February 15, 2010

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Can CDO's Revive the Global Economy?

CDOs – those toxic concoction's of "greedy Bankers" that nearly brought us to the brink of Great Depression II. Could they now be the best catalyst to grow the global economy? Are they really the evil brew that cast us all close to the abyss?

Did you know that the original construct for CDO securities emanated from creative solutions that helped the U.S. resolve both the Savings and Loan Crisis and the Latin American Debt crisis of the 1980's? It's true. The Resolution Trust Company's (RTC) use of equity partnerships, in the S&L Crisis, and Brady Bonds, in the Latin American Debt Crisis, laid the ground work for creative bankers to begin creating CDOs.

While mortgage loans had been used since 1969 as collateral for the creation of securities, popularly referred to as mortgage backed securities (MBS), it wasn't until 1982 that the first Collateralized Mortgage Obligation (CMO) was conceived. "The CMO's major financial innovation, which is responsible for the rapid growth of this market, is that it provides for redirecting underlying cash flows in order to create securities that much more closely satisfy the asset/liability needs of institutional investors." – *taken from my 1993 autographed book by Dr. Frank Fabozzi on CMOs.*

In early 1988 the US Treasury Department, together with Federal Banking Regulators, began an earnest collaboration with a select group of Wall Street bankers to save the economy from both the S&L and Latin American Debt crises. The offshoot of this collaboration was creative innovations leveraging off of CMO technology – a second derivative solution (see Figure 1 below). Not only did the effort create solutions for the crisis at hand, these new innovations had broader application at investment banks as well.

One of those select investment bankers was a fellow from my former firm, Kidder Peabody. It didn't take long for Kidder to see an opportunity to take this innovation further and on February 8, 1989, Kidder launched the very first Collateralized Bond Obligation (CBO) backed by high yield bonds. In June of that year, I was hired into that unit and began to learn the "ins" and "outs" of CBO's. I remember telling my wife, "honey, I'm either going to become an expert in a dead language or be on the forefront of a new industry". A new industry it was. By 1994, I held a leadership position in that unit and we had created CBOs that were backed by "junk" bonds, MBS and CMOs, and the last was backed by credit swaps linked to bank loans. At the end of 1994, Kidder was reorganized out of existence and I moved to Charlottesville in search of calmer waters.

It came with little surprise that the Collateralized Debt Obligation (CDO) business went on to flourish with great exuberance. Until greed, complexity and fear took hold and it flourished no more. The innovation that had served borrowers and lenders for almost 20 years now drew blame for bringing the global economy to its knees.

February 15, 2010

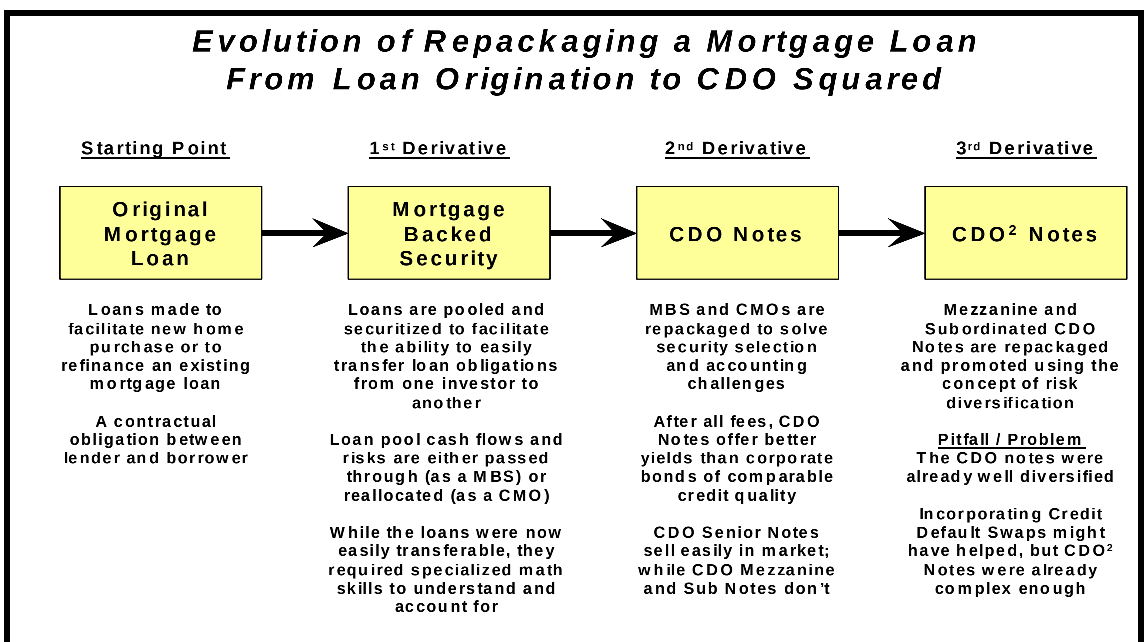
Innovators, Imitators and Idiots

Leave it to Warren Buffett, one of the world's savviest investors, to characterize what went wrong. In an interview during the late fall of 2008, he gave a masterful explanation of how the world got into this financial mess.

After being asked, "Should wise people have known better?" Buffett replied, "Of course they should have." He then went on to explain that "there's a natural progression to how good ideas go wrong." He called this progression the "three I's"…

"First come the **innovators**, who see opportunities that other's don't. Then come the **imitators**, who copy what the innovators have done. And then come the **idiots**, whose avarice [insatiable desire for wealth] undoes the very innovations they are trying to use to get rich." In other words, it wasn't the CDOs that were the problem; it was the idiocy that followed that got us into this mess.

While the first CBOs were backed by "junk" bonds, the size of the high yield market and economic opportunities – in terms of yield spreads – limited the ability to continue issuing CBO securities from that market sector. During 1991-1992, the focus then shifted from high yield bonds to residential mortgage securities. Not only was the mortgage market the largest sector of the world's debt market, MBS and CMOs were challenging for the average institutional investor to understand and account for. The security selection process and accounting for them was very tedious and burdensome.



Source: ELF Capital Management LLC ©2010

Figure 1

In the early 1990's, CBOs backed by a portfolio of MBS and CMO securities significantly reduced complexity rather than added to it. And, the two most prominent selling points were that this type of CBO:

- Served as a starting point for investors not familiar with MBS investing. They offered investors a way to invest in these assets without have to hire their own mortgage analysts. I.e., the CBO came with an outsourced asset management solution.
- Also, CBOs reduced the administrative and accounting burdens of directly holding MBS and CMO securities. The CBO issuing company took on those tasks and simplified the effort by paying out interest quarterly or semi-annually and returning principal at maturity. And, the CBO issuer reported its Net Asset Value (NAV) on a monthly basis – so investors could have an idea of how secure their principal was.

After having created and managed dozens of CBOs in the early 1990's, the product still seems quite elementary to me. Yet, I understand that they involve so many inter-related concepts that they are not often simple to explain. So, what is a CBO?

CBO's 101

The first thing to understand is that a CBO is a derivative security. For the sake of argument, let's say that a derivative is any security or financial instrument that either mimics or passes along *all of*, *part of* or *the inverse of* the economic opportunity of another security or financial instrument – call options and put options are an example of this kind. Another type of derivative is one that bundles the economic opportunity of two or more securities or financial instruments – a convertible bond is an example of this type.

A convertible bond is one that pays interest and returns principal at maturity, like a typical corporate bond. Yet the bond can also be converted into the issuer's common stock. So, the bond's pricing will be influenced by either the greater of its yield to maturity relative to the market or the price of the issuers stock net of any conversion costs.

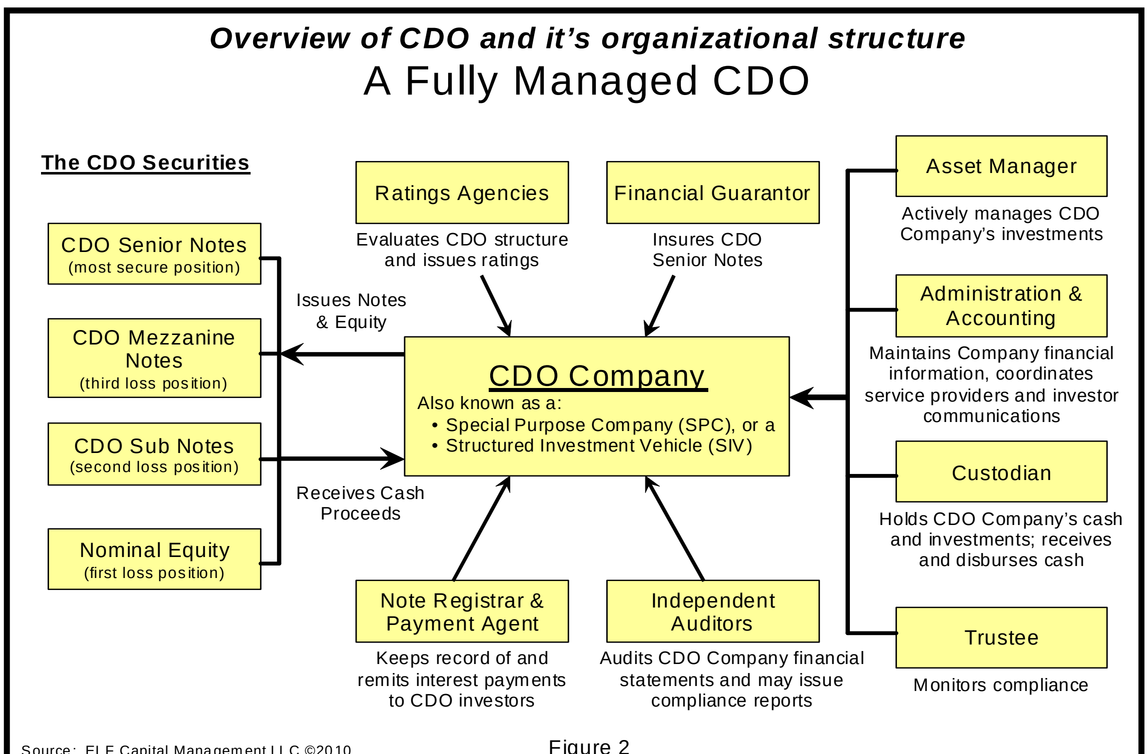


Figure 2

February 15, 2010

When seeking to understand any derivative instrument, the best way to start is to "break it down" into smaller parts or concepts and then look at each part in isolation. Figure 2 above is an overview of the very first high yield backed CBO. [Actually, the first CBO did not have CDO Mezzanine Notes. I added them for later discussion purposes.]

Next, let me define some of the terminology:

- Collateralized Bond Obligation (CBO) – CDO Notes whose principal interest payments are backed by a portfolio of Bonds (the Collateral);
- Collateralized Loan Obligation (CLO) – CDO Notes backed by un-securitized loan agreements
- Collateralized Mortgage Obligation (CMO) – Securities backed by mortgage loans
- Collateralized Debt Obligation (CDO) – a general term for all of the above. The term CDO was coined in the late 1990's after the above products went "mainstream".

Referring to Figure 2 above, we can begin to understand of how a fully managed CDO structure is organized:

- A company is formed and it gets initial funding through issuing debt and nominal equity – at this point, the CDO Notes come into existence (the Notes are originated)
- At the same time, a number of service providers are hired to: A) invest and protect its assets; B) administer its operations; and, C) report financial information to its share and Note holders. (Each of the service provider's specific roles is depicted.)

Figure 3, below, illustrates how the fully managed CDO company operates.

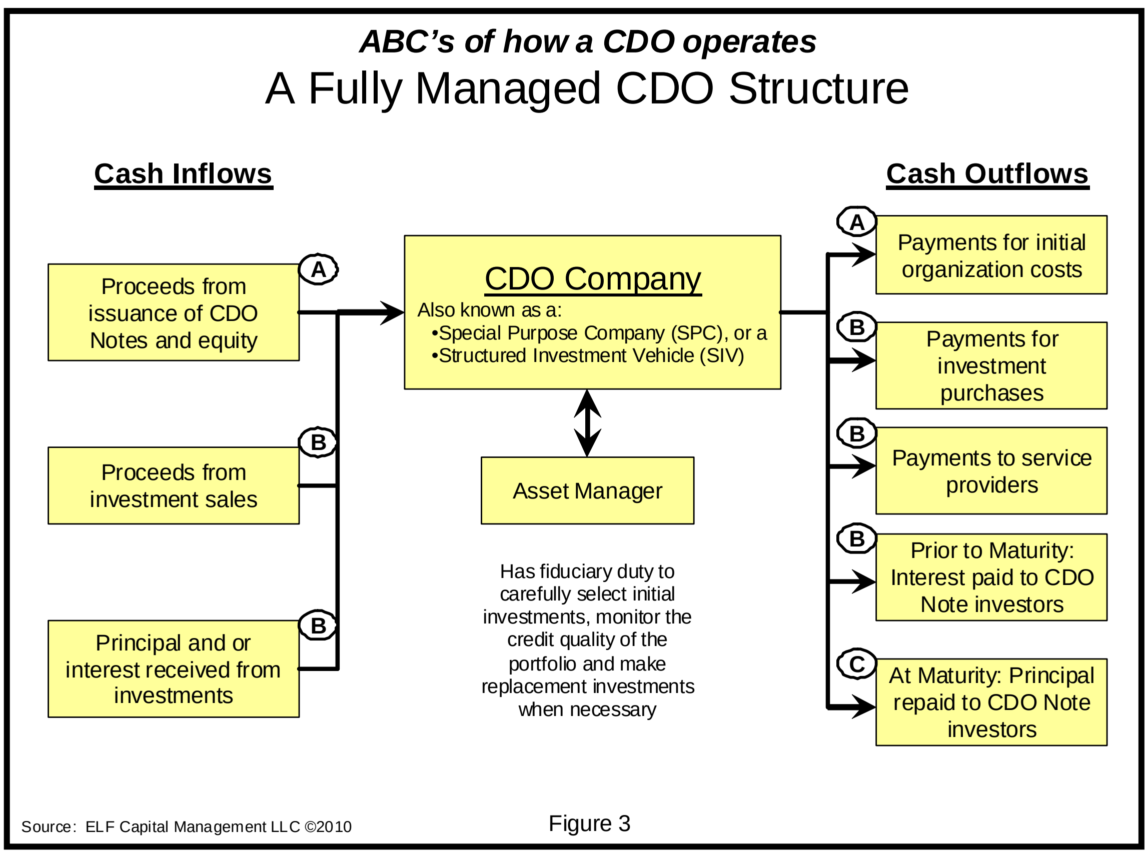


Figure 3

As mentioned above, the life cycle of a CDO begins when the holding company is formed and issues CDO Notes and nominal equity. From the issuance proceeds, it pays for its initial organization costs and invests the rest into MBS and or other investments. When initially invested, the portfolio should be constructed to generate sufficient income to safely and securely pay interest to its CDO Note holders and the company's other expenses. Typically, those in the industry refer to this as managing a "cash flow arbitrage". In a fully managed CDO, the asset manager's role is to: A) select the initial investments; B) continually monitor the quality of the portfolio investments; and, C) make substitutions to maintain or improve the quality of the collateral over time. On or before the CDO Notes mature, the portfolio investments are liquidated and the CDO Note holders receive their principal back at maturity. Once all of the CDO Notes are repaid, the CDO Company terminates and any residual is paid out to the equity holders.

In some CDO structures, the notes have a provision whereby the portfolio must begin to be liquidated if the portfolio quality and or interest or principal coverage dips below a certain point. This may also trigger an early retirement of all or a portion of the CDO Notes. This is commonly referred to as a *defeasance clause* or *unwind trigger.* If the entire portfolio has to be liquidated and all of the CDO Notes become required to mature early, losses can be sustained by the Note holders. Whether a particular CDO Note holder loses principal or not depends greatly the seniority of the investor's Notes in the CDO Company's capital structure. Here's a good point to introduce how a CDO structure re-allocates risk to its investors.

Overview of CDO Note Risk Allocation
The Math Behind Risk Apportionment

The CDO Securities	Capital (millions)	Loss Protection	Allocation of $10M Default Loss	Amount Returned At Maturity
CDO Senior Notes (most secure position)	$75M	$25M	$0	$75M
CDO Mezzanine Notes (third loss position)	$10M	$15M	$0	$10M
CDO Sub Notes (second loss position)	$10M	$5M	$5M	$5M
Nominal Equity (first loss position)	$5M	$0	$5M	$0
Total Capital	$100M	N/A	N/A	N/A

Source: ELF Capital Management LLC ©2010

Figure 4

In Figure 4 above, we can see that our sample CDO Company has three layers of Notes (tranches) and a layer of equity in its capital structure. The equity layer is the first to sustain losses and the Senior CDO Notes are the last to lose. Upon liquidation, the Senior Notes are paid off first; the Mezzanine Notes are paid off second and so on. In our example above, the CDO company has $90 million after the collateral portfolio is liquidated. The Senior and Mezzanine Note holders get their entire principal back, while the Sub Notes get half their money back and the equity holders suffer a complete loss.

This is a simple illustration of risk allocation and some CDO structures were developed with greater creativity than exhibited above.

If these innovative products were so good, where did it go wrong?

The Idiocy That Followed

When demand for a financial product becomes exuberant, bad things happen. When demand out strips supply, quality standards go down.

In the early days of CBO issuance, investment bankers introduced the concept to investment managers as a new type of managed fund structure. This was because the investment management function provided the credibility and expertise to ensure that the economics of the structure would work. The bankers and managers then enlisted the institutional sales and trading function to introduce the product to potential investors. All worked together collaboratively to bring the product to market – sales and trading introduced, investment managers educated and bankers initiated the structure. This was the effort that existed when I left the business.

By the mid 2000's, when I would get the chance to see a more current CBO model, I began to notice that some CBO structures had come to become more streamlined – a few of the service provider team had been stripped out of the product. Figures 5 and 6 below reveal what I saw.

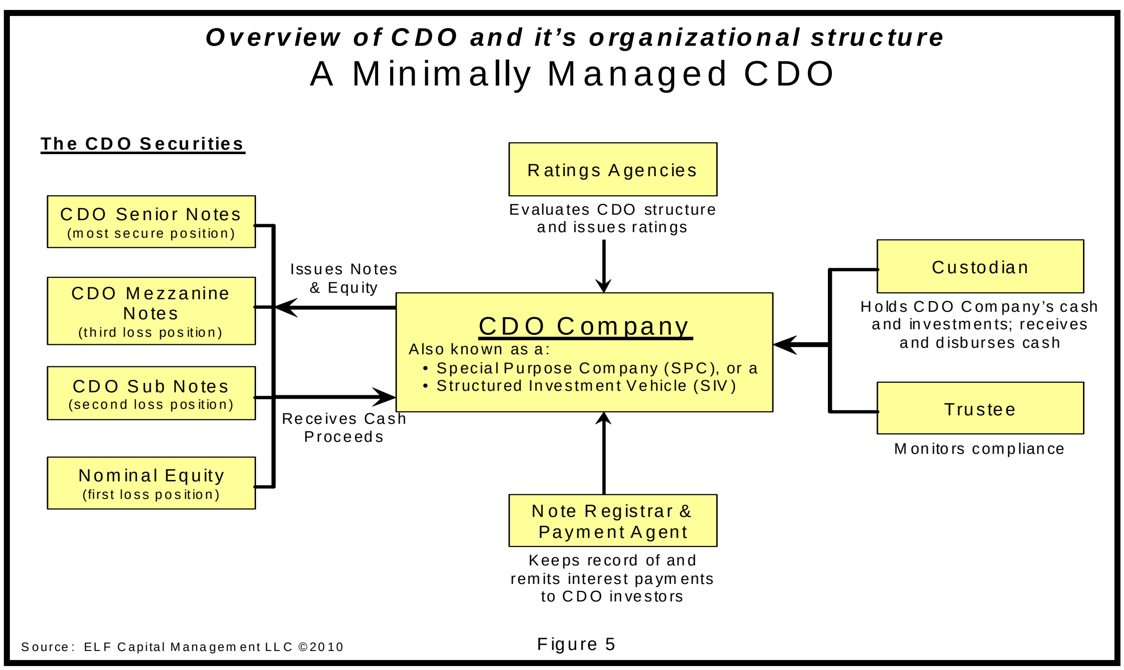
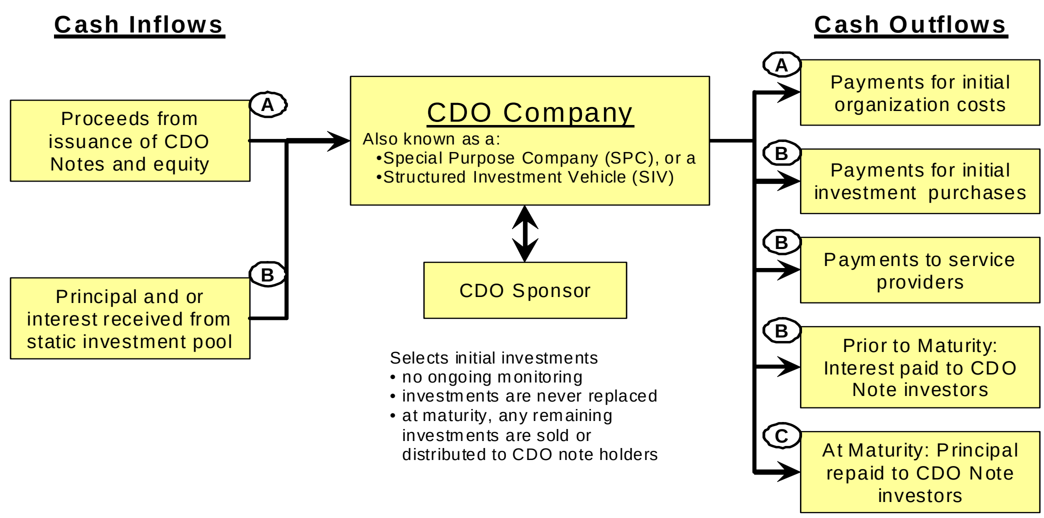


Figure 5

February 15, 2010

ABC's of how a CDO operates

A Minimally Managed CDO Structure



Source: ELF Capital Management LLC ©2010

Figure 6

What surprised me in these minimally managed structures was that the active manage feature was stripped out, along with administration, accounting, audit and financial guaranty functions. These were the very functions that simplified the investment and added the transparency and reporting functions that kept investors informed.

While I can't say that the minimally managed CDO structures reflected in Figures 5 and 6 above reflected the entire market at the time, it showed me that the few we saw reflected significantly reduced quality in the product.

Despite this, the deals sold into the market. This was a clear sign that investors were so enamored by the CDO's offerings that they tolerated less from the structures.

Another example of investor tolerance came to me when I had the opportunity to speak with one of the former Lehman brokers who purportedly specialized in selling CDOs. Having some background with them myself, I asked several questions about the latest issues he was selling. Unfortunately, he could only speak to me about the securities ratings and yield as he was unfamiliar with the CDO Company's structure and the assets that backed the CDO Notes. He was a successful specialist that wasn't very familiar with what he was selling?

Only an eager and tolerant investor base could allow this. Until CDO investors, all at once, decided to tolerate it no more. By fall of 2008, the market for CDOs had grinded to a halt and the largest holders of CDO Notes, the banks, had been forced to take paper losses against their capital due to mark to market accounting rules. With no liquidity in the CDO markets and a few distressed sellers, the trading prices of CDOs went significantly lower and banks kept having to write them down on their books. The banking systems went into a downward "death spiral" and individuals were frightened to the point of panic.

Then, the US Government stepped in…

Where Are We Now?

With the initial TARP loans into the banking system and the Federal Reserve Bank's (FRB's) monetary policy efforts, things have very much settled down in the banking system. Banks are lending under significantly stricter lending criteria and the world equity and bond markets have risen greatly from the March 2009 lows.

If I had to put my finger on one factor that caused the stock and bond market's turnaround from the March 2009 lows, I'd say that the mandate by Congress to the Financial Accounting Standards Board (FASB) to revise the mark to market valuation rules would be it. Within a week of that event, the stock and bond markets began a rally that continued through to the end of last year. Yet, the market for CDO Notes still has a long way to go to be considered active. The market is no longer "frozen; but it is only a trickle.

Consumers are beginning to spend again and producers are beginning to rebuild inventories. Corporate earnings reported for the 4^{th} quarter of 2009, on average, have bested expectations by better than 11%. By all accounts, it looks as if we are on a slow path to recovering from one of the worst recessions in most of our lifetimes. The largest overhanging cloud however, is that unemployment remains high – yet, the rate of layoffs has diminished and there has been growing increases in temporary labor employment. The signs of recovery look solid – yet slow.

While Washington continues to pursue legislation to improve the jobs outlook through additional spending programs, it may not be the best use of our tax dollars. At some point, the US Government's fiscal and monetary policies will have do be reined in – it is not sustainable to think that we can have them borrow our way out of this with any efficiency. The last thing the world needs is to have the US go through its own debt crisis like we are reading about Greece right now. And, we will be paying off this additional debt through higher taxes for as long as the eye can see.

In every past recession, it has been small business that created the new jobs needed to sustain a recovery. Many "smalls" have cut expenses to the bone and used available capital just to stay afloat during the worst days of the recession. As business activity picks up, many need additional cash to help finance that growth. Jobs are part of that equation. Yet the banks are imposing too strict lending standards to help right now. Borrowed money is the least expensive source of capital for most small companies.

Yet, I can understand why banks are so strict. It all leads back to the CDO Notes remaining on their books. As a result, they have limited capital to lend and need to rebuild their own capital and reserves. The FRB's keeping short term interest rates at a near 0% is helping banks recover, but the recovery is slow. One would have thought that since FASB eased the mark to market rules, banks would have been able to "write upwards" the CDO Notes on their books and have greater available financial capital to lend.

February 15, 2010

Unfortunately, CDO Note holders and their independent auditors continue to struggle with the mark to market rules and haven't fully written up the valuations.

I was out to dinner last month with an audit partner from a large international public accounting firm. Over dinner, we discussed some of the challenges we were facing in our own business endeavors. Maintaining his client's privacy, as is customary in both of our businesses; he mentioned that he was grappling with the fair valuation of CDO Notes on one of his clients books. He had quotes from two outside sources that were lower than what the client desired to report using an alternative valuation method. We didn't resolve the matter over dinner as I wasn't as familiar with the FASB rules as with CDO's and we didn't want to spend the entire evening discussing it. However, when I returned to my office, I looked over the new Fair Value Measurement guidance.

The key provisions of the new FASB accounting guidance "provides clarification that in circumstances in which a quoted price in an active market for the identical liability [a CDO Note for instance] is not available, a reporting entity is required to measure fair value using one or more of the following techniques:

1. A valuation technique that uses:
    a. The quoted price of the identical liability when traded as an asset
    b. Quoted prices for similar liabilities when traded as assets.
2. Another valuation technique that is consistent with the principals of Topic 820. two examples would be an income approach, such as a present value technique, or a market approach, such as a technique that is based on the amount at the measurement date that the reporting entity would pay to transfer the identical liability or would receive to enter into the identical liability."

How's that for a mouthful? As challenging as it is to read for a non-audit professional, it is equally challenging for an auditor to begin to apply. It seems fairly easy to determine whether or not there is an active market for a particular CDO Note. However, it's not so easy to determine whether a similar liability is actively traded without doing enough work to identify a similar one. And, it takes much more forensic work and analysis to attest to a "modeled" approach - not to mention, having the expertise to understand what to look for.

The key words in the FASB guidance seem to be "active market". If CDOs were trading in an active market, market forces would create an accurate fair value for these securities. However, there is no active market for them at present. Yes, there seems to be willing buyers, but these buyers want the CDO Notes at bargain basement prices. The holders don't want to sell at these prices as the economy is mending and the Notes are still paying interest. If you had a CDO that you could sell at a 10% or higher yield in order to then lend the money received from the sale at 5% or 6%, what would you do? You'd hold onto the CDO Notes! That's largely what we're seeing now and banks have precious little money to loan – with the money they do have to loan, they want very it safe. It's all about supply and demand dynamics.

We're also hearing that loan demand is very low at present. The only question I would pose to that statement is: Is loan demand low because borrowers are discouraged by strict lending standards? Some "small" business owners that I've talked to think so. So, we find ourselves back to the question at the beginning of this article: Could CDOs now be the best catalyst to grow the global economy?

ELF Capital Management, LLC
(Endowment Like Fund Management)

February 15, 2010

Currently, the US Government and its agencies through its TARP investments and holdings at Fannie Mae and Freddie Mac have considerable investments in mortgage securities. And, they want to spend more taxpayer's money on jobs stimulation programs. Both Democrats and Republicans don't have a good track record when it comes to fiscal responsibility. On the other hand, if more focus and effort were given to reviving the CDO markets, a free market solution could occur with the same or better result. The former will force higher taxes and the latter solution could reduce them.

Which alternative do you like better?

Market Update

While the markets rose splendidly in the first half of January, concerns about a possible debt crisis forming in Greece took the "winds out of the sails" of the market and the markets sold off. Now, in the middle of February, the Greek threat remains and the markets have begun to become complacent about such an event coming to fruition. Mainly because Greece represents a minute portion of the European community's GDP and there remains ample opportunitiy for any such crisis to be averted. Hence, it seems more probable that a crisis can be averted. There is always some economic crisis occurring across the globe and not all can lead the global economy back into recession.

We remain optimistic and since the beginning of the year began to lighten our exposure in high yield debt and moved a portion of that money into equities – buying into the correction. At this writing, those decisions look good. We ended the month of January down 3.80% and up 47.64% for the last twelve months. Here are some comparative numbers for you to review:

	Jan 2010	3 Month	Y-T-D	1 Year
ELF's ETF Strategy (net)	-3.80%	7.61%	-3.80%	47.64%
S&P 500	-3.70%	3.64%	-3.70%	30.03%
Russell 2000	-3.73%	6.98%	-3.73%	35.74%
MSCI EAFE Index	-4.44%	-1.44%	-4.44%	35.46%
MSCI All County World	-4.38%	1.32%	-4.38%	37.64%

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