

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

June 8, 2006

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Investing for Dividends, the GBU

Is the party over for the equity markets? Is the US consumer going to stop spending altogether? Will they clamor to sell their homes, begin saving money and living in tents? Has new Fed Chairman Bernanke decided to change his focus and target a recession? Also, will most developed and developing countries follow the US, like lemmings into the sea, and stop global commerce dead in its tracks? As global equity markets sold off in May and into early June, you might certainly have begun to think so.

What a difference a month makes! Other than the new Federal Reserve Bank chairman seeking to scare the heck out of the markets, what new macroeconomic trend happened that would explain the sell-off in global markets following the 8th of May? While there are a number of theories, was anything really significant and new?

When markets move dramatically, two things often accompany it. First, markets that trade independently from one another are prone to move similarly, often harmonizing in unison like babies in a nursery joining a comrade in letting the world know someone is seeking immediate attention. Second, both professional investors, and those served by them, will test their beliefs and convictions about how to be invested.

During the month, I was contacted by one of my long standing business relationships who asked me to look into an investment scheme. ML has always possessed a keen eye for ferreting out opportunity and often asks for my advice or perspective. Having followed my career for over 20 years, ML has become comfortable with the breadth of my exposure to various investment types or strategies and always expects me to offer an opinion.

ML's curiosity was peaked by a 30 page infomercial regarding a supplemental retirement income program. After my review, it became apparent that the advertiser was selling investment advice on how to develop a portfolio of equities that would payout a high yielding stream of income. Basically, it was discussing dividend and like income. As this became painfully evident, I was then able to offer my perspective. It was not a "magic-bullet"...

As readers of our newsletter well know, wealth management is the ultimate goal of all that we do at ELF Capital Management. Yes, we 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 things that you should know when investing for dividend income. As well, only those that read through will learn about the GBU. Following this discussion please be sure to spend some time looking over our market comment and performance at the end of this letter to find out how we fared against the market's turbulence. It should be well worth the investment.

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Dividend Investing, the Primer

In essence, a dividend is a distribution by a company or business to its owners. As opposed to payments for interest or for services rendered, this distribution is most commonly paid to those bearing the risks of ownership out of the operating profits of the business. But not all dividends are paid from operating profits. Should a company pay out profits from realized gains on invested assets, the dividend would be considered a capital gain distribution; and, a distribution other than from profits would be considered a return of capital. Dividend distributions can come in the form of cash, stock or payments in-kind.

Regular cash dividends, also referred to as ordinary dividends, are cash payments that are paid in regular intervals. Regular dividends are generally paid from operating profits. Otherwise, a cash dividend made as a one-time occurrence is referred to as a special dividend. Often, the company's per share price will be reduced by the amount of the dividend upon the ex-dividend date which is explained below.

Stock dividends are issuances of additional shares of company stock. And, a very large stock dividend is considered a stock split. After receiving a stock dividend your ownership percentage remains the same; your cost basis gets allocated across the total of your old and new shares; and, the stock per share trading price will often be adjusted downward on a pro-rata basis. Hence, you have more shares but your aggregate market value and cost basis remain unchanged. One advantage, however, is that at the reduced stock price, the shares may now be more affordable to a smaller investor. Think of the per share price of Berkshire Hathaway as an example. At \$91,000 per Class A share, how many can you afford to buy?

A payment in-kind dividend is usually a distribution of company property – other than cash. The company may distribute some of its assets or in goods or services. The most common form of in-kind distribution is a corporate “spin-off” transaction. A corporate “spin-off” occurs when a company divests itself of a subsidiary by distributing the subsidiary's shares to its own stockholders. Like a stock dividend, however, your original cost basis and current market values are allocated over the resulting two independent companies. And, as a result, you will now have two separate investments to consider.

With private investments, the process and timing for paying dividends can be quite informal. In this instance, dividend distributions are usually made at the end of a fiscal year, may be coincident with a significant transaction or made at the whim of a majority of owners.

However, for publicly traded securities, the process is much more formal. The timing of payments is more regimented. And, because ownership can change hands rapidly, here are some important dates that you should be aware of: The first is the **declaration date**. This is the date that the company approves and announces the per share dividend and records it on the company's books as a liability. The next two dates, the **record date** and the **ex-dividend date** serve similar purposes in that they determine who the dividend will be paid to. Purchasers of shares before the **ex-dividend date** will be entitled to the distribution; whereas, purchasers on or after this date will not. And, on the **record date**, the company's payment agent will review the registered owners of record for determining who to pay. Lastly, it is on the **payment date** that the company initiates the dividend payment to the registered owners of record.

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Dividend Investing, the Benefits

Among the most certain benefits to dividend investing for U.S. individual investors, is the favorable income tax treatment afforded under current law. Signed into law on May 28, 2003, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "Act"), reduced the maximum individual income tax rate on net long-term capital gains (i.e., generally net gain on the sale of assets held for more than one year) from 20% to 15%. This lower rate applies both to AMT and regular income. But, the lower rates do not apply to gains attributable to un-recaptured depreciation on real property, gain from the sale of "collectibles" or gain from the sale of qualified small business stock.

For dividends from operating profits, the Act lowered the rate of tax on "qualified dividend income" by taxing such income at the reduced long-term capital gain rate rather than at ordinary income rates. This reduced rate of tax is applicable to qualified dividend income received on or after January 1, 2003. As with the reduction of long-term capital gains rate, this rate reduction is scheduled to expire in 2009.

Qualified dividend income includes certain dividends received from U.S. domestic corporations and qualified foreign corporations. Qualified foreign corporations include foreign corporations whose shares are listed on U.S. exchanges, those incorporated in a possession of the United States and foreign corporations eligible for benefits under a comprehensive income tax treaty identified by the IRS. A foreign personal holding company, foreign investment company, or passive foreign investment company is not a qualified foreign corporation.

Qualified dividend income does not include: (a) dividends paid by tax-exempt organizations; (b) dividends paid by mutual savings banks and similar institutions; (c), amounts allowed as a deduction for dividends paid on employer securities held in an ESOP; or (d) dividends from real estate investment trusts (REIT) or regulated investment companies (RIC), unless they come from qualifying dividends that the REIT/RIC received.

A taxpayer must hold the shares of stock producing the dividend for more than 60 days during the 120-day period beginning on the date that is 60 days before the date such shares become ex-dividend. As an example, assume an individual has owned a share of common stock for 15 days when the share becomes ex-dividend. The individual must hold the share for at least 46 more days in order to qualify for the reduced rate of tax on the dividend. For preferred stock, the required periods are increased from 60 days to 90 days and from 120 days to 180 days. A dividend is not qualified dividend income to the extent that the taxpayer is under an obligation (whether resulting from a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

In addition to the tax benefits, dividends can provide a significant contribution to U.S. investors' total returns. According to Fidelity Investments, "since January 1980, approximately 56% of the S&P 500 total return was derived from the receipt of dividends." This, of course, includes periods when the S&P 500 produced negative returns for a year.

It is widely touted in the investment industry that investing in dividend paying companies offers many advantages. Paying dividends is perceived as a signal to investors that the company is healthy enough to share its profits. Another signal, or advantage, is that if a company increases its dividend each year, it's generally a good sign that the company has

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experienced continued growth and is optimistic about its future which, in turn, could potentially increase its stock price. It is also believed that stocks of companies that pay dividends can be expected to exhibit less market value fluctuation than stocks of companies that don't pay dividends.

In starting out investing for dividends, you should realize that, at the time of this writing, the average dividend yield on the S&P 500 is 1.68%. The dividend yield is calculated by taking the amount of dividends paid per share over the course of a year and dividing by the stock's price. For example, if a stock pays out \$0.84 in dividends over the course of a year and trades at \$50, then it has a dividend yield of 1.68%.

That's not to say that you couldn't find higher yielding opportunities to invest in, but that kind of effort brings its own set of challenges. In fact, some investors focus on doing just that. Have you ever heard of the "Dogs of the Dow" strategy? Dogs of the Dow is a stock picking strategy devoted to selecting among the higher dividend stock components of the Dow Jones Industrial Average.

So, how reliable is dividend yield as a predictor of performance?

Dividend Investing, the Considerations

Although dividends have historically been a large percentage of the S&P 500 total return, a study performed by Empirical Research Partners, LLC, reveals how yields have contracted since peaking in 1982. Not only are yields below their historical average, but the result is that they have also become more expensive. This may not be so bad if you're able to select companies with good to great profitability prospects and promising dividend growth potential.

As mentioned earlier, dividends are one way companies, usually mature ones, share their profits with the investors who hold their stock. But unless some of those profits are reserved for reinvestment back into the business, the probability that management would achieve continued success in maintaining and growing dividend yield could be greatly diminished. In fact, without periodic reinvestment back into the business, one could reasonably expect earnings and cash flow to decline over time.

Stocks with declining earnings are usually bad news. For starters, over the long haul, stock prices tend to track earnings. So a drop in earnings will probably result in a drop in share price. Further, declining earnings could lead to a dividend cut, which would not only further pressure the share price, but would reduce your dividend yield.

As a matter of fact, when evaluating the growth prospects of a company, securities analysts will measure the retention rate of net earnings to determine the maximum growth rate that a firm can sustain without having to increase financial leverage. The retention rate is calculated by multiplying a firm's return on equity (ROE) by the difference of 1 minus the dividend payout rate. Also referred to as the sustainable growth rate, this measure helps determine how much a firm can grow without borrowing more money. After the firm has passed this rate, it must borrow funds from another source to facilitate growth.

A company's payout ratio is a measure of the percentage of net earnings paid to shareholders in the form of dividends. Some companies strive to increase their dividends on

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a regular basis, even when their earnings may actually decrease. That will cause their payout ratio to jump, if only temporarily. But sometimes, an unusually high ratio over a longer period of time may be a danger signal that the company will soon have to cut its dividend. And a dividend cut usually sends a company's stock tumbling.

Unless a company is in a regulated industry, like utilities companies, a dividend payout ratio at or above 40% would be considered fairly high. As such, I would advise that you compare the payout ratio of a company with others in the same industry to better understand if it seems out of line. Then, if it is, you might want to dig a little further to understand why.

Another good ratio to look at is the dividend coverage ratio. This ratio measures how much cash flow a company is generating relative to its ability to payout its expected annual dividend. If this ratio is below 1.00, this would indicate that the company must sell assets or borrow to pay the dividend because it is not generating enough cash from operations to meet its obligation. This would indicate an increased risk that the dividend may not be "safe" from being reduced or eliminated. On the other hand, a company who generates a steady or growing operating cash flow is better able to fund a dividend than a company that cannot consistently generate cash.

If nothing else, you should now realize that dividend yield may not be so useful as a predictor of performance. As well, I would warn against relying on one measure or indicator for all of your investment decisions. If you had bought the five highest dividend yielding shares one year ago, you would have been buying into many of the companies who had subsequently cut their dividends and seen their share prices fall substantially.

As an investor it is important to assess the market environment and the economic backdrop before deciding on whether the stability of a strong income flow will be an attractive factor which will help one achieve financial security or encourage other investors to buy a company's securities.

So, if you are interested in pursuing a strategy of investing for dividends, the above provides you the GBU – the good, the bad, and the ugly.

Some Concluding Thoughts

Very often, I hear clients inquire or discuss with me the merits of investing in a single asset class or strategy. And, after experiencing a great many years in the investment industry from the portfolio management side of the business, I'm of the belief that there simply is no "magic bullet" to investing. Sound investing requires a great deal of thought and effort to understand the risks and how to navigate through them. And, at the end of the day, we make decisions today that the outcome will not be known until tomorrow.

ELF Capital Management Investment Performance Update

If you were invested in equities, May was a difficult month; if you were invested in fixed income, you earned interest only. Volatility increased significantly and all global equity sectors we track were down except for the S&P 500 utility and consumer staples industry

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sectors. With lackluster performance all year long, the Technology sector was hardest hit, down 6.5% for the month. In other markets, after running up better than 25% since the beginning of the year, Gold Shares (GLD) slid 1.3% and dropped another 5.8% since the beginning of June. Emerging markets fared worst with the S&P Latin America 40 Index (ILF) off 13.5% for the month. Wow, what a difference a month makes.

New Fed Chairman Bernanke sounded the alarms about inflation and traders listened? Did he really say anything different than what Mr. Greenspan has been saying for his last two years prior to retiring? Did the markets sell-off because of distrust in the abilities of Mr. Bernanke? In May, the Fed raised interest rates another 25 basis points (1 basis point equals 1/100 of a percent), at the same measured rate as has been done for the 16th consecutive time. I, for one, expected that. But, I think traders are becoming afraid that the Fed will over-shoot efforts to slow down the economy.

As Bernanke has flexed one of his three monetary policy tools, moral suasion (or, should I say fear), he impacted global markets. So much so, that he got a little help from his friends: Following two days of meetings in St. Petersburg, Russia last week, finance ministers from the Group of Eight leading industrialized economies concluded that "global growth remains strong and is gradually becoming more broadly based." Does that sound like a reason for the markets to sell-off?

For the month ended May 31, 2006, our one-month performance is down 3.11%, our three-month return is up 0.60% and our one-year return is up 9.87%.

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.