

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

March 5, 2007

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The Game of Risk

Have you ever heard of the game *RISK*?

RISK is probably the best known and most played war game. The game was first released in France in 1957 and made its way to the US in 1959. It is a game of world domination, where the object is to conquer the world. The game board features a map of six continents divided into 42 territories and accommodates two to six players.

The roll of the dice means a lot in the game of *RISK*, but so do strategy and intelligent tactical decisions. Winning involves a bit more than knowing the rules. Strategic thinking is required as, with each turn, you are required to make decisions about how you will launch daring attacks, defend your territory and move across continents with your plan to take over the world. Every decision made is subject to immediate or future risk. The game ends when there is only one player remaining.

Have you ever played it? What kind of player were you? Did you like to start off aggressively and march right into battle? Did you like to form alliances with other players and share risks? Or, were you the type of player that studied the game's most probable winning strategies to tilt the odds in your favor?

What kind of investor are you? Do you ponder risk that you'll be subject to when you decide whether or not to invest? Do you study the most probable winning strategies to tilt the odds in your favor? If you answered "yes" to the last question, you may be among a successful minority of investor types.

When we invest or don't invest, it is our turn to roll the dice in the financial game of *RISK*; it requires committing to a decision before the eventual outcome is known. Therefore, the decisions we make should be guided by a strategy for how we will launch our daring attacks, defend against losses and earn enough to enjoy the world in our own fashion. Yet, it is hard to formulate a strategy when you don't fully understand the rules of the game. It is also hard to distinguish a good investment strategy from a bad one without considering the risks.

At ELF Capital Management, LLC, we are 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 will provide you an introduction to some basic types of investment risks and briefly suggest how they factor into your decision making and investing strategy. If you are looking for information and ideas to help you achieve better 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. And, our web site recently received a long-needed "make-over", so please take a look.

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Investment Risk – Course 101

As investors ponder the possible outcomes of their decisions, behavioral scientists believe that we don't often think enough about risk, which we shall define as the possibility of an undesirable result. Well stated by Sir John Krebs, a former medical research professor at Oxford, that "we all take risks, but most of the time we do not notice them. We are generally bad at judging the risks we take, and in the end, for some of us, this will prove fatal."

If true, maybe this is due to lack of understanding, impatience or the over-whelming or dampening emotional effect of considering risk. So, before we delve into understanding some basic types of risk, let's consider some basic premises of how we make decisions:

In Dr. Tom Spradlin's "Lexicon of Decision-Making", found on Duke's Fuqua School web site, he explains: "At the time of the decision, the decision maker has available to him at least two alternatives, which are the courses of action that he might take. When he chooses an alternative and commits to it, he has made the decision and then uncertainties come into play. These are those uncontrollable elements that we sometimes call luck. Different alternatives that the decision maker might choose might subject him to different uncertainties, but in every case the alternatives combine with the uncertainties to produce the outcome...For example, an objective might be to increase wealth, but any alternative intended to lead to that outcome might lead instead to poverty...A bad decision may lead to a good outcome and conversely a good decision may lead to a bad outcome. The quality of a decision must be evaluated on the basis of the decision maker's alternatives, information, values, and logic at the time the decision was made."

In the world of investing, the probability of consistently achieving positive results should not be left to luck. When one gains confidence based upon past luck, your decisions could certainly lead to an outcome of poverty when risks are not considered in the equation.

It should also be considered that risk is unavoidable. This seems best articulated in Wikipedia.org's introduction to investment risk: "On ground of assurance of the return, there are two kinds of investments – Risk-less and Risky. "Risk-less" investments are guaranteed, but since the value of a guarantee is only as good as the guarantor, those backed by the full faith and confidence of a large stable government are the only ones considered "risk-less." Even in that case the risk of devaluation of the currency (inflation) is a form of risk appropriately called "inflation risk." Therefore no venture can be said to be by definition "risk free" - merely very close to it where the guarantor is a stable government."

In the investment world, the game is fraught with a great many risks to consider. In fact, there are so many that you may easily be overwhelmed by the number of them and the pursuit of identifying each and every one prior to making a decision is a daunting task. But that doesn't mean that they should be ignored. So let's begin to discuss a framework for understanding them.

It is believed that all risk can be categorized into one of two "buckets" – either it can be classified as "systematic" risk or "un-systematic" risk. I know that these terms can seem quite technical and I'll do my best to simplify their meanings for you.

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Systematic risk should be considered as any type of risk that is influenced by broad factors. While the word “systematic” may conjure up the thought of processes that are executed by following a logical and methodical series of events, I want you to focus more on the word “system”. Think of these types of risks as being dependent upon or as being influenced by being part of a bigger group. Call it risk by association.

As an example, let’s consider “**market risk**”. If the stock market suffers a downward correction, like it did last week, you may have seen your particular investments dragged down by the “market”. When we look further into types of market risk, they can be broken down into smaller segments of systematic risk. They could be geographically related, industry related or even, grouped by company size.

On the other hand, un-systematic risk should be considered as any risk that is unique or specific to a particular situation. These are risks whose outcomes are not particularly related to or shared by a broad group. In the investment arena, the two most common sources of these specific types of risk are business risk or financial risk. **Business risk** would relate to any number of situations where a single or multiple events could occur that would hinder the operations of a company; and, **financial risk** relates to the possibility that a company will not have adequate cash flow to meet its debt service obligations or to meet operating expenses.

Now, let’s identify a few types of investment risk and test yourself to see how you would classify them.

Basic Investment Risks

When we begin to identify investment risks, try and think of how a tree forms: The primary stem of the tree forms the tree trunk – let’s call this all risk. Then, offshoots from the trunk will form into the initial broad branches – let’s call these “systematic” risk limbs. Then, each of these broad branches will form smaller limbs that will blossom leaves – let’s call the smallest limbs and leaves “un-systematic” risk twigs and leaves.

In terms of gauging the impact of risk types in your decision-making, you should begin to understand that as you go further “out on a limb” or higher “up the tree”, the more severe the impact may be should you suffer an adverse or bad outcome.

Market Risk, Business Risk and Financial Risk have already been described in the section above, and below are listed some other basic investment risk types (I’ll leave it to you to determine where they fit on the “risk tree”):

Inflation Risk – this is also referred to as “purchasing power risk” and it can impact investors in many ways. Through the ages, the cost of purchasing goods and services has risen over time. So, if you keep your money under a mattress or your investments don’t keep pace with inflation you will lose purchasing power over time. And, inflation has also been known to impact market risk, interest rate risk, political risk, currency risk, etc.

Liquidity Risk – has to do with how readily you can buy or sell an investment or a personal use asset. With investing, it is important to remember that an asset is only as valuable as

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the next person would pay you for it. If you readily need to sell an illiquid asset and nobody wants to trade with you, you may have to liquidate at a much lower price than expected in the market place. Liquidity risk can also compound other risks when a company, or a country or a financial market experiences a liquidity crisis.

Credit Risk – this is the same as “financial risk” explained above.

Interest Rate Risk – this is the risk that the relative value of a loan made between a borrower and a lender will worsen due to a change in the market rate for loans of that type – whether those loans represent government bonds, corporate bonds or a loan between a banker and an individual. The market for interest rates can be impacted by a government’s monetary policy and or by inflation risk or other factors.

Currency Risk – also known as “foreign exchange risk”, this is a type of “market risk” that can adversely impact the purchasing power of goods, services and investment between parties in one country trading with parties in another country. For investors, it can reverse or enhance returns earned on investments; and, for consumers, it can adversely impact the cost of purchases. A weaker currency can make imported goods and services more costly and, at the same time, make exporting goods and services more attractive.

Political Risk – this can also be referred to as “legal risk” or “regulatory risk”. When a government, or a governmental agency, makes changes in its political structure or policies, the impact can trigger a whole slew of other risks – certainly every one of those described above.

Active Risk – this refers to the risk in an investment portfolio that would be attributable to the decisions made by the portfolio manager and is exclusive of any market risk. Active portfolio management is simply an attempt to beat the market as measured by a particular benchmark like the S&P500; whereas, passive management is more commonly called indexing. Active risk has more to do with how well an active manager may or may not perform relative to his or her index benchmark from both a risk (volatility) and return perspective.

Asset Allocation Risk – as opposed to active risk, this risk relates more to the adequacy of, or lack thereof, an investment portfolio’s diversification among different asset classes (or “index benchmarks”). Poorly managed asset allocation risk occurs when a portfolio manager allows a particular market risk to be over-concentrated due to undisciplined risk-taking or through ignorance of over-lapping positions. Asset allocation risk can sometimes be unavoidable when two or more markets, asset classes or index benchmarks – that are generally driven by dissimilar factors – begin to act similarly.

What Kind of Investor Are You?

When we started this letter, we discussed the board game called *RISK* and how winning at that game required more than just knowing the rules. We discussed how strategic thinking is required and that every decision made is subject to immediate and future risk. The same is true for investing.

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As stated earlier in this article, in the world of investing, the probability of consistently achieving positive results should not be left to luck. When one gains confidence based upon past luck, your decisions made could certainly lead to an outcome of poverty when risks are not considered in the equation. As with *RISK*, where the roll of the dice means a lot, luck plays a role in the investment process. Yet, it is strategic thinking and intelligent decisions that help you win at both the game and when investing.

At HWK Financial, we take a prudently targeted risk approach to investing. Our clients desire having a reliably stable source of invested funds for their current or future spending goals and needs; they want their invested funds to keep pace with inflation; and, within reasonable bounds of risk-taking, they want to see their invested funds grow beyond their expected spending goals and needs plus inflation.

Our Individually Managed Account program represents a broadly diversified investment strategy designed to offer institutions, individuals, families or groups a risk managed approach that maximizes the benefits of investing in both traditional and non-traditional investment opportunities.

ELF Capital Management Investment Performance Update

Much of February started with a continued rally in the markets, right up until the last two days of the month. On the 27th of February, a market correction that started in China made its way clear across the globe and we experienced a long overdue correction in equities and commodities markets. This was the first correction in almost four years and many broad market indices retreated anywhere from 4% to 12% in a matter of a day. As we progressed through the week global market indices continued their retreat at a more modest pace.

The correction was reported to have been orchestrated by the Chinese government, much like when Fed Chairman Bernanke spooked the markets last summer and past Fed Chairman Greenspan spooked the markets in April of 2004. Each time the markets climbed "the wall of worry" and recovered to new yearly highs. We see the potential this year to be no different.

Many governmental policy makers and market pundits characterize this as a healthy correction where the markets had seemingly gotten ahead of themselves. It didn't help much that the Dow Jones Industrial Average appeared to have dropped by more than 300 points in roughly 30 seconds time on February 27th at approximately 3pm. It later came out that the company responsible for computing the average had a computer glitch that made the drop look more panicky than it actually was. The DJIA was actually down 500+ points but it didn't happen in 30 seconds.

For the month ended February 28, 2007, our one-month performance is down 2.69% and our three-month return is up 1.61%.

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.

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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.