

# Oakwood Outlook

## & Quarterly Review

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"I think it was an election year."

### A WORD FROM THE ADVISOR

## "HAPPY NEW YEAR"

**H**appy 2008! In the spirit of the New Year, we have compiled a few top ten lists for you to read and think about.

As this is an election year, the first is:

#### Top Ten Reasons to Be an Elected Official in 2008

- 10) You can add two and two together (and the answer must always be four). This is a *good* thing.
- 9) Your hair has to be perfect...every day.
- 8) You buy better stuff at the grocery store, because everybody's watching.
- 7) Everyone (almost) knows your name.
- 6) Someone is always awake at midnight, and wants to call you.
- 5) You have inside information about City Hall.
- 4) You get to ride on the back of a fire truck on the 4th of July.
- 3) School kids want to be you.
- 2) Someone will always disagree with you about something, and you like it.
- 1) You are able to create change and make a difference.

On a more serious note, here is a real **Top Ten list of why you will be a successful investor in 2008.**

#### 10. Markets Work

Capital markets are not perfect and prices are not always in balance, but markets are so competitive that it is unlikely an investor can systematically profit from mispricings in the market at the expense of other investors over extended periods of time.

#### 9. The Plight of Active Management

For active managers to succeed, free markets must fail. There have been (and will be) managers that outperform the market, in the short run, but no more than you would expect by chance, and it is difficult to identify them in advance.

#### 8. Market Timing Is Risky

Following decades of empirical investigation of capital markets by literally thousands of financial economists, there is no widely accepted and conclusive evidence that market timing works. A successful timing strategy requires three correct decisions: when to get in, when to get out, and when to get back in. When timing between stocks and cash, for example, the frequency of correct decisions must also be high enough to overcome the higher expected returns of stocks over cash and to make up for the costs of transactions. Academic research favors a buy-and-hold strategy.

#### 7. There Is No Crystal Ball . . . and You Don't Need One!

At the root of all forms of active management is some sort of forecast, but the future is by definition unknowable. Although no one can predict the future, you don't need to in order to have a successful investment experience. With capitalism, there is a positive expected return on capital.

#### 6. Risk and Return Are Related

Markets are drawn to a state of equilibrium where risk and return are related. Returns come from risk. Financial science over the last fifty years has brought us to a powerful understanding of the risks that are worth taking and the risks that are not. Only non-diversifiable risks are rewarded with higher *expected* returns.

#### 5. Diversification Is Key

Diversification is the closest thing there is to a free lunch. Proper diversification increases the likelihood of earning expected returns and may reduce risk you are not being compensated for taking.

#### 4. You have Brought Discipline to the Process

Capital markets are noisy; but in the face of that noise, you have learned to maintain your discipline and stick to a long-term investment strategy in order to have a successful investment experience that captures

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RESEARCH UPDATE

US Core Portfolios - US Core Equity 2 and US Vector Equity

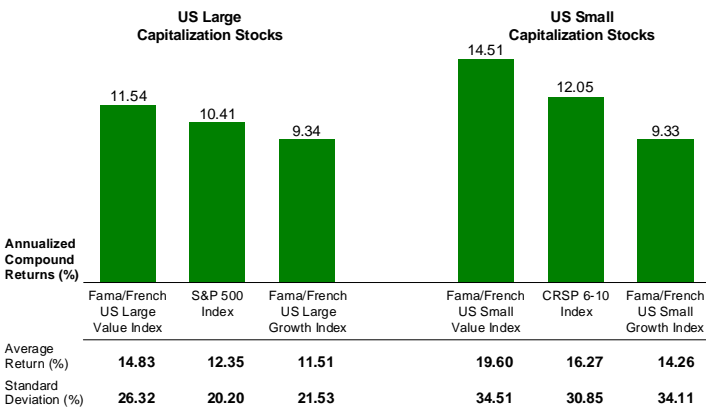
Oakwood's research has led us to select the DFA US Core Equity 2 (Core Equity 2) and the DFA US Vector Equity (Vector Equity) portfolios as part of a larger allocation to US equities. Core investments are the workhorses of your portfolio. What do we mean by core? A core holding is just what it sounds like: It's the central part of your portfolio. The core requires an investment that will be reliable year in and year out. It is a solid foundation of your investments, and as such, should provide stability. For purposes of this discussion, we will focus on the Core US Equity portion of client portfolios.

As you can see in the Structured Global Equity Strategies section of this edition of the Oakwood Outlook, each Global Equity strategy (Conservative, Moderate, and Aggressive), consists of varying percentages of the US equity market. In constructing this portion of client portfolios, the Core Equity 2 for the Conservative Global Equity Strategy, and the Vector Equity, in differing percentages, for the Moderate and Aggressive Global Equity Strategies.

How do the Core Equity 2 and Vector Equity Portfolios differ?

The primary difference between the Core Equity 2 and the Vector Equity Portfolios is their respective exposure to value and small capitalization stocks, and the resulting differences in volatility as measured by standard deviation. A company's size is determined by measuring its market capitalization and its placement on the value/growth spectrum is measured by using the ratio of a company's book value to its market value (BtM). We are well grounded in the scientific evidence that relative performance among stocks is largely driven by two 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.

Size and Value Effects in the US Annual: 1927-2006



Fama/French data provided by Fama/French. The S&P data are provided by Standard & Poor's Index Services Group. CRSP data provided by the Center for Research in Security Prices, University of Chicago. Small company risk: Securities of small companies are often less liquid than those of large companies. As a result, small company stocks may fluctuate relatively more in price. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.

Oakwood clients have the distinct advantage of having their US Core Equity portfolio invested in the Core Equity 2 or the Vector Equity portfolio, with its increased exposure to small capitalization and value

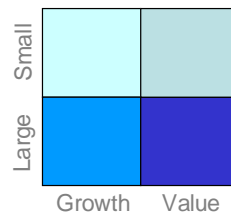
companies. While both the Core Equity 2 and Vector Equity have a tilt towards value and small capitalization stocks, the Core Equity 2 has less exposure to these areas, and less volatility, than does the Vector Equity Portfolio. The weighted average market capitalization for the Core Equity 2 is \$57.2 billion as compared to the Vector Equity of \$29.7 billion. The weighted average BtM ratio of the Core Equity 2 is 0.50, as compared to the Vector Equity weighted average BtM ratio of 0.63. Note that the higher the ratio, the higher the value orientation. When comparing either of these measurements to the total stock market, you can see a tilt towards value and small capitalization stocks, as shown below.

Equity Characteristics	Core Equity 2	Vector Equity	Total US Equity Market
Number of securities	3,546	3,419	4,297
Weighted average market capitalization (in millions)	\$57,227	\$29,743	\$71,388
Median market capitalization (in millions)	\$588	\$496	\$517
Weighted average book to market	0.50	0.63	0.39
Median book to market	0.47	0.53	0.41

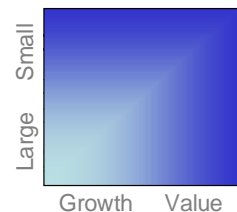
How are the Core Equity 2 and the Vector Equity alike?

Both the Core Equity 2 and the Vector Equity portfolios invest in the US equity market with a tilt toward small cap stocks and value stocks. By spreading the investment gradually across all but the largest growth stocks in the market, the Core Equity 2 and the Vector Equity portfolios can hold stocks for maximum efficiency and minimize counterproductive trading costs. The result is the inclusion of the maximum number of stocks in the asset classes that have historically provided higher expected returns. To integrate the portfolio, the US market is divided into a number of book-to-market (BtM) and size categories. To achieve a value tilt relative to the market, the portfolio's target weights are gradually increased for stocks in the value (highest BtM) category and decreased or eliminated for stocks in the growth (lowest BtM) category. The portfolio's small cap exposure is achieved by gradually increasing the target weight of small cap stocks relative to their market weight and by decreasing large cap stocks.

The graphs below depict the integrated approach that the Core Equity 2 and Vector Equity Portfolios take in investing.



Traditional asset allocation uses components that segment a portfolio



Core Equity 2 and Vector Equity provides multi-factor tilted exposure to the entire market

Asset allocation is traditionally achieved by investing in a core portfolio that replicates the characteristics of the total equity market or by building a portfolio from component asset classes. The US Core Equity 2 and Vector Equity Portfolios provide total market representation by targeting increased exposure to small cap stocks and value stocks across the US equity market.

A focus on the whole rather than the parts frees us to choose portfolio components based on the right reasons—their cost, consistency, strength of design, and tax efficiency. ■

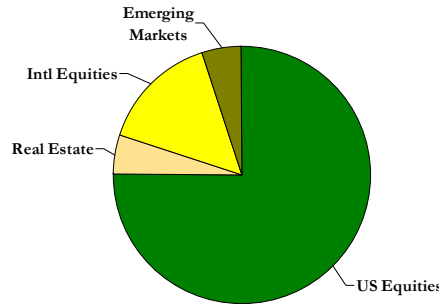


**STRUCTURED GLOBAL EQUITY STRATEGIES**

World stock markets extended their winning streak in 2007, outperforming the US for the fifth year in a row thanks to respectable gains in emerging markets and a weakening dollar. Global equity markets ended the year 2007 in positive territory, with the exception of small capitalization stocks, and the real estate sector. Both in the US and internationally, growth stocks outperformed value stocks. Industrials, energy and technology were the best performing sectors in the US, with consumer services and financial services being the laggards. International mid-cap growth stocks and real estate were, respectively, the best and worst performing asset classes for the fourth quarter.

**Oakwood Conservative Global Equity**

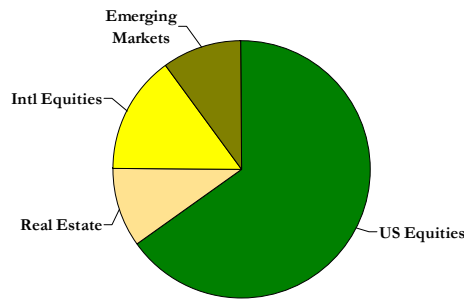
- Balance of value and growth as well as large, medium and small capitalization stocks
- Suitable for investors seeking income and long term capital appreciation



The Conservative Global Equity strategy posted a positive return for the year 2007. Its reduced exposure to smaller capitalization companies and its increased bias to US large capitalization companies aided its return. This strategy also benefited from its allocation to emerging international markets.

**Oakwood Moderate Global Equity**

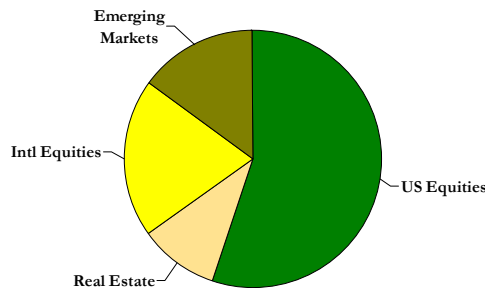
- Has an increased bias towards value by using multiple asset classes and greater emphasis on smaller capitalization stocks than the conservative strategy
- Suitable for investors seeking above average returns through long term capital appreciation



The Moderate Global Equity strategy had a positive return for the year 2007. Its exposure to emerging international markets enhanced the return. Its increased bias to smaller capitalization and international real estate diminished returns.

**Oakwood Aggressive Global Equity**

- Has a higher non-US companies component as well as a greater value tilt and emphasis on smaller capitalization stocks than the moderate strategy
- Suitable for investors with a higher tolerance for risk seeking higher returns through long term capital appreciation



The Aggressive Global Equity strategy had a positive return for the year 2007. The increased exposure to emerging international markets helped returns. The strategy's increased bias toward small capitalization, both on the domestic and international side, as well as international real estate, diminished returns.

**What Helped Strategies for the Quarter:**

- Emerging Markets
- US Large Growth

**What Hurt Strategies for the Quarter:**

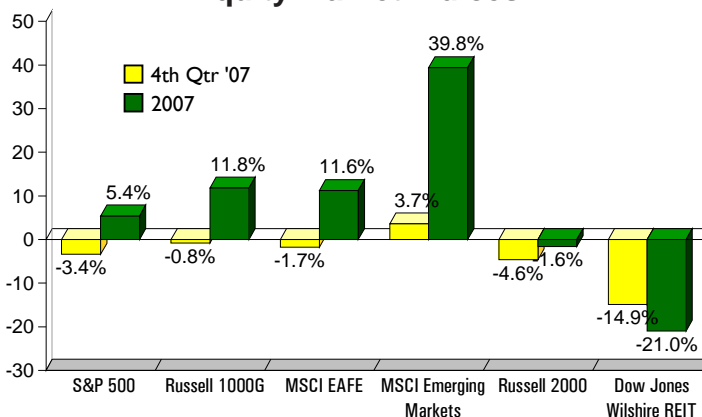
- International Small Cap
- International Real Estate
- US Large Cap Value
- US Small Cap Value

**EQUITY INCOME & CAPITAL APPRECIATION STRATEGIES**

Starting this past summer, as credit turmoil in the US began to reverberate across global markets, several factors combined to support stocks world-wide. Commodity prices, which have underpinned the boom in many overseas markets, remained strong. Fears of a potential contraction in the US economy were counterbalanced by expectations that much of the rest of the world would continue to expand. Most Asian stock markets, led by China, Hong Kong and India, in fact continued to outpace the US in 2007, reaching record highs in the second half after a mixed performance in the first half of the year.

Despite some jitters about credit markets and the housing market, the S&P 500 Index, a broad measure of the US equity market, ended in positive territory for the year despite a fourth quarter decline. Even though the performance of the S&P 500 Index was negative for the quarter, compared to value stocks, it fared relatively well, as over 50% of its composition is US large capitalization growth companies. For the year 2007, clients' exposure to emerging markets and international developed markets gave a solid boost to returns. In other time periods, other asset classes will be the top performers, such as the year 2006, when US real estate was the top performer.

**Equity Market Indices**



Source: Frank Russell Company, Standard & Poor's Index Service Group, MSCI data copyright MSCI 2005, Dow Jones Indexes, Oakwood Capital Management LLC

Some experts remain confident that the US economy will withstand pressures and escape recession, with a combination of Federal Reserve (Fed) interest rate cuts and the ripple effect from strong growth in places such as China and India. **High quality multinational companies, such as those found in Oakwood Equity Income and Capital Appreciation portfolios, will benefit from these factors and continue to grow and expand.** However, the current combination of high energy prices, weakening employment, real estate deflation and tightening credit conditions mirror the conditions of 1991, the last time the US experienced a recession.

Looking forward into 2008, we anticipate the real Gross Domestic Product (GDP) growth in the range of 1 to 2%, and profits, in general, to decrease. We also anticipate an increase in volatility, which was already on the increase in the second half of 2007. You may recall the following chart, which we have updated. At its recent peak on August 16, 2007, the Volatility Index (VIX) was up 108% from 50 trading days earlier. Since 1990, there have been only six other peri-

ods of such intense short-term volatility. Each time, the S&P 500 was higher one, three and six months later. History is not a perfect guide, but the table highlights the market's tendency to recover, at least in the short term, after volatility spikes.

**Market Performance After Volatility Spikes**

Date of volatility spike	Volatility 50-day rate of change	S&P 500 Change After Volatility Exceeds 90%		
		One month later	Three months later	Six months later
8/23/1990	109.8%	1.4%	2.6%	18.9%
4/4/1994	113.9%	3.2%	1.7%	5.2%
8/31/1998	102.0%	9.5%	21.6%	29.1%
9/17/2001	119.1%	4.9%	9.2%	12.2%
7/22/2002	94.2%	16.0%	9.7%	8.3%
6/13/2006	109.0%	4.0%	7.3%	15.4%
8/16/2007	108.0%	2.8%	3.9%	?
<b>Average</b>	<b>108.0%</b>	<b>6.0%</b>	<b>8.0%</b>	<b>14.9%</b>

Source: Oakwood Capital Management LLC, Charles Schwab, Bespoke Investment Group, LLC.

**Our well diversified, high quality client portfolios were positioned to withstand the volatility during the quarter, generating very favorable quarterly and annual returns.** We continue to be cautious towards the US equity market, and therefore, we remain well diversified with no individual position over 4% of the portfolio at its cost.

For this last quarter, we have added and sold certain stocks that we believe are appropriate for each of the different strategies. We would like to share with you the fundamental reasons behind these decisions. Please note that the stocks described below represent our major purchases and sales and do not include every stock purchased and sold for the quarter.

We have been underweighted for some time in the financial sector, which has been a tremendous benefit to client portfolios. We are selectively adding to the financials as we see opportunities, like the recent addition of a major bank. Its wide economic moat is derived from a geographically diverse core deposit base, higher customer switching costs, and scale advantages in the asset-management and mortgage servicing business that fortifies its profits against competition. **We believe returns on equity will remain around 20% for the next five years.**

Another new name in certain Oakwood equity strategies is an integrated energy firm controlled by the Brazilian government. At the end of the last fiscal year, the firm posted proven reserves of 11.4 billion barrels of oil, equivalent with average daily production of 2.3 million barrels. This company's daily refining capacity is greater than 2 million barrels, representing more than 98% of Brazil's total refining capacity. The company also has 6,600 retail outlets in Brazil. It plans to increase its oil and gas production by more than 7%, compounded annually, between 2006 and 2012. This firm has improved its financial flexibility and has started reducing its debt load.

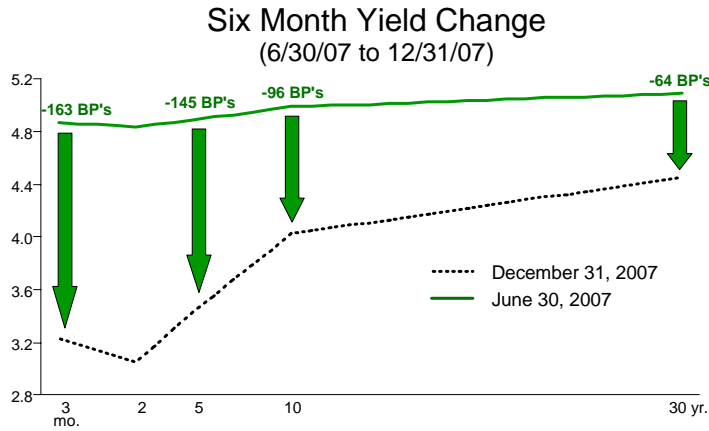
In the healthcare sector, we recently added the world's largest medi-



**FIXED INCOME STRATEGIES**

**Taxable Fixed Income Strategy**

We are pleased to report excellent taxable bond results for Oakwood clients for the year 2007. In fact, despite all the angst about higher energy costs and a weak U.S. dollar, total returns for Oakwood fixed income strategies easily exceeded reported rates of inflation and their respective benchmarks. As shown in the following graph, since June 30, 2007, Treasury yields, aided by multiple Federal Funds rate cuts, fell precipitously throughout the yield curve.



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

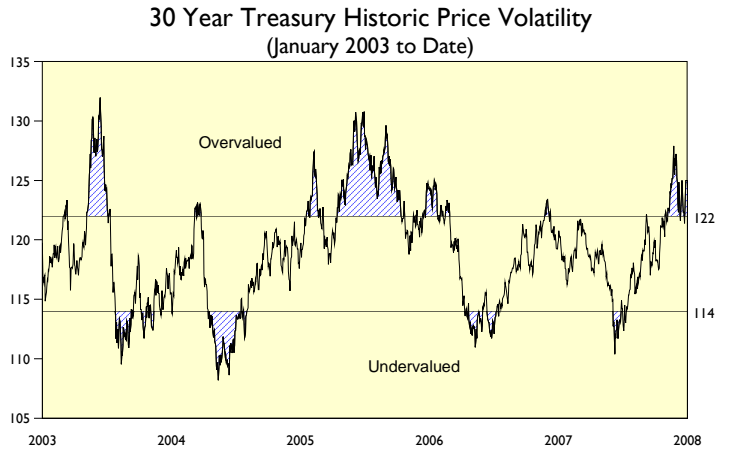
Investors who chose higher yielding or more complex investment strategies fared poorly and received little or no benefit from the decline in Treasury yields. By contrast, over this period, we systematically reduced our more vulnerable corporate and Federal agency holdings and resisted temptations to “chase yield” in the mortgage backed sectors. Instead, we allowed many of our Agency holdings to shorten or mature. Furthermore, we initiated sell programs in order to accelerate the move to more liquid U.S. Treasuries.

Now that yield spreads have widened dramatically, the yield relationships between the corporate and Treasury sectors favor corporates. Even rock solid companies such as General Electric, Toyota and Costco have seen their yield spreads widen in sympathy to the market. We are in an excellent position to take advantage of this widening. We have begun by investing in Deere & Company and McDonald’s Corporation. Both have been resilient to periods of stock price volatility and remain in an enviable position to grow both domestically and internationally.

Our goal is to move slowly and selectively. While the negative effects of sub-prime housing should soon wane, overall declines in housing values are likely to impact future consumer spending plans. This increases the risks of an even harder landing for the U.S. economy in

2008 and the potential for negative earnings surprises. This could force yield spreads to widen even further.

Furthermore, the recent news on inflation has been somewhat negative, not to mention the import cost implications from a weaker dollar. This may force the Federal Reserve to slow its pace of interest rate cuts. To date, we have been careful to remain fully invested; however, based on historical Treasury price patterns (shown below), we may begin to shorten our durations and utilize cash as a defensive management tool.



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

As we have seen over the past four years, volatility of long-term Treasury prices provided investors an opportunity to take gains at market highs or position themselves for a rally at market lows. While we ultimately expect yield levels to move much lower, this trading pattern remains intact.

Meanwhile, we will monitor the movements in stock prices, employment, energy and consumer spending patterns for signs that long bond prices will break-out on the upside. So far, most stock market indices have been resilient to the bad news in housing; however, this may start to change as cautious consumers and rising fuel costs turn even more negative.

**We stand ready to meet all challenges during the New Year. Our current portfolio choices are ideal for this environment and because they are very liquid, we can modify our current holdings quickly. Overall, our forecast for bonds in 2008 is favorable. Once we get past this short term inflation concern, bond returns should easily outpace inflation. More importantly, our risk sensitive approach to bond management makes good sense as we move forward. ■**



## FIXED INCOME STRATEGIES

### Tax Exempt Fixed Income Strategy

This past year has been an interesting and challenging year for tax-free investors. Until now, most economists were confident that the economy would remain resilient and the impact on the overall economy from sub-prime mortgage losses would be limited. Unfortunately, delinquencies on mortgages to the riskiest borrowers reached a 20-year high in the third quarter. While the total number of these types of loans may be somewhat small in relation to the entire housing market, repossessions accompanied by distressed sales are sending property values lower. This in turn will begin to reduce the level of tax receipts to towns and cities throughout the country. Even the more historically stable states such as Vermont and Texas are seeing weakness in the housing sector.

As a result, we have seen yield differentials between AAA municipal bonds and lower or unrated debt widen three fold, or 2.5 percentage points, to well over 6%. This deterioration is a result of fear, especially for the mutual fund manager or individual investor that invested heavily in low quality securities. Unfortunately, the price erosion can be quite negative while the liquidity of their holdings is severely hindered.

**In past issues of the Oakwood Outlook, we stressed the importance of retaining only high quality bonds and we emphasized our reluctance to “chase yield” by compromising quality standards. Because of this, our yearly performance is very favorable and the liquidity of the securities in our portfolios remains very high.**

This provides us with some advantages as we enter 2008. Our first recommendation for the year is to invest in those states that impose little or no state tax on their residents or to pick local municipalities managed in a fiscally responsible manner. Specific to California, with its high state tax, we have placed a mandate to purchase only the municipal bonds of strong local communities or bonds with a direct revenue stream in support of its debt. This means that we have chosen to avoid state level California debt, unless it is collateralized by Government securities or has insurance attached, and a final ma-

turity not to exceed four years. **As we enter 2008, we have not changed our view on these security restrictions.**

Second, over the past several years, we placed an emphasis on “above market” cash generation from scheduled coupon payments, as a protection against higher interest rates. Recently, many of these holdings are becoming pre-refunded and are now backed by Government collateral. This dramatically improves the liquidity of these holdings and allows us the potential to swap in favor of yield improvement.

A factor weighing heavily on the markets is the deterioration in most municipal bond insurance carriers. As an example, bonds sold by state governments make up about 33% of the insurance premiums collected by MBIA and 50% of revenue for AMBAC, two leading insurance companies that offer municipal bond insurance. They too found themselves straying into risky structured products such as collateralized debt obligations (CDOs). **While most of the municipal bond insurers should retain a high quality rating, it places the burden of quality directly on the underlying creditworthiness of the town or city that issued the bonds.** Prior to the announcement of these problems, we had taken protective measures by requiring that holdings in Oakwood portfolios have a strong single A minimum underlying quality rating, or AA rating without insurance. On the positive side, Warren Buffett recently received approval to establish a new bond insurer, and has received the highest AAA credit ranking from all of the major ratings agencies. This will help to stabilize the markets and provide a future source of new securities.

As outlined above, our previous decisions have proven to be of benefit to our clients. We are in an excellent position to meet any client cash needs and have the flexibility to take advantage of future market opportunities. Looking ahead, we believe this year will be very rewarding to tax-free investors. **The yield separation of tax-free versus taxable Treasury investments is at its narrowest separation in many years. As this relationship begins to return to its historic normal range of 75% to 85%, the municipal bond sector should easily outperform taxable bonds, especially on a taxable equivalent basis. ■**

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#### Equity Income & Capital Appreciation Strategies continued from page 4

cal-equipment maker, maintaining greater than 50% market share in its core heart devices. It also holds market-leading positions in spinal products and insulin pumps. This company expects to launch three artificial disc systems in the United States in 2008-09, including the first cervical discs. **It enjoys great profitability, with returns on invested capital that are more than double the firm’s cost of capital.**

A company in the Technology sector was recently added to certain client strategies. It is a global provider of processing services to financial institutions in the US, including check services, card issuer and transaction processing services, risk management services, mortgage loan processing and outsourcing services. The company is a

solid cash-flow generator with sustainable competitive advantages. **It is solidly profitable, with an operating margin of 14% in the last fiscal year. Margins should improve as a result of the falloff of integration costs and economies of scale from acquisitions. We project operating margins to hit 19% by 2011.**

Lastly, we recently sold a holding company in the consumer services sector at a profit. It has operations that are grouped into three segments: mountain, lodging, and real estate. While a predominant amount of its profits are derived from its ski resort properties, we felt its exposure to real estate development in this volatile environment made its risk profile no longer suitable for Oakwood client portfolios. ■



Word from the Advisor  
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capital market rates of return. Some studies conclude that individual investors underperform the market by as much as 5% over time, likely due to a lack of discipline that results in chasing hot stocks or hot funds or by trying to time the markets.

### 3. Investor, Know Thyself

Investors often exhibit behavioral biases that can lead to poor investment decisions. You have learned that overconfidence, self-attribution, mental accounting, searching for patterns, hindsight, regret, and fear are cognitive biases and emotions that Oakwood Capital Management has helped you overcome in order to promote both your wealth and well-being!

### 2. Costs Matter

All investors in the aggregate form the capital markets. Therefore, it must be the case that the average investor earns the market rate of

return less fees and expenses. Managing costs (management fees, operating costs, trading costs, taxes, etc.) allows you to capture more of the capital market return that is there for the taking. We help to keep costs down and increase your net return on investment.

### 1. Oakwood Capital Management is your wealth management advisor

Our mission at Oakwood is to provide our clients with outstanding investment and wealth management services. The time-tested investment process we use to tailor portfolios to our clients' specific needs is based on quantitative and qualitative techniques and sound research. We all know that anyone can go to the store to buy flour, eggs, sugar and butter. The "magic" occurs in how those ingredients are put together to create a culinary masterpiece. The same is true of stocks, bonds, or mutual funds. The "magic" occurs when these investment vehicles are properly structured to create a portfolio that matches your risk tolerance and return objectives. ■

