Oakwood Outlook

& Quarterly Review

Volume 11, Number 2 April 2008

A Word from the Advisor

To Oz and Back

Here in Tinsel Town, we're known for manufacturing appealing fairy tales like MGM's enduring 1939 cinema classic, "The Wizard of Oz." In this iconic film, four travelers traverse a golden path, each in pursuit of a personal objective. Arms linked in camaraderie, the lion, scarecrow, tin man, and a girl in ruby-red slippers ramble through a vast Technicolor maze. All are seeking opportunities "somewhere over the rainbow."

And yet, the movie's murkier and more disturbing moments reveal a road that is anything but a straight shot. Strewn with obstacles and challenges, it twists and it turns. It requires grit and determination for the babes-in-the-woods to reach their goal on an increasingly harrowing journey.

Back to reality, the U.S. stock market's five-year bull run lulled, transfixed, and even mesmerized some investors into believing that what goes up … will continue to go up. Who has not been tempted by such a fantasy? Recent market behavior (one-hundred-point upward lurch one day; two-hundred-point downward jolt the next) serves as a not-so-subtle reminder that twists and turns are not only a part of the Yellow Brick Road; they are inevitable in investment reality as well.

Skip the Popcorn …

Because we all know that our heroine reaches her goal in the end. Indeed Dorothy comes full circle, realizing, while still in glittering Oz, that "there's no place like home." The film suggests that we all have tremendous inner resources and capabilities to help us achieve our personal goals. That's why, in times of market turbulence, we poignantly draw upon Dorothy's insight to advise clients to stay the general course. Allow us to quote from last quarter's *Oakwood Outlook*:

Investor, Know Thyself!

> *Investors often exhibit behavior 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!*

And remember that it's a long and winding road … with the way ahead not always clear. The path is fraught with obstacles and challenges. Investors who remain rational and patient and who have at least a five-year time horizon will benefit most from Oakwood's conservative style of equity management.

Brainy Scarecrow

We see investors stumble all the time, in ways large and small, along their investment pathway. They hesitate, they second guess, and they fall prey to their emotions. One major benefit of working with a manager like Oakwood is that we insulate clients from emotional investing. This is smart thinking. And because we share a mutual interest in making your money grow, you have in us a solid, interested partner. We are not paid per transaction; therefore our decisions are truly objective, with no conflict of interest. This also makes good sense. In short we are

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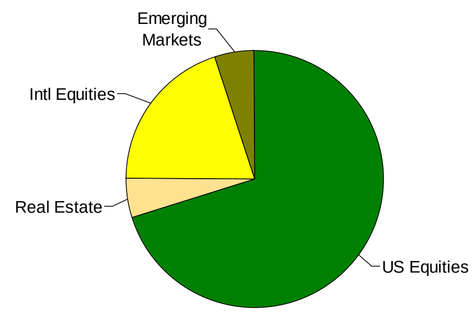
Oakwood
Capital Management LLC
1990 South Bundy Drive Suite 777
Los Angeles, CA 90025
www.oakwoodcap.com
310-772-2600 800-586-0600

Structured Global Equity Strategies

The US financial market's mortgage-driven crisis left no region of the world untouched. In both the developed and emerging economies of Europe and Asia, stock markets fell dramatically, experiencing their worst quarter in years. Foreign shares, which had outperformed US stocks consistently since 2002, reversed course and lagged the US market. The relatively milder drop by US stocks provided a cushion for our portfolios, which consist of a balanced global exposure to 40 different economies and includes a range of 50 - 70% US-market exposure. Our broadly diversified approach also captured gains in smaller markets like Taiwan and Mexico. U.S. real estate was the best performing asset class in the first quarter; emerging markets was the worst.

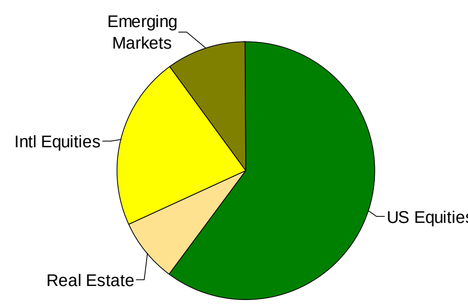
Oakwood Conservative Global Equity

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



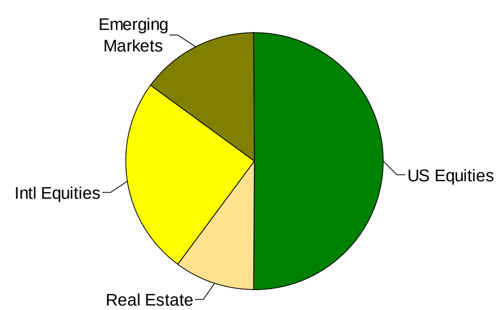
Oakwood Moderate Global Equity

- 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



Oakwood Aggressive Global Equity

- Has a higher component of non-US companies, 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



What Helped Strategies for the Quarter:

- US Real Estate Investment Trusts (REITS)

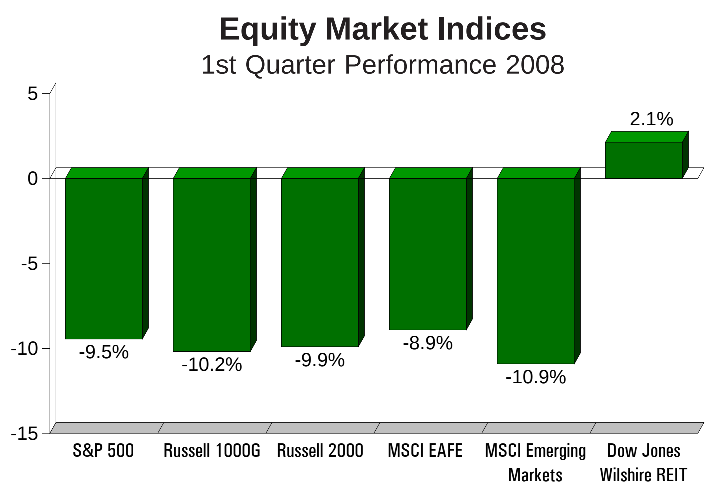
What Hurt Strategies for the Quarter:

- Emerging Markets
- US Micro Cap
- US Small Cap
- US Large Company

Equity Income & Capital Appreciation Strategies

A Tough Start to the Year

The drop of 9.45% in the Standard & Poor's 500 index during the first quarter was an admittedly grim start to the new year. This decline put Oakwood clients into a new reality following five years of buoyantly bull markets. Now is the cycle's tough time—requiring investors to hunker down, a message we playfully address in the *Word from the Advisor*. The surfeit of scary statistics might spur the bravest of investors to stash the cash under the mattress, to which we say: resist! We see a stock market that has recovered smartly from its lows, and a boom whose frothy exuberance has been well wrung dry. When you consider the S&P 500 from its October high to its recent low, you see an approximate 20% decline. This is the perfectly normal process by which markets shake out the excesses and form new foundations on which to build and advance. While higher volatility may continue and the markets may test the lows again, we expect improvement over the coming year.



Source: Frank Russell Company, Standard & Poor's Index Service Group, MSCI data copyright MSCI 2008, Dow Jones Indexes, Oakwood Capital Management LLC

Yes, there has been pain and suffering. Yet by applying our skill, Oakwood clients were spared the hardest knocks. Our quarterly results fared considerably better than did overall market performance. While the S&P 500 and Russell 1000 Growth Indices were both down around ten percent, our Equity Income and Capital Appreciation portfolios declined only modestly, healthily outperforming their benchmarks.

The most dramatic event of the quarter took place on March 16th, when concern over sub-prime mortgage lending took alarming form in the collapse of one of Wall Street's most formidable houses, Bear Stearns Co. Dangerously exposed to mortgage-backed security debt and lack of liquidity, Bear Stearns may not be the last fatality of the sub-prime debacle. The story here is still unfolding, so, please stay tuned.

Unparalleled rescue actions by the Federal Reserve and the U.S. Treasury shored up the financial system in the short run, but doubts still linger about the U.S. economy's health and the stock market's direction. The "R" word is now openly discussed, even by Chairman Bernanke, with the only debate over how long and how deep a recession. Equity investors are buckling their seatbelts across the globe to withstand a bumpy ride.

Wall Street's optimists believe that a turning point will arrive sooner rather than later, thanks in large part to the coordinated efforts of the Fed and the Treasury to stabilize the financial system and reduce short-term interest rates. There seems to be a concerted effort in both Washington and New York to rebuild confidence in the system.

Pessimists contend that the pain has just begun, with job losses and home price declines accelerating. Meanwhile, raw material and energy costs remain stubbornly high, despite a slowing economy that is pinching consumers and crimping corporate profits.

Our Take on the Economy

Although they are clearly synergistic, the two sets of issues confronting the equity investor are in fact separate: those of the financial system and those belonging to the economy per se. As the year progresses, we believe emphasis will shift from the financial system crisis to that of the overall economic cycle.

Given the data, we do concur that recession is upon us—factory activity is soft, confidence numbers imply deep consumer recession, the central bank is still getting minimal traction, durable goods reports are soft, the home price index is in decline, profits are running at their slowest pace since 2001, and jobless claims are rising. Altogether, not a pretty picture.

Our expectation is that recent government tax benefits and the actions of the Federal Reserve and the Treasury can help soften the severity of the downturn by the end of the year. We also have the upcoming taxpayer "stimulus" check intended to spur consumer spending that may get channeled instead into paying down the family debt.

An additional stress facing the economy is the **credit market crunch**. The Federal Reserve and the government are finally coming together to offer help to the credit market. The lowering of the Fed funds rate, the opening of the discount window to banks for non-liquid assets and the change of Fed policy to allow financial institutions to collateralize non-liquid mortgages, and the changing of the equity requirements for Freddie Mac and Fannie Mae to 20%, down from 30%, will go a long way to ease the strain in the credit markets.

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Fixed Income Strategies

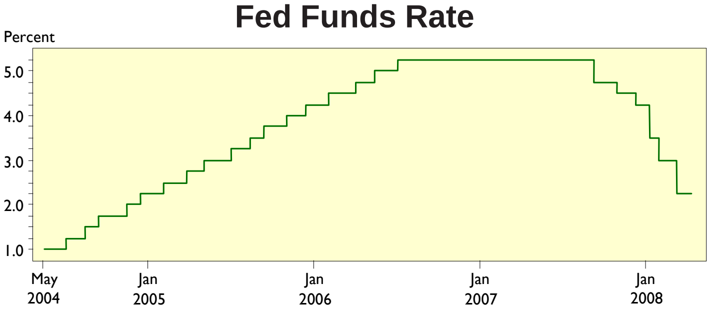
Spirals are Reversible

Taxable Bond Commentary

The lowering of the Fed funds rate to 2.25% on March 18th marked the Federal Reserve's sixth consecutive cut since the rate peaked at 5.25% in August 2007. While additional cuts cannot be ruled out, the Fed's aggressive actions are making investors wary of inflation. On the other hand, battered credit markets and the illiquidity of many investment vehicles are a clear threat to economic growth. This self-feeding economic downturn is becoming entrenched—with erosion in financial conditions reinforcing predictions of recession.

The chart depicts the Fed's attempt to assist our faltering economy with its decisive monetary policy easing.

Fed Funds Rate



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

The heart of the U.S. economic problem is housing. The collapse of the sub-prime mortgage market has led to $208 billion in write downs or credit losses since the start of 2007. This is causing home values and consumer confidence to spiral downward to the point of pushing the likes of Bear Stearns to the brink of bankruptcy. Not since the 1973 oil embargo have consumers been so pessimistic about the economy.

Strong Positioning Helps Portfolios

Despite these problems, Oakwood clients nonetheless experienced steady improvement in the value of their fixed-income assets. Last year, anticipating these problems, we significantly reduced our exposure to financials and allowed many of our federal agency holdings to mature or be called prematurely. With the proceeds we overweighted U.S. Treasury securities. This action was taken as a protective measure to deteriorating credit conditions and to benefit from declining interest rates.

In the year's first quarter, we reversed that decision. We began swapping select Treasuries to mostly non-financial corporate bonds, e.g., McDonalds, General Electric, John Deere, and Berkshire Hathaway. We have also recently renewed our interest in both the Federal Home Bank and Federal Farm Credit Bank. We believe the mortgage credit freeze is forcing politicians to scrutinize the mortgage origination process and potentially redefine the Fed's role in conducting monetary policy. For example, along with the Fed's ability to conduct policy through open market operations, lowering of short-term rates or the availability of reserves in the system, the Fed must also convince investors of its readiness to support Government-sponsored agencies (e.g., Federal National Mortgage Association, Federal Home Loan Mortgage Corporation) in times of crisis. By contrast, we continue to avoid mortgage-backed securities. The clear identity of collateral, market place support, liquidity, credit support and investor confusion all contributed to this decision.

Affordable Mortgages to Give Positive Traction

The bottom line is that the U.S. public needs access to mortgages at affordable rates. Even with its aggressive monetary policy actions, the Fed has been unable to achieve this goal thus far. Rather than pass the lower borrowing costs along to consumers, we see banks tightening lending standards and applying the savings to rebuild their balance sheets. The evidence is that recent differentials between 10-year Treasury yields and fixed mortgage rates is 2.75%, one of the widest gaps since 1986.

It's possible that until the Federal Reserve stops the aggressive easing, the problem will linger. There's little incentive for banks to originate new mortgages by paying higher interest rates to attract deposits. Furthermore, the endless flood of Fed liquidity is rekindling inflation fears. This in turn raises 10-year Treasury yields and keeps fixed mortgage rates higher than they would otherwise be. We feel that homebuyers will re-emerge if fixed-rate, 30-year mortgages drop to around 5.50%, and if buyers qualify. According to the U.S. Census Bureau, nearly 18 million homes stood empty in the first quarter.

Looking Ahead

Our current duration target on portfolios is modestly aggressive to the respective benchmarks. We still like U.S. Treasuries in the 11 to 13 year maturity area. The present yield gain is +40 to +50 basis points versus 10-year alternatives.

The balance of the year should prove rewarding to fixed-income investors. While last year investors saw large gains in Treasury prices, this year the added yield in high quality corporate and agency bonds should benefit returns. We continue to closely monitor economic conditions and corporate earnings for signs that may alter our current outlook. ■

Fixed Income Strategies

Municipal Bonds Weather the Storm

Municipal Bond Commentary

In the year's first quarter, tax-free municipal bonds generated mixed results depending on maturity. Two-year municipals returned around +1.90%; 10-year munis returned +0.47%; and 20-year munis returned a negative -3.50%.

Oakwood client returns were positive, ranging from +0.40% to around +1.80% depending on client preference or restriction. In view of the weak economy and declining revenue growth to municipalities, we are pleased by these results.

We are experiencing the worst housing slump in 16 years. This problem is severe in states like California, where mandated spending increases are met with slowing revenues. With its $16 billion deficit, California is not alone however. A full half of U.S. states, including New York and New Jersey, are projecting budget deficits this year and Florida's credit was recently downgraded.

Troubled Insurers

Market prices on even the safest municipal investments have faltered, regardless of the municipal issuer's ability to meet debt obligations. Almost half of the outstanding municipal debt has an insurance support as a protection against default. Unfortunately, along with insuring municipal bonds, insurance carriers also guarantee mortgage-related debt. As housing defaults rise, many insurers are falling short of the required minimum capital. Even though the historic occurrence of tax-free-bond default has been rare (below 1%), this has triggered drops in credit ratings. Investors are naturally worried, and this helps to account for the sector's short-term underperformance.

Munis Relative to Treasuries & Corporates

It's surprising how well the value of most municipal bonds has held up—a testament to the sector's rare default experience and to ongoing strong demand. Tax-exempt bonds typically move in the same direction as taxable Treasury yields, although not at the same pace. The weak economy and problems surrounding sub-prime mortgage defaults has prompted the Federal Reserve to quickly and dramatically lower short-term interest rates. Considered to be the safest fixed-income investment, Treasuries respond rapidly to changes in the economy, inflation and Fed policy. Municipal and corporate bonds, by contrast, take into account credit quality, liquidity, and supply/demand characteristics and thus may not respond as rapidly.

We see current market conditions as an opportunity for municipal bonds. We have reached a point when municipals, like high-quality corporate bonds, are very attractive relative to Treasuries. In fact, the yield level on many tax-free bonds is now higher than Treasuries. As the housing crisis and the economy begin to stabilize, we expect municipals to easily outperform Treasuries. However, we must be very careful in our selection. We have consequently upgraded our quality preference to focus on Government-collateralized investments and issues that have a minimum underlying quality rating of AA. We also continue to avoid state-level California debt until the budget shortfall is addressed in a meaningful manner.

To take advantage of the recent attractive yield levels, we're adding 13 to 15 year maturities to portfolios. A tax-free yield of 4.40% equates to a taxable equivalent of more than 6.75%. By comparison, high-quality taxable corporate bonds are yielding around 5.75%, while Treasuries yield only 4.00%.

Demand will Remain as will Role of Insurers

As the November election approaches, it's unlikely that tax rates on the wealthy will fall and therefore demand for tax-free municipal bonds should remain strong. We're confident that the municipal insurer problems will be resolved. There are a number of adoptable proposals on the table: bank infusions of capital, government involvement, or a split up and sale of assets by quality. For now it's likely that despite the enviable high-quality nature of municipal bonds, many issuers will continue to augment their debt with insurance. For investors unfamiliar with the specifics of each municipality, this insurance provides quality reassurance.

Until issues surrounding the economy, housing and insurance carriers are resolved, we will continue to invest in only the strongest municipalities. We remain patient and careful prior to making investment decisions. Now more than ever, trading skill and due diligence are essential to capital preservation and the expectation of favorable investment performance. ■

Word from the Advisor
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able scarecrows—brainworkers armed with the experience and knowledge to speed and protect you on your journey.

Remember that Oakwood adheres to a wealth management approach that creates properly structured portfolios that are periodically fine-tuned or rebalanced, with diversification of risk along different asset classes.

Here's a perfect example of the need to diversify by asset class: The top-performing asset class for the 1st quarter of 2008 was the Dow Jones Wilshire REIT Index of US real estate investment trusts which was up +2.14%. In the current real estate downturn, few would have expected this to be the case. We believe that our clients should not be trying to second-guess which asset class will outperform in a given year. This belief grounds us in our dedication to creating well-structured, diversified portfolios with exposure to many asset classes.

Big-hearted Tin Man

Our value proposition as a firm: we free you and your family to enjoy the wealth you have created and to live life fully, secure in the knowledge that your investment manager is moving your assets in the right direction. The value we impart is the confidence that your best financial interest is being actively pursued and managed. Indeed our entire aim is to liberate you from the daily anxiety of monitoring financial markets.

Our foundation in taking you, as our client, safely on this adventure rests on our ability to listen carefully and understand real human beings and their families—their values, goals, relationships, assets, advisors, processes, and interests. The ensuing dialogue illuminates financial objectives and clarifies the risk you are willing to tolerate in order to achieve your goals. We then know how to properly structure your portfolio and diversify assets in order to withstand difficult periods like now. On your side, you should stay focused on who you are, and where you want and need to be.

Courageous Lion

After decades of wealth management experience, we note that discipline and bravely staying the course while making modest adjustments along the way will get you there. You cannot overestimate the positive effect that time brings to bear on a well-diversified, periodically rebalanced portfolio.

Because, frankly, we've all been through this before, haven't we? We've all lived through many market adjustments in recent decades. You are reasonably asking us how severe the fallout will be. Our no-less-reasonable response is that no one knows, short term. Yes, markets are challenging —sub-prime mortgage debt, the weak dollar, and the impending election. It's our job to get you through all the noise. By making rational adjustments en route, we can endure modest losses, certainly with some pain, while effectively positioning ourselves to re-emerge into a more robust market. And, remember: risk will be rewarded.

Self-possessed Young Woman

When Dorothy rambunctiously heads "off to see the Wizard" she has no idea that her journey will point her right back to where she began—only as a richer, more experienced, and savvier young woman. She ventures on her time-and-space travel without the necessary knowledge or tools to reach the finish line. While advancing down the road, she encounters detours, false alarms, missteps, and bad advice till she gets back on track. As Dorothy ultimately learns that reaching the Wizard is all about getting back to yourself, her story is a triumph. We at Oakwood are ready to guide you on this journey ... despite the twists and turns. Your patience will be rewarded. ■

Congratulations, Nick!

We're delighted to share the news that our colleague, Nicanor Mamaril, has been granted the title of Personal Financial Specialist (PFS) by the American Institute of Certified Public Accountants (AICPA). The PFS credential is granted exclusively to qualified CPAs who demonstrate broad-based financial planning expertise through their knowledge, skills and experience.

A Tough Start to the Year
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Another area of concern is **consumer debt**. The consumer has piled on additional debt during this cycle so that the ratio of interest and principal payments to after-tax income is now close to an all-time high of 14.3%, which is one-third higher today than this ratio was during other periods when interest rates were in double-digits.

Inflation pressures continue to mount as evidenced by higher consumer price index (CPI) rates which are being pressured by rising commodity prices. We believe the Fed has placed their charge to fix the economy first before addressing the inflation rate. One key issue is import prices; for example, import prices from China (now approximately 15% of U.S. imports) continue to move upward adding to the inflation pressure.

The combination of slow/negative economic growth underpinned by weak housing fundamentals, credit strain, asset deflation and weak employment may continue to keep interest rates in check.

Whither the Stock Market?

From a historical standpoint, valuation metrics – price-to-next twelve months estimated earning (P/E), price-to-sales (P/S), dividend yield (DY), price-to-cash flow (P/CF), and enterprise value-to-earnings before interest, taxes, depreciation and amortization (EV/EBITA) - do not show the market as overvalued. But with a slowing domestic and international economy, earnings are questionable. Thus, the current quantitative ratios may be generous. As a result, markets continue to be volatile.

Smart Thinking

We took positive and thoughtful actions during the quarter to protect and advance the interest of our clients, and it worked. Our overweighted position in healthcare proved a good thing, as several names outperformed nicely. Our best performer, with a positive return in the quarter, is the designer/marketer of orthopedic products including reconstructive implants and fracture management devices. Also catching the growth wave of the healthcare sector is a manufacturer of specialized medical devices and diagnostic imaging agents. In general, we do prefer equipment manufacturers and health management providers to pharmaceutical stocks.

During the last half of 2007, we were substantially underweighted in financials. We continue to underweight financials in the quarter although there are some high quality names that are becoming attractively priced. Consequently, we recently added a banking name to our portfolios. The bank is a diversified global financial services company headquartered here on the West Coast with operations around the world. It's the fifth largest US bank by assets, the ninth largest in the world by market cap, and the only bank in the United States to be rated AAA by S&P. We may add an additional financial security to client portfolios in the coming quarters.

Energy is another area we want to continue to overweight and we are once again attracted to companies that deal in magnesium, uranium, and copper.

Caution Ahead

Because of the uncertainty of valuations, we remain extremely cautious in our investing, preferring to broadly diversify and overweight the healthcare and energy sectors. In summary, our Yellow Brick Road may not glitter and sparkle with MGM Technicolor, but our underlying approach to wealth management remains strong. ■

Oakwood
Capital Management LLC
1990 South Bundy Drive Suite 777
Los Angeles, CA 90025
www.oakwoodcap.com
310-772-2600 800-586-0600