

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

June 10, 2011

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Consumer Confidence Measures

*“We simply must have faith in each other, faith in our ability to govern ourselves, and faith in the future of this Nation. Restoring that faith and **confidence** to America is now the most important task we face.” – U.S. President Jimmy Carter July 15, 1979*

The U.S. and most countries around the world rely on the health of consumer spending as the mainstay of their respective economy. While there is considerable debate about the generality that consumer spending comprises 70% of the U.S. economy, few can deny that it is the single largest component of aggregate demand in our substantially free-market economy. President Carter realized this when he addressed the Nation in mid-1979 shortly after consumer confidence began the deep nosedive that contributed to the first of two severe recessions experienced in the 1980's.

As a reminder, when you hear or read “aggregate demand” as an economic term, it is synonymous with GDP (Gross Domestic Product) or the value of all purchases and sales of goods and services in a nation's economy. When aggregate demand grows, the economy expands and vice versa.

As the largest component of demand, consumer spending is an important economic factor that often coincides with the overall consumer confidence in an economy. High consumer confidence indicators usually relate to higher levels of consumer spending. And when confidence wanes, consumers tend to save more and spend less. When there is a decline in confidence, other sectors of the economy begin to expect that consumers will likely reduce their spending and begin to adjust their plans accordingly. For example, if retailers and manufacturers anticipate consumers will reduce their purchases, especially for expensive and durable goods, they will cut down their inventories in advance and may delay investing in new equipment and facilities. So, this translates into business spending slowing down too. Similarly, banks become more cautious about their lending activities, such as mortgage applications and credit card use. This can carry over to the service sector also. In addition, Government can expect to bring in less future tax revenues which, in this current era, can lead to an increase in our Nation's debt.

After recently completing a three part series on leading, coincident and lagging economic indicators, many kind readers expressed interest in delving further into some of the components of those indices. This month's article will briefly discuss some of the widely followed indicators of consumer confidence, sentiment and expectations here in the U.S. As consumer confidence, sentiment and expectations are interrelated; I hope to offer you some context to these frequently released and widely followed measures.

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

ELF CAPITAL MANAGEMENT, LLC
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June 10, 2011

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 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.

Several U.S. Consumer Confidence Measures

There are a number of organizations that release measures of consumer confidence in the U.S. and most use small relative samples to gage the sentiment of the nation. While technology advances will provide the ability to expand the accuracy of these measures some time in the future, the following are the most widely followed today:

Consumer Confidence Index ®

For the sake of efficiency, the following summarizing excerpts are taken from the February 2011 Technical Note prepared by The Conference Board:

“The Conference Board Consumer Confidence Index ® (CCI) is a barometer of the health of the U.S. economy from the perspective of the consumer. The index is based on consumers’ perceptions of current business and employment conditions, as well as their expectations for six months hence regarding business conditions, employment, and income. The Consumer Confidence Index and its related series are among the earliest sets of economic indicators available each month and are closely watched as leading indicators for the U.S. economy.”

“In 1967, The Conference Board began the Consumer Confidence Survey (CCS) as a mail survey conducted every two months; in June 1977, the CCS began monthly collection and publication. The CCS has maintained consistent concepts, definitions, questions, and mail survey operations since its inception.... The CCS mailing is scheduled so that the questionnaires reach sample households on or about the first of each month.... The targeted responding sample size — approximately 3,000 completed questionnaires — has remained essentially unchanged throughout the history of the CCI.”

“The CCS concepts and questions used to compute the Consumer Confidence Index... are based on responses to five questions in the survey:

- 1. Respondents’ appraisal of current business conditions.*
- 2. Respondents’ appraisal of current employment conditions.*
- 3. Respondents’ expectations regarding business conditions six months hence.*
- 4. Respondents’ expectations regarding employment conditions six months hence.*
- 5. Respondents’ expectations regarding their total family income six months hence.”*

“Each of the five CCS survey questions has three response options: positive, negative, or neutral.”

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

June 10, 2011

University of Michigan Consumer Sentiment Index

UM's Consumer Sentiment Index (UMCSI) is probably the most widely followed and highly regarded of all the consumer confidence measures. Perhaps because the Index of Consumer Expectations, a subcomponent of the overall index, was selected in 1989 by the U.S. Commerce Department to be included in the Leading Economic Indicators Index. Then again, its prominence may be a result of this sentiment measure having been developed in 1946 and maintained since the early 1950's.

For the sake of continued efficiency, quotations (*in italics*) are from various University of Michigan, Department of Surveys of Consumers white-papers that have been included to help summarize and describe the background and methodology of the UMCSI.

“Consumer confidence measures were devised in the late 1940's by George Katona at the University of Michigan as a means to directly incorporate empirical measures of consumer expectations into models of spending and saving behavior. Katona summarized his views by saying that consumer spending depends on both their “ability and willingness to buy.” By spending, he meant discretionary purchases; by ability, he meant the income and assets of consumers; and by willingness, he meant consumers’ assessments of their future job and income prospects. When consumers become optimistic they increase their spending, and when they become pessimistic they decrease their spending and increase their precautionary saving.”

“Each monthly survey contains approximately 50 core questions, each of which tracks a different aspect of consumer attitudes and expectations. The samples for the Surveys of Consumers are statistically designed to be representative of all American households, excluding those in Alaska and Hawaii. Each month, a minimum of 500 interviews are conducted by telephone from the Ann Arbor facility.”

“The University of Michigan’s Index of Consumer Sentiment was formed at the start of the 1950's when sufficient time-series data had been collected. The Index is based on the responses to five questions; two questions on personal finances, two on the outlook for the economy, and one question on buying conditions for durables... The questions are: a) We are interested in how people are getting along financially these days. Would you say that you (and your family) are better off or worse off financially than you were a year ago? b) Now looking ahead-- do you think that a year from now you (and your family) will be better off financially, or worse off, or just about the same as now? c) Now turning to business conditions in the country as a whole--do you think that during the next twelve months we'll have good times financially, or bad times, or what? d) Looking ahead, which would you say is more likely--that in the country as a whole we'll have continuous good times during the next five years or so, or that we will have periods of widespread unemployment or depression, or what? e) About the big things people buy for their homes--such as furniture, a refrigerator, stove, television, and things like that. Generally speaking, do you think now is a good or a bad time for people to buy major household items?”

I found it interesting that UM's monthly survey contained 50 questions yet the Consumer Sentiment Index is based on only 5 – or only 10% of the responses. *“Indeed, the Michigan surveys include a large range of additional questions. The questions range from*

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

June 10, 2011

income, unemployment, interest rates, and inflation expectations to what respondents think are the most important recent changes in economic conditions, measures about buying conditions for a variety of products, attitudes toward savings and debt, holdings of various assets, and many other topics.”

After researching UM's Surveys of Consumers, it became clear the CSI was only one of many indices prepared from the monthly interview results. Another prominent outcome from the monthly study is the Index of Consumer Expectations.

“The Surveys of Consumers have proven to be an accurate indicator of the future course of the national economy. The Index of Consumer Expectations, produced by the Surveys of Consumers, is included in the Leading Indicator Composite Index published by the U.S. Department of Commerce, Bureau of Economic Analysis. The inclusion of data from the Surveys of Consumers by the Commerce Department is a significant confirmation of its capabilities for understanding and forecasting changes in the national economy. Each series included in the composite Index of Leading Indicators is selected because of its performance on six important characteristics: economic significance, statistical adequacy, consistency of timing at business cycle peaks and troughs, conformity to business expansions and contractions, smoothness, and prompt availability. No other consumer survey meets these rigorous criteria. The Index of Consumer Expectations focuses on three areas: how consumers view prospects for their own financial situation, how they view prospects for the general economy over the near term, and their view of prospects for the economy over the long term. The Expectations Index represents only a small part of the entire survey data that is collected on a regular basis.”

Other Consumer Sentiment Measures

Other related indices that I'm familiar with are the Washington Post-ABC News Consumer Comfort Index and those prepared by Bloomberg LP and Ramussen Reports.

The Post-ABC Consumer Comfort Index is based on telephone interviews with 1,000 randomly selected adults over the previous four-week period. New data is released every Tuesday at 5 p.m. EST. The index is based on three core questions. These questions ask respondents to rate the condition of the national economy, the state of their personal finances and whether now is a good time to buy things.

All of these other consumer confidence measures are prepared from reputable firms and I'm sure they apply some level of rigor to their methodologies. Depending upon your motivations for tracking consumer sentiment, it may be worthwhile to review each of their results and perform a more detailed comparison if there seems to be inconsistencies among the reports. However, if Consumer Sentiment is just one of many data points that you are following, the more widely followed measure comes from the Michigan Surveys.

Having a Healthy Perspective

As I began, consumer spending is an important economic factor that often coincides with the overall consumer confidence in an economy and measures of consumer confidence can generally be thought of as leading indicators of an economy's direction. However, consumer sentiment can be fleeting based upon why people are happy or cautious.

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

June 10, 2011

In order not to be fooled by a brief change in any trend, it always helps to dig deeper to understand why sentiment is changing direction or gathering momentum. Just remember:

*"It is healthy to enjoy **sentiment** as to enjoy jam."*—Gilbert Keith Chesterson (1874-1936), British author. Generally Speaking, "On Sentiment," (1928). But,

*"Let us beware of common folk, of common sense, of **sentiment**, and of the obvious."*—Charles Baudelaire (1821-1867), French poet and critic. My Heart Laid Bare, XLI (1887).

ELF's Outlook and Performance

Little did I expect when I penned last month's letter that the old adage "sell in May and go away" would be so opportune and to the point. During May, stock markets around the globe were trading quite choppy. While the markets rallied back in the last week of May, equity markets have fallen significantly from the beginning of June to now.

Consumer confidence measures dropped in May after showing positive trends through April. Consumers' assessment of current conditions, while mixed, was less favorable than in April. In their press release, Lynn Franco, Director of The Conference Board Consumer Research Center reflected: "A more pessimistic outlook is the primary reason for this month's decline in consumer confidence. Consumers are considerably more apprehensive about future business and labor market conditions as well as their income prospects. Inflation concerns, which had eased last month, have picked up once again. On the other hand, consumers' assessment of current conditions declined only modestly, suggesting no significant pickup or deterioration in the pace of growth." If this were our only data point, it might not be so helpful in explaining why the equity markets have sold off so much in June. However, we've also seen significant drops in manufacturing activity, housing prices and the pace of hiring. Nothing yet suggests that we are heading back into a recession, but current economic statistics definitely point to a slowing.

As for our activity, we began taking profits in mid-April and continued to sell in May, raising our cash positions to slightly better than 60%. This has significantly buffered us from June's selloff. We're prepared for an ugly summer market and will be looking any bargain opportunities that a potential oversold market might bring.

Our portfolio clients ended the month of May down 2.63%. Here are some comparative numbers for you to review:

	May 2011	3 Month	Y-T-D	1 Year
ELF's ETF Strategy (net)	-2.63%	1.91%	5.49%	5.73%
S&P 500	-1.35%	1.35%	6.96%	23.48%
Russell 2000	-1.96%	3.02%	8.25%	28.22%
MSCI EAFE Index	-3.60%	-0.92%	4.50%	27.05%
MSCI All County World	-2.52%	0.89%	5.22%	25.52%

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 CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

June 10, 2011

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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.

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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