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For over a year now, we have been voicing our concern regarding the uninterrupted rise in stock prices since the market bottom in 2002. In April we wrote that: "... the market is overdue for a 10% to 15% decline... 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." Despite our concerns, in our portfolios we generally continued to maintain above target equity allocations, while we waited for indications of an impending market break. Finally, with investor sentiment reaching bullish extremes, we decisively reduced our equity allocation in late June of this year. Less than a month later, stock prices collapsed over liquidity concerns related to the mortgage markets and worsening data from the housing industry. The S&P 500 fell 10% in a matter of weeks. Needless to say, our prudently positioned portfolios weathered the decline well. To our surprise, however, the market rebounded strongly from its August low, and is again making new highs. We have used the recent rally to further reduce the equity exposure in our portfolios (relative to each portfolio's target allocations). Despite the market rebound and some recent encouraging economic data, we continue to believe that an economic recession (or at least a sustained business slowdown) is inevitable given the weakness in the housing industry. Historically, recessions have been associated with declines in the stock market of 15% to 25%. As such, the prudent course is to continue to limit our overall market exposure with an emphasis on large, high quality growth stocks here and abroad.

Thanks to the strong market recovery, the S&P 500 Index actually rose 2.0% in the third quarter, while the NASDAQ Composite Index gained 4.0%. Foreign stocks also continued their run, as the MSCI EAFE Index rose 2.2%. High quality bonds mirrored these gains, with the Lehman Aggregate Bond Index returning 2.8%. For the year-to-date, the aforementioned S&P 500 Index is up 9.1%; the MSCI EAFE Index has gained 13.7%; and the Lehman Aggregate Bond Index has risen 3.9%.

Within the equity markets it is important to highlight an important change that has occurred this year. After many years of laggard returns, large growth funds are now outperforming the broad market, while value funds (especially those with a small-cap focus) are underperforming. We have been predicting such a shift for some time now and have been gradually positioning our portfolios for this change. In fact, the Vanguard Growth Equity Fund, one of (if not our largest) holdings is up 19.2% year-to-date and ranks among this year's best performing diversified stock funds.

Going forward, we believe that our portfolios are well positioned given the macroeconomic environment and the associated risks. Generally speaking, we are

underweight equities, but with an emphasis on high quality growth stocks, both domestic and foreign. We are overweight high quality government and corporate bonds for retirement accounts and highly rated municipal bonds in our taxable accounts. Bonds provide a reasonable alternative to stocks at this juncture and should provide us a cushion should stock prices fall further. In addition, we continue to maintain some modest exposure to gold stocks, which remain an attractive investment and which could also provide us with some insurance against rising inflation or the unexpected.

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