

ACKERMAN CAPITAL MANAGEMENT, LP
5956 SHERRY LANE, SUITE 1600
DALLAS, TX 75225
(214) 361-5383

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After a dismal first quarter, U.S. and foreign stock markets rallied during April and early May. With the failure of Bear Stearns and enormous write-offs from many other major financial institutions, the thinking seemed to be that "things could not get any worse." By late May, however, a signal from the Federal Reserve that they would not cut interest rates further and the continued rise in energy prices sent stocks back into decline. The S&P 500 ended the second quarter down 11.9% for the year, while the MSCI EAFE Index of foreign stocks is down 10.5%. For bonds, the second quarter action was the inverse of the stock market. Prices declined for most of the quarter, before recovering in the final weeks. The Lehman Aggregate Bond Index is up 1.2% for the year to date.

We were not enticed by this recent stock market rally. We continue to believe that stock prices could fall further as they discount an economy that, to us at least, is clearly in recession. Accordingly, your portfolios have been defensively positioned all year with equity allocations well below targets outlined in each client's Investment Policy Statement. In fact, we took advantage of the recent rally by selling the Excelsior Pacific/Asia Fund (now called the Columbia Pacific/Asia Fund). We purchased this fund in March 2004 and sold it within days of the recent market top. During the time we owned the fund, it generated an annualized return of nearly 13% - almost twice that of the S&P 500 during the same span. We sold the fund due to a recent change in management along with an eye toward reducing the equity allocation in our portfolios even further.

We are very pleased with the performance of our portfolios since the market peak last summer. While most clients' portfolios have not been immune to losses during this period, the percentages have been relatively small. To put it in better perspective, generally speaking, our portfolios have given back only half of last year's gains and are still solidly in the black over the past eighteen months. The S&P 500 Index, meanwhile, has fallen twice as much this year as it was up last year and is down 7% over the past eighteen months. Our ability to conserve capital during this difficult period can be attributed in part to our timely, tactical asset allocation moves. We reduced our equity exposure just before the market peak last summer and used the rallies that have since followed to reduce our exposure even further. Our fund selection has also been quite good during this period. Our focus on large, high quality growth stocks, here and abroad, has been spot on. Finally, our contrarian and risk averse approach steered us away from some (formerly) very popular investments that have declined a lot more than the broad market. For instance, over the past three years, housing stocks are down more than 75%.

REIT funds are down 19% since the beginning of 2007. In just the past twelve months, financial sector funds are down 42%, large cap value funds are down 22%, small cap value funds are down 19%, and high yield bond funds are down 10%. Chinese stock funds are down 38% since last October and India stock funds are down 35% since the beginning of the year. I think it is a safe bet that many investors have suffered some major losses.

Looking forward, we expect to maintain a defensive posture in our portfolios until this market decline has run its course. The eventual bottom, which we could see before year end, will likely be characterized by extreme negative investor sentiment, and even more dour headlines about the state of the markets and the economy. It is at this juncture, when other investors will be “throwing in the towel”, that we will take advantage of overly depressed prices by increasing the equity exposure in our portfolios. Most investors wait for the scary headlines to abate before they buy stocks again, thereby missing out on much the recovery in stock prices. In fact, stocks tend to bottom well before the economy actually begins to recover. Furthermore, history has shown that market advances from recession driven lows are some of the most profitable times to own stocks. We will be prepared to take advantage of this opportunity.

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