

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

July 2, 2008

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## **Oil Paints the Landscape**

What do you think about this oil situation? Has this recent spike begun to change your spending habits? How about your view on politics? And, your view on investments?

Since last month's letter, I've done a considerable amount of qualitative research to understand how oil shocks have impacted us in the past. Beginning with the Arab Oil Embargo of 1973, we are now in the fifth and longest running oil shock which started in 2002. If history is a guide, the current outlook isn't very pretty and my thinking is being changed as a result.

Drawing from an article, written in 2005 by Roger Kubarych, one can find a concise summary of "How oil shocks affect markets". Kubarych is a senior economic advisor at HVB America, Inc. with an impressive career in both industry and government, and his article outlines both the causes of past oil shocks and how financial markets have responded. His article reflects that, unless you have a "tech bubble" like situation helping you ignore spiking oil prices, supply and demand imbalances have a more severe impact on financial markets than geopolitical conflicts. When writing his article, Kubarych believed that "as the economic impact of successive oil shocks has become progressively less destructive to growth, so too have the financial market effects become milder ... that is because [he believed] moderately higher crude oil prices no longer have a decisive effect on overall inflationary developments." This was a reasonable assumption back in 2005. However, I think the limits of that theory are now being tested.

As I mentioned in my previous letter, "Oil is an incredible staple commodity that is used for more than transportation and heating. It is used in so many products that efficiently preserve our other natural raw materials and resources that I am hard pressed to not see its by-products in any of my surroundings..." [add] "...Up to this point, consumers have been lax to reduce consumption in the face of higher prices (in economic terms – demand has been almost perfectly inelastic to price changes)..." [and] "...people do not generally change their habits unless they feel enough "pain" to prompt them toward change." Now, I think the public may be as eager as I am to see the concept of the "Invisible Hand" take over and gain momentum to help make things better.

*"...every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good." Adam Smith, Wealth of Nations (1776)*

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One of the more common interpretations of Adam Smith's theory of the Invisible Hand contends that if consumers are allowed to choose freely what to buy and producers are allowed to choose freely what to sell and how to produce it, the market will settle on a level of availability and prices that are beneficial to the to the community as a whole. The reason for this is founded in the belief that the pursuit of self-interest will drive behavior. Efficient methods of production will be adopted in order to maximize profits; low prices will be charged in order to undercut competitors; and, investors will invest in those industries that are most urgently needed to maximize returns, and withdraw capital from those that are less efficient in creating value. Yet, Smith made it clear that an infrastructure of moral norms must exist to prohibit activities such as misrepresentation and theft.

When moral norms are breached the benefits of free-markets are diminished. In an article written by Helen Joyce for the University of Cambridge's Millennium Mathematics Project (1997-2004), Joyce challenges whether the Invisible Hand theory can really work. In the following passages, she makes some very good points: "...even assuming all the correct conditions, does the invisible hand theory really lead to the maximization of human economic wellbeing in some sense, as Smith asserts? This is where mathematics, in the form of Game Theory, can provide us with some insights.

The "Prisoner's Dilemma" is a very famous "paradox" in Game Theory. It describes two people in a simple situation, acting in an informed manner, both attempting to maximize their wellbeing, and yet making choices that lead to an unnecessarily poor outcome for both. ... We can think of the prisoners [under interrogation] as being asked to decide whether to keep a contract they have made with each other (remain silent) or to default (confess and betray the other). ... The reason we don't see ... [contracts broken] ... too often is because we live in a society where courts can enforce contracts. ...

[Also] In a democratic society, there is a strong temptation for "special-interest" groups to form and lobby the government to provide tax-payers' money to the group in the form of subsidies. Politicians find the prospect of buying the loyalty of the group attractive, and the group sees the prospect of getting other people's money for nothing. Clearly, everyone would be better off if no one sought subsidies - by definition, subsidies are only needed for unprofitable activities, that is, activities that other people do not value sufficiently to pay their own money for. However, if other people seek and gain subsidies, anyone who doesn't bother trying to do the same for themselves will end up subsidizing others while receiving no subsidies themselves. This fear may force large numbers of people to spend their time lobbying the government for subsidies, rather than simply engaging in more profitable activities - a classic example of the Prisoner's Dilemma, and one over which no court has jurisdiction.

A very similar situation occurs regarding monopolies. Since pretty much every producer is a consumer, it is probably to everybody's benefit overall if no producers attempt to raise prices by monopolizing their market; however, attempting to enforce a monopoly can be very attractive to individual producers."

How does this all tie in? Well, I think it begins to explain how consumers are beginning to consider their spending habits, their political views and their investments.

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First, let me state that I think that high oil prices are not just a problem in the US. By all accounts, it looks to be a global problem. Data as of May 2008, reported in the June 28<sup>th</sup> issue of The Economist magazine, reflect that Asia and Africa are experiencing an annual inflation rate at or nearing double digits while the US is on the lower end of the spectrum. What is troubling, however, is that the US seems to be experiencing a greater rate of inflation per unit of GDP growth than most of the other countries reported on. Given the trend of this data over the past six months, this leads me to believe that the US is exporting slower global growth while, at the same time, importing global inflation.

When I look at global balance of trade figures (the difference between the monetary value of exports less imports), the picture becomes clearer. The data reflect that oil producing countries are gaining surplus at an enormous rate, with Russia and Saudi Arabia accelerating towards the top of that list; while the USA has run the largest deficit at more than 4.5 times the next nearest contender.

When I look at the average US consumer, I tend to think of them as falling into one of three categories: those who are savers, those who spend what they make, and those who live beyond their means. Before the recent oil spike, I was less concerned about the prospects of recovering from the “credit crisis” because it mostly impacted those who live beyond their means and others whose income is linked to the housing markets. As far as I was concerned, we talked (scared) our way into that mess and we were going to talk our way out of it – with more safeguards put into place. However, the unabated rise in oil prices has changed my thinking – because it harms each category of consumer.

*When the facts change, I change my mind. What do you do Sir?*  
John Maynard Keynes

Also, recently many executives in the oil exploration and oil services industries have been interviewed by the media. Not only is it clear that the US has neglected development of its oil and gas resources – both on and offshore; even if government were more friendly towards development, it will take five years or more before we could expect to get it out of the ground!

As a result, the average US consumer is now being thrown under a bus. The combination of gloomy financial markets together with rising food and fuel costs is causing them to be more cautious and reel in their spending. There is a general feeling that we are defenseless against rising oil and people seem to be restructuring their routines (changing some habits) and choosing to keep activities closer to home. I’ve even begun to hear reports of people siphoning off gas (theft) from others and the other day saw someone abandon their vehicle because it ran out of gas. If this isn’t a new “sign of the times”, I don’t know what is. And, a credible solution doesn’t look available over the near term.

Some areas of the economy should benefit, however. While discretionary spending can be expected to remain low for a while, households will likely be spending more on home entertainment. I also expect service providers like accountants, financial planners and business consultants of every type to see greater activity as households and business clients grapple with altering their routines and the need to retool strategies.

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The political arena does not seem to be closing in on a solution either. With the Presidential election gearing up, rather than seeking solutions, politicians are employing rhetoric that encourages “special-interest” groups into lobbying for subsidies and protectionism. They’re having a “prisoner’s Dilemma” party and we’re all invited!

And, as for alternative fuels being a better solution to this oil crisis. I don’t know about you, but neither my house nor my car run on alternative fuels. And, unless and until we create a more favorable environment for developing oil and gas resources in the US, that big sucking sound will be your dollars going to people that don’t really like us. In case you hadn’t heard, Libya recently played their “oil card”. They threatened that they would reduce oil production unless the US dropped their pending court actions against Libyan terrorists. Oil rose more than \$5/barrel that day. Sounds like economic warfare to me...

Unless the US, seemingly the only country holding back, begins taking steps to bring new supply to the market, the existing oil producing countries will be exerting monopolistic power to control prices. Why should we expect them to be generous? Basic economics dictates that when prices get high enough, new supply and innovation will find its way into the marketplace unless large barriers are in place. The supply comes in quicker when barriers to entry are reduced and competition is encouraged. In my humble opinion, if the US would send a clear message that we are now encouraging the development of our own energy resources, this would do more to lower crude oil prices than raising interest rates to encourage a stronger dollar. As a matter of fact, a stronger dollar would be a likely result of the US taking steps to developing its oil and gas resources. Push your politicians to reduce the up-front costs and time delays for US drilling. In return, ask for a 5% to 10% royalty charge on production sold that will be used to enforce environmental concerns, encourage development of alternative fuels and send the remainder to taxpayers. Again, push your politicians to a solution!

While the US is purported to have approximately 2.3 trillion barrels of oil, the largest store of untapped oil reserves on the planet, much of it is either in federally protected areas, in hard to get at places, or leased for exploration under terms that obfuscate the ability to bring any oil or natural gas into production. This week’s Barron’s, in the DC Current section, discusses “...Not only will you then appreciate how difficult it is to win approval to drill offshore, you’ll also appreciate the inanity of Democratic charges the Big Oil isn’t drilling on all of its existing leases.” In all fairness, the article states that Republicans are guilty of obstruction also. In fact, I heard John McCain come out and talk about how he would be reluctant allow drilling in Alaska’s National Wildlife Reserve (ANWR), while Sarah Palin, Alaska’s Governor, is pounding the pavement saying that Alaska’s voters are all for drilling there. You really should read the Barron’s article if you can.

As for this November’s elections, unless I hear a credible solution for US oil, the candidate with the least Prisoner’s Dilemma tally’s may get my vote. Otherwise, I may vote “none of the above”. The alternative may be that I wind up telling my grandchildren that the US was once the world’s greatest super power.

As for investments, in the two trading sessions immediately before June’s FOMC meeting, we sold off and raised significant cash in our client portfolios. We suspected that the Fed would disappoint the markets and they did. We substantially reduced our allocation to financials, got out of industrials and began significantly pulling back on our international

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allocations. We like energy (not energy commodities) explorers, innovators and service companies; we like basic materials for the agriculture play; we like utilities and technology; and, we like foreign exposure that will benefit from petrodollars. Outside of these areas, we expect that both earnings and P/E multiples will contract and should be approached with a short bias – short bias means that we will seek to profit from share prices that are going down.

As mentioned earlier, we changed our view on financials. We still think that they offer great promise over the long term, yet they now have some strong headwinds due to oil. Our position in financials looked great on our books when Goldman Sachs upgraded their analyst expectations in May. Then, on June 23rd, Goldman reversed and downgraded the sector to underweight. This caused us some pain and we substantially reduced our exposure in that sector prior to the FOMC meeting announcements. Since, they've dropped another 5%. Now is not the time, but we will see great promise for that sector in the future – possibly at a 10% to 20% discount to current market levels.

Our performance for June was down .....

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