

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

January 21, 2008

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A Time for More Objectivity and Less Fear

One would have had to have been hiding under a rock not to know that global equity markets have experienced a rapid downward correction since New Year's Eve. Rapid corrections can bring the most sedate investor from calm to panic in the wink of an eye; especially when emotions overcome rational thought. In this letter, I will be seeking to get my tender readers to consider that this recent market slide has created opportunity for investors who can set their fears aside. I will also convey that frightened investors, acting merely upon their emotions, fall prey to the "small investor theory".

As the theory goes, a "small investor" buys – invests – when prices are high and sells when prices are low. This is because the "small investor" is more likely to follow the crowd rather than follow a disciplined approach. They invest when they hear of rising markets and successful experiences of friends and neighbors – usually after a significant run up – and sell when they hear that the market is falling. This is the parenthetical opposite of what it takes to create wealth – one needs to buy low and sell high.

But, what about all this talk of the US economy heading into a recession you might say? Well, if a recession is considered a decline in the US gross domestic product (GDP), I'd have to say that even though the numbers haven't yet reflected it, we may already be in one. Fear might just be taking us there. And, that prospect doesn't concern me much as we needed to slow the US economy down to avert runaway inflation. Yet, what seems more important than just the prospect of a recession is: How deep will it be? And, how many calendar quarters will GDP continue to recede? To me, the prospects may not be dire and the outcome really depends upon US and our ability to act with sensibility.

Here is an argument from someone who is not panicked:

If you listen to the media and any number of market pundits, you'd think that they have an authoritative handle on the direction of the US economy and that the outlook is very grim. I disagree. As I see it, the pundits are looking into their **economic "crystal balls"** and trying to predict far into the future in a way that supports their own agendas; and the media is the "bully pulpit" looking to generate enough emotion to fill its 24/7 programming needs. And, I'll go one further by saying that they are waging a war to talk us into a prolonged recession for their own personal short term gains. Don't fall prey.

First, economics is a social science involving the study and exploration of human relationships and environmental factors relating to the production, distribution, and consumption of goods and services. Economists rely on statistically analyzing events from the past and endeavor to apply what was learned to forecast the future. The two biggest challenges in economic forecasting are: 1) over simplifying factors and trends; and, 2) ignoring the potential for people to innovate and change. I believe that the majority of pundits, currently in the media, have made both of these mistakes.

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Even the best economists rarely forecast with any accuracy. When in grade school, it usually took 90% accuracy or better to get an A on your report card; however, most economists' predictions are graded on a "bell curve". In this field of study, the best economic forecaster's are those who are "right" more times than their peers. So, hear these predictions from a more rational perspective and consider the alternatives.

Second, in the most basic terms, supply and demand are the greatest determinants of market prices. In this regard, it makes no difference whether we are discussing stocks, bonds, or commodities. And, it is my position that the emotions of fear and greed are often the most influential drivers of supply and demand dynamics; whereby all other factors call upon people to act upon these emotions. Yet, when these emotions can be tempered with sensible objectivity, the outcomes of our actions can offer greater rewards. Right now, I believe that over abundant fear is driving the markets down.

"Bear Market" players are feeding into this fear by preaching (in crystal ball fashion) that the "day of reckoning", from poor lending standards and over inflated real estate markets, will lead the US economy into a deep and prolonged recession. With all due respect, their arguments are plausible. In fact, they are plausible enough to diminish confidence, evoke fear and create a "road map" toward a self fulfilling prophecy. Yet, it doesn't have to be.

Are these arguments compelling enough to lead us like lemmings into the sea? I don't think so. Quite conceivably, at current market levels, we think that recession is already baked into the numbers. Why?

This month, Northern Trust Global Economic Research released an analysis of the S&P 500 and Economic Recessions since the 1950's. And I quote: "two major conclusions can be drawn: (1). The S&P 500 is a leading indicator par excellence. Since the 1950s, the S&P 500 has always peaked before the peak of a business cycle, with one exception (1980 business cycle). The S&P 500 establishes a trough prior to the end of a recession without exception. (2). The median percent decline of the S&P 500 from its peak to trough is 16.9%." The chart also reflected an average decline of 20.2% from peak to trough.

Below is a chart of where we as of January 18, 2008:

Index as of 1/18/2008	Since	
	52 Week Peak	12/31/2007
Dow Jones Industrial Average	-15.3%	-8.8%
S&P 500 Index	-15.9%	-9.8%
NASDAQ Composite Index	-18.2%	-11.8%
Russell 2000 Index	-21.4%	-12.1%
MSCI EAFE Index	-14.1%	-9.0%
MSCI Emerging Markets Index	-15.1%	-8.8%
MSCI AI Country World Index	-14.6%	-9.4%

If history is any guide, we started this market decline with reasonable equity valuations and significantly stronger employment. These facts correlate with more modest peak to trough recessionary declines. So, it is very likely that the worst has already occurred.

What other factors do we have going for us?

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First, it should be clear that the US Federal Reserve Chairman Bernanke will be supplying more significant monetary stimulus soon. At the same time, he made a very public plea for immediate fiscal stimulus in his recent testimony before Congress. Now, Bernanke has no other choice but to follow through to remain credible before Congress – Wall Street will always be critical of him out of sheer arrogance. Yet, these monetary and fiscal policy moves are very stimulative for growth and could very well pre-empt any severity in a recession. In fact, the outcome these moves could produce explosive upside growth.

What seems more significant – today - is the potential near term positive impact from our weak US Dollar against the Euro and other currencies. Not only does a weak dollar stimulate exports, it also makes the potential for significant foreign direct investment much more attractive.

Yes, the markets could go lower over the short term. However, based upon historical levels, the market is already very cheap. So, don't get caught trying to pick the bottom and sell here. After all, the USA is now ON SALE at bargain prices!

Here is what I make from the perspective I've just shared with you. Right now we are comfortable to move towards being fully invested and like large caps with emphasis towards financials (broad based), industrials, technology and energy sectors; we are still believers in global growth and like the BRIC related and other benefiting countries. We expect to frequently rebalance, into any further market dips, to maximize our upside at the turn. We see financials as our most contrarian play and believe that the impending monetary and fiscal stimulus will benefit them first and believe them to be substantially over sold at this point. We think that CDO market values are trading well below intrinsic value and that banks are being punished by the dysfunctional market pricing right now.

Check your fear. Use good reasoning and judgment. Make well informed decisions.