

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

January 15, 2007

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Large University Endowments

In 2006, speculators were rewarded by the market while risk-averse investors weren't. How did you do? Now let's look back to 2005. Then, the markets were not as generous to these risk takers or their counterparts. How did you do then?

Year in, year out, those who rely on one style of investing or another can experience wide differences in results from one year to the next. Professional investors understand this fact all too well. Yet, a great lesson can be learned from how large university endowments create reliable returns, year after year. In fact, the institutions they represent require it.

When we invest, we are placing a wager on the future. So, reason should guide you to acknowledge that predicting the future is an uncertain task. Or, that past performance may not always be indicative of future results. What would you think if I told you that 2005's "Dogs of the Dow" were last year's winners? Or, that this year's top fund managers could have been found in the middle or bottom of the pack at some point also? Chasing today's "hot picks" often causes investors to buy when the price is already too high. And, how many times have you exited a poorly performing strategy only to see it do well afterwards? What's an investor to do? Try doing your own research? Muddle through the conflicting babble of "experts" only to wind up scratching your head in confusion? By the time a magazine tip hits the newsstand it is often old news. And, with the instant impact of global events, the markets invariably will bounce around in unexpected ways over the course of time.

Yet, there are workable strategies. One investment philosophy that's generating interest today involves the investment approach taken by endowment fund managers at the major universities in the United States and Canada. The Yale endowment fund is considered to be among the most noteworthy. Over the ten-year period ending June 30, 2005, the Yale endowment earned an annualized 17.4% return, net of fees, placing it in the top one percent of large institutional investors. The performance of their peer institutions is quite exceptional as well. Recently, Mark Yusko left his position as CIO of the University of North Carolina's endowment group and started a private investment fund designed to offer endowment like advantages to private investors. This has generated some interest in the world of accredited investors as to just how would an endowment-like fund operate? What are the lessons that an investor can take away from this information?

At ELF Capital Management, LLC, we are deeply committed to providing our investors and our readers with every advantage when trying to preserve and grow their wealth. We seek to empower you with the results of careful, deliberate and rigorous thinking.

In this newsletter we explore some insight into the observable traits driving the success of top performing endowment funds and give you some guidelines that you can use to increase your financial wealth. If you are looking for information and ideas to help you achieve better

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long-term results with your investments, we think you'll get a great deal from this newsletter. Then, be sure to look over our market comment and performance data at the end.

Endowments and Their Performance

According to the National Association of College and University Business Officers (NACUBO), the "one-year average annual rate of return of 10.7 percent for the fiscal year [ended June 30] 2006 marks the third consecutive year that endowment investment income is enough to both support annual educational spending as well as reinvest a portion of earnings to protect against inflation, and pay management fees...Over the long run, a nine percent annual return rate allows higher education institutions to maximize both the endowments' current and future support for priority activities." These figures represent average performance for seven hundred and sixty-five (765) endowment funds reporting to NACUBO. Funds at the top performing schools did much better.

Thinking like an endowment can create advantages for many investors

Yet, the situation of a large university endowment fund is somewhat unique. While the better performers operate much like a hedge fund, there are observable differences in perspectives and execution when compared to the typical hedge fund.

- When looking over the NACUBO results, the larger endowment pools did better than the smaller ones. In the hedge fund world, smaller sized funds seem to do better.
- Endowments don't generally experience large redemptions or withdrawals. For the most part, endowments are comprised of restricted monies considered as permanent. Whereas, hedge funds can be plagued by "hot money" investors moving in and out.
- Top performing endowments rely most heavily on broad asset allocation strategies and selections are made with a long-term mentality. Whereas, top performing hedge funds generally focus on exploiting narrower market opportunities and trading.
- Endowment clients, the institutions represented, require a stable source of invested funds to subsidize operations and expansion. Whereas, hedge fund clients represent a variety of reasons for investing and toleration for varying levels of risk taking.

According to NACUBO, "In keeping with recent years, preliminary data indicates that overall endowment investments continue to increase in the non-traditional asset classes while investments in the traditional equities and fixed income classes decrease." This is a reflection of the growing breadth of investment strategies available and the desire for more.

The primary purpose of endowments at large universities is to ensure the school's financial independence while it pursues academic excellence. While every investment manager wants to maximize returns, they do so within the context of their strategies and the goals of their clients. For a university, this means seeking returns in a way that ensures operational budgets are met and that the returns are also large enough to grow the endowment fund beyond the rate of inflation. These requirements usually set the target benchmark for returns at roughly eight percent. More is always welcomed.

The primary responsibility of the endowment fund manager is to preserve capital and the purchasing power of the institution. This translates into the priorities of meting subsidies, keeping pace with inflationary pressures and then growing the capital, in that order. Risk

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management is therefore of primary interest to the fiduciaries and their strategies are built from this foundation. While bonds and other fixed income instruments form a small portion of their portfolios, by themselves they are not sufficient to meet the universities' requirements. So, the fund managers use the principles of Modern Portfolio Theory (MPT), the uncorrelated diversification of assets, a disciplined approach to portfolio construction and continuous rebalancing to manage risk while reaching for higher returns.

While many hedge funds make similar claims about using MPT, one difference lies in the extent, breadth and depth of the strategies employed. For a large endowment, illiquidity is not much of a concern. So, as discussed earlier, they can take an extremely long view in their strategic approach and consider investments, like timber, which could take twenty years or longer to monetize. However, only larger endowment funds would probably consider investing in something as specialized as timber. In contrast, many hedge fund strategies are so narrowly focused that they can rapidly reach a point of diminishing returns as assets grow faster than available opportunities and the impact becomes dilutive. By comparison, the diversity of investment strategies employed and expertise developed within an endowment fund can offer distinct advantages over the typical hedge fund.

A second advantage, albeit related to the first, relates to the intellectual diversity focused on and developed within the typical large university endowment. Many hedge funds are started by managers with deep expertise in a market niche – expertise that is often “an inch wide and a mile deep”. As such, great familiarity with various other markets and investment strategies beyond their area of expertise is often lacking. Whereas, the typical large endowment fund manager would be actively engaged in the rigorous auditioning of fund managers representing a broad spectrum of opportunities and develop experience with many different styles and strategies. In order to manage risk, you have to understand it and this global perspective provides the background and context with which to compare, blend and create funds of funds that manage risk and augment the core strategy of the endowment pool. While endowment managers are focused on the big picture, they are seldom involved in picking stocks and are less likely to seek opportunities through timing the markets directly.

Lessons That Can Be Learned

There are a number of factors that come together to support the success of the best endowment funds.

Managing risk: An endowment's portfolio is designed to provide the university with a reliably stable source of funds. This isn't going to happen through concentrated investing in highly volatile investments. Chasing big returns requires taking big risks, and big risks lead to potential high volatility which is anathema to a stable, reliable source of funds sought by these non-profit institutions. Risks are managed through methodical portfolio allocation and diversification techniques that are applied to combine uncorrelated investments to achieve stability. Finally, risk is managed through a continuous monitoring of performance and periodic rebalancing of the investment weightings so that allocations stay true to the expected outcomes of their strategy. While returns may not compare well to riskier strategies in the short run, over time it is “slow and steady that wins the race.”

Alternative investments/alternative managers: Endowments have been early adaptors in the alternative investment markets. As mentioned in the NUCABO reference above, the

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portion of stocks and bonds in the portfolio has diminished over time in relation to the portion of funds at work in alternatives. Endowments also spend a great deal of effort identifying alternative fund managers whose reputation, history of returns, and fund strategies fit and augment the endowment's strategy. On-going monitoring is as essential a part of the process as the initial identification.

Long horizons: While endowments may look to capitalize on market inefficiencies, they are not looking for quick hits. They put more trust in the construction of their portfolios and their allocation formulas than they do in the ability of the portfolio team to guess correctly about short-term trends in the marketplace. The view of the endowment manager is a long one. They have the time to let their strategies mature and garner benefits. Not having to placate "hot money" or compete on a monthly or a quarterly basis provides an environment that allows the blend of seasoned qualitative judgment with sophisticated quantitative analysis to build powerful results in real time. It is well known that few active managers outperform their passive benchmarks over the long-term, regardless of the strategy employed.

Global reach: Finally, endowments have broadened their thinking beyond the traditional thoughts of investing all of their eggs in simple baskets of domestic stocks and bonds. They seek superior returns while artfully controlling risk through understanding the advantages of investing in global financial markets and non-traditional opportunities. This understanding affords them the ability to construct portfolios of made up of high risk and reward opportunities while maintaining overall stability in their portfolios. The focus on managing risk rather than avoiding it offers more choice and flexibility when seeking out opportunities. To do less is much like playing tennis with one hand tied behind your back. There is no need to play that way if the rules of the game do not require it.

What should this mean to you as an investor?

There are ways to operate in the financial market place that can provide you with superior returns over time while controlling your exposure to unwanted risks. Look for an investment advisor with a strategy for the long-term. Short-term windfalls are associated with long-term mediocrity. If you know a little about baseball, then you know that the overall batting averages of home run hitters usually trail those of their more consistent teammates. It takes a wide variety of athletes to make a winning team, and in managing wealth, success comes from steady performance over time as well. Next, returns must always be considered in relation to the amount of risk tolerated by the investment manager (and by extrapolation, the risk appetites of his or her investors). Thoroughly explore that risk tolerance of those managing your investments. Terms like high risk or moderate risk are insufficient for you to understand the implications of the manager's strategies and the choices he or she will make when seeking returns for your money. Finally, a deep knowledge of and experience with alternative investments creates a vital advantage in someone you entrust to preserve and grow your wealth. Solid research on your part on where you are entrusting your funds can go a long to enabling good returns.

How do we know so much about endowments? When you have investment professionals who have worked at the venerable University of Virginia endowment management group, one of the better performing large endowments amongst its peers, it certainly helps. As well, we too are exploring the ability to create an endowment-like fund and are currently reaching out to determine investor interest through our contacts.

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ELF Capital Management Investment Performance Update

U.S. equity markets ended 2006 with one of the best showings in the last three years. While at the end of 2005, investor's outlooks were focused on the potential risk of slower economic growth, higher inflation and a new Fed Chairman who was expected to continue raising rates, the worst never materialized. In May, the new Fed Chairman spooked the markets by coming out very hawkish and seemingly miscommunication with the press. This boosted market volatility, globally, to heights not seen in well over a year's time. Only Larry Kudlow assured us that we were entering a Goldilocks phase and that the U.S. economy's strength "was the greatest story never told".

According to The Wall Street Journal's 2006 year end review, "Many investment pros, most notably at the bigger hedge funds, became overly skeptical during the summer and fall and refused to believe that the markets would resume rising." We were in that over-conservative camp and prices did resume rising. It wasn't until mid-fall that we moved back into the markets with greater confidence. Thankfully, we were able to out-perform in the last quarter of the year and regain some lost ground.

For the month ended December 31, 2006, our one-month performance is up 3.32% and our three-month return is up 7.65%.

For disclosure purposes, past performance is not necessarily indicative of future results and ELF Capital Management LLC (ELF), formerly Hoffman White & Kaelber Financial Services LLC, cannot guarantee the success of its services. There is a chance that investments managed by ELF may lose a substantial amount of their initial value.

ELF is an independent discretionary investment management firm established in February 2003. ELF manages a strategic allocation of primarily exchange-traded index funds (ETFs), and may invest in other carefully selected securities. ELF may also employ hedging techniques, through the use of short positions and options. ELF manages individual portfolio accounts for both individual and business clients.

The ELF ETF Strategy returns presented herein represents a composite of actual results from all client portfolios managed by ELF. Currently, it is the only composite presented by ELF and separate client account portfolio positions are substantially similar, except as may be modified for retirement plan accounts and accounts with net equity of \$60,000 or less. There is no minimum account size for inclusion into ELF's ETF Strategy composite and accounts with net equity of \$60,000 or less have a tendency to downwardly skew the combined results.

The performance data presented herein includes the reinvestment of dividends and capital gains; as well, ELF's ETF Strategy composite returns are presented after deducting actual management fees, transaction costs or other expenses, if any. ELF charges an annual investment management fee as follows: 1.25% on the first \$250,000; 1.00% on the next \$750,000; 0.95% on the next \$4,000,000; and, 0.75% thereafter.