

## A WORD FROM THE ADVISOR

# We Hear You

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*"To be or not to be, that is the question. Next question?"*

Warren Buffett admonished investors to "Buy American. I am." on Oct 17, 2008. Since then, US equities have retreated an additional 15%, with the S&P 500 down over 48% from its peak in October 2007. Needless to say, it's been a rough period for shareholders all around the world.

Oakwood clients are justifiably apprehensive, and we spend a great deal of time listening to your concerns. Our goal, as always, is to assess your needs in order to design the most appropriate strategy for your particular situation.

During difficult times, the value of solid financial advice becomes even more important. When times are good, investors are happy, even if their portfolios may in fact be underperforming customary benchmarks. When markets turn, however, the discipline and rigorous analysis provided by the best advisors causes them to stand out from the crowd.

For this quarter's *Word from the Advisor*, we thought it would be appropriate to highlight the key questions we've been hearing from clients and share with you our thoughts and responses.

### Q: Did you see this market debacle coming?

**A:** We did see it coming, but certainly did not anticipate the magnitude. Over the past few years, as equities have appreciated in value we took steps to position clients appropriately to manage through this period.

For example, we advised clients to shift their allocation away from over exposure to increasingly expensive US equities and toward a more stable balance of equities and fixed income. We also encouraged clients to expand into Oakwood's structured global DFA portfolios as a way to further diversify their holdings.

In our US equity strategy, we moved towards more defensive positions and higher cash balances. While we are not market timers, when values move outside of long-term trend lines, we become more conservative. In order to maintain a reasonable balance of risk and reward, we use bonds to counter balance equity risk, and we have been moving clients in this direction where appropriate.

Historically, the lack of correlation among major global markets provided diversification benefits to investors. However, this time most markets moved downward together. Unlike the bear market of 2000-02, where global market exposure offered an effective buffer to US equities, there has been little refuge from the storm. As we look ahead, we believe global markets will once again offer attractive diversification opportunities.

Regardless of your investment structure, it is very important to maintain a reasonable time perspective. As we discussed last quarter, it is essential to focus on asset allocation. Remember, that as an Oakwood client, you are guided through a comprehensive wealth management process that assesses your needs, risk tolerance, expectation of return and time horizon. We continue to implement this wealth management process to provide appropriate risk-adjusted returns over the course of market cycles.



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### **Q: When will it be over?**

**A:** It's impossible to know exactly when an individual market will find its bottom and turn positive, although we may already have begun to see this happen with the US equity market rise in March. After falling nearly 50% since October of 2007, US stocks certainly appear undervalued. However, just as share prices exceeded underlying value on the way up, our study of market history suggests that share prices tend to overshoot on the downside. Alternatively we could have a period of steady prices while earnings catch up.

What is crucial to understand at this juncture is that equity prices are more attractive on a normalized earnings-per-share basis than they have been in the past ten years. This means that investors stand a vastly greater likelihood of strong positive returns over the coming years.

Most economists are predicting a slow recovery beginning in 2010. Typically, equity prices lead an economic turn by six months or so. Economic recovery will depend on the effectiveness of government policy, particularly the impact of the fiscal stimulus package, focus on the financial system and mortgage and housing market issues. It depends even more crucially on the elusive quality of 'investor confidence'.

We may see new lows and continued volatility. We are consequently caught between the two fears of putting money into the market either too early or too late, i.e. missing the bottom. A practical solution is to shift money into equities slowly and carefully and to rebalance holdings conscientiously. The conservative nature of our firm benefits our handling of this difficult process. We are thoughtful in reinvesting in the market and we hew to the more cautious approach. We are fully prepared for the possibility that the testing of lows and volatility will continue.

Market recovery will eventually come. There is something in the American character that always finds a way to make money. Corporations will take fundamental actions to find profitability and ultimately reward investors. They will do what they must to survive, however objectionable it may be to lay people off in difficult times. In addition, the federal government's new initiatives could benefit corporations.

### **Q: What should I be doing? Should I move to cash to avoid further pain?**

**A:** In last quarter's *Word from the Advisor* we discussed the need for disciplined asset allocation. This message is equally true today. While we consistently focus on asset allocation tuned to your individual risk tolerance and time horizon, we also recognize that your circumstances can change.

With the market stumbling, and with the possibility of further declines, some clients naturally ask about the safe haven of cash. In doing so, they tend to ignore the crucial fact that, beyond minimal interest income, there is no investment return on cash. Bear in mind that a balanced portfolio (20% stocks / 80% bonds) delivered positive returns in 11 of the past 12 years; with the only down year being a modest decline in 2008.

Cash is an unattractive investment choice over time. Without taking some risk, cash will surely disappoint. For longer term investors, only proper asset allocation will get you to your goal.

### **Q: If we believe that the economy will continue to go through a rough period, what returns should we expect from the markets?**

**A:** *The market has already fallen sharply. This decline in market prices combines two effects: lower current and expected future profits, and higher risk and rewards for expected future profits. The discount rate, in turn, has increased because uncertainty about future profits (in other words, risk) has increased and, apparently, because investors have become more risk averse. This may sound unpromising, but in fact higher discount rates for expected profits translate into higher expected stock returns.*

The bubble burst and the economy has slowed. Not only are corporate profits weak, but investors are not willing to pay the same price/earnings multiples as before. As that persists, the markets will remain stagnant. But corporate profits will recover and right now prices are more reasonable than at any time since the 1980s. You have every reason to think you will have good returns in the coming five to ten years.



**Q: How long will it take to recoup my losses?**

**A:** The answer may not feel satisfying, but it's best to think about it in the aggregate. Since 1926, bull markets in the S&P 500 Index have lasted longer than bear markets and have delivered disproportionately greater price gains than the bear market losses.

Moreover, fluctuating performance within each trend illustrates that volatility and uncertainty occur even within established market cycles: that is, bull markets may have short-term dips, and bear markets may have short-term gains. This illustrates the difficulty of accurately predicting and timing market cycles.

It also validates the importance of maintaining a disciplined approach that views market events and trends from a long-term perspective. Investors who react emotionally to short-term movements are at risk of making ill-timed decisions that compromise returns.

**Q: Is it different this time?**

**A:** We believe that the forces behind the markets decline are essentially cyclical and not permanent, but that the impact is magnified by several forces converging at once: deflation, highly leveraged institutions and households, illiquid financial assets, and social demands. What's different now is that in the past, government involvement was traditionally limited to fiscal and monetary policy, but now government is contemplating intervention in our economy on an unprecedented scale. The risk is a misallocation of resources, or government nationalization of assets. Alarming, the administration is seeking to take healthy assets and invest them in inefficient entities. What differentiates the current decline from prior recessions, therefore, is the degree to which wealth is being redistributed. Taken to an extreme, this policy could remove the incentive for capitalists to invest. Indeed the need to monitor markets closely, given this difference, makes the most compelling case for professional portfolio management. Our job is to not rely on the most promising scenario, but rather to anticipate the full range of possible outcomes, and to position you most effectively given your specific time horizon and risk tolerance. ■

**Bull and Bear Markets**

**S&P 500 Index**

Daily Returns: January 1, 1926-December 31, 2008

Average Duration

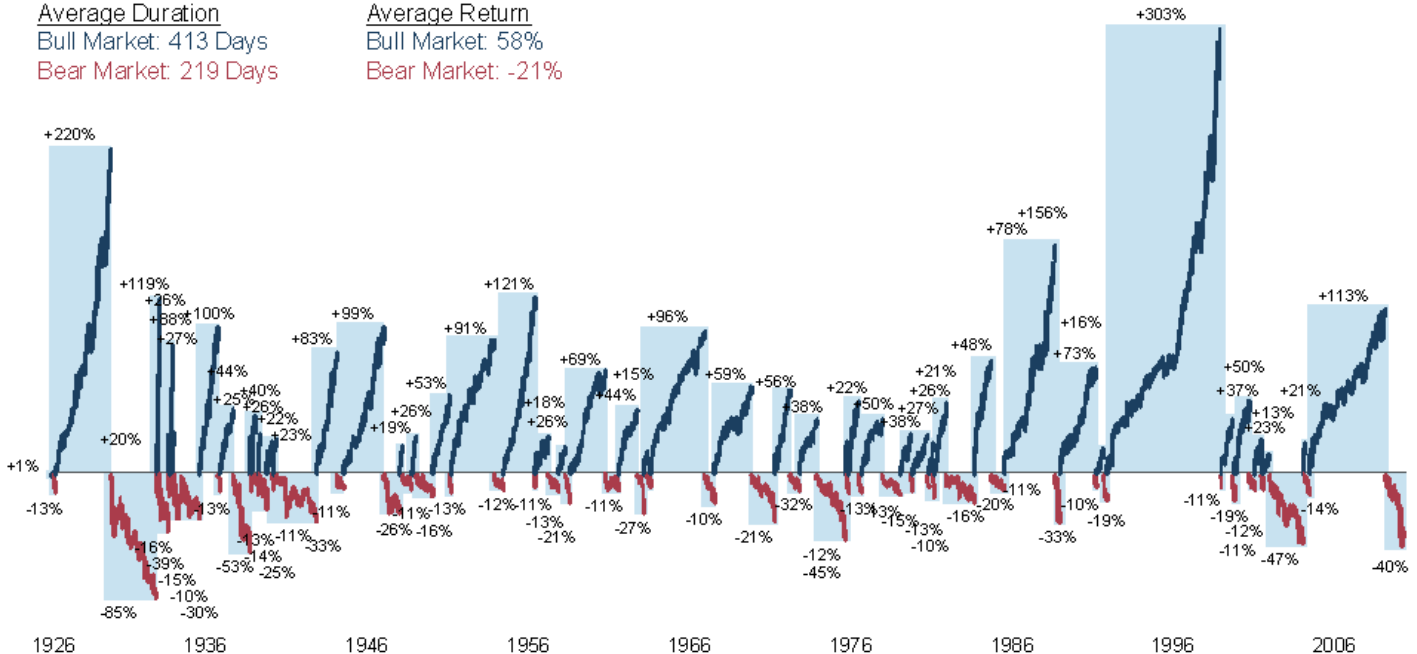
Bull Market: 413 Days

Bear Market: 219 Days

Average Return

Bull Market: 58%

Bear Market: -21%



The S&P data are provided by CRSP (January 1, 1926-August 31, 2008) and Bloomberg (September 1, 2008-December 31, 2008).

Returns include reinvested dividends.

Bull and bear markets are defined in hindsight using cumulative daily returns. A bear market (1) begins with a negative daily return, (2) must achieve a cumulative return less than or equal to -10%, and (3) ends at the most negative cumulative return prior to achieving a positive cumulative return. All data points which are not considered part of a bear market are designated as a bull market.

Performance data represents past performance and does not predict future performance.

Source: Dimensional Fund Advisors



# Global Equity Markets Once Again Diverge

Throughout the 2002-07 market rally, diversification across markets and asset classes offered investors protection against the inevitable downswings in any single market. The global economy reflected this reality when robust growth in China offset sluggish European economies. This position was sorely tested in 2008, when markets declined across the board, leaving no safe haven for investors.

However, divergence among global markets has returned in the first quarter

of 2009, raising the prospect of genuine global diversification benefits. Global stock markets are now striking out on separate paths, in contrast to last year's universal downturn. While the US market declined, BRIC countries (Brazil, Russia, India, China) staged impressive recoveries.

The Dow Jones World index, excluding US shares, fell 12% in the quarter, while emerging market shares improved 4% in local currency terms (0.5% in US currency terms).

Individual emerging markets recovered impressively in the first quarter. Both Brazilian and Russian indices rose 9% in local-currency terms, and India has moved into positive territory. China's A shares did even better, jumping 30%, vs. a 65% decline in 2008.

Several factors appear to underpin the emerging market resurgence. They include (i) investors returning to global assets that are now available at substantial discounts, (ii) surprising strength of developing country financial sectors, and (iii) the size and scale of China's economic stimulus package, which is garnering expectations of an earlier-than-expected return to trend growth for the Chinese economy.

European markets performed in line with the US. Specifically, German, French, and UK indices all fell in the range of 11 to 15%. Japan fared better than the US, but worse than emerging markets, with the Nikkei Stock Average falling 8%.

Dollar-based investors failed to capture the full benefit of these moderating markets as continuing economic uncertainty inevitably encouraged dollar buyers, driving up the value of the currency.

The return of divergent markets indicates that investors may no longer be indiscriminately selling; instead, some seem to be bottom fishing for individual stocks that they think are most likely to benefit from the inevitable recovery. However, we believe that investing in Oakwood's globally diversified DFA fund portfolios is the best way to participate in the global economic recovery. ■

## Oakwood Conservative Global Equity

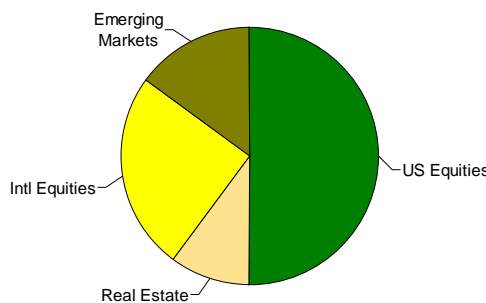
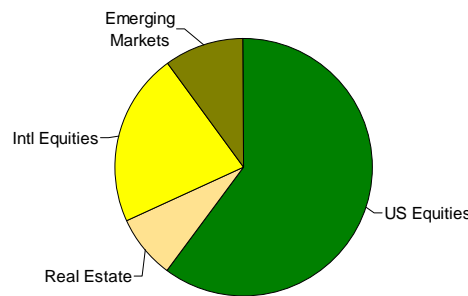
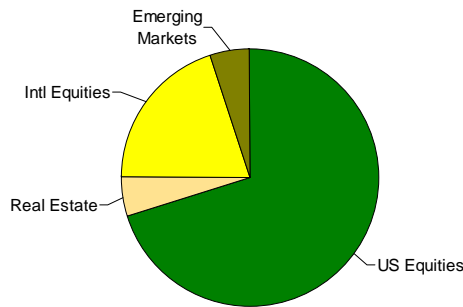
- Balance of value and growth as well as large, medium and small capitalization stocks
- Suitable for investors seeking income and long term capital appreciation

## 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 Global Strategies in the Quarter:

- Emerging Markets

### What Hurt Global Strategies in the Quarter:

- Global Real Estate
- US Small Cap Value

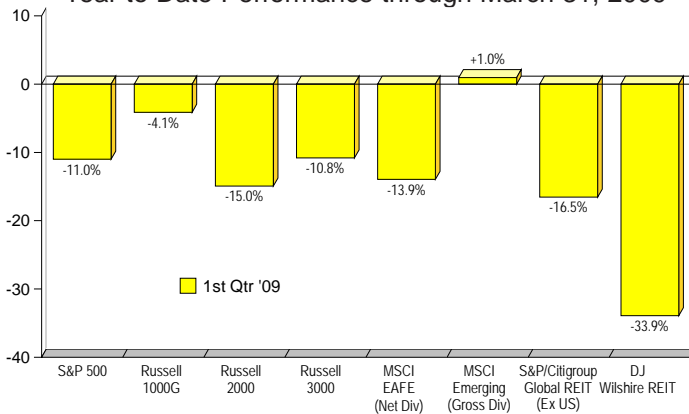


## Positioning for the Turn

The first quarter of 2009 closed with both the Dow Jones and S&P 500 indices down -12.4% and -11.0% respectively. US equity market indices did enjoy a nice bounce in March led by the financials sector up 18.6% and the basic materials sector up 13.6%.

### Equity Market Indices

Year to Date Performance through March 31, 2009



Source: Frank Russell Company, Standard & Poor's Index Service Group, MSCI data copyright MSCI 2009, Dow Jones Indexes, Oakwood Capital Management LLC

The market has responded positively to Treasury Secretary Geithner's latest private/public investment plan to address toxic assets plaguing the banking system. In addition the Federal Reserve has further eased interest rates by moving to purchase \$300 billion of Treasuries and \$750 billion of agency mortgage-backed securities. Deployment of these programs set off a significant bond and equity market rally and a US dollar sell-off. Also driving favorable market reaction was the indication that both the Fed and the Administration are working collectively to address concern about the economic outlook and the risk of sustained deflation.

Economic announcements of the last quarter spurred us to revise our GDP expectations. Four key factors have changed. They are:

- global recession – worsening
- energy prices - higher
- interest rates - lower, and
- US dollar - weaker.

The first two are negative; the latter two are positive. The bottom line is that the US economy faces stiff headwinds this year, but 2010 looks somewhat better given recent policy moves. We are now looking for GDP to decline 3 to 4% this year, and recover to 1.5 to 3% next year.

### Implications for the stock market

We believe that while news and the economy will continue to drive occasional market recoveries; for now, these remain bear

market rallies. Sometime toward the end of this year, or in the first part of next year, we could begin to see the start of a new bull market as fundamentals improve. Positive triggers may include improvement in the housing industry, savings rates approaching the 10% level, and/or increased liquidity in the banking system.

While we have been exceedingly cautious in the market over the past year, our strategy during this quarter was to increase weighting in financials by adding one to two banks. Our action was in part predicated on our anticipation that the suspension of mark-to-market accounting would ultimately benefit banks. Our recently purchased banks are in the large-cap category and are generally considered to be well managed and well capitalized. This important sector currently offers attractive prices and valuations not seen in the past 20 years. We also added a large-cap diversified precious metals firm for the basic materials sector. Traditionally, when you come out of a bear market, your best performing sectors are financials, followed by consumer discretionary and basic materials sectors. We are currently slightly over-weighted in financials and about equal-weighted to the market in basic materials.

### Why gold? Why energy?

We were bullish on gold before the Fed's latest balance sheet maneuvers and we remain so. Bullion is a traditional hedge against financial, economic, and geopolitical uncertainty. We believe it is an appropriate addition given world events and uncertain times.

We continue to be optimistic on energy and thus remain slightly overweighted in this sector. Oil prices have moved up above the \$50 level, but may trade between \$42 - \$55 for awhile. We like the energy sector's long-term fundamentals, especially as world economies pick up. Over the last few years growth in demand for energy outstripped the growth of supply. This led to diminished excess capacity and higher prices. The oil industry simply had not anticipated the strong growth in global demand. Prices dropped substantially due to the worldwide recession. Now, due to OPEC cutting back on supply and the oil industry substantially cutting capital expenditures, we anticipate that over the next three-to-five years we will revert to the predicament where demand again outstrips supply. ■



# Safety in Quality

**T**axable markets are behaving quite differently than last year. As economic and credit market conditions worsened over the course of 2008, stock prices fell sharply, dramatically widening yield spreads of quality-sensitive corporate bonds to their Treasury counterparts. This prompted us to systematically reduce exposure to vulnerable corporate sectors and opt for the safety of U.S. Treasuries. By year end, Oakwood clients reaped relatively generous returns and enhanced portfolio liquidity, while capturing valuable investment management flexibility.

While the 10-year Treasury at 2.67% offers additional yield, market risk to principal must be closely monitored. The Federal Reserve has made clear that it will purchase a substantial amount of longer Treasuries should yields rise to a level that threatens fixed-term home-mortgage rates. Should 10-year yields again rise to a level above 3.00%, we will selectively add to longer positions. As these yields move to 2.50%, we will take gains and reduce our exposure. Our goal is to add value as the markets search for a new long-term direction.

## Edging back to corporates

We have reversed our stance this year by investing in attractive corporate bonds—primarily in food, agriculture, transportation, and select banking sectors. Examples include McDonald’s, John Deere, Monsanto, Union Pacific and J.P. Morgan. In the network solutions area we hold Cisco Systems.

Overall we favor lower coupon securities in the short maturity area to limit reinvestment of coupon cash flow in the current low-yield environment. In contrast, we favor above-market higher coupon securities in the longer maturity area to counter any risk of price erosion should yields suddenly move higher. We stand ready to quickly alter our present market view should the seemingly excess stimulus to the economy by Congress and the Federal Reserve increase the risk of inflation. ■

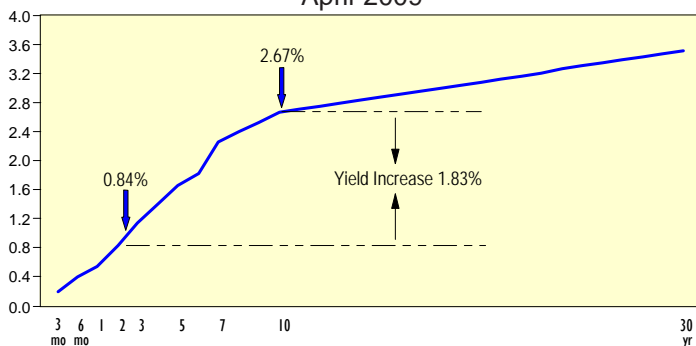
As corporations reorganize, reduce inventories, and write-down troubled assets to transition from “damage management” to future growth, investment opportunities are beginning to surface. This is not to suggest that the wave of bad news is over, but that we feel the time is right to increase yield on client portfolios. Recent purchases include Paccar and Pfizer. We will seek others as the year progresses.

## Foregoing growth for capital preservation

As shown in the following chart, US Treasury yields remain at very low levels. We feel it wise to limit longer maturity positions, although longer maturity yield levels are notably higher than short maturity yields. A 2-year Treasury yielding a meager 0.84% may be a better investment choice than a 10-year Treasury at 2.67%. Clearly, investing in short-term Treasuries may be a bad idea for investors seeking higher return; what it buys, however, is capital preservation.

**Treasury Yield Curve**

April 2009



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



## Time for Investment Discipline

**O**akwood clients enjoyed several benefits from their municipal investments in the first quarter. Perhaps the most important was capital preservation, especially when compared to equity and real estate investments. In fact, the capital preservation feature of the municipal bond sector provides an excellent complement to other investment sectors.

As the economy continues to contract, it is prudent for us to review our individual municipal bond holdings to ensure that each one remains credit worthy. Just as the lack of regulation and disclosure requirements has become a major concern for corporations, financial transparency in the municipal bond sector has also come under scrutiny.

### Guard against credit shocks

At Oakwood, our most important protection against credit shocks is possibly one of the most obvious: research, discipline, technology and the collective experience in our fixed income department. This level of experience is important as the economy vacillates between contraction and expansion, and as history reveals price patterns in a particular municipality's ability to manage through economic changes. Over the years we have seen professional managers reward consistently well-managed municipalities by placing a higher value on their bonds. To identify these municipalities, you need to have been in the market over time — as we have.

Another safeguard concerns a municipality's value to the community as a whole. One criterion is "too big to fail." Metropolitan areas and states fall into this category. Some clients may remember New York City's default in the 1980s and the ensuing government bailout. Similar to disaster relief, even smaller municipalities will be rescued by their resident state, or by the Federal government, if required. For added protection, we review each bond indenture to validate the source of bond payments and to assure they are direct and irrevocable obligations with discretionary taxing power. In the case of revenue-type bonds, we are careful to select issuers whose service is considered essential and vital, regardless of economic condition.

### Even the mighty can fall

This is not to suggest that a municipal bond cannot go into default. In fact, over the past year, we've seen a significant rise in defaults, albeit still at a fraction of total outstanding municipal debt. Hospital, housing and redevelopment

projects are the most vulnerable to weakening economic conditions. In the case of default, financial support is usually determined by an entity's value to the community. In any case, we continue to avoid these issuers.

At Oakwood, we have taken additional steps to reduce the risk of default or disruption in scheduled coupon payments. As we've been reporting for the last two years, we have raised our minimum quality standard on new municipal purchases to AA, absent any consideration for secondary insurance coverage. This provides us with an early-detection buffer in the event that credit conditions change.

We're confident that with this continued discipline and our unbiased decision-making process, we are able to make sound investment decisions, even as transparency issues come under SEC scrutiny. At Oakwood, we pride ourselves in holding only the safest investments with features that are well understood in advance of purchase and that are reviewed on an ongoing basis. ■

