

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

May 6, 2011

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## **Understanding the Economy: Lagging Indicators**

What drives your economic thinking? What information contributes to your business decisions? Or, your investment decisions? I pose these questions because a great many people allow themselves to be influenced by looking through the rear view mirror and let the past guide too much of their future. In fact, always looking backwards may only serve to increase your chances of becoming the victim of an accident.

Take for example, how the average investor makes decisions when selecting mutual funds for their company retirement plan account. According to the annual investor behavior studies conducted by Dalbar Inc., an organization that performs research in this area, the average investor most often selects funds that were the prior year's winners. And, more often than not, in the following year, these past winners earn below average returns. Even after several years of poor results, the average investor keeps chasing past performance. This strategy keeps them in the same battle, fighting the same counterproductive war over and over.

Now I'm not saying that backward-looking information isn't useful. The Dalbar example was just an illustration. At the same time, these average investors may just be giving too little thought when making changes to their retirement plan selections. Rather than taking more time to learn how to make better decisions, or seeking professional help, they may just be giving short-shrift to the selection process and hoping for the best.

Yet, I wouldn't be surprised if this introduction led you to think: Why waste my time learning about lagging indicators? And, you may be right! However, depending upon the type and use, lagging indicators can provide a signal that a real trend has or hasn't yet started. And, this could be very important if those current and forward looking indicators are simply misleading. If leading indicators weren't so notorious for giving false signals, you wouldn't need to look at coincident and lagging indicators too!

This article is the last in a three-part series that discusses some of the more widely followed economic indicators. And, my goal was to bring context to their usefulness through summarizing them as: leading indicators, coincident indicators and lagging indicators. My prior articles discussed "leading" and "coincident indicators" and this one will review "lagging indicators".

Each month, various governmental agencies and research associations compile and release a wide variety of information about the economy. Much of this data is "after the fact" information or relates to measures of confidence. In addition, quite often the data is derived from statistical sampling methods which carry a margin of error – usually, the smaller the sample, the greater the potential for sampling error. Yet despite their potential

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for error, these “economic indicators” can help guide our ability to make more confident financial decisions. That is, if you take the time to understand them.

As the categories indicate, **leading indicators** help to predict what the economy will do in the future; **coincident indicators** help us understand the current state of the economy; and **lagging indicators** help to confirm or deny the validity of the other two.

### **The Lagging Indicator Index Components**

For the sake of efficiency and debate, I will describe these indicators in groupings used by The Conference Board. The Conference Board is a global, independent research association who compiles data and publishes the indices of leading, coincident and lagging indicators each month.

The Conference Board’s lagging indicator model is composed of seven economic measures currently thought to be indicative of confirming the validity of economic trends. The lagging index can also serve to signal the sustainability and momentum of an existing economic trend. Each component indicator is described as follows:

Average duration of unemployment: usually expressed in “number of weeks”, this is a measure of how long the average individual is unemployed. While the sharpest increases seem to occur after a recession has started, decreases in unemployment generally occur only after a recovery or expansion phase gains strength.

Inventory to sales ratio: inventory and sales data from manufacturing, wholesaling and retail businesses are used in this measure. And, as used in the LEI, the numbers are adjusted for seasonal business cycles and for inflation.

Actually, this ratio can be very telling. When an economy begins to slow down, what do you think happens to sales figures? You’d expect sales to slow also, wouldn’t you? And, if sales are slowing before manufacturers and purchasing managers find out, inventories should begin to build up. As a result, it’s not unreasonable to see this ratio peak by the time we’ve reached the middle of a recession. Alternatively, you should be able to observe a big decline in this ratio at the beginning of an expansion. Why? Because inventories may not be replenished fast enough to meet the newly increased demand.

Change in manufacturer’s labor costs per unit of output: this is another business related measure that focuses on the manufacturing sector. This ratio is considered to be erratic on a month-to-month basis, so The Conference Board “smoothes” over the data before including it in the index. To smooth things over, they apply seasonal adjustments and recalculate the numbers over “rolling” six-month periods.

In a recession, labor costs per unit should increase as production is scaled back faster than workers are being laid off. That’s the example given in The Conference Board’s literature. Yet, unit labor costs could also rise as a result of a number of factors – including wage inflation.

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Average prime rate charged by banks: prime is one of several short term interest rates used by banks to price business loans. As implied, this is an average rate posted by a majority of the largest U.S chartered and insured commercial banks. While prime rate statistics are compiled daily, the measurement used in the LEI index is a monthly number compiled by the Federal Reserve Board of Governors.

This, perhaps, might be one of the most lagging numbers in the LEI index for one reason. The U.S. Prime Rate has been traditionally tied to the Fed Funds Target Rate set by the Federal Reserve's Open Market Committee. It is potentially the most lagging indicator as the Fed doesn't usually change the target rate unless it wants to take significant steps to either slow down or stimulate growth in the economy. This factor aside, the Prime Rate has commonly been 3 percentage points higher than the Fed Funds Target Rate

Commercial and industrial loans outstanding: this measure reflects the trend of business only lending activity in the economy. The majority of these loans are usually short-term in nature and tied to some form of collateral. This series measures business loans held by banks plus the amount of commercial paper issued by non-financial companies as published by the Federal Reserve Board of Governors.

The Conference Board's rationale for this index is that the measure tends to peak after an expansion peaks because declining profits usually increase the demand for loans and it typically bottoms more than a year after a recession ends.

Consumer credit outstanding to personal income: this ratio measures the relationship between consumer debt and income. Consumer installment credit is a statistic compiled by the Federal Reserve Board of Governors that measures the difference of new consumer credit less the repayment of principal on existing debt; and, the personal income data is the same employment related measure that I discussed in my article about Coincident Indicators – it is compiled by the Bureau of Economic Analysis.

The Conference Board contends that because consumers tend to hold off personal borrowing until months after a recession ends, this ratio typically bottoms after personal income has risen for a year or longer.

Change in Consumer Price Index (CPI) for Services: this is the change in the service component of the CPI that is compiled by the Bureau of Labor Statistics. The Conference Board asserts that it is probable that because of recognition lags and other market rigidities, service sector inflation tends to increase in the initial months of a recession and decrease in the initial months of an expansion.

### **Which Indicators are Considered Important?**

As mentioned at the onset of this article, lagging indicators are useful in confirming long-term trends – but not for predicting them. They help investors, managers and consumers understand that the economy has already begun to follow a particular pattern or trend.

In my two prior articles, I reviewed that leading indicators are useful to help predict turning points in the economy and coincident indicators help us compare where we are versus

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where we've been. Adding on, lagging indicators provide you the ability to understand the strength and reliability of the other two which should reduce uncertainty.

In constructing the lagging indicator index, the Conference Board assigns weightings and averages to the individual components listed above in order to smooth out any volatility in the readings. The weightings given to the individual components are summarized as:

- Three of the seven components account for almost 70% of the index. The Average Prime Rate (28.2%) is considered the most influential, with the Consumer Credit to Income ratio (21.2%) and Services CPI (19.5%) rounding out the top tier.
- The remaining measures comprise the balance: Inventory to Sales 12.1%; C&I Loans 9.7%; Labor Cost per Output Unit 5.9%; and Average Duration of Unemployment 3.6%.

It is interesting to see that short-term lending activity and inflationary forces are considered the most influential lagging components and unemployment has less of a footprint on it. After comparing the component types, can you really agree with the general assumption that employment data is one of the most lagging of economic indicators? I know I can't...

### **ELF's Outlook and Performance**

It's been a brisk several months since issuing our last letter as business activity has kept me from finding time. The markets have been brisk too. Since the beginning of the year, investors have been returning to U.S. markets and exiting from emerging market stocks. Maybe because the US markets have looked like the most attractive home in a shabby neighborhood. Around the globe, inflationary forces have been challenging central bankers in both developed and emerging market economies while the U.S. Fed is using it to bolster growth.

As a group, emerging market stocks have spent most of this year in negative territory while the US Dow Jones Industrial Average has remained positive and is currently besting most of the major market averages by roughly 2%. The Dow ended April up 10.65%. But this year's rise has not been steady. In mid March, all of the major averages gave back all of the year's gains before reaching new highs by month's end. And, since the beginning of 2011, the Russell 2000 gets the award for the most volatile performance of the bunch.

Running into May, we're seeing momentum shift into "low gear" as the old adage "sell in May and go away" may bear some credence. Many are anxious of the uncertain effect as we near the end of the Fed's money printing exercise in June. By some accounts, it was believed that the Fed had already completed 95% of their announced \$600 billion of bond purchases by mid-April. So, we're not so sure that the end of QE2 is the reason. Perhaps reaching \$4 per gallon at the gas pumps and high food costs has created fears that consumers will cut back on their spending. Nevertheless, the past week's market action implies that there is a major sector shift afoot as precious metals and other commodity related stocks have just had a significant correction and it is too early to say if it is over. West Texas Intermediate Crude ended the week dropping more than 10% to settle under

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\$100 per barrel. Hopefully, that translates into lower gas prices as we enter the summer driving season – but don't bet on it.

As for our activity, we began taking profits in mid-April and have raised our cash positions to slightly better than 40%. I don't see us holding such high cash levels throughout the summer but with the market's current downward sentiment, it sure feels good to be ready to go bargain hunting if the momentum stays to the downside.

Our portfolio clients ended the month of April up 2.08%. Here are some comparative numbers for you to review:

	<b>Apr 2011</b>	<b>3 Month</b>	<b>Y-T-D</b>	<b>1 Year</b>
<b>ELF's ETF Strategy (net)</b>	2.08%	6.83%	8.34%	-8.13%
<b>S&amp;P 500</b>	2.85%	6.03%	8.43%	14.91%
<b>Russell 2000</b>	2.58%	10.76%	10.42%	20.75%
<b>MSCI EAFE Index</b>	5.58%	5.96%	8.40%	15.89%
<b>MSCI All County World</b>	3.86%	6.35%	7.94%	16.12%

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.

Broad market index information provided is solely for the purpose of comparison. This index data was obtained from third party sources believed reliable; however, ELF does not guaranty its accuracy. An investment account managed by ELF should not be construed as an investment in an index or in a program that seeks to replicate any index. In most cases, investors choose a market "index" having comparable characteristics to their portfolio as a benchmark. An ETF is a security that tracks an index benchmark or components thereof. As ELF actively manages a strategic allocation of primarily ETFs, selecting a comparable benchmark poses significant challenges. Over time, the broad market indices provided above may exhibit more, similar or less variability of returns and risk than ELF's strategic allocation. As well, the broad market index information provided above reflects gross returns and have not been reduced by any estimated fees or expenses that a person might incur in trying to replicate an index.