Oakwood Outlook

& Quarterly Review

Volume 11, Number 3 July 2008

The New Yorker

At checkout counter, cash register says "Hidden Costs."

A Word from the Advisor

Cost Matters

We invite you to consider one of Oakwood's key wealth management tenets: the notion that costs matter.

Oakwood's value-added comes in part from our ability to minimize the frictions of investing for our clients, costs among them. Along with asset allocation and proper portfolio structuring, cost containment is a crucial component of investment success.

Controlling the inevitable

Costs and expenses are inevitable in investing. The wealth management activity we undertake on your behalf—creating and managing portfolios, providing account statements, offering our customized advice and service—engenders costs. However, Oakwood's intelligent investing combined with our careful, conscientious scrutiny of costs—management fees, operating costs, tax costs, transactional costs, other expenses—positions our clients to capture an enhanced share of market return over the long term. While we cannot control the market's direction or its outcome, containing costs is one of the most powerful tools to increase the potential for investment success.

Long-held Oakwood policy

Cost containment has been integral to our service promise for years. This benefit applies to all Oakwood strategies across the board. Each one has a philosophy of best price and best execution while avoiding unnecessary turnover. We do not chase hot investment products, companies, funds, or the investment theme of the month. Instead, we stay true to our philosophy of seeking higher expected return over time with lower risk and minimizing costs. Remember, our sole compensation is a fraction of a percent, calculated quarterly, on your assets under management (this fee may be tax deductible). Our goal is to grow your assets while minimizing the frictions of costs and expenses.

Partnership with DFA

Most of you know that for several years Oakwood has forged a strategic alliance with Dimensional Fund Advisors ("DFA"), one of the industry's most consistently successful, low-cost, no-load mutual fund companies. Through DFA, Oakwood offers structured global equity strategies based on the science of capital markets with the objective of increased returns through state-of-the-art portfolio design and trading. DFA's asset-class-driven approach allows Oakwood to structure portfolios with easily understandable risk/reward dynamics, providing our clients with institutional execution consistent with our low-cost approach.

Oakwood has been approved by DFA to offer these extremely cost-effective funds in your Oakwood account. The fact that the general public cannot access DFA funds through retail or discount brokers relates strongly to cost. We've identified nine key building blocks of this cost-efficiency from DFA. Please note how well they synchronize with Oakwood's approach to wealth management:

- **Low expense ratio**
  This refers to the percentage of fund assets that go exclusively toward the cost of running a fund. The expense ratio is comprised of internal management fees, administrative costs, distribution fees, and other operating expenses. DFA fund expense ratios, compared to

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Structured Global Equity Strategies

In recent times, global stock markets have begun to move in sync. What's noteworthy about the second quarter of 2008 is the variety of ways in which a confluence of issues affected different markets simultaneously.

Global stock market returns for the second quarter, while mixed, were dismal overall — from Shanghai where shares were down 21%, to Paris, down 6%. Left unscathed was commodity-rich Canada where stock prices rose 8.4% and Japan, where the Nikkei staged a second-quarter comeback, up 7.6% following a loss of 18% in the first quarter.

The second quarter opened with hopes that the worst of a U.S.-led credit crunch was over. And growth did hold up better in some places. But another dynamic, inflation, took center stage as credit fears resurfaced. Some economists place the global inflation rate at 5.5%, up from 3.5% at the beginning of the year, thanks to soaring food and energy costs.

In addition to inflation, emerging markets like China and India are wrestling with the aftershocks of huge stock market run-ups in 2007. Europe is struggling with a weakened banking system. The U.S. is reeling from a double crisis: housing and record-high oil prices.

A year ago, when credit-market problems were building in the U.S. and Europe, investors saw Asia as a safe haven. In China, exuberant investors pumped stock-price valuations to a point where some stocks traded at more than 50 times earnings per share. Many of the region's stocks have fallen under the weight of expectations. In China, down 48% so far this year, higher raw-materials costs and a strengthening currency are squeezing profits.

India took a beating for the quarter, down 14%. Double-digit inflation has spooked foreign institutional investors, who have pulled out more than $6 billion so far this year, according to the Securities and Exchange Board of India.

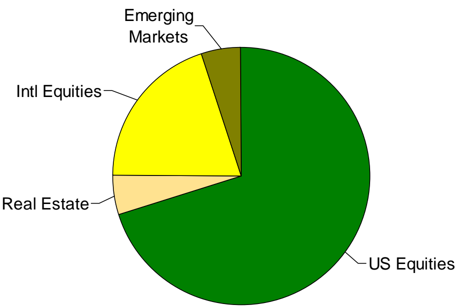
In Europe, major banks, overseeing billions of dollars of asset write-downs, are tightening lending standards for European companies just as soaring energy and borrowing costs take the wind out of corporate profits. Investors don't expect Europe's central bankers, with their hands tied by inflation, to do anything about it. Germany's DAX index fell 1.8% for the quarter and is off 20.4% for the year. The UK FTSE 100 fell 1.3% for the quarter and is off 12.9% for the year.

Some Latin American markets, buoyed particularly by Brazil's commodity-led economy, were winners. The MSCI Latin America emerging-markets index was up 10.1%, while the broad MSCI emerging markets index was down 1.6%.

The surge in the cost of raw materials is one reason that fast-growing commodities importers like China and India have taken a beating in recent months. By contrast, markets in Russia and Brazil, both producers/exporters of commodities, are still essentially flat for the year. The best hope for a turnaround would be a downturn in commodities prices, taking pressure off profit margins and inflation, and giving central banks room to maneuver. ■

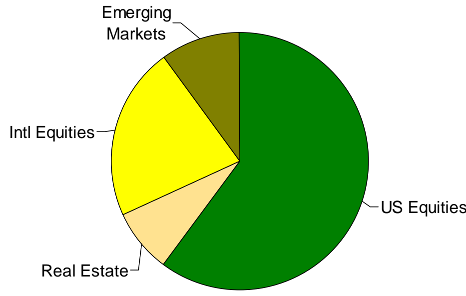
Oakwood Conservative Global Equity

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



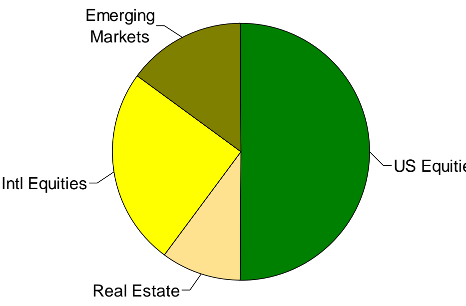
Oakwood Moderate Global Equity

- 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 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



What Helped Strategies for the Quarter:

- Low costs (please see *A Word from the Advisor!*)

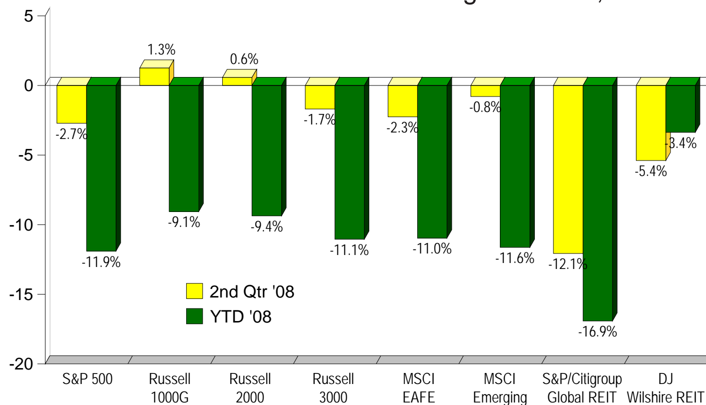
What Hurt Strategies for the Quarter:

- International real estate investment trusts (REITS)
- International value
- US real estate investment trusts (US REITS)
- US small value

US Equity Income & Capital Appreciation Strategies

Stock Market: Rebound Reversal

Rising energy prices and the credit market's ongoing problems sent stocks lurching downward in the second quarter. The S&P 500 index lost -2.7% to close at 1280, bringing this broad index of large-cap corporations down -11.9% for the first half of a tough year. Rallies in April/May that accompanied good corporate earnings reversed in June. Normally a month of pleasant weather and outdoor weddings, June 2008 (down 8.4%) bore the unpleasant distinction of being the stock market's worst-performing June since 1930 (down 16.5%).



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

The market's hope that the government's $168 billion stimulus-rebate program would revive the economy influenced the quarter. Retail, financials, capital goods, material and technology sectors all participated in the April/May uptrend. But momentum changed in June as concern about growing weakness came to dominate economic news. The U.S. economy now faces strong negative headwinds, as record prices for oil and other commodities are pushing inflation higher, and difficulties in the housing sector and availability of credit is suppressing economic growth toward recessionary levels.

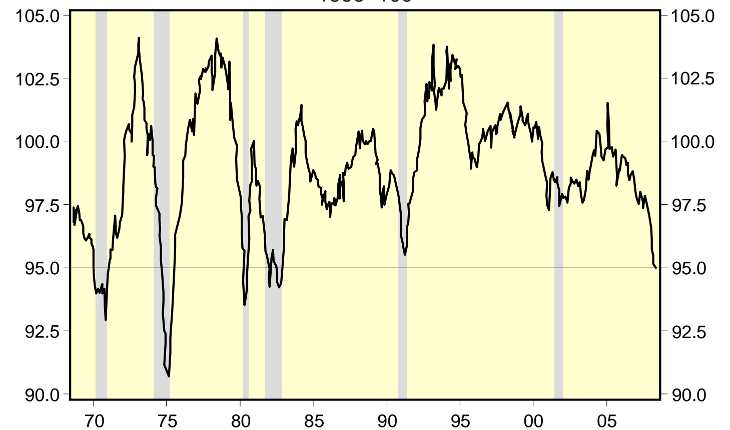
Consensus estimates of reduced second quarter corporate earnings put the stock market under increasing pressure. This consensus -the fourth quarterly contraction in a row - reflects that S&P 500 earnings per share will decline 9% over the next 12 months. Since financials comprise the largest market sector, their dismal performance - down 53% - has had an oversized impact on overall market performance. The best-performing sector is energy, up approximately +22%. Next quarter estimates are for +13.9%, but this number has been falling and will continue to decline. Lower estimates are the result of companies' limited ability to improve margins by passing on higher commodity costs through increased prices.

We clearly remain very cautious on the stock market. The key to success, we believe, is to continue to invest carefully in sectors/industries that offer good relative returns in the continuing market turbulence that awaits us. We adhere to our belief that well-structured, highly diversified portfolios are our best means of positioning to reap the benefit from the inevitable turnaround.

Market Outlook: Hope for the End of 2008

A recent Merrill Lynch/Haver Analytics study compared the S&P 500 to government indicators of the economy. The study caught our attention because it intelligently guess-estimates a timetable for market recovery.

The government's terminology for data-indicators—leading (before the economy turns), coincident (when the economy turns), lagging (following the economy's turn)—are great business cycle barometers and have been very useful in determining our position in the economic cycle. The study's intriguing aspect is its finding that the coincident-to-lagging indicator ratio has been a better indicator for projecting the economy's direction than the leading indicator alone.



Source: The Conference Board/Haver Analytics, Merrill Lynch

Based on May numbers (see chart), the leading economic indicator was up 0.1%, but the coincident-to-lagging indicator was down 0.1, to 95 – the lowest level since November 1982. According to the study, recession begins once this metric is 96.3 – precisely where it was in January 2008. At 95, the study suggests that the economy is about 20% of the way through a correction; which means that, typically, another 8 months (range 4 to 11 months) remain before the downturn ends. Historically the stock market generally bottoms four months before a recession ends. Thus, the average decline in the S&P 500 in that four-month time frame from the 95 level (on the coincident-to-lagging indicator) to the lows in the market, has been in the

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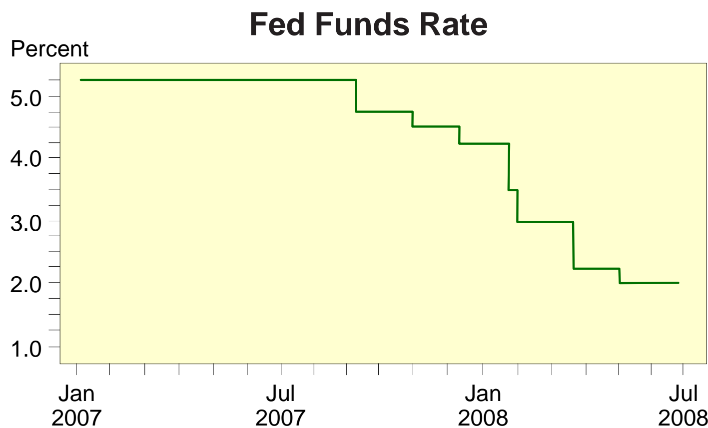
Fixed Income Strategies

Could the Economy Possibly be More Complex?

Taxable Bond Commentary

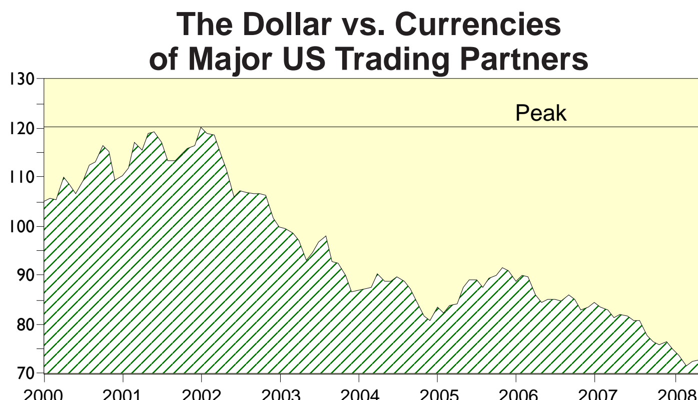
In recent Oakwood Outlooks, we explained the beneficial role we expected "yield" to play in 2008 investment returns, and we began to add yield to the portfolios by purchasing corporate bonds. Our goal was a targeted 45-50% corporate-bond allocation, a significant increase over last year's target of 20-25%. This marked departure from our 2007 strategy, when we focused on "price action" as a means of capturing return, proved to be successful, as weak economic conditions propelled a bond rally and forced the Federal Reserve to lower short-term interest rates. The chart depicts the dramatic shift in monetary policy.



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

Fed sacrifices inflation & the dollar for the credit market

We believe that the Fed has been overly aggressive in lowering its funds rate to 2%. This ratcheting down of short rates has in fact been counterproductive to the need for lower home mortgage rates and has been very detrimental to the US dollar, as shown in the following chart. This brings inflation to the epicenter of consumer and interest-rate anxiety. At its June 25th meeting, Fed policy makers (fortunately) decided to hold interest rates steady. While we support market observers urging the Fed to raise rates, it's difficult to envision such a hike for the balance of the year given the financial system's ongoing strains, and with no clear sign that the economy can regain its footing soon. To halt the negative effects of inflation, we do urge that the Fed intervene strongly, in conjunction with other international trading partners, in support of the dollar.



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

Massaging the economy's opposing forces

We believe the Fed is correct in its view that inflation will wane in the coming months. Even though we may not technically be in a recession, history shows that recessions kill inflation. As rising commodity prices push up the cost of producing goods, it becomes increasingly difficult for corporations to pass on increases to consumers at the retail level. We also note the sharp decline in housing values as a major deflationary force on the system. The negative effect on wealth may have a significant impact on future consumer spending. As stated in the last Oakwood Outlook, any meaningful improvement in housing requires fixed term mortgage rates to fall to 5.50%. For this to occur, 10-year Treasury yields may first need to fall from a recent peak of 4.25% to around 3.50%. We believe this is likely to occur.

Of Corporates & Agencies

We continue to seek attractive corporate bond candidates, however difficult the task given the earnings slowdown. We're pleased by the additions we made to our holdings in 2008: Berkshire Hathaway, Monsanto, Halliburton, Union Pacific, McDonalds, and Province of Ontario Canada. Absent from this list are banks/finance companies, which we monitor daily. Prior to purchasing banks/finance companies, however, housing must regain traction, commodity prices must retreat, and oil prices must fall – all preconditions for growth of earnings and the economy.

There's a desire to use Federal Agencies in portfolios. They are currently under Congressional scrutiny and are likely to experience further regulation – a policy designed to protect against future missteps. On the other hand, politicians must be sensitive to an Agency's obligation to shareholders to produce a fair return on capital. We've begun to invest in Federal Farm Credit Bank and Federal Home Loan Bank. Both possess strong management and a manageable mortgage exposure. We're moving slowly and, as yield spreads stabilize, other Agency issuers are currently under review.

We'll pass on the looking glass

Rather than speculate on possible outcomes in the current dif-

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Fixed Income Strategies

Munis Prevail Through Taxing Times

Municipal Bond Commentary

Tax-free investors face many challenges this year. Among them, the market price of municipal securities has been forced to adjust lower, due in part to changes in the landscape of secondary bond insurance.

Insurer's vital role in debt issuance

Approximately half of last year's new issues benefited from some form of insurance enhancement. Insurance lowers the overall cost of borrowing money for municipalities, for example, a 'single A' rated, 10-year-maturity bond can enjoy a monetary savings equal to approximately 20 basis points versus a similar non-insured bond. In California, the yield differential can be more than 30 basis points. The net savings of thousands of dollars easily justifies the cost of insurance. Insurance also enhances liquidity and provides comfort to investors from around the country that are unfamiliar with local-level municipal issuers.

Credit downgrades amidst new players

Unfortunately, most major insurance carriers have seen their AAA quality rating crumble, as both Standard and Poor's and Moody's have revalued huge ongoing losses in housing derivatives and other structured investments. With the recent downgrade in AMBAC and MBIA, five of seven financial guarantors have suffered cuts to their credit ratings. The two remaining AAA rated bond insurers FSA and Assurance Guaranty are devouring the market, along with new players, including Warren Buffett and Macquarie Corp. Below is a listing of the major insurance carriers along with their most recent debt ratings.

Insurer Ratings

Insurer	Moody's	Standard & Poor's	Fitch Ratings
Ambac	Aa3 negative outlook	AA negative watch	not rated
Assured Guaranty Corp	Aaa stable outlook	AAA stable outlook	AAA stable outlook
CIFG Assurance	Ba2 under review	A- negative watch	CCC evolving
FGIC	B1 negative outlook	BB negative watch	BBB negative outlook
FSA	Aaa stable outlook	AAA stable outlook	AAA stable outlook
MBIA	A2 negative outlook	AA negative watch	not rated
XL Capital	B2 negative outlook	BBB- negative cash	BB negative outlook
ACA Financial	not rated	CCC "developing watch"	not rated
Berkshire Hathaway	Aaa stable outlook	AAA stable outlook	not rated

Source: Raymond James, Oakwood Capital Management LLC

Wary of state-level debt

Our decision to own only high-quality investments in our portfolios irrespective of insurance has been a good one. More than any other state, California is reeling from the worst housing market in years and a significant economic slowdown. As a result, we're avoiding state-level California bonds unless collateralized by government securities. California, the biggest borrower in the $2.7 trillion municipal market, bears the brunt of poor fiscal management and is looking at an estimated budget shortfall of over $15 billion. Adding to the problem: lawmakers are deadlocked over whether to raise taxes or cut spending.

Go local

We do see good value in "local-level" California bonds. There are many very well-managed high-quality issuers offering yields equal to states that impose little or no state tax on residents. Of particular interest are essential-service bonds for water, sewerage, transportation, as well as numerous local municipalities that have reached a proper balance between tax receipts and expenditures. The use of local-level California munis, even for non-California clients, should provide a performance benefit as the year progresses.

Muni bond outlook

After only short-lived improvement, the yield-ratio of municipal bonds to Treasury securities has climbed back to 100%. This means that you can get the same cash flow from a tax-free municipal bond as you can with a taxable US Treasury. This prompts us to reevaluate our shorter holdings for possible extension. We find a 14-year muni bond yielding 4.35% to be attractive. It equates to a 6.7% taxable yield equivalent for investors in the maximum tax bracket. To compare, 14-year Treasuries are presently yielding 4.45%, while high-quality corporate bonds yield between 5.5 to 5.75%.

As the November election approaches, it's unlikely that tax brackets will move lower; in time, they could even move higher. This means the demand for tax-free bonds should remain strong. We're confident that the problems facing insurance carriers will soon be resolved, and that municipalities with sound budgets will be met with strong investor demand. We continue to emphasize stringent quality standards and avoid all temptation to "chase yield" at the expense of liquidity and the potential for future market appreciation. We're likely to see a pick-up in municipal defaults this year, so every alternative must be examined carefully prior to investment. That's why we're here. ■

US Equity Income and Capital Appreciation Strategies
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12% range (-2% to -19%). The study concludes that the market could indeed turn around in the fourth quarter.

Portfolios: A Defensive Posture

We managed our way to market-beating performance in the second quarter in a very difficult environment, and have positioned ourselves prudently for the year. The second quarter's outperformance may be credited to:

- US large-cap defensive securities performing well
- prescient underweighting/overweighting of sectors
- cash reserves from selected sales adding defensiveness to the portfolio

We continue to believe the key to superior rates of return during the current U.S. market correction will be proper sector/industry weightings and stock selection. As you know, we've been overweighted in energy and slightly underweighted in capital goods (until our recent sale of some defense stocks). We think the economy's structural changes will allow energy/commodities and certain companies in the industrials sector to have superior returns compared to previous down markets. Specifically for the energy sector, we believe, long term, that demand outweighs supply; despite this, we would not be surprised by a short-term pullback in energy stocks. Thus we remain overweighted in energy even though we reduced our exposure by taking profits.

We have substantially underweighted financials in prior quarters. This quarter we began to add some names on the processing side of the banking industry. We also added one banking name that boasts credit quality and a balance sheet stronger than others in the industry.

In capital goods – where we intend to increase our weighting – we sold defense companies in the belief that a new administration will put defense budgets under scrutiny. That's why we are focusing on capital goods exporters that stand to benefit from the weak dollar.

In technology, we purchased for the US Equity Income portfolios a large-cap stock with a great five-year track record. One of the world's largest IT firms, the company is a player in enterprise storage and servers, services, software and laptops/PCs, imaging and printing and financial services. For US Capital Appreciation portfolios we purchased a small-cap stock in the semiconductor industry. Its principal activity is to design, develop, manufacture and market proprietary, high-voltage, analog integrated circuits used in converting alternating current (AC) power to direct current (DC) power. We are currently slightly underweighted in this sector.

We continue to be underweighted in consumer staples. We should point out that for the past two months this sector has underperformed due to the recent bounce in the dollar. We are currently looking to add to this sector as we find undervalued companies. ■

Taxable Fixed Income Strategy
continued from page 4

ficult environment, we prefer to let the market's directional changes dictate the appropriate strategy. We continue to structure portfolios based on quantitative techniques and risk/reward probabilities. This includes the selection of new corporate holdings based on yield benefit and the potential for spread contraction. It also means taking advantage of short-term price movements to alter portfolio durations between neutral to modestly aggressive. Our overriding goal is to avoid weak-quality bonds and to avoid chasing yield at the expense of principal preservation.

At times market outcomes seem obvious to us. But market conditions can change rapidly. While we do have strong viewpoints, we remain quite cautious and prepared to alter portfolio structures quickly, especially if inflation ramps up. While the year's first half saw modestly positive returns, bonds continue to offer an excellent method of capital preservation as well as an alternative to riskier investment vehicles. ■

A Word from the Advisor
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those generated by the average mutual fund, fall into the lowest decile.

- **Low distribution costs**
  By offering funds exclusively through wealth management firms like Oakwood, DFA circumvents traditional mutual fund distribution channels. It therefore reduces hefty marketing and distribution costs like advertising and brokerage commissions.

- **Aggressive negotiation of fees**
  DFA can aggressively negotiate fees based on its strength as a $150 billion mutual fund company. They diligently negotiate with vendors and custodians—from the company that prints prospectuses to the broker transacting trades; from rent and electricity to foreign exchange commissions. The leverage DFA's size commands in negotiating these costs subsequently benefits investors, who profit from proportionally higher returns. This is highly consistent with Oakwood's approach.

- **Low portfolio turnover**
  This rate represents the percentage of a fund's assets that turnover, or change, every year. DFA funds are steeped in an academically driven, asset-class approach that delivers much lower turnover than the industry average. This translates into lower transaction costs.

- **Tax efficiency**
  Investors strive for tax efficiency in funds that are held outside retirement assets such an IRA or 401(k) plan. DFA manages funds with the specific intent of minimizing tax consequences when selling shares and realizing gains. This is achieved by careful selection of what shares to sell and by matching capital gains with capital losses. These tax-managed structured funds defer gains until they are long term and taxed at a lower rate. In short, we exercise particularly thoughtful discretion when we sell. Finally, reducing portfolio turnover also reduces taxes.

- **Lending / hypothecating**
  Like most mutual fund companies in our industry, DFA lends and hypothecates against the securities in the portfolio. This is basically a way of creating liquidity in less-liquid markets. It also earns income. Some mutual fund companies put this income into their own pocket. DFA delivers this income back into the portfolio to enhance returns and benefit the investor.

- **'Just say no' to hot money**
  DFA fund management is based on academic research that confirms the advantages of longer-term holding periods. "Hot money" investors buy and sell based on emotions, swings in the market, or whatever style might be in favor. This creates massive inflows and outflows for mutual fund managers who may be forced to buy or sell at inopportune times.

- **Focus on the high-net-worth market**
  DFA, like Oakwood, primarily serves high-net-worth clients. These are relatively patient investors who think long term, unlike "retail" investors who trade and turnover frequently, generating transaction costs that gnaw at returns.

- **Avoiding momentum**
  One of the key ways we add value is by separating your emotions from your portfolio. This benefit is crucial, though difficult to quantify. Our dispassionate and intelligent approach protects you from costly errors arising from emotional investing or buying momentum.

Continuous investment management

At Oakwood, we increasingly believe our greatest value comes from properly structuring portfolios to reflect your investment goals, time frame, and risk tolerance. Properly structuring portfolios goes a long way toward achieving good total returns.

Because it's intelligent investing that beats the market, we deliver a comprehensive wealth management experience that aims to give clients a rewarding investment experience.

Much of our management of your money is transparent and highly visible. But our other actions may be less apparent, and yet, we are constantly monitoring and managing on your behalf. Our ability – and our promise – to contain the hidden costs associated with investing remains a key tool in our arsenal to increase your opportunity for higher portfolio return relative to risks.

Please call us if you have any questions or would like to discuss this topic further. ■

Oakwood Earns "Top Dog" Honors

We are pleased that Oakwood Capital Management LLC has once again been named as one of the "Top Dogs - the Top Advisory Firms in the Country" by *Wealth Manager* magazine, a highly recognized publication for the high-net-worth community. ■