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It was a rough summer for most investors. In late July, the capital markets abruptly shifted from a state of optimism and complacency to one of pessimism and outright fear. This shift was sparked by negative global economic news and concerns about Europe's debt woes. Almost overnight, the talk turned to weighing the risks of our economy sliding back into a recession. The fallout in the markets was significant. The S&P 500 fell 17% in just twelve days. Small capitalization stocks fell more than 20%, and foreign developed and emerging markets fell nearly 30% from their summer peaks. Commodities were not spared from the turmoil, as the DJ-UBS Commodity Index also declined more than 20% from its highs earlier in the year. Bonds, on the other hand, benefitted greatly from the shift in sentiment as interest rates plunged, sending the ten year U.S. Treasury rate down to an all-time low of 1.7%.

While many investors were caught off guard by the recent turmoil in the markets, we had anticipated just such a shift and had our portfolios positioned appropriately. In our first quarter letter earlier this year we outlined our stance:

"...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 the allocation ranges. In both asset classes our primary focus is '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...Today these investments are far too popular with the investment 'crowd'...History has taught us that when there exists such speculative fervor for a particular type of investment that, eventually, things will end badly...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." (ACM 1Q Letter, 5/12/11)

Because of this defensive positioning, our portfolios held up very well during the market collapse, and we were in an excellent position to take advantage of lower prices. Across our portfolios, we took profits in our long and intermediate bonds and meaningfully increased our equity exposure at or near the market lows in early August. We also reallocated a portion of those bond sales to shorter-term bond funds, which will be less impacted by higher interest rates in the future. While interest rates may fall further in the short-term, we believe that the August plunge represents the "beginning of the end" of the more than three decade decline in interest rates. We are of the belief that interest rates will be much

higher in the second half of this decade, and our recent moves are just the first step in what will be a gradual process of lowering the interest rate sensitivity of our investment portfolios.

We continue to believe that our economy remains in what one could consider a “soft depression” as we will continue to struggle with a long-term deleveraging cycle and a continued decline in residential housing prices. These headwinds will limit economic growth for the foreseeable future. Expect to see our economy move back and forth between tepid growth and mild recessions for years to come. Comparisons made to Japan’s experience of the last two decades are not misplaced. There are many differences, of course, though not all of them are positive. Japan has had the advantage that its debt is internally owned by Japanese citizens and corporations. More than half of our debt is owned by foreigners, with China being the largest holder. Japan has managed to keep their economy afloat all these years by keeping interest rates extremely low. We can envision a time when we may not have that same luxury, particularly if our own growing debt problems are not properly addressed.

On a more positive note, however, in the short-term there appears to be some room for improvement in investor sentiment. While the resolution of the sovereign debt crisis in Europe remains the major wildcard, we are entering the seasonally strong half of the year for the stock market. The capital markets should also benefit from less uncertainty in the political arena as we move closer to the election next fall.

Overall the investment backdrop can only be described as difficult and confusing, and volatility in the markets will not subside any time soon. These types of markets, however, are perfectly suited for our approach to investing where we combine forward thinking with flexible and tactical portfolio management. We have navigated the “roller-coaster” markets of the past decade quite well, and we are confident that in the coming years we can continue to both protect the value of our portfolios in difficult periods and profit nicely in better times.

Sincerely,

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

David B. Ackerman, CFA, CFP