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The capital markets rebounded from a weak second quarter and generated healthy returns in the quarter just ended. The S&P 500 Index rose 5.7% in the third quarter and is now nearing levels not seen since the market peaked in the spring of 2000. The NASDAQ Composite Index is still well below its former highs, but rose 4.2% in the quarter. The MSCI EAFE Index of foreign stocks rose 4.0% in the quarter and established new all-time highs for that index. Bonds, meanwhile, benefited from receding inflation fears, as the Lehman Aggregate Bond Index returned 3.8% in the third quarter. Our portfolios were well positioned for this rally. In our previous quarterly letter, we correctly predicted that “the recent market decline will be short-lived and that future market gains await us in the second half of the year.” In that letter, we also explained our tactical decision to increase equity holdings in our portfolios in accordance with this outlook.

While we believe that this stock market rally will likely continue into next year, we are growing increasingly concerned about the prospect for a meaningful correction in equity prices. Since the market bottom in the spring of 2003, the S&P has returned 67.7% (an annual rate of 15.9%) and smaller stocks have performed even better, as the Russell 2000 Index has risen 107.7% during this period (an annual rate of 23.2%). What is more notable is that during this 3 ½ year period, the S&P 500 has not experienced a single decline greater than 10%. By historical standards, this represents an unusually long period of uninterrupted markets gains, and portends that a period of falling prices is imminent. Our analysis of the macroeconomic environment only serves to confirm this outlook. Corporate profit growth is beginning to slow as a result of two years of Fed interest rate hikes, and the boom in housing activity has come to a screeching halt. While many economists and Wall Street strategists are predicting a “soft landing” for the economy, we are less optimistic. We have long believed that the housing boom was being driven to a much larger extent by aggressive lending practices than underlying fundamentals, and as a result, we believe that we are entering a housing slump that will be deeper and longer than most “experts” are predicting. Given that outlook and the integral part that housing activity plays in our economy, we believe that the risk of an eventual economic recession is fairly high.

Given these growing concerns about the economy and the risk of falling stock prices, as we head into next year our focus will shift towards reducing the risk in our portfolios. This will involve a lowering of equity allocation (relative to each client’s Investment Policy and asset allocation targets) and a corresponding increase in our bond allocations. Within each of those asset classes, our growing emphasis on higher quality and less risky securities will also stand us in good stead. Finally, as I meet with each of you in the coming months, we will review your Investment Policy, specifically, the analysis of possible downside risk if stock prices begin to fall. In some cases, we may choose to amend your target asset allocations to further minimize your risk of loss.

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