

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

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The stock market pulled back in late February in response to a sharp and sudden drop in the Chinese stock market. On February 27th the S&P 500 Index fell 3.5% in one session, which was the largest one day decline in almost four years. Fears were further compounded by the continued meltdown in the sub-prime mortgage industry, which led to additional losses in the days that followed. Investor enthusiasm returned quickly, however, pushing the major market indices back into positive territory for the year. The S&P 500 Index ended the quarter up 0.6% and the NASDAQ Composite Index rose 0.4%. Foreign stocks continued to demonstrate relative strength, with the MSCI EAFE Index rising 4.2%. Bonds, meanwhile, rallied as the equity markets fell, but retreated just as quickly when the stock market recovered, netting a 1.5% gain for the Lehman Aggregate Bond Index for the quarter.

We used the correction in stock prices to increase the equity exposure of newer portfolios that may have been under-invested relative to their Investment Policies. For the vast majority of our portfolios, we simply maintained the current equity exposure. While we did not (and do not) believe that the recent market weakness is part of a larger correction, we believe it to be a harbinger of a more significant decline in stock prices that could develop later this year or early next year. As we have stated before, the market is overdue for a 10% to 15% decline (this latest decline was only about 5% from the high to the low). We continue to believe that the slowing residential housing market could likely push the economy into recession, and that eventually the stock market will discount this risk.

Our focus, going forward, will soon shift towards reducing the risk in our portfolios given the looming correction in stock prices. This process will involve a lowering of equity allocations (relative to each client's Investment Policy and asset allocation targets) with a corresponding increase in our bond allocations. Within each of these asset classes, our emphasis on higher quality securities will stand us in good stead. The performance of the capital markets over the past four years has left many investors complacent about the possibility of losses. It is precisely when others are complacent that our contrarian approach leads us to be more aware of the risks to our portfolios.

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