Oakwood Outlook & Quarterly Review

Volume 15, Number 1 January 2012

A Word from the Advisor

Fresh Thinking for Twenty Twelve

"Remember, son, these are your tax-free years. Make the most of them."

To our valued Oakwood clients,

We'd like to share a letter we recently received from a long-time client, David. In it, David describes a shift in his perception of his investment life:

> *"I keep getting pulled into conversations about investing—rarely initiated by me—but the topic is definitely on my friends' minds. Times are scary; people are uncertain, and several have taken drastic actions with their investments. They are turning to me for support. Five years ago, I would have told them that I work with Oakwood because you've been most effective at reliably generating high long-term returns. That reason has become secondary. The reason I engage Oakwood, and I've thought about this deeply, is because it brings comfort and solace to my financial future. I don't feel emotional about my investments; I feel* smart *about my investments by letting you guys do your job, versus my own engaging in chaotic markets, watching them constantly, and experiencing anxiety. For me this applies both to these "despondent times" as well as when markets are flying high. I'm turned off from the preaching about missing this or that opportunity. I'm simply not open to it, not interested."*

We applaud this kind of thinking. The stock market's listless performance in a volatile 2011 has discouraged some investors and even exhausted their confidence in the financial markets. Secure in our knowledge that markets historically recover after corrections, we believe the battle fatigue, while understandable, to be misplaced. It hinges on expectations about investment results that may be rooted in another era. These assumptions bear examination.

The new normal

The equity market, on steroids during the years 1995-99, yielded positive returns between +20 and +37%. Baby boomers, as new investors, grew accustomed to the wonder of watching their assets almost magically mushroom. Now with an outlook for sluggishness in the global economy, and given the debt that continues to afflict consumers and governments, these expected returns may no longer be realistic.

The general perception now is that, over the next 5-10 years, the US and much of the developed world may be obliged to whittle down their excessive debt instead of investing for other purposes. Financial market investing, some believe, may no longer augur ten plus percent annual returns for stocks, but rather seven percent or even less. Bonds, it is felt, will command even more modest single-digit returns.

How not to react

Some shell-shocked investors internalized this pessimistic assessment when it surfaced, and took it as a confirmation of their natural instinct to follow a more conservative path. Those who bailed out of the market during the grim winter of 2008 missed an almost 100% rally in the subsequent spring of 2009.

How to react

By contrast, we strive to keep our portfolios on a steady course that neither denies changing realities, nor reacts too emotionally. We are committed to help you navigate through this transitional time, by encouraging you to reevaluate your perspective on your investments and manage your expectations. We genuinely believe that together we can find ways to help you feel more secure, and not ride the daily roller coaster our client David characterized at the beginning of this essay.

We need to face the hard and challenging facts of investing but still keep a positive outlook and realistic perspective. Here are the building blocks of that perspective:

continued on page 2

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

Word from the Advisor from page 1

- ***Maintain a sense of history.***
  Our current period is not particularly unique. A simple review of history quickly clarifies. The 1970s brought double-digit inflation, gas lines, and concerns about war. Yet this stressful period was met by tremendous equity returns from 1981–98. A study illustrates the jolts to the market and subsequent positive recoveries, a string of them starting with the stock market decline of October 1987, savings and loan crisis of 1989, Asian Contagion of 1998, dot-com Crash of 2000, 911 terrorist attack, and so forth. The market recovered strongly over one year, three years and five years through all these events.

  The chart below tracks the performance of a balanced investment strategy (60% stocks, 40% bonds)* following historical crises. Please note that each event is labeled with the month and year that it occurred or peaked. The subsequent one-, three-, and five-year cumulative returns start from the first day of the month following each crisis.

  Negative events may tempt investors to flee the financial markets, historically a bad decision. Remember that diversification and a long-term perspective can help you ride out the storm.

- ***Try to remove emotion.***
  As a client, when you began working with Oakwood, we assessed your risk tolerance and agreed upon appropriate long term investment goals. We take your long term goals seriously. Investors often lose when they react, emotionally, to short-term events.

- ***Remind yourself what it's all about.***
  What motivates your investment activity anyway? Most of our clients strive to prudently manage their financial lives, saving for retirement and caring about future generations. But, remember, it's not just about the money. In the blindness of chasing return, we sometimes forget that we can perform good works and deeds independently of how financially flush or secure we feel. And these may be our most generous acts.

- ***Recognize the challenge and promise of our times.***
  Clearly, fundamental change is afoot in the economy. Technology and a shrinking public sector are dramatically reshaping the US job market. American businesses, both large and small, are undergoing structural changes, and learning to produce more with less.

  We see young entrepreneurs embracing change, creating and commercializing exciting new technologies. But in the older generation, there is also widespread trepidation about what will emerge in the new American economy.

  Overall, we see positive trends in the economy. For example, weak companies are disappearing while strong ones grow stronger. Companies can generate profit with fewer customers due to efficient corporate restructuring. Municipalities are operating within budgets and are avoiding add-on projects. This is a first for many of us in our lifetimes. Alternative energies sources are emerging and trends toward energy efficiency are growing dramatically. Information technology continues to have enormous productivity gains. We have previously mentioned the evidence of manufacturing returning to the US. And finally, housing is cheap and mortgage rates are at historically low levels.

- ***Recognize the potential of the moment.***
  While we are not market timers, we understand that when equity prices drop, equities can be expected to deliver higher expected returns. Investors need to recognize the risk and the opportunity inherent in these market movements.

And of course, as always, we focus on ***preservation of capital through effective and vigilant risk management.***

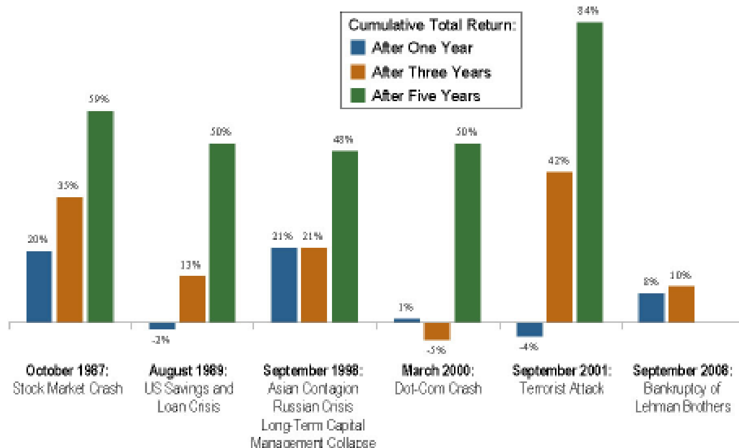
Our ability to match your tolerance for risk with your expectation for return is an invaluable part of the advisor-client relationship. Asset flows into Oakwood over the past year indicate that you appreciate the disciplined environment that we provide and the wealth management that we deliver.

Wishing you and your family a happy, safe and prosperous 2012,

Oakwood Capital Management LLC ■

The Market's Response to Crisis

Performance of a Normal Balanced Strategy: 60% Stocks, 40% Bonds



Source: Dimensional Fund Advisors

* Balanced Strategy: 7.5% each S&P 500 Index, CRSP 6-10 Index, US Small Value Index, US Large Value Index; 15% each International Value Index, International Small Index; 40% BofA Merrill Lynch One-Year US Treasury Note Index. The S&P data are provided by Standard & Poor's Index Services Group. The Merrill Lynch Indices are used with permission; copyright 2010 Merrill Lynch, Pierce, Fenner & Smith Incorporated; all rights reserved. CRSP data provided by the Center for Research in Security Prices, University of Chicago. US Small Value Index and US Large Value Index provided by Fama/French. International Value Index provided by Fama/French for July 1981–December 2010 and MSCI World ex USA Value for January 2011–September 2011. International Small Cap Index compiled by Dimensional from StyleResearch securities data; includes securities of MSCI EAFE countries in the bottom 10% of market capitalization, excluding the bottom 1%; market-cap weighted; each country capped at 50%; rebalanced semiannually. Indexes are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Not to be construed as investment advice. Returns of model portfolios are based on back-tested model allocation mixes designed with the benefit of hindsight and do not represent actual investment performance.

2011 Review: Economy & Markets

Global investors entered 2011 with hopes that the world economy would continue to recover from a painful deleveraging process. Equity markets had posted two straight years of positive performance, central banks remained committed to pro-growth monetary policy, and major developed nations were focused on reducing debt.

By mid-year, however, optimism faded as troubling events dominated headlines. The earthquake and tsunami in Japan, political unrest in the Middle East, rising oil prices, a US credit downgrade, the threat of recession, and an escalating debt crisis in Europe all weighed on markets. Investors faced a major test to their discipline and staying power.

Although US stocks experienced some of the highest volatility in years, the broad US market delivered flat performance in 2011. Developed markets logged negative returns, and emerging markets had mixed performance, with most countries underperforming the US. The bright spots were in the fixed income arena, where a flight to quality triggered by the euro debt crisis and US credit downgrade boosted returns on US government securities, inflation-protected securities, and municipal bonds.

While investors with broadly diversified portfolios would not have avoided losses, they were better equipped to endure the uncertainty. Major themes during the year included:

European Debt Problems

The sovereign debt crisis intensified as European authorities struggled to avert a Greek debt default and alleviate fiscal pressures in Italy and France. But these restructuring attempts fell short of market expectations, raising concerns of additional sovereign debt downgrades and a possible breakup of the Eurozone. Higher borrowing costs in the most indebted countries, combined with reduced government spending and revenues, raised concerns that the Eurozone may be heading for recession.

Economic Uncertainty

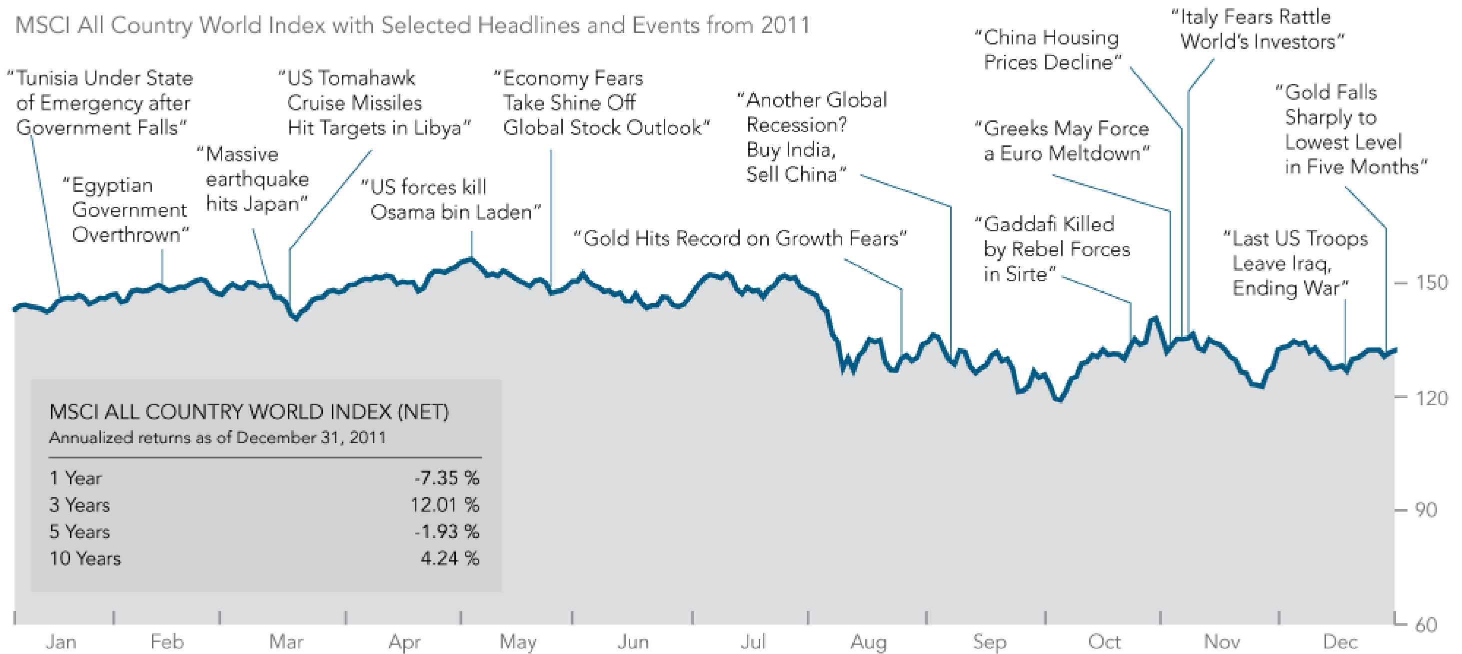
Since the global financial crisis in 2008, central banks and governments have taken bold measures to fuel business activity and stabilize financial markets—and investors have eagerly awaited signs that economic recovery has taken hold. The signals were mixed in 2011.

- Favorable US news included strong corporate profits and dividends, substantial levels of cash on corporate balance

continued on page 4

World Stock Market Performance

MSCI All Country World Index with Selected Headlines and Events from 2011



Source: Dimensional Fund Advisors, MSCI.
In US Dollars. Index is not available for direct investment. Performance does not reflect the expenses associated with management of an actual portfolio. Past performance is not a guarantee of future results.

What Helped Global Strategies in 2011

- Inflation-Protected (TIPS)
- Intermediate Government Markets
- US Real Estate (REITS)

What Hurt Global Strategies in 2011

- Emerging Markets
- International Markets
- Commodity Strategy

Structured Global Equity Strategies from page 3

sheets, low interest rates and inflation, a booming domestic energy sector, continuing strength in auto sales, record-high share prices for some multinationals, and improved numbers in manufacturing, exports, consumer confidence, and employment.

- Pessimists point to the longstanding joblessness, slumping home prices, tepid growth in retail sales, worrisome levels of government debt, and political gridlock at both the national and state levels.

Although emerging economies showed resilience, investors were concerned that another recession in Europe would impact its trading partners particularly in China, where high inflation and a manufacturing slowdown threaten to send its fast-growing economy into recession.

Rising Volatility

Investors in US equities had to endure a heavy dose of uncertainty for very modest gains. The S&P 500 Index reflected this volatility by closing up or down over 2% on thirty-five days in 2011, compared to twenty-two days in 2010. Before the global financial crisis of 2008, the S&P index did not have a single day with a 2% or more movement in 2005, and only two such days in 2006.

Falling Commodity Prices

In early 2011, commodities soared with expectations of improving economic growth around the world. Copper, cotton, corn, and crude oil hit all-time highs in the first half of the year. The Dow Jones-UBS Commodity Index peaked in April, then lost 13% for the year—its first negative return since 2008. The exception was gold, which set more records in 2011 but only returned about 10% for the year. ■

Tax Report Enhancement

As you know, Oakwood reconciles your tax reports with Form 1099s before sending them to you. Since our firm's inception, we have always provided you with cost basis that is typically adjusted in accordance with IRS rules. Starting this year, the IRS requires custodians to include the cost basis in the Form 1099s. We anticipate some differences because the method or starting date of the custodian's calculation may differ slightly from ours.

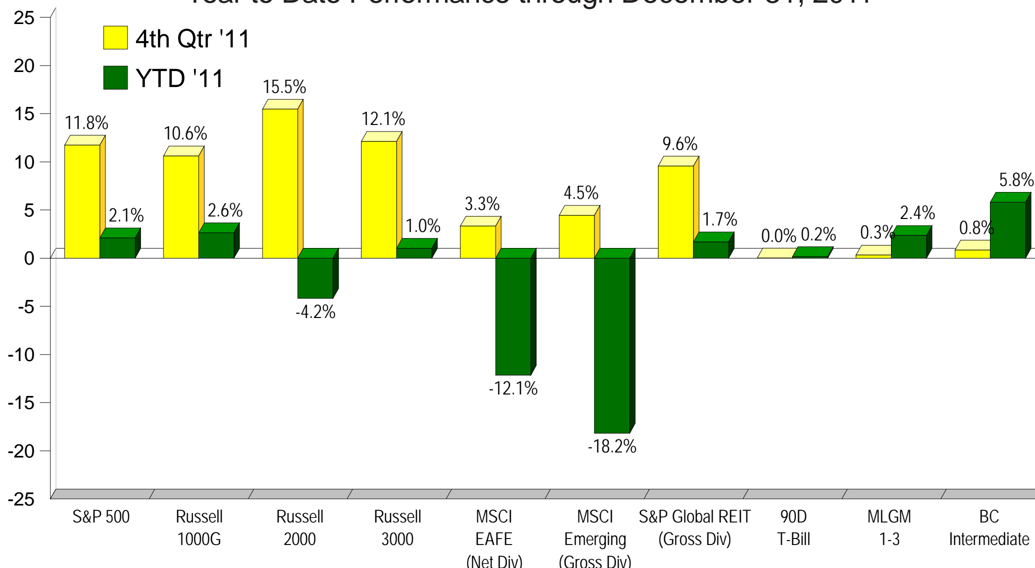
We have also added enhancements to the 2011 tax reports this year.

- Reclassification of dividends, interest income, capital gains/losses and other expense items to match the classifications in the Form 1099s you will receive from the custodians.

- Downloadable tax reports in Excel format.

These enhancements should make your tax preparation easier and more efficient.

Please let us know how we may help on this or other issues.



Source: Frank Russell Company, Standard & Poor's Index Service Group, MSCI data copyright MSCI 2011, Bank of America Corp., Barclays Bank PLC, Oakwood Capital Management LLC

Diagnosis Confirmed, Cure Pending

Given all the challenges in 2011, what's most amazing about the year is that we got through it with a positive gross domestic product (GDP). It's also reassuring that we didn't fall into another recession, although that confirms the pattern that, since World War II, the probability of recession is low when cyclical spending remains depressed.

The US equity market, essentially flat, confounded the expectations of optimists for a stronger bounce back. Post financial crisis growth tends to be sluggish and volatile and we've closely followed that script. Even with the fourth quarter's uptick in GDP strength (estimated at slightly more than 3%) the full-year's growth may not even reach 2%.

Recovery impeded but not waylaid

Global recovery was hindered, but not derailed, by an ongoing string of shocks: food and energy shortages arising from the Arab spring and drought; Japan's earthquake and Thailand's floods disrupting the auto and technology supply chain; and the policy and political stand-offs in the US over the debt ceiling and in the Euro zone over the debt issue. These international themes, in varying states of resolution, will continue to influence the US recovery.

But from a domestic perspective, data suggests that US economic expansion can sustain itself. The fourth quarter GDP revision of +3 to 3.5% reflects faster inventory building than initially assumed, as well as a narrowing of the real trade deficit. In addition, the Fed districts are recording better readings of the forward-looking regional production and manufacturing indices (PMIs) than in the springtime. Initial jobless claims fell to the lowest levels since May 2008 at 366,000, hinting at an improvement in the pace of labor market recovery.

Corporate balance sheets strengthening

Corporate earnings in the fourth quarter are estimated to be up about five percent, which equates to an annual improvement of approximately 17% in earnings per share. Early estimates for 2012 are expected to be flat to slightly up due to slowing global demand. The causes of the US economy's reacceleration include post-storm rebuilding, vehicle production bounce-backs, and easing in gasoline prices and mortgage rates. While equipment depreciation is scheduled to diminish, bank lending is growing, corporate profits are increasing, and dollar weakness contributes to US trade competitiveness.

Even with the recession scare this past summer, economists believe we will have positive but modest real GDP growth, just not the traditional 3% level the nation had grown accustomed to. Within this environment, we prefer large domestic companies that have the flexibility to adjust and remain profitable in a slower growth environment.

A world at odds

On the global front, Europe is caught in a cycle in which high-risk sovereign debt demands high yields, impeding deficit reduction, and thereby perpetuating higher risk. By kicking the can down the road, European policymakers inject time, a necessity to pursue effective deleveraging. China started applying the brakes in the second half of 2009 after a fiscal and monetary response that was sharply expansionary through the global financial crisis. The Chinese government has reversed its loose policy, tamping down on lending to businesses. As a result, exports have slowed. Unlike the US and Europe, China has plenty of fiscal and monetary ammunition to offset a decline in external demand. Assuming this outlook for a "soft landing," US companies investing and selling in China represent an attractive long-term investment.

In summary …

A world of private-sector deleveraging, fiscal austerity, and monetary stimulus translates to a market which will remain quite volatile over the next year as the forces of restraint and monetary reflation oppose each other. The prices of equity assets are likely to end the year higher, but will be volatile in the meantime. We are not bearish on equities given the modest current valuations and our expectation is that the global economy will continue to grow.

Now is the time to focus on capital preservation. It is a time to remember that equity asset valuations are reasonable rather than cheap. Markets are priced for an environment of weak growth, but not for another global recession or Lehman-style financial event. In this sort of environment, assets that generate strong and consistent income flows but are not particularly vulnerable to cyclical slowdown should outperform. We will continue to be opportunistic in terms of buying on any major price dips, while looking to further increase the dividend yield of the portfolios.

Portfolio Construction

For our **Equity Income** strategy, given our conservative objectives, stock selection continues to focus on quality, preservation of capital and income. In the current environment and in view of the market's expected volatility with an

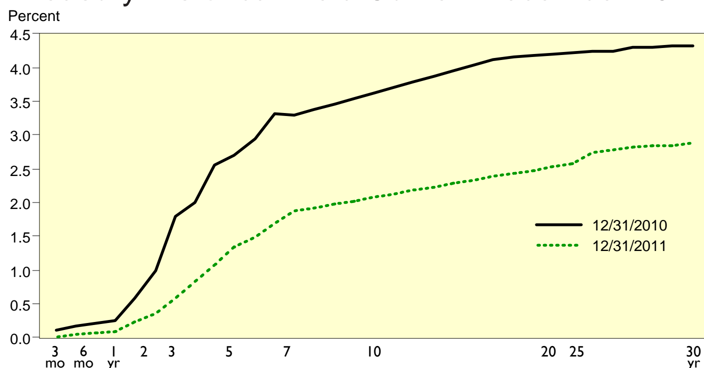
continued on page 7

TAXABLE BOND COMMENTARY

The Key to Success: Asset Allocation

Yield levels on US Treasury securities will likely remain below inflation for years. That seems to be the consensus among prominent economists. Some economists have stated that we're entering an era of unsatisfactory investment returns for bondholders. With almost 14 million Americans unemployed and factories operating at 78 percent of capacity, that may be valid. It's clear that artificially low interest rates impact investors seeking reasonable return on their investments. In fact, since the Federal Reserve announced its intention to maintain a zero interest rate policy through 2013, bond yields in most maturity areas have fallen well below reported inflation, as illustrated in the chart below.

Treasury Historical Yield Curve - December 2011



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

Investors have traditionally turned to asset allocation to achieve returns compatible with their objectives. Unfortunately, as the Fed has taken earnings power from individuals to finance out of control deficits at little or no cost, investors are forced to revisit their security preferences. The historical role of bonds has been to capture a modest return premium over inflation, while stocks are designed to achieve higher growth.

In order to manage return outcomes, fixed income professionals must balance between two dominant market factors, **interest rate exposure** and **credit risk exposure**. Through 2011, we were effective in the use of both to achieve better than expected returns for clients. In fact, while naysayers urged bondholders to avoid Treasuries at all costs, we held longer maturity Treasury positions as rates plummeted to record low levels, and Oakwood clients benefited from this decision.

We now believe the time has come to limit interest rate exposure by reducing Treasury securities in client portfolios. We agree there is no value in owning Treasuries at rates below inflation. However, we do not support the suggestion that Treasury yields will remain below inflation for an extended period. We feel there will be a time, probably soon, when European central banks reduce their appetite for Treasuries and domestic investors once again demand a respectable yield for the risk they are taking.

We also focus on **credit risk exposure.** As reported previously, we are well over-weighted in corporate securities. After concern last summer of an imminent double-dip recession in the US, new data indicates a brighter future. As the economy in recent quarters grew faster than expected and companies grew earnings, corporate yield spreads contracted. Unfortunately, current growth projections may not be enough to maintain strong profit growth. This has prompted an extensive review of all corporate bond holdings to validate credit fundamentals. If necessary, we'll reduce some holdings.

What is Oakwood's current strategy and forecast for 2012?

- We will continue to take gains in the short-maturity areas in favor of higher cash positions. If we are correct, interest rates will begin to move higher as the economy shows improvement. This will provide an opportunity to reenter the markets at higher yield levels.

- We will use market volatility to our advantage. Since 2010, we targeted specific Treasury holdings to add value to the portfolio. We will continue to move in and out of the market, as bond prices shift between a rally and retreat mode. To buffer any risk of poor market timing, we utilize high coupon securities which have an income advantage.

- We believe properly selected corporate bonds can add to return. Where in the past we implemented a buy/hold strategy awaiting economic growth, we will now take gains and seek new investment opportunities. To assist in this effort, we pay close attention to stock market trends and individual company fundamentals.

With interest rates at unreasonable and unsustainable low levels, some investors may think they have to increase risk to achieve reasonable returns. We urge caution because this may result in an over allocation to stocks. Today, the 5-year Treasury is yielding less than one percent. If inflation accelerates, the real rate of return will be negative. Conversely, if inflation remains subdued, that 5 year yield below 1% provides little help to clients seeking growth or income.

Oakwood provides active bond management that utilizes market dynamics and quantitative techniques to reach each client's return objectives. If history is any guide to the future, market prognosticators are likely to adjust their predictions. For taxable fixed income clients, this will provide us with ample opportunity to exceed market expectations. ■

Municipal Bond Commentary

A Triumph Over Perception

With 2011 now in the history books, we are pleased to report that it was an impressive year for the municipal bond markets. For Oakwood clients, it resulted in solid tax-free income and preliminary total returns of approximately 10%. However, we had to manage through multiple issues affecting the $3.7 trillion muni-bond market. One of the most challenging issues was the perception that low yield levels make this sector a poor investment choice. The truth is that tax-free bonds provided a taxable equivalent yield advantage to corporate bonds and proved less volatile than the stock market.

Another false perception of 2011 was the misguided call for rampant defaults and bankruptcies. In reality, actual defaults were far less than 1% of the total market and remained near historic averages. This does not imply that all municipal bonds are secure, or that investors should be indifferent to security choices. After all, there were a number of downgrades and there continues to be a high degree of economic uncertainty. Investors need to scrutinize all holdings to protect against damaging credit deterioration and need to implement stringent valuation standards to avoid return-robbing transaction costs.

We find the tax-free market to be well positioned for the new year. As current prospects for inflation remain low, the Federal Reserve and Congress will continue to push for maximum economic growth. Unlike the Treasury markets, where huge rate distortions linked to global 'flight to quality' factors may prove temporary, both municipal and corporate bonds should be more predictable, as they follow the path of the domestic US economy.

The 10-year tax-free municipal bond yields versus taxable Treasury yield ratios now sits at a very attractive 110%. While we don't see this dipping down to its historic averages of 82 to 85 percent, we believe 90 percent is a realistic forecast. To reach this target, we expect Treasury yields to move up at a faster rate than municipal yields, especially if the economy experiences solid growth. Furthermore, we expect yield differentials between higher and lower investment grade (AA/BBB) credit spreads to compress, albeit gradually. With this in mind, we will begin to swap our highest quality positions in favor of A-rated bonds, for yield gains.

Investors still face several major challenges. We are reminded that Nevada, with a 13.4 percent unemployment rate, the highest in the US, needs growth to maintain its high AA Standard & Poor's bond rating. In California, tax collections since the start of the July fiscal year have fallen $1.5 billion behind projections. It appears that Governor Jerry Brown will face automatic spending cuts to avoid cash shortages in the months ahead. Nevada and California are not the only states facing financial challenges. Throughout the country, politicians are slashing budgets. Whether through curtailed projects or adjustments to worker entitlements, municipalities are now forced to function within set budgets.

Two factors are vital to the future success of most investments: **volatility** and **credit default risk.** As such, we believe the municipal bond market continues to offer investors the ability to control expectations, using a conservative investment platform. Whether choosing between State and local general obligations (backed by property taxes), or revenue type bonds (supported by user fees), Oakwood's commitment to research fundamentals may be the best approach to dealing with market volatility and exposure to credit risk. With more than two million individual security choices that encompass nearly one-hundred thousand issuers, having the access to Oakwood's multiple trading sources may prove to be the best prescription for a healthy and prosperous New Year. ■

US Equity Income & Capital Appreciation Strategies from page 5

upward bias, the portfolio continues to reflect low price/earnings ratios, strong balance sheets, earnings growth, and dividend income. We continue to favor consumer staples and income stocks, and over the longer term, energy and large capitalization technology. We also added, in the fourth quarter, a large capitalization manufacturer with global distribution of consumer packaged goods. We added a company in the energy sector with a substantial dividend yield. This company is the third largest master limited partnership in the US and gathers, processes, stores and transports natural gas.

For our **Capital Appreciation** strategy, with its more aggressive approach to the market, the portfolio is oriented toward medium-capitalization companies. In the fourth quarter, we reduced the exposure to technology by selling a company that focuses on outsourcing and value-added messaging and communication services. We continue to look for faster-growing companies that have unique characteristics within their industry, which explains our current higher than normal cash position. ■