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During the second quarter, the stock market shrugged off its recent jitters and resumed its upward march. The S&P 500 Index returned 6.3% during the quarter and is now up 7.0% for the year to date. It is of note that this key index reached new all-time highs with this recent advance, surpassing its peak level from July of 2000. The NASDAQ Composite Index enjoyed an even stronger quarter, up 7.7% and is up 8.2% on the year. Unlike the S&P 500 Index, this index remains about 45% below its previous 2000 highs due to the magnitude of its earlier declines. Foreign stocks continued to show strength. The Morgan Stanley EAFE Index gained 6.7% on the quarter and has returned 11.2% so far this year. This impressive quarter for stocks ran counter to a weak bond market as the yield on the ten year U.S. Treasury moved back above 5%. The Lehman Aggregate Bond Index lost 0.5% on the quarter, but remains up 1.0% for the year.

The uninterrupted advance in stock prices over the past five years has been driven by strong corporate profits and a very accommodating monetary backdrop. With interest rates continuing to rise and lending practices tightening, the monetary environment is no longer positive. If the stock market were a jet airplane, we would now be flying on one engine. The status of the remaining engine (corporate profits) is also now in doubt, particularly given the turmoil in the housing market. While an economic recession may be avoided thanks to strong economic growth abroad, it remains our belief that the market is not properly discounting the risk of an economic slowdown and lower corporate profits.

As such, we continue to reduce the equity exposure in our portfolios, where such a decrease is warranted. Generally speaking, our portfolios have benefited from above target equity allocations over the past year. Now, however, recent sales have put the equity exposure for most portfolios in line with (or just below) each client's target allocation for stocks. Typically, these sales have come from some of our better performing value-oriented stock funds, so that our remaining equity exposure has a greater emphasis on high quality, large, growth stocks. After many years of laggard returns, we are confident that such growth funds are primed for a period of strong relative performance. The proceeds from our recent sales were, in most cases, re-invested in high-quality bond funds, which provide a compelling alternative to stocks in the current environment and provide us with a "safe harbor" should stock prices fall.

Sincerely,

A handwritten signature in black ink, appearing to read "David B. Ackerman". The signature is fluid and cursive, with a long horizontal stroke at the end.

David B. Ackerman, CFA, CFP
Partner