

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

March 11, 2008

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Is This Market Testing Your Resolve?

February began with a stock market rally and ended with a drop. Then, in the first week and a half of March, the US stock market was testing new lows. To many investors, I'm sure it seems like a roller coaster ride that just won't end. And, whether you are listening to the radio or watching television, there seems to be plenty of gloomy news about the markets, inflation and a US recession. Are these market ups and downs and gloomy news scaring you? Is it testing your resolve?

Actually, you would have to have a really strong stomach not to be bothered by all of the doom and gloom news!

As I wrote in my prior two letters this year, now is "A Time for More Objectivity and Less Fear" and "You Should Be Buying Stocks Right Now". Although those messages have been getting drowned out by what seems like a great deal of bad news and gloomy opinions, you really need to check your resolve and logic. While I can't stop the markets from gyrating, I can offer you up an optimistic view of why buying in and/or staying invested is the better course at present. Let's review some reasons why:

Have you been hearing that the markets will bottom only when we see capitulation? Do you know what that means? If you look in a dictionary, you'll find capitulation defined as "the act of surrendering or giving up". Yet in this investment world context, it refers to times when we see wide-spread panic selling. Wait! Wide-spread panic selling is the signal for a bottom? This sounds like a "call to action" for investors to fall prey to the "small investor theory" if you ask me. And, who is making this call? People, some would call them vultures, who want to buy stocks and CDO's really, really cheap.

Have you ever heard the saying: "put your money where your mouth is"? In the "Wall Street" community, those considered savvy investors, the opposite of this is more the fashion. They put their mouth where their money is! How, you say?

First, let me start by saying that analysts play an important role in capital markets and investors need to educate themselves about their role. In today's investment climate, it is often hard for investors to know where to turn for objective guidance about industry trends and issues that may affect their interests. FINRA, the U.S. Financial Industry Regulatory Authority (formerly, the NASD), provides a Guide to Understanding Securities Analyst Recommendations. The Guide was prepared to assist both current and potential investors in successfully navigating through the large amount of financial information available today and covers two basic types of issues: The first stems from the fact that analysts' ratings today do not have clear, standardized meanings. The second relates to potential conflicts of interest that you should be aware of in assessing the usefulness of any particular analyst recommendation.

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Let me offer a contextual view of how this may apply to information coming from large investors (buy-side analysts), brokers (sell-side analysts) and the media:

In the case of large investors, including traders, moving into or out of large positions can often be challenging. Especially, in light of the market volatility that we have been experiencing recently. These savvy players know that buying into market dips or selling into market rallies offers the best way for them to move into or out of positions. When they do this, they can actually be a stabilizing factor for volatile markets. However, when large investors are seeking to execute a strategy, they will often remain silent until they have made their trades and later espouse an opinion that reinforces their stance. As long as the potential conflicts are disclosed, this activity is considered lawful. At the same time, we often only hear “sound bites” from this group rather than a full analysis or story.

In the case of sell-side and media analysts, there are far greater pressures and challenges that influence their work. These analysts represent businesses that are more transactional in nature and the potential conflict can be traced to the word “actionable”. Motivating people to action creates transactions; and, increased transactions translate into increased profits. As a result, these analysts may be reluctant to make recommendations or reports that might be transactionally unpopular. At the same time, if “actionable” information is pushing you into capitulating at the market’s bottom, how can that be a good thing for you?

Now, let’s consider why capitulating at a potential market bottom is not a good idea. Lately, I’ve heard many market pundits espouse that the market is going lower and you’ll have time to pick up stocks cheaper. But what if they are wrong?

To begin my argument as to why you shouldn’t capitulate, I want to draw your attention to DALBAR Inc.’s most recently published Guess Right Ratio. DALBAR provides research, ratings, and rankings of intangible factors to the mutual fund, brokerage and banking industries; and, its Guess Right Ratio indicates when the average investor correctly “guesses” the direction of the market. The average investor guesses right when there is either a net inflow, into mutual funds, followed by a market rise or net outflow followed by a down turn. Incorporating annual data from 1987 through 2006, DALBAR’s GRR shows that investors make the most mistakes – more than 70% of the time – after market downturns and these mistakes are driven by fear that the market won’t recover.

Next, I want to call your attention to the direction of short interest, mutual fund redemptions and money market inflows:

- Reports for stocks traded short (short interest) on the NYSE and NASDAQ as of February 29 continues to show steady increases since the beginning of the year. This is a positive as short positions must be bought back sometime in the future. This could buffer further downside moves and may even lend itself to an explosive rally.
- AMG Data Services reports that equity funds (excluding ETF’s) saw net redemptions of \$25.2 billion for the 4th quarter of 2007, \$31.9 billion for January 2008, and have averaged \$1 billion for the last 4 weeks. This looks like the Guess Right money that DALBAR was talking about. To me, this represents future buying power for stocks.
- Lastly, AMG reports that Money Market funds have been averaging net cash inflows of more than \$105 billion per month for the last 5 months bring total assets in that sector to a record \$3.4 trillion. This is also future buying power – big future buying power.

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Are you starting to “connect the dots” as to why you should be buying stocks right now? As a follow on, let’s now consider what is going on in the U.S. economy and what we believe has been fueling all of this hysteria.

The story begins with scares about the expectations of sub-prime adjustable rate home mortgages resetting at much higher rates and causing an avalanche of defaults. One scare leads to another about how these sub-prime ARMs had been repackaged into hard to analyze CDOs and sold to a broad array of investors. These scares then drove down the market values of the CDOs, forced margin calls and, as a result, some leveraged CDO hedge funds blew up. Apparently, these CDOs were bought by many investors based upon the S&P and Moody’s ratings assigned to them and the purchasers were not doing their own research. The lack of a large educated market for these securities have kept buyers from stabilizing this market and accounting rules have forced the biggest holders, mainly large banks, into marking-to-market their CDO holdings below expected recovery value and taking large write-offs as a result.

It is this author’s contention that the mark-to-markets are considerably lower than the recoverable value of these securities, including expected defaults. In fact the Honorable Senator from New York, Charles E. Schumer, acknowledged this belief through his questioning of Fed Chairman Bernanke during Ben’s recent testimony before Congress. We are eager to see how this hunch plays out as the underlying securities continue to pay off. Having been involved in the origination and management of more than a dozen mortgage and junk bond backed CDO’s in the early 1990’s, at the former Kidder Peabody Group, affords me a little understanding of these vehicles from which to speak.

Despite this expectation for recovery, the CDO liquidity crisis negatively impacts new loan origination and, by extension, the real estate markets. Banks have little available capital to make new loans and what they do have is probably best deployed in soaking up the excess CDO securities overhanging the market. Why not? These are loans selling way below market and buying them up makes more profit sense than making new loans.

On other fronts, the liquidity crisis can be blamed for the dropping global stock markets, the dropping U.S. dollar, the inflationary impact of the dollar dropping, and maybe even a U.S. recession. Yes, de-leveraging can cause some pain and it can also create some incredible opportunities for logical investors. Those who can look past the “call to action” for capitulation and buy into this market!

At some point, we expect that smart money is going to realize the value in snapping up these CDOs at bargain prices. Perhaps, foreign money, in the form of Sovereign Wealth Funds will be the purchasers. This all seems very reminiscent of what had happened after the CMO market crashed at the end of 1994 when Kidder, then the largest CMO issuer on “The Street”, was sold to Paine Webber (now UBS). By the end of 1995, people who picked up CMOs at bargain prices saw more than 5x the returns from those securities than what would have been expected in a more stable market. Once sanity returns to the CDO market, you’ll see write-downs become write-ups, economic prospects dramatically improve and a market recovery that will happen in the blink of an eye.

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For those of you that think you'll be able to buy back into stocks before the markets stage a 60% percent recovery – Good Luck! While you may have some experience of how hard it is to sell in a down market, have you ever tried to buy stocks when nobody wants to sell'em?

We continue to be fully invested and are overweight in financials, industrials and technology. We also, like the BRIC and related countries and believe strongly in continued global growth. Although we've taken some lumps regarding our returns since the beginning of the year, we are confidently putting our mouth where our money is!