

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

May 8, 2006

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## **Are You Itching to Invest in China's Growth?**

If you've been following the dynamics of global trade lately, the statistics suggest that China is leading the world as an exporter (seller) of goods and that the US is the world's largest consumer (importer). This isn't really new news, yet, if the direction of global capital flows represents a good indicator of economic growth opportunities, wouldn't this lead you to believe that investing in China makes a lot of sense?

During this past month, I corresponded with my good friend and client, John. John emailed me out of the blue with: "we need to invest in China...any ideas?" For a number of reasons, John's question startled me. Yet, he had put forth an excellent question that, in my opinion, could not be answered easily through a couple of brief e-mails.

To set the stage, John is a very busy medical professional who barely has time for social activities and much less time to study finance. Yet, I thought his observation about China was very astute. He also inquired about investing in alternative fuels...

In my response to John, I complimented him on exhibiting good instincts in seeking to uncover an investment opportunity. At the same time, however, I expressed that it is also very important to consider how and when you take advantage of opportunities that will determine whether you win or lose.

With global capital flowing into – or through – China, I certainly do believe that there is an investment opportunity to consider. However, how exactly, does one take advantage of it? Will opportunities come from currency – in the form of an appreciating Renminbi (the Chinese "People's Currency")? Will it come from an empowered business environment? Or, will it come from an exploitation of their relatively inexpensive labor?

As readers of our newsletter well know, wealth management is the ultimate goal of all that we do at ELF Capital Management. Yes, we also promote our services; yet, you will find that we always seek to present thought provoking topics that are relevant to our wide audience.

This month's letter will explore the "China Machine" as an investment opportunity and how you might want to consider exploiting it. Following that, do you think a highly diversified and conservatively managed portfolio returning 15.22% over the last 12 months is desirable? If so, please be sure to spend some time looking over our market comment and performance at the end of this letter. It will be well worth the investment.

## **Is China a Currency Play?**

Since the beginning of this decade, China's booming economy, fueled by large inflows of foreign direct investment (FDI) and rapid export growth, has emerged as a significant force in

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the global economy. In 2003, China surpassed the United States as the world's largest recipient of FDI, and its foreign exchange reserves surged to nearly UD\$820 billion by the end of last year, second only to Japan.

Both inward investment and export growth continues to create strong demand for China's currency, the Yuan (also referred to as, Renminbi). All things being equal, such demand pressures should cause the Yuan to appreciate relative to the U.S. dollar and cause China's external position to return to balance. But all things are not equal.

From 1994 through mid-2005, China's Yuan, stood at the de-facto peg of 8.28 to the dollar while its economy roared ahead. On July 21, 2005, the People's Bank of China (PBOC), the country's central bank, began a new policy of calculating the Renminbi's value against the US dollar using a weighted average of the prices, given by major banks. The prices are pegged to a basket of currencies representing their biggest trading partners. The list is comprised of: the US Dollar, the Euro, the Japanese Yen, South Korean Won, the UK Pound, the Thai Baht and the Russian Ruble. The highest and lowest offers are excluded from the calculation.

If the ramifications of the prior paragraph aren't clear, let me explain: the market effects of supply and demand remain very controlled at present. In fact, several US politicians are arguing that the Yuan is artificially low, giving Chinese exporters an unfair advantage, contributing to US trade deficits and hurting US labor markets. Nevertheless, the Chinese government is not anxious to let their currency float freely anytime soon.

From my research, the consensus suggests that the stance of China's Communist Party-led government will not change, despite the broadening of its global trade surplus and its buildup of foreign exchange. It is expected that Beijing will continue to allow only gradual moves from its prior Yuan peg against the dollar and is loath to increase the Yuan enough to dampen growth in its coastal factories. Exports are a key source of jobs in a country that must find employment for tens of millions of the poor farmers and workers laid off by bankrupt state factories in the continued transition from communism to capitalism.

To appease its major trading partner, last July, China bumped up the value of the Yuan by 2% against the US Dollar, somewhat diminishing tensions with the United States. But in the months since, the Yuan has appreciated less than 1% more against UD Dollar. Still, some economists believe that China's reserves are now growing so huge as to compel the central bank to deliver a more significant revaluation. Time will tell...

### **Should You Be Investing in Chinese Companies?**

Few can deny that the growth potential of China is vast. The country's success is dazzling, investment inflows are huge, and the society is being transformed in a monumental economic achievement. Because of this, China's potential for investors appears significant, but the market poses a number of unique political and cultural risks.

To better understand the China Machine, let us begin with a passage from the CIA World Fact-Book: "For centuries China stood as a leading civilization, outpacing the rest of the world in the arts and sciences, but in the 19th and early 20th centuries, the country was beset by civil unrest, major famines, military defeats, and foreign occupation. After World

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War II, the Communists under MAO Zedong established an autocratic socialist system that, while ensuring China's sovereignty, imposed strict controls over everyday life and cost the lives of tens of millions of people. After 1978, his successor DENG Xiaoping and other leaders focused on market-oriented economic development and by 2000 output had quadrupled. For much of the population, living standards have improved dramatically and the room for personal choice has expanded, yet political controls remain tight...

...Economic development has generally been more rapid in coastal provinces than in the interior, and there are large disparities in per capita income between regions...One demographic consequence of the "one child" policy is that China is now one of the most rapidly aging countries in the world. Another long-term threat to growth is the deterioration in the environment - notably air pollution, soil erosion, and the steady fall of the water table, especially in the north. China continues to lose arable land because of erosion and economic development. China has benefited from a huge expansion in computer Internet use, with more than 100 million users at the end of 2005. Foreign investment remains a strong element in China's remarkable expansion..."

In November 2001, with China's entry into the World Trade Organization, the Chinese government made a number of specific commitments to trade and investment liberalization. This began opening the Chinese economy to foreign firms. Yet despite these moves toward privatization, much of China's economy continues to be controlled by large State Owned Enterprises ("SOEs"), many of which are inefficient and unprofitable. Rather than undergo a large scale effort towards privatization, a restructuring of the SOE sector has been a major priority of the government and one of its biggest challenges has been the banking sector. Many Chinese banks have had to write off large amounts of delinquent debts from state-owned enterprises and China's banking sector remains a key concern for the country's economic stability as the ratio of problem loans appears to be rising.

Layoffs have played a large role in the restructuring of the SOEs, as many were severely overstaffed. This has created unemployment, which has been a burden on the government budget due to their providing social benefits which were previously the responsibility of the SOEs. At the same time, the geographic concentration of privately-owned industry in the urban centers along the coast also has created additional social strains.

As a result of its effort, China's real gross domestic product (GDP) grew at a rate of 9.8% in 2005, 9.5% in 2004 and 9.5% in 2003. For 2006, real GDP growth is forecast to drop to 8.9% as a whole. Much of the GDP growth rate appears to have come from excessive spending on capital goods and construction, particularly in the SOE sector.

Given China's booming economy – if you haven't been scared off – how does one invest in Chinese companies without risking unacceptable losses?

Aside from trying to acquaint yourself with specific companies or industries, stock shares resemble a veritable alphabet soup. They range from "A," "B," and "C" to signify types of shares traded on the Shanghai and Shenzhen exchanges to "H," "N," "L," and "ADR" to denote shares traded on the Hong Kong, New York, and London exchanges and under the American Depository Receipt agreement.

Traditionally, A shares are held only by residents of China and are traded in Yuan. B shares are denominated in Yuan but payable in foreign currency and are designated for foreign

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investors. C shares are wholly owned by state-owned enterprises and are not publicly traded.

In June 2003, China approved a handful of qualified foreign institutional investors, or QFIIs, to invest in "A" shares listed in Shanghai and Shenzhen.

To qualify for "A" shares, a financial institution must have US \$10 billion in assets under management in its past fiscal year. Fund management companies must have a minimum of five years of operational experience, while insurance companies and brokerages are required to have at least 30 years experience and paid-in capital of at least US \$1 billion. To keep a rein on "hot money" escaping China and prompting a financial crisis, the QFII scheme also requires funds to be held onshore for at least one year before being repatriated.

Among the "H" shares, the highest rated are known as "red chips" and they come in two varieties: mainland Chinese companies with Hong Kong subsidiaries and Hong Kong companies that do the bulk of their business with mainland China.

For most investors, the best way to play China is through a mutual fund. And, the number of fund offerings is growing as investor demand for China-related products increases. But remember, it's not like investing in the US markets. China is a volatile economy. Investing in China is very risky, suitable only for long-term investors, and should be limited to a small portion of your portfolio. The things we take for granted, like investor laws, private property, and accounting standards, won't protect your investments there. To some, this may be considered more risky than the US penny-stock market...

### **Should You, Instead, Be Investing in China's Economic Growth?**

China is the world's second largest economy on a purchasing power parity basis and is driven by a population of 1.3 billion people. And, it is estimated that China enjoys a household savings rate of more than 40%, one of the highest in the world. As incomes rise, newly empowered consumers represent an enormous market potential.

For example, an estimated 4 million mobile phones are sold in China each month, the world's biggest market with nearly 250 million subscribers. That's just 19 percent of the population and sales in the last two years have reportedly increased 17 percent. And, from the CIA Fact-Book passage previously referenced, we also know that the Chinese have embraced computer technology and internet use.

Noted economist and advisor to several US presidents, Dr. John Rutledge, had this to say about investing in China's economic growth:

"The re-awakening of China is the biggest economic storm system of our lifetimes. The opening of China has created an incredible growth machine... China is a category 5 hurricane, gobbling up the commodities and capital it needs to feed its ferocious growth. This increase in demand is the major force driving world commodity and product markets today. For example, China's growth, not Iraq, is responsible for the run-up in oil prices; it is also the driver of the surges in steel, aluminum, and coal prices last year. It's also generating huge increases in sales and profits for the companies selling the materials and capital goods China is buying to expand their economy. That spells opportunity for investors."

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According to Rutledge, “if you’re invested in big U.S. companies, you’re already invested in China. Many big companies...have made direct investments in China and plan to invest billions more.”

To back this up, in March of this year, China's Ministry of Commerce, released statistics that foreign direct investment (FDI) into China from January to February totaled US\$8.6 billion, up 7.8 per cent year-on-year. Hong Kong the British Virgin Islands – an offshore haven for US managed money – and South Korea topped China's major foreign investment sources. China attracted US\$60.3 billion in FDI last year, down slightly from the record of US\$60.6 billion posted in 2004. In 2004 and 2005, Japan, South Korea, Taiwan, and the United States were China's most important sources of FDI.

Below is a list of China’s top imports and trading partners:

**China's Top Imports (\$ million)**

HS #	Commodity Description	Jan.-Nov. 2005	% Change*
85	Electrical machinery & equipment	156,237.7	21.5
84	Power generation equipment	86,943.5	4.5
27	Mineral fuel & oil	57,925.3	35.2
90	Optics & medical equipment	44,695.9	22.0
39	Plastics & articles thereof	30,356.0	19.8
28, 29	Inorganic & organic chemicals	30,149.1	19.2
72, 73	Iron & steel	29,583.3	13.8
26	Ores, slag & ash	23,539.0	51.2
74	Copper & articles thereof	11,824.2	25.5
87	Vehicles other than railway	10,915.5	-8.9

\*Percent change over Jan.-Nov. 2004

Source: PRC General Administration of Customs, *China's Customs Statistics*

**China's Top Trade Partners (\$ million)**

Rank 2005	Country/Region	Jan.-Nov. 2005	% Change*
1	United States	191,585.5	25.4
2	Japan	166,985.6	10.3
3	Hong Kong	120,484.6	20.7
4	South Korea	101,457.7	24.7
5	Taiwan	82,042.8	15.8
6	Germany	57,079.4	16.8
7	Singapore	29,618.2	24.0
8	Malaysia	27,525.6	15.6
9	Russia	26,529.7	37.3
10	The Netherlands	26,226.0	38.4

\*Percent change over Jan.-Nov. 2004

Source: PRC General Administration of Customs, *China's Customs Statistics*

For 2006, the US-China Business Council summarizes “some analysts do not see China's export-driven growth decelerating much in 2006. Hang Seng Bank forecasts that exports and imports will each grow 25 percent in 2006. Others are more measured in their outlook...”

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These estimates are based on the assumption that the global economy will be weaker in 2006...and that rising domestic costs especially in land, raw materials, and minimum wages will place significant cost pressures on exporters, which already operate on thin margins.”

### **Some Concluding Thoughts**

John certainly asked me an interesting question and, since he moved from Charlottesville, we haven't had much time to visit with one another lately. Yet now, I hope it's clear to John and our other faithful investment clients, when reviewing their portfolio holdings, that we've been invested in China's economic growth engine for some time. And, it sure has helped our returns.

And, John, if you want a single stock play, you might want to take a look at 3Com (symbol: COMS). 3Com also is the majority owner of Huawei-3Com Co., Ltd. (H-3C), a China-based joint venture formed by 3Com and Huawei in November 2003. H-3C brings innovative and cost-effective product development and manufacturing which has a strong footprint in China. I own some, personally, but not in my client portfolios. Too risky...

### **ELF Capital Management Investment Performance Update**

This April was certainly upbeat for most of the major markets we track. All but the Russell 2000, S&P Technology sector and S&P Health Care sector indices showed positive gains for the month. The largest performers were Gold shares, the MSCI South Korea index and the S&P Energy sector index registering gains of 12.03%, 6.32% and 5.04% respectively. This represents unusual volatility toward the upside. A 12% gain in gold for the month! Wow! It certainly wasn't a global inflation threat moving gold, or was it?

Our hard work continues to reward us. For the month ended April 30, 2006, our one-month performance is up 2.08%, our three-month return is up 4.00% and our one-year return is up 13.91%.

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.

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.