

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

May 10, 2010

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Can The 3G's Stall This Nascent U.S. Recovery?

Whether you have yet to experience the change, signs of an improving U.S. economy are showing up all over. Not since 2006, have those sectors of the U.S. economy that first led us into recession seen such strong activity. And signs of broad based momentum appear to be gaining strength.

During the worst part of the recent downturn, we saw fear so wide-spread that the U.S. consumer stopped spending on all but the most basic of necessities. While this was happening, businesses slashed prices for goods and reduced their inventories to the lowest levels in a lifetime. The economy was grinding to a halt. In March of 2009, we turned the corner towards recovery and it appears to be gaining momentum.

The turn began when, by the end of June 2009, the U.S. stock market ran up approximately 25% from the March lows. Then, we began to learn that businesses became confident to begin restocking inventories. The inventory restocking effort began a rekindling of economic activity that initiated a trend of bringing some back to work – mostly temporary labor. Rises in “temp” labor have always been a precursor to hiring for desired “permanent” jobs. This sends a strong signal that the worst is over. By October of last year, we saw a strong rebound in consumer spending for food and retail goods. This immediately translated into a significant rebound in corporate profits for industrial, transportation, financial, technology and discretionary spending sectors.

Now, with most of the housing industry continuing to lament over the high number of foreclosures, the home improvement sector is beginning to see a burst in activity. On a local level, a couple of contractors I know have gone from twiddling their thumbs to getting so many commitments for work that they are experiencing scheduling challenges; and, the local Lowe's store is seeing greater activity; even while offering fewer promotions.

These factors point to a strong economic recovery that is fanning out across more segments of the economy. This recovery looks sustainable and should lead us to an expansion phase on the highway to prosperity. Unless of course, this nascent economic recovery is stalled by the 3G's...

Goldman Sachs

In mid April, the U.S. Securities and Exchange Commission filed civil charges against Goldman Sachs. The charges accuse Goldman of defrauding investors by failing to disclose potential conflicts of interest in mortgage related investments it sold as the housing market was falling apart. A few days later, the SEC filed criminal fraud charges.

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Goldman Sachs, one of Wall Street's most prestigious investment banks, advises and invests in nearly every industry group and its business is greatly intertwined in financial transactions throughout the world. During the financial crisis, Goldman was among the many banks deemed "too big to fail" and received billions of dollars in taxpayer money to help it stay afloat.

Just as lending and capital market activity is rebounding, one can only hope that the Government's effort doesn't cause more harm than good. The fraud charges have been creating quite a stir across the financial sector. This happens just as we are recovering from a severe banking led recession.

Media pundits and financial sector analysts suspect that the Goldman charges are coincidental to the U.S. Senate's financial reform bill and an effort to sway some on-the-fence Senators to get tough on financial reform. They think that using Goldman Sachs to create and perpetuate anti-Wall Street sentiment offers the type of publicity needed to support the bill negotiations at this juncture.

Warren Buffet, a large investor in Goldman, came out publicly to defend the charges against Goldman in a recent in a CNBC interview. He believes that under current regulations, he didn't feel that they did anything wrong.

If Goldman has broken the law, then they should pay any fines and clean up their act; and, if the SEC has wrongly accused Goldman, then the U.S. Government will appear to be playing Russian Roulette with our financial system. We may never know the truth as political rhetoric will likely be used to cover their tracks if the latter scenario proves out.

In the public's eyes, Goldman has long been criticized for their arrogance. Yet, they have often played a significant role in expertly facilitating important financial transactions throughout global economies over the years.

This is one of those issues where politically charged negative publicity could run Goldman into the ground and hurt our financial system in the process. And, if there was wrong doing, we might be better off if the charges were contained to those who perpetrated the acts without causing greater risk to the bigger picture.

Greece

As I pen this article, the happenings in Greece have taken center stage as a potential threat to global economies. If fear creates a contagion that spreads across Europe instead of containing the problem to Greece, it could become a more global problem.

The Greek problem is well summarized by the CIA Fact Book as follows: *"Greece has a capitalist economy with the public sector accounting for about 40% of GDP and with per capita GDP about two-thirds that of the leading euro-zone economies. Tourism provides 15% of GDP. Immigrants make up nearly one-fifth of the work force, mainly in agricultural and unskilled jobs. Greece is a major beneficiary of EU aid, equal to about 3.3% of annual GDP. The Greek economy grew by nearly 4.0% per year between 2003 and 2007, due partly to infrastructural spending related to the 2004 Athens Olympic Games, and in part*

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to an increased availability of credit, which has sustained record levels of consumer spending. But growth dropped to 2% in 2008. The economy went into recession in 2009 and contracted by 2%, as a result of the world financial crisis, tightening credit conditions, and Athens' failure to address a growing budget deficit, which was triggered by falling state revenues, and increased government expenditures. Greece violated the EU's Growth and Stability Pact budget deficit criterion of no more than 3% of GDP from 2001 to 2006, but finally met that criterion in 2007-08, before exceeding it again in 2009, with the deficit reaching 12.7% of GDP. Public debt, inflation, and unemployment are above the euro-zone average while per capita income is the lowest of the pre-2005 EU countries; debt and unemployment rose in 2009, while inflation subsided. Eroding public finances, a credibility gap stemming from inaccurate and misreported statistics, and consistent underperformance on following through with reforms prompted major credit rating agencies in late 2009 to downgrade Greece's international debt rating, which has led to increased financial instability. Under intense pressure by the EU and international market participants, the government has adopted a medium-term austerity program that includes cutting government spending, reducing the size of the public sector, decreasing tax evasion, reforming the health care and pension systems, and improving competitiveness through structural reforms to the labor and product markets. Athens, however, faces long-term challenges to push through unpopular reforms in the face of often vocal opposition from the country's powerful labor unions and the general public. Greek labor unions are prepared to strike over new austerity measures and continued widespread unrest could challenge the government's ability to implement reforms and meet budget targets, and could also lead to rioting or violence.”

During the first week of May, we saw rioting in the streets of Athens, the Euro currency dropping precipitously, and stock markets around the world selling off strongly. On May 6th, the Dow Jones Industrial Average dropped just shy of 1,000 points for a brief period – a combination of lost confidence and computer glitch were cited as reasons for the “free fall”. Over the weekend, the members of the European Central Bank met and approved a more than \$600 billion bail out plan after recognizing the negative momentum was snow balling with the potential of causing greater challenges throughout the Euro-Zone.

For the moment, this crisis has been mitigated.

Government Spending

The Greek crisis has drawn attention to the fact that the current fiscal deficits of “developed” countries around the world – including the U.S. – are unsustainable. Currently, we are seeing bond investors pressure Greece to be more fiscally responsible. And it is only a matter of time until other developed countries are treated similarly.

What does “unsustainable” mean? The text book definition of “unsustainable” in this context means – not able to continue or be maintained.

Fiscal deficits are created when a government spends more than it collects in taxes. When a government spends more than its tax revenues, it must borrow to make up the difference. It borrows by selling debt to investors. The more debt it issues, the more interest it must pay out of its spending budget – not to mention, at some point, the debt

ELF CAPITAL MANAGEMENT, LLC
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May 10, 2010

must be repaid or refinanced. Both interest and principal must be paid from tax collections. At some point, the interest payments, alone, can become more than tax collections with nothing left over to pay for schools, military protection, law enforcement, bridges and highways, Social Security, Medicare, etc. It can get ugly.

Let me illustrate.

Let's say that the U.S. GDP is roughly \$14 trillion dollars each year. For the sake of argument, consider GDP as the value of all items bought and sold within the U.S. during the course of a year. Also, let's guesstimate that tax collections average 25% of GDP each year. These are illustrative numbers – not far from reality. So, federal tax collections are roughly \$3.5 trillion per year.

Also, let's consider that current U.S. debt held by the public is \$8.5 trillion and costs an average annual interest rate of 3.5%. So, the annual interest is just shy of \$300 billion per year or 8.5% of the U.S Government's tax revenues.

Current estimates project that the U.S. Government's budget deficit is expected to grow by \$1.25 trillion per year in each of the next three years. Historically, these estimates have been overly optimistic. As these deficits will be funded by additional borrowings, at the end of the third year, interest payments will rise to almost 12.5% of tax collections (a 44% increase). And, this supposes that we will remain at historically low financing rates. Over the last decade the average interest rate paid was closer to 5% per annum. If rates rise back to that average rate, interest charges will rise to above 17.5% - more than twice the current percentage of the budget. All while Social Security and Medicare payments take up a bigger part of the budget as well.

If we experience an investor boycott as Greece experienced, the U.S. could be in for some real troubled times. Greece's sovereign debt rating was downgraded by the ratings agencies and their cost to borrow more than tripled overnight – until the ECB stepped in to bail them out. If this happened to the U.S., who will come to our rescue?

The best medicine for avoiding such a disaster is to see greater fiscal responsibility exhibited by our government. However, when politicians learn that the easiest way to win an election is to offer more “free hand-outs”, it is challenging to expect our elected officials to have the back bone needed to change course. After all, there is no “free lunch” because any government borrowing costs will ultimately be paid by all of us through higher taxes. Unless our voting record shows that we want greater fiscal responsibility and the overspending to stop!

Only a Wall of Worry

All of the threats / risks described above are political in nature. While it is not so unusual that governments run deficits when the economy needs stimulus to avert or reverse a recession, there comes a time when dramatic measures are less needed. Often government stimulus is the medicine needed to stabilize the patient. However, when the patient is on the road to recovery, continuing to administer such strong medicine can manifest new illness. Most doctors know this. However, many politicians don't.

ELF CAPITAL MANAGEMENT, LLC
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May 10, 2010

With the economy showing strong signs of recovery, we should look for our elected officials to help it along rather than continue with medication that is less needed. At this juncture, moving towards greater fiscal responsibility is what the patient needs and public opinion needs to begin to telegraph this desire to government. If they choose not to listen, then we can effect change through how we vote.

There are always threats in any economy and awareness is often adequate to assist in averting disaster. Challenges that we know and pay attention to are ones that can be resolved. Yet, for investors, it pays to follow the stories to understand whether they are moving towards resolution or getting worse. At this point, they are only worries. Potentially harmful to the economy, but worries nonetheless.

Investment markets always climb rather than descend a “wall of worry”. It’s what makes markets work and sometimes there are bumps in the road. Optimism creates buyers, pessimism creates sellers. When the greater economic trend is positive, optimism prevails; and when the trend is negative, one should become defensive. Currently, the statistics reflect a positive trend and the markets are discussing potential threats.

Long ago, one of my favorite financial journalists wrote about investing in terms of tidal activity versus waves. Waves come in all sizes and shapes. The most common of them are caused by the wind and are of a short duration as they crash and form anew. Whereas, tides are longer lasting events that occur as a result of the gravitational forces that occur between the moon and the earth – essentially, the moon pulls a bulge in the ocean on the side of the earth closest to it.

From my point of view, the momentum of the economic recovery is the force that will pull the markets up this wall of worry. As such, I am optimistic and will continue to watch to see if I actually see the tide begin to turn.

Our portfolio clients ended the month of April up 3.45% and gained 55.02% for the last twelve months. Here are some comparative numbers for you to review:

	Apr 2010	3 Month	Y-T-D	1 Year
ELF's ETF Strategy (net)	3.45%	15.78%	11.37%	55.02%
S&P 500	1.48%	10.51%	6.42%	35.96%
Russell 2000	5.59%	19.03%	14.58%	46.98%
MSCI EAFE Index	-2.10%	2.68%	-1.88%	30.80%
MSCI All County World	-0.02%	7.34%	2.64%	36.45%

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.

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.

ELF’s 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.

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