

**ELF CAPITAL MANAGEMENT, LLC**  
*(ENDOWMENT LIKE FUND MANAGEMENT)*

March 8, 2010

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## **Knowing When to Hold 'em or Fold 'em**

*You got to know when to hold 'em, know when to fold 'em,  
Know when to walk away and know when to run.  
You never count your money when you're sittin' at the table.  
There'll be time enough for countin' when the dealin's done.  
Chorus to Kenny Rogers "The Gambler"*

These lyrics filled the airwaves in the late 1970's when American country music icon Kenny Rogers released his multi-million selling album The Gambler. "The Gambler" was also the title track to Kenny's 1978 album which won him the Grammy Award for best male country vocal performance in 1980.

When the song came out, I was in my second year at college and not a very big fan of country music. Despite my earlier music preferences, the song was wildly popular and frequently played on the radio. Now, every time I hear of someone struggling with an investment decision, these lyrics immediately come to mind.

The song's lyrics provide some sage advice for novice investors and one particular lyrical bridge says it all...

*Ev'ry gambler knows that the secret to survivin'  
Is knowin' what to throw away and knowing what to keep.*

The most common struggle I hear of from novice investors goes something like this: They own an asset whose current fair market value is significantly down in value. Rather than sell the asset and redeploy the cash into an opportunity with greater potential, they want to hold the asset in the hope that the price will recover.

When it comes to making an investment decision, "hope" is not a good strategy. Rather than relying on hope, you've got to know when to hold 'em and know when to fold 'em.

A couple of weeks ago, I was having a conversation with a successful home improvement contractor. He had just completed some work at my home and stopped by my office to present his invoice. I was very pleased with the work done and even more pleased that he and his crew were really good at keeping appointments and communicating. During his visit, he asked me about a financial decision he was struggling with.

His business revenues for 2009 were significantly lower than prior year levels; and most, if not all of the family's wealth is tied up in his home and business – the home representing the "lion's share" of savings. He has one child readying to go off to college and another in the next year and a half. He was very concerned about how he'd be able to come up with

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the tuition. While the business is generating enough profits to meet his family's living expenses, unlike the past, it is not generating much savings now. Their house and landscaping are stately and he has more than 70% equity in it at today's prices. From the past fruits of his business, he renovated and transformed the modest home he purchased more than a decade ago into an artfully created master planned grand residence and grounds. His wife has expressed thoughts of selling the home, moving into a lesser home and using remaining proceeds to pay for the children's college expenses. He wants to hold onto the current home until the real estate market improves - at which time he hopes they can get more for it.

I thought he might be not be considering all of his options.

In this month's letter, I will review some of my recommendations and discuss how a new breed of "mom" and "pop" property managers might represent a next wave in the recovering residential real estate market.

### **Providing Some Food for Thought**

Good parents want the best for their children and each has their own way of preparing offspring to be self sufficient enough to go on their own. We want to offer opportunities – sometimes, more than we've had – to allow them the ability to pursue their own passions. We all know that passion is an important ingredient for success. Yet, more often than not, our children's passions have barely developed beyond a desire to gain social experiences instead of seriously considering any career.

Maybe the better route is to remain open to how we can help before committing to a costly game plan. In this case, my contractor friend was trying to mentally prepare himself for having to finance \$40,000 per year, per child. Maybe he does; and maybe he doesn't.

The first suggestion I passed along to him was to take immediate steps to determine the family's eligibility for college financial aid. This involves completing a FAFSA form and filing it with the U.S. Department of Education. FAFSA is the acronym for Free Application for Federal Student Aid and it is not only used for determining qualification for federal aid, it is used to obtain financial aid from state coffers as well as from a school itself. In addition, I explained how it worked and why it was important that the application should be filed sooner rather than later.

The FAFSA is used to calculate the student's Expected Family Contribution (EFC) for the coming school year. The EFC is the minimum amount that the family is expected to pay towards the student's college costs, at any school. So, each school will subtract the EFC from the cost of attendance there to determine the student's financial need eligibility. And, financial aid is often allocated on a first come, first served basis. So, getting the application filed early increases chances of getting more free money than student loans.

In April and May, most of the schools will have issued the Financial Aid Award letters to prospective students at the same time they are issuing acceptance notices. At this time, most, if not all of the financial aid resources for the year have been allocated out by the school. By the way, it is important to note that the schools are responsible for allocating

**ELF CAPITAL MANAGEMENT, LLC**  
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March 8, 2010

federal and state college financial aid programs – they need qualified students to “unlock” that money to be used at their school. It is also important to know that not all schools can meet 100% of the family’s need; some schools can only meet 50% and others may only meet 20%. This could be a critical factor if you are dependent on receiving financial aid. Now for the Good News! Generally, most of the more expensive schools are better endowed. This means that they have more money to give to people who want to go to their school.

I also alerted him how he might double or triple his family’s eligibility for financial aid. This is because usually the majority, if not all, of a student’s Expected Family Contribution comes from the parent’s financial information. The parental side of the equation will be divided by each household member attending college at least part time. One additional household member attending college could potentially double eligibility and so on. If he and or his wife could find themselves taking a college course or two, they could legitimately increase their financial aid eligibility.

Lastly, as his business income was more modest at present, the family might have a good chance in qualifying for aid this year. As an additional consideration, I suggested that Virginia has a number of well respected state universities and colleges whose residents pay far less than half of the \$40,000 per year that out-of-state students pay. Another alternative was to explore using the local Community College for the first two years. Not only is the cost savings more significant, I’ve heard that many who have gone this route find it easier to transfer into one of Virginia’s four year schools as a 3<sup>rd</sup> year student than to be accepted as a 1<sup>st</sup> year student.

But what about potentially selling his home?

### **The Next Wave in Residential Real Estate?**

As I discussed earlier, my contractor friend’s wife had asked him to consider selling their home and moving into a lesser one. He seemed preoccupied with that thought as he was proud of how he developed it and enjoys living there. On the other hand, his espoused affection for his family exceeds that for his residence and he appeared to be mentally preparing himself to part with the home. “If only business would return to where things were before the [economic] downturn” is what I heard. I hoped to inject some optimism.

First, I began to mention that I thought the worst of the current economic downturn had passed and that it looked like we were in the early stages of the recovery. In addition, I encouraged him that he was among the more polished of his industry peers and did excellent work at my home. And, that it wasn’t unreasonable for him to expect to gain market share as a result of these traits. I suggested that he might want to market himself a little more.

“Marketing?” He couldn’t remember the last time he had to market his business before! Apparently, he had been blessed with enough referrals in the past that he didn’t have to do any. Come to think of it, another good friend of mine recommended I contact him for the work I needed done. OK, marketing was something new, but he got it.

ELF CAPITAL MANAGEMENT, LLC  
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March 8, 2010

Moving on, I asked if he had considered borrowing against some of his home equity to pay for school. He had, but didn't really feel comfortable to increase his monthly cash outflows – as servicing the loan would cause. Then, I asked if he had considered borrowing from or taking a distribution from his retirement plan. Not that I'd recommend this route, but I asked. He hadn't really focused on funding a retirement plan yet.

Then the focus returned back to selling the home. "If only the market for homes like mine would recover before I needed to raise cash [for tuition], would I feel more comfortable with selling my home. When I do, and after I purchase another [lesser] home, should I diversify my money and could you help me invest it?"

When I heard the first comment, I immediately thought of "the Gambler" song; and, when I heard the questions that followed, I imagined that most brokers or managers would immediately say "Yes" to both. However, I did not take that route.

I am someone who believes in the concept of diversification; I also view the concept in varying degrees. Most people think of diversification in terms of the need to diversify among asset classes; while diversifying within a specific investment type or within an asset class is sensible as well. To understand the distinctions, you might want to review my February 2006 article on [Managing Asset Allocation](#).

In crafting my response, I started with the advice that "*You got to know when to hold 'em, and know when to fold 'em*". I asked, "isn't the whole residential real estate market depressed right now?" He believed so. Then I asked if he thought he could find 2 or 3 lesser homes as similarly depressed in value as his? He thought so. "So, then", I replied "why do you need to wait for the value of your home to improve? You may be missing out on an opportunity to improve your financial situation." He leaned forward to listen.

It was my impression that he had already maximized the potential for upgrading his current residence. And while the market was soft, his home should be the "diamond in the ruff" so to speak. After all, of purchasers in that price range, who wouldn't like to own a home that a quality home improvement contractor painstakingly improved over a decade of thoughtful planning and care? And from our dialogue, it was clear that under current US tax laws the he wouldn't have to pay much, if any, taxes on profits from the sale.

If he was willing to commit most of the proceeds – less tuition for a year or two – and the mortgage debt he was currently paying off, he could have a new residence and possibly two rental properties generating positive cash flow. He is in his mid to late 40's and his wife has a real estate license. He could develop his new residence into another "dream home" and begin to prepare for his retirement with two rental properties throwing off tax advantaged cash flows. Presumably, any new properties he might buy would also have undeveloped potential for improving upon. Then, as his business grows faster than the economy, he could begin funding that more liquid retirement plan and diversify those funds into something other than real estate. However, he has a special expertise that only increases his chances to be a successful rental property owner. And he should use it.

He liked these ideas and we are scheduled to meet more frequently.

**ELF CAPITAL MANAGEMENT, LLC**  
*(ENDOWMENT LIKE FUND MANAGEMENT)*

March 8, 2010

Given the current state of depressed housing and construction activity, I would expect that others are already thinking about this opportunity. This leads me to believe that a new breed of “mom” and “pop” property managers might represent a next wave in the recovering residential real estate market.

### Market Update

Global Insight, an industry leader in economic analysis, forecasting and market intelligence recently wrote: *“Recent key economic indicators have been positive, with evidence that the recovery is finally broadening beyond manufacturing to services, and that positive job growth could be just around the corner. Right now the main drag seems to be depressed housing and construction activity, which is a key driver of employment, building materials, and freight activity.”*

We continue our optimism about the recovery and, in February, we significantly lightened our exposure to high yield debt. We believe the biggest gains from the high yield market have already been garnered and are more comfortable to be in US equities at this time.

We rebounded nicely from the correction in January and ended the month of February up 5.42% and gained a record 72.56% for the last twelve months. Here are some comparative numbers for you to review:

	Feb 2010	3 Month	Y-T-D	1 Year
<b>ELF's ETF Strategy (net)</b>	5.42%	7.32%	1.41%	72.56%
<b>S&amp;P 500</b>	2.85%	0.81%	-0.95%	50.25%
<b>Russell 2000</b>	4.41%	8.42%	0.51%	61.58%
<b>MSCI EAFE Index</b>	-0.88%	-3.99%	-5.28%	50.09%
<b>MSCI All County World</b>	1.11%	-1.42%	-3.32%	54.67%

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