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The capital markets began 2011 in very much the same way they ended 2010. The capital markets were strong and investors continue to be well compensated for taking risks. The S&P 500 Index gained 5.9% on the quarter, with particular strength among energy and natural resource companies. Commodities, as measured by the DJ-UBS Commodity Index, gained 4.4% in the quarter. Taxable bonds managed to eke out a 0.5% gain as measured by the Barclays Aggregate Bond Index. Municipal bonds, meanwhile, recovered from weakness late last year to post a respectable gain of 2.9%, as measured by the Barclays Municipal Bond Index.

Our portfolios continue to profit nicely from the advance in the capital markets despite our conservative posture. Generally speaking, the equity allocations in our portfolios are at or near the low end of investment policy ranges, and, conversely, our fixed income allocations are at or near the high end of their allocations ranges. In both asset classes our primary focus is “quality.” In equities, this means holding funds which give us exposure to large, “blue chip” companies. In fixed income, this quality bias means limiting our taxable bond exposure to government and investment grade corporate bonds. In municipal bonds, we are invested in funds whose portfolios are among the highest in average credit quality. We are avoiding exposure to commodities, commodity-oriented stocks, emerging market stocks and bonds, precious metals, real estate, high yield bonds, and smaller speculative stocks. We participated nicely in a number of these areas during the market recovery, but have long since taken our profits. Today these investments are far too popular with the investment “crowd”. Given our outlook for a weaker economy, we believe that these areas of the markets are vulnerable to significant price declines.

This type of contrarian stance is nothing new for us. We have made a number of successful tactical moves in our portfolios over the years, but nothing stands out more than our successful avoidance of any major losses related to the Internet Bubble at the beginning of the decade and the Housing Bubble near the end of the decade.

Eleven years ago at the peak of the internet bubble, we wrote in our quarterly client letter dated April 20, 2000 that:

“...the speculative bubble in technology stocks has reached its final stage. Investors are now focusing only on the highest risk situations. This is indicative of a peak in speculative enthusiasm and portends the end of the technology and Internet bubble is near.”

These comments coincided almost perfectly with the top in these stocks, after which the Nasdaq Composite fell 75% and the Inter@ctive Week Internet index fell 90% over the next couple of years. Our portfolios were invested away from these stocks, and losses were minimized.

More recently, we positioned our portfolios in a defensive manner (very similar to our current posture) ahead of the bursting of the Housing Bubble and the major declines in stocks and risk assets in 2008.

On April 17, 2008 we wrote to our clients that:

“While some may debate the odds of a possible recession, we believe that it began last December or January. Furthermore, we believe that this recession could be deeper and last longer than many might expect. The housing downturn is far from over. As such we anticipate another down move in the market before things improve. We can envision an eventual market bottom that will be accompanied by very negative investor sentiment in the face of scary headlines about regional bank failures as well as comparisons to the stagflations of the late 1970’s and even to the great depression.”

As our clients who have been with us since then know well, our losses in 2008 were modest in comparison to similarly managed portfolios. Even more impressive is that we timed the bottom of both markets well and generated excess gains in the year following both bubbles.

The situation today feels very similar to the periods preceding these two recent stock market debacles. Like these examples, currently there is almost uniform consensus among the investment “crowd”. Today that consensus is that the economic recovery will remain strong and that serious inflation and rapidly rising interest rates are just around the corner. History has taught us that when there exists such speculative fervor for a particular type of investment that, eventually, things will end badly and fortunes will be lost. As such, we will maintain our defensive posture in an effort to protect our capital from serious losses and to provide us with the means to take advantage of the values that are sure to follow.

Sincerely,

A handwritten signature in cursive script, appearing to read "David B. Ackerman".

David B. Ackerman, CFA, CFP