the goal of forced reconstitution and *tracking error* minimization, which is the difference between the performance of the benchmark and the indexed portfolio. Traditional index fund managers are forced to reconstitute, which has proven to be a costly objective. When a stock migrates into the buy or sell range of one of our strategies, we have the *option* to buy or sell. Index fund managers are forced to replicate their respective indices, and have no option to buy or sell; it is *mandatory*. Traders know in advance which stocks are being added to or deleted from the index and often front run changes to the index, the result of which is that index fund managers are forced to buy high and sell low, to the detriment of index fund investors. For Oakwood/DFA, the decision about a security's weighting is made based on the price of execution, and is not based on the mandate of an index. If we can buy a large block of stocks below market price, avoiding the often damaging impact of bid and ask spreads in less liquid areas of the market, we are willing to take positions larger than the exact market cap weighting to capture the discounted price. We favor price over the timing of a trade execution.

Structure drives performance. **The best way to ensure that you actually receive the returns of the asset allocation we've designed for you is to implement your investment program with portfolios that we believe will deliver *precise* risk factor exposures.** The ability to use more flexible and patient trading than is customary of traditional index fund managers allows us to achieve this objective in a more cost-effective manner.

We welcome the opportunity to further discuss how Oakwood structured and managed portfolios can improve your investment performance, or any other investment matter. Please give us a call at 1-800-586-0600. ■

Taxable Fixed Income
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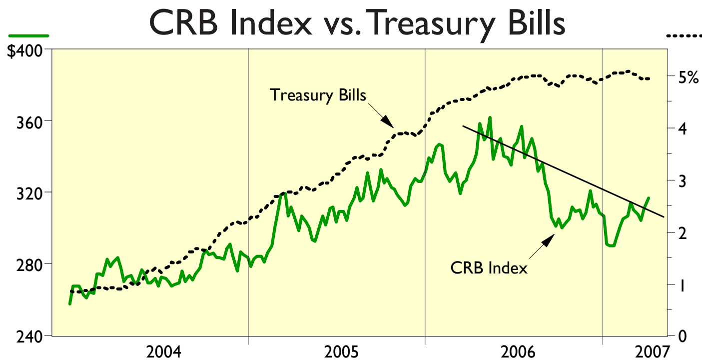
overly stimulative monetary policy. Therefore, the balance of the rate increases can be defined as "restrictive." **There is now growing evidence that Gross Domestic Product (GDP) growth is beginning to slow under the weight of this restrictive policy.**

Second, changes in 3-month Treasury bill yields reflect both current Fed policy and future expectations. It is interesting to observe that short-term T-bills reached a high yield point shortly after a peak in the Commodity Research Bureau (CRB) price index and a change in the Fed's periodic policy statement. Unfortunately, because energy price volatility influences the CRB index, a decisive change in the direction of inflation remains unclear.



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

Third, while housing is rarely the sole cause of recessions, median home prices are beginning to moderate or fall and the inventory of unsold homes is mounting. This, combined with the rise in mortgage defaults, raises concerns that **the Fed has been too restrictive and must lower interest rates soon.** This may be the strongest factor explaining the notable drop in short and intermediate maturity yield levels and resistance to the Fed's negative comments on inflation.

Finally, costs associated with labor may not be the feared inflationary grim reaper. In spite of the historically low 4.4% unemployment rate and select labor shortages, wage/benefit increases have been muted by increases in corporate productivity.

As stated earlier, interest rates are now somewhat lower than year end levels. This has benefited Oakwood clients as they enjoy good cash flow from coupon payments and modest growth in asset values. We believe the bond market is only in the early stages of a rally. However, the key to its success hinges on INFLATION, INFLATION, and INFLATION. **While inflationary pressures may have already peaked, for any sustained change in interest rates to occur, we believe the impact of the restrictive monetary policy must continue to flow through the economy.** Otherwise, investor sentiment will shift back and forth between bullish to bearish on any given day or data point.

As part of our second quarter investment plans, we will look past market gyrations driven by emotion and continue to extend short maturity positions during market pullbacks. Furthermore, we proceed to swap fully priced Federal Agencies and more risky corporate holdings into more price-responsive higher quality Treasuries. Finally, we will monitor the progress of inflation as a guide to overall duration management. This entails a potential shift in client portfolios from neutral to more aggressive versus respective performance benchmarks. Meanwhile, our primary goal is to add to first quarter returns in a controlled fashion. ■

Tax Exempt Fixed Income
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On a taxable equivalent basis, 13-year tax free bonds provide investors with yields approaching 6%. To take advantage of this, we have started to selectively extend shorter maturity holdings. **Even though the Fed is unlikely to lower interest rates at this time, the benefits of their steadfast monetary policy should continue to benefit our clients.** Through this, the key is patience. As you are aware, we have always stressed very strict quality standards which include a minimum strong single A underlying rating with insurance enhancement or double A without. In addition, we prefer those security choices with nationwide investor appeal. We believe the key to future success lies in high quality, maximum diversification, and sound liquidity. ■

Global Equity Strategy
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the US still have significant growth potential internationally. This company recently announced a $7 billion two-year share repurchase program and raised its quarterly dividend 4.3%. We're pleased to see that the company is proactively returning cash to shareholders rather than potentially pouring it into value-destroying projects or acquisitions.

Consumer Staples. We continue to see the potential benefits of our overweighting of the consumer staples sector as the overall market experiences an increase in volatility. This traditionally defensive group provides some measure of protection against further selloffs. Additionally, we continue to believe that the combination of the impact of a slowdown in housing, combined with the accumulated affect of the Fed rate hikes, could potentially lead to a greater economic slowdown than the market is now expecting. Should this come to fruition, it should help to support this defensive sector as we go through the year.

A client holding in the consumer staples sector was recently successful in acquiring a dominant mail order pharmacy company. We like the acquisition, which will ultimately create shareholder value through economies of scale and a more compelling offering to health plan sponsors. This company will also realize growth through an increased demand for generic prescriptions. We expect the multiple to increase to a more normal P/E ratio, as investors appreciate the acquisition.

Our overweighting in real assets, which include domestic oil and gas reserves, hydroelectric and nuclear power, gold and copper and real estate, will continue to contribute to portfolio returns. New data show the tight balance between oil and gas supplies and demand becoming more critical, as massive Saudi Arabian production reaches its peak. As natural resources continue to become more scarce, our portfolios are positioned to appreciate. We take comfort that our clients are well protected by these real assets, which also protect against the falling dollar which will accompany these trends.

Often, allocating a percentage of your managed equity strategy to investments in other markets helps reduce long-term volatility and allows you to capitalize on some great non-US companies. The investment alternatives that we use to accomplish this are the Oakwood Structured Global alternatives, along with exchange-traded funds (ETF) alternatives. These help provide diversification into developed and emerging economies of our increasingly globalized world.

For exposure to non-US markets, alternatives made available through the Oakwood/DFA alliance are the International Core Equity Portfolio and the Emerging Markets Core Equity Portfolio, exclusively available through registered investment advisors such as Oakwood. The goal for the International Core Equity Portfolio is to invest across the entire developed international market and to integrate target weights efficiently to achieve a higher exposure to small cap and value stocks relative to the market. The goal for the Emerging Markets Core Equity Portfolio is similar, with the emphasis on sixteen emerging markets. The Oakwood/DFA portfolio construction method casts a wider net by starting with the entire international market universe.

Oakwood/DFA engineering and trading expertise results in both the International Core Equity Portfolio and the Emerging Market Core Equity Portfolio's broader and more efficient exposure to the risk factors that we believe drive higher expected returns. The International Core Equity Portfolio currently invests in companies in Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. The Emerging Markets Core Equity Portfolio currently invests in Brazil, Chile, Czech Republic, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Philippines, Poland, South Africa, South Korea, Taiwan, Thailand and Turkey.

With respect to ETF alternatives, 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 iShares MSCI Emerging Markets Index Fund, with about $12 billion in assets.

We believe that the use of Oakwood Structured Global alternatives, along with ETFs in your portfolio will provide additional diversification as well as the potential for increased returns. We intend to add these alternatives to your managed equity strategy this year. Please contact us if you have questions or objections about using any of these alternatives. We welcome the opportunity to further discuss how Oakwood's range of structured and managed portfolios can provide you with a targeted focus that is tailored to your personal investment goals. ■

Economic Outlook
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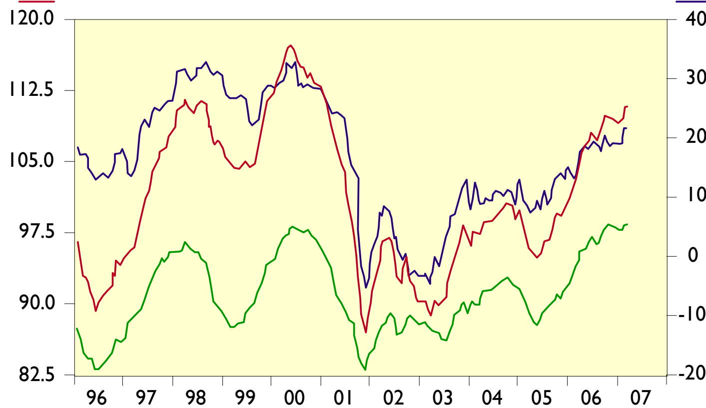
Analysts and pundits alike are claiming that the recent high-profile failures in the subprime (lower credit quality) mortgage market are in reality a small part of the US economy, and that the "crisis" is manageable. However, we feel that it will not be loan losses that threaten future economic growth, but the tightening of credit conditions that are in part a result of those losses. Lender fears of potential new regulations will begin to restrict additional lending. Tighter lending standards and increased regulations will change the investment outlook for some time to come.

While the Fed must be cognizant of an array of asset prices in addition to housing, the housing market is one of the keys to future economic trends, and therefore fundamental to the outlook for consumption. Consumer spending, the primary driver of US growth, is the most closely watched sector of the economy. Currently, while a low unemployment rate and solid income growth have been underlying supports, consumer spending has slowed in response to higher oil prices, some slowing in the rate of employment growth, and concerns for a slowing US economy.

As in the US, there are indications that growth around the globe may be moderating somewhat, one reason why global inflation trends remain quite favorable. Economies in India, China, and many other emerging markets are still growing robustly. In developed countries, although there are some indications of a slowing in growth, the most recent report by the European Commission shows the Economic Sentiment Indicator (the European Union equivalent of the US Consumer Sentiment Indicator), has the highest reading since January of 2001.



Source: European Commission/Haver Analytics

Economic fundamentals continue to support higher oil prices, and Iran's continued defiance has prompted resurgence in the geopolitical risk premium that is currently priced into oil futures. The combination of raging geopolitical tension, strong motor gasoline demand, weak refiner activity, and the potential for additional supply disruptions far outweigh the downward drag that a potentially slowing US economy is causing on oil's short term pricing momentum.

In recent years, US consumers and businesses have shelled out more and more dollars to buy Chinese goods and Middle Eastern oil, and most of those dollars came back to the US in the form of stock and bond investments. At first, most of the investment was in Treasury bonds. More recently, the investment has been wide-ranging, from stocks to residential mortgage-backed securities to hard assets like office towers. The US current account deficit is, of course, the mirror image of other nations' current account surpluses, the source of the so-called global saving glut. With the weaker dollar and stronger global growth now cutting into the US trade and current account shortfalls, fewer dollars will be going overseas, and thus there will be fewer dollars for such investment.

The current consensus continues to reduce 2007 GDP growth expectations, which now fall in the range of 2 to 3%. We believe the range will fall in the 2.0% area, later in the year. Consumption growth will slow as moderating housing prices act as a drag. However, business investment should bounce back from the weak fourth quarter of 2006, and trade should generally be a positive. ■