

## A WORD FROM THE ADVISOR

# Bulls, Bailouts & Fishermen



The bull says, "Stocks, my friend. Now is the time." The bear replies, "I dunno. I'd hedge my bets a little, do a few bonds." The ant adds, "Excuse me, but hasn't anybody ever heard the words "SAVINGS ACCOUNT"?" The grasshopper says, "Let's stop talking about money and go have some FUN!"

The fact that we don't predict the future doesn't mean that we don't think deeply about markets and the economy. The Standard & Poors 500 has surged 65% in only nine months, one of the strongest rallies ever recorded. So, what's an investor to do? Is there still time to jump in, or is this just a giant sucker's rally about to collapse?

Of the many well-known market pundits, from Bernanke to Buffet, our interest was piqued by a well recognized analyst who identifies four legs which typically support bull markets, namely:

**Leg #1:** Improving fundamentals, or a "V-Shaped Recovery of the Market Index": Across the globe, economies are recovering much more quickly than anticipated only six months ago.

**Leg #2:** Unprecedented stimulus, or "Don't Fight the Fed": The Federal Reserve continues printing money in its valiant effort to stave off deflation, with no signs of easing up in the near-mid term. Those dollars have to go somewhere, and the odds are that they will continue to flow into financial assets, pumping up prices.

**Leg #3:** Strong technicals, or "Don't Fight the Ticker Tape": Technical analysts perceive many signs that the bull has room to run, e.g. market breadth – we continue to see the market reach higher highs and higher lows which has confirmed every new price high for the major averages. However, recent price action suggests that the rally may be tiring.

**Leg #4:** Favorable sentiment, or "The Rally Everyone Loves to Hate": Investors don't trust this rally. They either missed it and surmise they are too late to climb aboard, or they are waiting for the other shoe to drop with regard to the economy. While that may be a valid concern for now it seems to be part of a "wall of worry" that the market likes to climb. When investors become euphoric, it's oftentimes the beginning of the end.

While the weight of evidence suggests that the bull market is still alive, this analysis indicates that the "technical" and maybe even the "sentiment" legs are transitioning from the "straight-up" part of this bull market to a more challenging and volatile two-sided market environment.

The bottom line is that while all four legs remain bullish, they're not quite as bullish as they were a few months ago. The V-shaped recovery still looks good (although not growing as fast as other recoveries) and the Fed should continue to keep short term rates low, but sentiment is not as compelling as it was earlier in the year. So, this is no longer the "just close your eyes and buy" market of spring and summer. It's a more challenging and tactical environment in which there is still upside potential but also more risk. We agree that the rally is sustainable, but this will not be a one-way, upward-barreling market, as increasing volatility will bring inevitable sell-offs. Of course this is to be expected and even welcomed following a 65% run-up over a short time period. This is a market which should reward patient and disciplined investors; short-term speculators are unlikely to fare as well.

We don't time the market but we are keenly attuned to market dynamics. When we begin to see issues that raise our concern, we pay attention, moderate, and adjust course. One of our favorite metaphors for our approach is that of the fisherman...



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## The parable of the fisherman

A fisherman preparing for a weeklong excursion naturally consults the weather report. But he doesn't rely only on a weather forecast to ensure a safe return. Rather, an intrepid fisherman understands that weather is inherently unpredictable and beyond his control. Consequently, he focuses intently on things within his control, by preparing the fishing boat for any potential weather behavior. He undertakes regular maintenance on the hull, the lines, the engines, as well as thoroughly checking all navigation, communication, and safety systems. Most important, he prepares his supply stock, including all necessary tools to make repairs should anything go wrong en route.

At Oakwood, in our quest to deliver attractive risk-adjusted returns over the long term, we undertake preparations uncannily analogous to the fisherman. We understand that we cannot control or predict markets, so we don't try to. We do, however, check economic trends and financial movements, just as our fisherman checks the weather forecast. And like the fisherman, we focus our efforts on areas within our control. This means constantly monitoring risk/reward tradeoffs, and rebalancing portfolios as the need arises. It means structuring portfolios for optimal tax efficiency. It means minimizing transaction costs. It means remaining vigilant to changes in the weather, and being prepared to adjust course as needed. Above all, it means using our robust set of tools to make necessary adjustments in our investors' portfolios.

## What does this mean for the Oakwood client in 2010?

Uncertainty about the stock market is not unfounded. Fortunately it doesn't require perfect powers of prediction to prepare oneself for practically any market. In periods of uncertainty, we moderate our investment decisions as we assess whether the stock market will continue to rally through 2010 or retest the lows of last March. As time goes on, we promise that whatever the market delivers, we will emulate the fisherman by applying our best preparation and tools to each client portfolio, in order to maximize your ability to achieve your goals over the long term.

## Our nation's unprecedented bailouts

At Oakwood, we have studied the effects of the unprecedented bailouts our nation has deployed in the one-year period ended March 2009. We provide this chart to illustrate historical comparisons.

In just one short year, the total bailouts managed to surpass the total of nearly every major one-time expenditure in US history, including both world wars (not in graphic), the New Deal, the moon shots, NASA budgets (not in graphic), Iraq, Vietnam and Korean wars — combined! ■



Source: Barry Ritholz, [www.ritholz.com/blog](http://www.ritholz.com/blog)



# World Stocks Stage Strong Recovery

After a dismal first quarter, stock markets all over the world revived spectacularly in the following three quarters as cash-flush, bottom-fishing investors hunted for bargains. Developed-country markets, including the US, performed well, but emerging markets did even better. Oakwood clients participated fully in our global portfolio strategies.

For the year, the Dow Jones World Index (which excludes the US), soared 37% in US dollar terms. While the BRIC countries (Brazil, Russia, India, China) remain below all-time highs of 2007-08, they all staged remarkable gains, exceeding 80%, during the year. According to the *Wall Street Journal*, Russia's RTS Index was up 129%, India's Sensex was up 81%, China's Shanghai

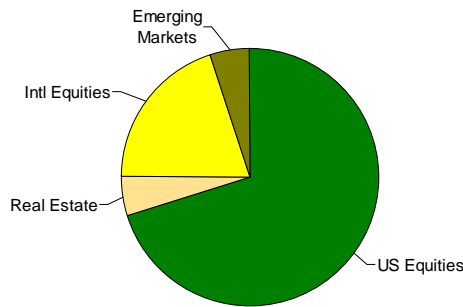
Composite gained 80%, and Brazil's Bovespa gained 83%. Even the laggards did well in 2009, with the worst performing major market, Japan's Nikkei 225, gaining 19%.

This broad-based market recovery, biased towards emerging markets, suggests a reprise of pre-crisis performance, where international stocks did better than US stocks for several years. Much of that phenomenon was driven by a weakening American currency, which meant gains in local currencies increased when converted into dollars. This was evident as well in 2009, as Morgan Stanley's international stock index increased 21% in local currencies which equated to 28% in dollar terms.

Despite the impressive recovery, at Oakwood we are cautious as corporate earnings remain depressed, and global economies continue to sputter below productive capacity. In addition, stocks are no longer cheap by many valuation metrics, though they remain substantially less expensive than at the market's peak in October of 2007. Many of us believe a combination of reasonable valuations, imminent earnings recovery, and low interest rates means that it is too early to turn very cautious. While no one expects a repeat of 2009's spectacular performance in 2010, at Oakwood, we expect global shares to deliver solid double-digit returns over the next few years. ■

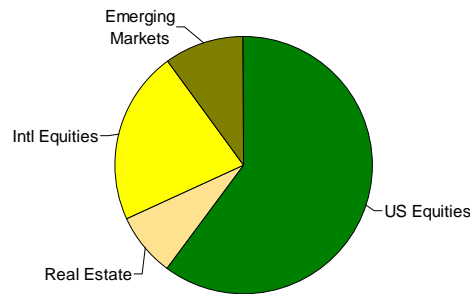
## Oakwood Conservative Global Equity

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



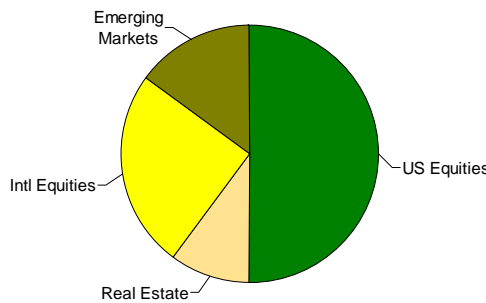
## Oakwood Moderate Global Equity

- 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
- US Real Estate (REITs)
- US Large Companies

### Year

- Emerging Markets
- International Small Cap
- Int'l Real Estate (REITs)

### What Hurt Global Strategies in the... Quarter

- International Small Cap
- 5 Year Government Bonds
- International Value

### Year

- Intermediate Gov't Bonds
- Cash



## 2009: A Great Ride for Equities

Another outstanding quarter! The fourth quarter of 2009 closed with the Dow Jones and S&P 500 indices up 8.1% and 6.0%, respectively. For the year, the two indices were up 22.9% and 26.5%, respectively, with the S&P up 65% from its low on March 9<sup>th</sup>. The best performing sectors for the quarter were health care, consumer products, and technology. As a result Oakwood clients enjoyed solid positive returns in 2009.

### Economic recovery: picking up steam

Gross domestic product (GDP) grew at a 2.2% annual rate, up sharply vs. the second quarter's negative rate of -0.7%. The economy's much slower pace of growth than the 2.8% initially reported was due to weak business investment and slightly more aggressive liquidation of inventories. But it was still the fastest pace of growth since the third quarter of 2007, and it ended four straight quarters of decline.

Last month's data releases suggest significant acceleration in fourth quarter GDP growth, from 3.5% to approximately 4.5%. A major contributor to this acceleration was the increase in business inventories in October and November.

The Federal Reserve's latest assessment notes:

- improving jobs market - the labor issue is now framed in terms of a lack of hiring rather than in additional firing.
- income growth is now described as "moderate" rather than "sluggish"
- no change in describing inflation as "subdued for some time."

Despite the improved outlook, the Fed reiterated that "economic activity is likely to remain weak for a time," thereby reducing investor concerns that the Fed will raise short-term interest rates anytime soon.

### Forecast for 2010: getting back on track

Economic activity remains subdued. Structural headwinds, particularly private sector deleveraging and massive public sector deficits, are daunting. Nevertheless, we see a critical mass of data which points to a cyclical recovery that is gathering momentum, particularly in output and sales.

For 2010 we generally expect 4% to 4.5% GDP growth, with the year's first half stronger than the second. The question

then becomes whether the private sector picks up the slack from the diminishing benefits of the stimulus package. However, on the other hand, does an improving economy ultimately cause the Fed to increase short-term interest rates? In the near term, no, unless the economy truly kicks into higher gear. As we go through the year, investors could potentially get buffeted between tepid growth and higher borrowing costs, along with the potential for higher taxes.

At the current rate of public debt expansion, the US is heading toward a 13% deficit-to-GDP this fiscal year. That alarms us. We have seen countries approaching this level of deficit to GDP (one example, Greece) which has triggered skyrocketing interest rates in their sovereign debt. If our debt level continues to climb, at some point creditors may shy away from funding our debt obligations, causing higher interest costs.

We expect minimal inflation in the coming year, due to continuing excess capacity as evidenced by 15 million job seekers, 5 million vacant apartments, and an economy running at 71% capacity, well below the four-decade average of 81%. However, corporate profits should continue to rebound. According to Thomson Reuters and Standard & Poors, corporate earnings are expected to rise dramatically in the coming quarters as banks move back into the black. The profit-growth projections for the S&P 500 sectors are shown below:

### Profit-growth projections for the S&P 500 sectors

S&P Sector	Est Earnings Change		
	4Q '09	2009	2010
Technology	30%	-4%	24
Financials	N/A*	N/A*	172
Health Care	-4	1	9
Energy	-24	-56	45
Cons Staples	3	0	8
Industrials	-13	-32	12
Cons Discret	112	14	28
Utilities	-7	-4	7
Materials	161	-55	75
Telecom	52	2	6
<b>Average</b>	<b>203%</b>	<b>-8%</b>	<b>30%</b>

\*Growth rate can't be calculated from negative base-year earnings. In the fourth quarter of 2008, the financial sector lost \$79 billion, Thomson Reuters says. As of Dec. 23.

Source: Thomson Reuters, Standard & Poor's

The 2009 S&P 500 earnings are likely to fall about 8% to \$60. For 2010, we expect earnings to climb back to around \$80.

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At Oakwood, we favor sectors with accelerating earnings e.g., energy, materials, capital goods and technology (see chart on page 4). These sectors offer large cap stocks which participate in expanding overseas markets. The bottom line, however, is that 2010 will not be a Goldilocks economy and will not duplicate the stock market of the late 1990s. Rather, it will be a year of consolidation in which crosscurrents will impact the market. At Oakwood, we remain flexible in our market outlook, adjusting company and sector selections to take advantage of value pricing in stocks.

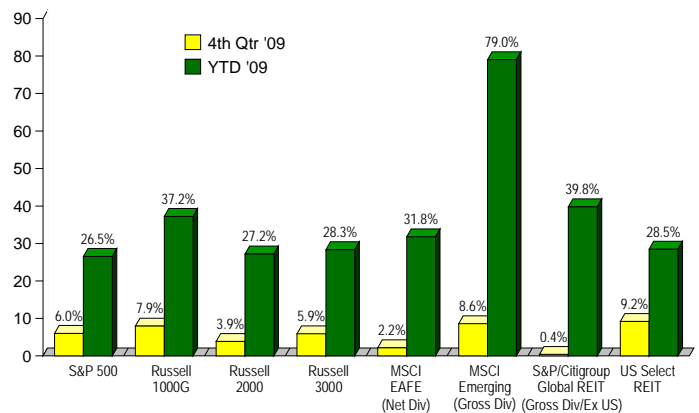
## Investment strategy: anticipating new currents

In the third quarter of 2009 we increased our exposure to stocks in the Equity Income and Capital Appreciation strategies, believing the economy was slowly coming out of recession and that risk/reward favored stocks. During the fourth quarter, after experiencing market appreciation, we lowered the risk profile of our portfolios slightly by selling two technology stocks in each strategy. In the Equity Income strategy, we purchased one of the country's largest pharmacy chains and a large agricultural products company. In the Capital Appreciation strategy, we sold a bank to reduce our weighting in the financial sector and we purchased two companies in the consumer discretionary sector – a retailer of home improvement products and a specialty coffee company that produces high-quality Arabica coffee.

As we go through the year, we anticipate a gradual shift in the strategies to a more defensive posture by lowering risk and by favoring the consumer staples, energy, health care and capital goods sectors. We also anticipate increasing the income component of the strategies by purchasing additional high-quality dividend-paying stocks. We intend to reduce the potential risk/volatility in the second half of 2010, when a number of cross currents may become more evident. The potential exists for any or all of the following: an increase in short term interest rates, higher employment, higher taxes, a new government stimulus, an improved housing market, the election of new legislators, and changes in world economies and geopolitical events, especially in Iran and Pakistan. No matter *what* eventually happens, we remain focused on our primary goal which is to help you meet your investment objectives, particularly the preservation of your capital. ■

## Equity Market Indices

Year to Date Performance through December 31, 2009



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

## Mission Statement:

Oakwood uses a consultative approach to create personalized structured portfolios. Our strategies include actively managed domestic taxable & municipal bond portfolios and separately managed US & multinational stock portfolios and global portfolios utilizing DFA Funds (Dimensional Fund Advisors). Ideal clients are those looking for an ongoing hands-on working relationship that involves discussion and solutions for their entire financial picture. Our goal is to simplify our client's financial life through controlling risk and solving their most pressing financial challenges in order to achieve their investment objectives.

## Note:

- Superior communication and personalized client services have always been a strong point for Oakwood
- Secure online access is available for our clients to review their portfolio(s) at all times
- Quarterly reports are provided along with the Oakwood Outlook & Quarterly Review
- Consultative process with investment goals, objective reviews and tax considerations are utilized in the ongoing management of client portfolio(s)
- Over half of our professionals have worked together for over 20 years



## Changing Environment Requires Close Scrutiny

In previous Oakwood Outlooks, we highlighted the role that economic cycles play on corporate bond attractiveness. We urged investors to overweight corporate bonds as the economy began its recovery. This decision led to solid performance for Oakwood client portfolios in 2009.

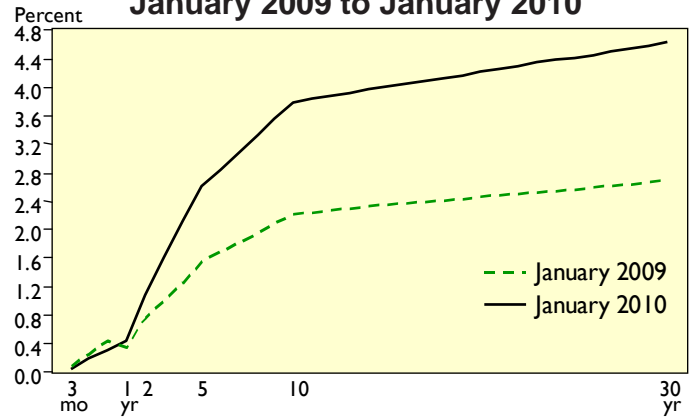
Now that higher quality (single A or better) yield spreads have narrowed considerably to Treasury alternatives, we may begin to swap some of our best performing positions to gain added yield from the somewhat lower quality, but still investment grade, Baa area. However, straddling the line of “down in quality trades” requires extensive review of company and market fundamentals. Unlike stock investors who look to future earnings projections to evaluate price expectations, bond investors stress current fundamentals to determine a company’s ability to make near-term coupon payments. For example, a company must maintain and generate high levels of free cash flow to satisfy both coupon payments and to reduce its dependence on debt.

As the economy factors in the growing likelihood of sustained growth, investors are expecting that the Federal Reserve may hike interest rates, perhaps as early as June. In fact the Fed has already announced its intention to slow the injection of reserves by ending their massive purchases of Treasury, Federal agency, and mortgage-backed securities. This initial change to a less accommodative policy is beginning to push longer Treasury yields higher, which in turn is pushing fixed mortgage rates higher.

While expectations of future Fed rate hikes may seem counterintuitive to owning bonds in 2010, at Oakwood, we would welcome such preemptive policy actions. Ultimately, inflation containment is the only way to keep interest rates low. Otherwise, concerns of increasing inflation could well trump the hopes for economic expansion and renewed improvement in the housing market.

We accept that investors may not initially applaud calls for the Fed to act quickly. If it does occur, bond traders may attempt to push rates even higher across the entire yield curve. If 10-year Treasury yields approach 4.25%, we may respond by extending portfolio durations as the impact of higher mortgage rates will act to stall economic progress. The Fed cannot rely on inaction or bond prices will suffer, forcing mortgage rates to ratchet upward – long before the economy and housing can fully recover.

**One Year Treasury Yield Comparison  
January 2009 to January 2010**



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

We expect 2010 to be unusually volatile as the economy searches for clear direction. Naysayers are again urging investors to shun bonds. They expect the extreme levels of stimulus to create a stronger economy and consequently higher interest rates. Our view on the economy is more pessimistic than the market’s view. If we prove to be correct, Treasury yields should remain surprisingly low into the year. But in the near-term, we remain cautious because the market has not yet adopted our view.

At Oakwood, we take into consideration market forecasts from multiple sources. As you know, our quantitative investment process results in flexible and active management designed to preserve capital during difficult times while positioning portfolios for future opportunity. Fixed income investments will always play a vital role for clients seeking investment returns greater than the reported levels of inflation or as a complement to higher-risk investment choices. ■



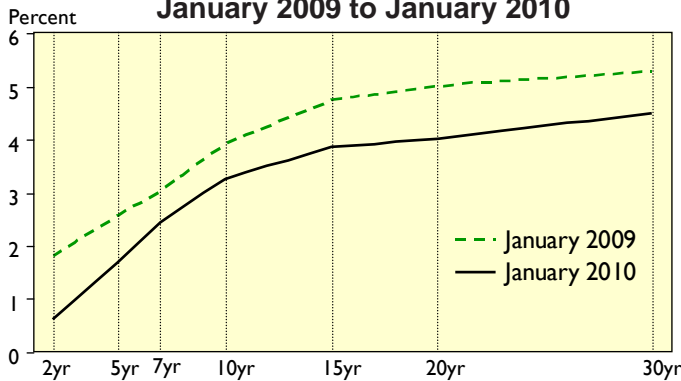


# The Squeeze on Muni Supply Continues

**B**uild America Bonds continue to be the primary driver of municipal bond returns. As you know, municipalities are able to issue tax-free bonds at a lower yield due to their tax exemption. The Build American Bonds program now allows municipalities the additional opportunity to issue taxable securities, with a portion of the interest expense (35%) subsidized by the federal government. Municipalities' new preference to issue taxable bonds has created a shortage of tax-free bonds, which is positively impacting the value of existing tax free securities. As a result, Oakwood municipal bond clients enjoyed solid positive returns in 2009.

As noted in the taxable bond commentary, the US economy appears to be on the mend. This does not however mean that quality levels throughout all municipal bond sectors will improve. Many states, including California and Nevada, are plagued with the worst housing slump since the Great Depression. Arizona, one of the states hardest hit by home mortgage foreclosures, recently suffered a Moody's ratings downgrade, to A1, from Aa3. Others states' revenues that climbed by double digits in 2006, have plunged at a record pace. During this difficult period, our approach has been to avoid all purchases rated single A or below and to shun all state-level California debt.

**Aaa Municipal Yield Comparison  
January 2009 to January 2010**



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

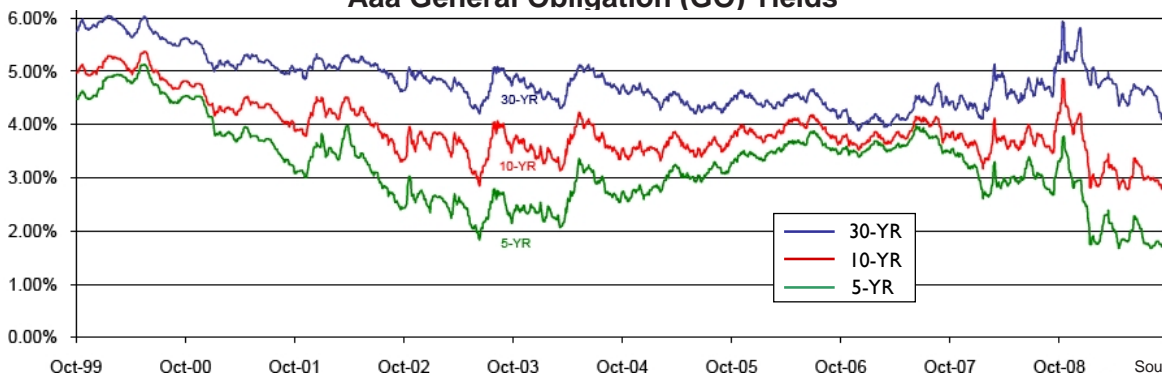
While the potential extension or expansion of the Build America Bonds program remains an open question for now, it has bolstered tax-free prices, which is helping to offset a recent decline in Treasury prices. As a result, the benchmark yield ratio of the highest quality tax-free bonds to their taxable Treasury counterparts has declined, to a more normalized 86% in the 10-year maturities. We expect this trend to continue, due to both the constrained supply of tax-exempt bonds, and the higher tax bracket investor's demand for secure tax-free income. This is especially true as the Bush-era tax cuts are scheduled to end in 2010, raising the top federal income tax rate back to 39.6%.

As the economy continues to rebound, most state and local coffers will slowly improve and this will trigger our reinvestment into single-A-rated bonds. Because of our current higher portfolio quality, this change in strategy will result in a substantial yield pickup. Before we implement the shift, we need to see further proof of sustained economic growth. However, regardless of the recovery's timing, because debt growth at state level in California is chronic and inadequately constrained, we will continue to avoid all state-level California debt.

We recently began a strategy of using callable bonds in the intermediate-maturity area. In the past, we restricted callable investments to longer maturities, where ten years of call protection is the norm. By using callable bonds with a more narrow 1-2 years of call to maturity separation, we can add generous yield while still limiting risk to principal. When this strategy is combined with longer term investments, clients capture generous yield and added cash flow from coupon payments. The chart shows the benefit of extending maturities. We note that the yield curve has not been this steep since 1995.

Tax-exempt investors continue to reap the benefits that municipal bonds have to offer. Demand should remain strong in 2010 as the prospects of rising taxes and constrained supply continue to dominate market conditions. ■

**Historical Perspective on the Municipal Market  
Aaa General Obligation (GO) Yields**



Source: MMD