

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

April 17, 2009

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### ETF Death Watch: Is This the Next Shoe to Drop?

Have you heard about the ETF Death Watch? Do you know what it is? Is this the next big bearish shoe to drop?

The ETF Death Watch is a relatively new list comprised of ETF securities that a handful of analysts and internet bloggers believe could terminate and go into liquidation over the near term. One web site that I found, [www.investwithanedge.com](http://www.investwithanedge.com), posts a monthly "ETF Deathwatch" describing a list consisting of "U.S. listed ETFs and ETNs at least six months old with an Average Daily Value Traded for the most recent calendar month of less than \$100,000 per day." In other words, this site's editor believes that any ETF that existed for six months or longer and attracts less than \$100,000 per day in trading volume is destined for the "scrap heap".

Maybe this is a fair criteria, and then again, maybe it isn't. However, my knee jerk reaction is... Who cares? After specializing in the management of ETF portfolios for the last six years, I find this kind of information rather trivial.

Despite my indifference, the ETF Deathwatch concept has gotten much press in the last several months. And, I'm happy to say that the media has done a fair job to alleviate the potential anxiety that the name conjures up. It is one thing to educate people and another to foster fear and uncertainty. Haven't we had enough of the latter?

Yes, the ETF market is consolidating a little and it is about time. Since I started managing ETF portfolios in February 2003, the number of funds has grown seven fold. Back then, many of the ETFs that were available represented the same basket of stocks offered by different fund sponsors. In other words, competing fund companies were vying for the same investor dollars. The result was that there were actually less than 30 index types available and most represented only the broadest market indices. Oh, how I longed for more selections to pick from. Then in 2006, originations of new ETFs types began to explode – creating many new investment segment opportunities. Now, there are more types of ETF investment opportunities than the average person might imagine and it certainly seems as if we have reached a saturation point. In fact, many of the newer ETF innovations have not seemed to attract enough investor interest to keep them going. Hence, the ETF Deathwatch lists.

So, why would an ETF terminate? And, what is the significance of not attracting enough investor interest? Perhaps more relevant than the criteria of daily trading volume, a more significant measure would be the particular ETF's assets under management – the size of the fund. Given the low cost structure of ETFs, it takes roughly \$50 million to \$100 million of underlying assets to cover the cost of maintaining the average fund – the cost involved to keep it going. After some period of time, if an ETF is not able to attract enough investor

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capital, the fund's sponsor will have to come to the painful decision of determining whether to close the fund or continue to subsidize costs. If they believe that the fund size will grow in the future and have the resources to keep holding on, most sponsors would rather maintain the fund rather than conceding to a failure. This decision varies from sponsor to sponsor and the larger fund ones usually have more staying power.

And, what if you happen to own an ETF that decides to liquidate? Well the worst thing that I could imagine happening would be to receive a pro-rata distribution of the underlying shares. Especially if it means receiving 2 or 3 shares each of the stocks that comprised the ETF. Actually, given the cost of liquidating small numbers of shares, this would be bad! But, if you liked the fund's concept to begin with and purchased with a long term mentality, you could selectively add to those positions and work them out over time. The more likely scenario is that the fund sponsor liquidates the portfolio and distributes you back cash.

But, you might ask, would the liquidation of an ETF cause the underlying shares to be sold at depressed prices? Couldn't I lose value that way?

Possibly, but I think the chances are remote. If an ETF decides to liquidate, it is because the fund is too small to perpetuate. As such, the liquidation of the underlying basket of stocks into the market would hardly be expected to sell at "fire sale" or depressed prices unless they were thinly traded underlying stocks to begin with. The term "thinly traded" refers to a stock – or other investment security – that has a limited amount of interested buyers and sellers and, as a result, transactions occur infrequently or in small amounts. By the way, if you are looking at any EFTs comprised of thinly traded securities, you should be aware that thinly traded securities tend to be much more volatile than actively traded securities.

Rather than rely on an ETF Deathwatch list, it always pays to do your homework before investing. ETF's are great risk management tools because they provide diversification from unique events and leave the investor able to focus more on the "big picture". I.e., you are less like to suffer a total loss due to a single company going bankrupt in an otherwise profitable sector, or some other unique event. However, there are other risks involved that always need to be considered: like liquidity risks, leverage risks, or political risks – just to name a few. To read more about investment risks, please refer to my earlier article "[The Game of Risk](#)" – via this link.

## **Market Update**

While I would have liked to report to you that the worst was behind at the end of February, the global stock markets tested new lows on March 9<sup>th</sup>. The first 10 weeks of 2009 were among the worst declines for global stock markets and, quite frankly, the markets had showed their worst performance since the 1930's. As I suspected, more hedge fund selling took the market to levels that were down-right frightening. Thank goodness that the remainder of March offered greater prospects and April continues to show promise that the worst may now be behind us. What more could possibly go wrong?

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I don't know about you, but with each passing day I am growing more positive that 2009 will end on a very positive note. Many economic indicators have either begun to stabilize or are actually beginning to show improvement. This is a darn good start!

While the unemployment rate continues to grow, the number of jobs lost each month is definitely slowing. Historically, this has been a good signal that the economy is beginning to stabilize. And, as I noted in my November 2008 market letter, unemployment is the most lagging of economic indicators. Also, other many other economic indicators are reflecting even more promising results...

The housing market has begun to show improvement for two months in a row now. This is unusually good and we have yet to enter the spring selling season for the residential real estate sector. Several of the larger banks have reported better than expected first quarter results and the markets have begun to respond in kind. If you remember, it was the troubles in the banking sector that was a primary factor in this economic contraction we are now experiencing. Retail sales have begun to show improvement and the stock market has begun a significant rally upwards. At the same time, buying volume in the markets has picked up significantly in this rally also. These are very good signs.

With exception to one client who has requested I maintain a specified minimum cash level in their taxable account, on average, our portfolios are invested approximately 50% in high yielding bond funds, 40% in US equity funds and 10% in cash. Over this next quarter, I will be putting more cash to work, possibly bring cash levels down to 5% by buying market dips. By the way, we significantly added to our equity exposure in the middle of March and have been taken good advantage of this rally. And, as of this writing, the aggregate value of our portfolios are up better than 15% in April. Let's just hope this rally has much more upside to go as more companies report their earnings.

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