

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

July 6, 2010

This is the ELF Capital Management, LLC Market Letter for the month ended June 2010. If you do not wish to be included in our circulation, please reply indicating your desire to be removed and we will be happy to oblige. Alternatively, any of your friends or colleagues may receive this on a regular basis by entering their email address on our list-server via this [link](#). Feel free to forward this to any of your friends! Thanks for your interest and we hope you enjoy the letter.

Economic Chicken and Egg Quandary

Which came first, the chicken or the egg?

This question has a reputation for being impossible to answer and, over the ages, the world's most thoughtful philosophers have considered it a conundrum – a difficult question to answer.

Over the past two months, the performance of the US stock market and that of the economy are somewhat a similar quandary. Economic data reflected that the US economy entered the second quarter of this year with plenty of economic recovery momentum and exited with very little. The only objective data points that occurred were that the stock and bond markets reflected fear making a comeback – bond yields went significantly lower and so did stock prices.

In this context, objective data refers to observing near term historical data and events that are independent from subjective opinions and forecasts.

When we talk about subjective data, we are referring to the predictive musings (forecasts) of investors, traders and economists. Currently the trader's and investor's forecasts are reflecting opposing views and economist' forecasts are mixed. To understand why, let's review the roles of each:

The “Investor”. This player generally seeks to know plenty of fundamental information about his or her investment. Traditional financial analysts fit in this category and operate under the belief that sound investing requires thorough fundamental analysis of a security to determine if it is attractive or not. For example, to increase the probability of making a good stock investment, an individual should try to buy that stock at a good price. In order to do that, the investor needs to determine if the current price of the investment is attractive relative to others by studying earnings trends, current and future business environments, interest rates, and many, many other factors. In making the investment, the investor is not concerned with what is going to happen to the price of the stock the next day, because investments are longer term in nature.

The “Trader”, on the other hand, uses other information in seeking to generate quick short-term profits. This may be puzzling to some, since the traditional concept of stock ownership involves shared ownership in the prospects of a company, group of companies or a country's economy. The trader has little use for the concept of ownership. Rather, he or she is more interested in the short term dynamics of supply and demand and how to quickly turn a profit. A trader is not trying to predict what is going to happen in the next year; his or her goal is “turn a profit” as soon as possible.

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

July 6, 2010

The “Economist” is a different breed of participant whose work provides valuable input for both traders and investors. Economists study how society distributes resources, such as land, labor, raw materials, and machinery, to produce goods and services. They perform research, collect and analyze data, monitor economic trends, and develop forecasts on a wide variety of issues, including energy costs, inflation, interest rates, exchange rates, business cycles, taxes, and employment levels, among others. Preparing reports, including tables and charts, on research results also is an important part of an economist's job, as is presenting economic and statistical concepts in a clear and meaningful way for those who do not have a background in economics. Some economists also perform economic analysis for Governments and/or the media. Larry Kudlow is an example of an economist working for a media company – CNBC.

As a side note, in today's day and age, it is not unusual for economists to be in the money management business and those who do are more likely to fall into the “investor” role. As economists are more “big picture” player than the traditional stock pickers, exchange traded funds (ETFs) offer an opportunity to complement their work quite well. Yet, there are economists who use their work to “trade the markets” as well.

So, why is the performance of the US stock market and that of the economy similar to the “chicken and egg” quandary?

The Quandary

The quandary is this: Are stock and bond markets guided by the economy; or is the economy guided by stock and bond prices? Which comes first?

In the long past, I've always believed the economy has guided stock and bond markets. However, due to the cause and deepness of the recent recession and the fragility of the recovery and investor behavior, I'm beginning to think that the economy is being guided by the markets. In the second quarter of this year, it sure looked like the markets had impacted the economic numbers. Again, economic data reflected that the US economy entered the second quarter of this year with plenty of economic recovery momentum and exited with very little!

Human behavior has much to do with how the economy and the stock and bond markets perform. And, in this context, human behavior is almost always driven by the emotions of fear and greed. These emotions are not bad – when indulged in moderation. However, too much greed promotes excessive risk taking – causing asset bubbles and borrowing over one's head, etc.; while, too much fear promotes excessive risk aversion – is a deterrent to prosperity causing personal to economy wide recessions or depressions.

Stock and bond prices go up when there are more buyers than sellers; and stock and bond prices go down when there are more sellers than buyers. Greed creates buyers, fear creates sellers. In today's electronic age and with – 24 hour per day – dedicated financial news coverage, the markets sentiment of fear and greed can change quite rapidly. One can observe, by the large swings in the markets that the trend of sentiment can change many times in a single day – sometimes with good reason, and other times as a result of persuasive rumors or speculations.

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

July 6, 2010

The economy, however, has historically been less susceptible to directional changes in sentiment swings. Maybe, because an economy improves with consumer's confidence – the opposite of fear – and has long been comprised of many more decision makers than “investors”, “traders” and “economists”. As consumers regain confidence, greed provides the stimulus for people to risk pursuing a business opportunity. And successful business opportunity pursuits create new jobs – which then serves to reinforce confidence and add more fodder for the economy to grow. And, these events take a much longer time to play out. Unlike the volatile markets, economic up-trends and down-trends play out over much longer periods of time. In fact, to the average person, the markets should look schizophrenic by comparison.

Over the short term, it looks like the economy is being guided by the markets; and over the long term, the markets have more often been guided by the economy. Yet their relationship seems to have become more intertwined.

Now more than ever before, a larger number of people have money at work in the markets through retirement plans. And, as a result, they base more of their economic decisions upon whether the markets are up or down. Couple this with the rapidity with which financial information is currently being disseminated and society has a heightened awareness to be fearful or confident about their futures.

What Might we Expect Going Forward?

At present, “investors” have been bullish – looking for the economy to continue to improve and for the markets to continue going up; “traders” have been bearish – looking for the economy to deteriorate and for the markets to go down; and “economists” are mixed. Of the economists that are mixed: Those that have been guided by the recent data trends of the economic recovery are bullish; and those that are fixated on government over-spending and the threat of higher taxes are bearish.

In furthering this attempt to sort it all out, let's recap the roles of the “investors”, “traders” and “economists”. **Investors** look for reasons why others should become greedy or fearful about a particular investment(s); they make their calls and wait for the rest of society to notice and act on the same opportunity or pitfall. **Traders** are guided by immediate patterns of fear or greed in the markets; they make their calls on very current market trends and seek to “ride the wave” of the perceived emotional momentum. **Economists** study the fear and greed of groups of societies (communities, industry sectors, countries, etc.); they base their calls on historical and current trends and may inject how future events may change the course of fear and greed in a societal unit.

Here are some reasons for my bullish view based upon the above:

- “Investors” see ample positive signs in the economy and relatively attractive value in the stock market. They are players who are more vested in the outcome of their viewpoint(s) as their view is longer-term;
- The bullish “Economists” are those who seem to be relying more on the current data and less on forecasting the effect of future events on fear and greed. Nobody has a “crystal ball” and predicting behavior is no easy task. Any number of factors can influence the direction of behavior for the masses.

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

July 6, 2010

- The bearish “Traders” are following trends and trend patterns that predispose them to believing that the trend is down. Yet the markets are more “fickle” than the economy. And every Trader is aware of the old saying: “the trend is your friend, until it isn’t”.
- The bearish “Economists” believe that many of the world’s developed nations – including the US – are spending well beyond their means and will be soon raising taxes in an effort to make up the difference. They believe that sovereign debt investors will revolt causing interest rates to rise significantly and threaten the global economy; and, that probable tax increases will take more out of consumer’s pockets and cause the effect of reversing this fragile recovery. There is also a concern about too much government regulation in-process and coming out of Washington, DC that is idling business planning and spending from benefiting the recovery.

Don’t get me wrong, the threats concerning the bearish Economists portend potentially bad consequences for the economy. However, I also believe that there are plenty of reasons those dangers can be averted.

First, government over-spending was needed to reverse the trend of the economy towards recovery. Yet, now it is important that the spending needs to taper down significantly. Maybe increasing taxes will be necessary in the future, but not until the recovery gains more momentum and is less fragile. Cutting spending and raising taxes at the same time could well be more than the recovery can bear.

Next, I agree that too much regulatory reform is taking place in Washington. Businesses will stay on the sidelines and only make modest investment decisions until they understand the rules of the game. This will keep unemployment high for longer than necessary as a result. I’m of the belief that the financial reform bill working its way through the system will do more harm than good and is less necessary than believed. If existing laws were better enforced for most of the last decade and Washington were more fiscally prudent, I believe we wouldn’t have faced “too big to fail” and could have experienced a much milder or no deep recession.

Lastly, I believe that voters are preparing to make changes in our elected officials coming up for re-election in November and will be voting more fiscally minded candidates in office. Look for the “tea party” groups and their favored candidates to gather momentum as we near November. Voters do not want to remain in fear and more are fiscally minded than Washington gives credit for; they want to regain “normalcy” and rebuild their lives after the Great Recession we just experienced. Voters understand that we need to cut spending and nobody wants to pay more in taxes if it can be avoided. Political “grid-lock” in Washington isn’t a bad alternative and I think it might be the most likely outcome. Nevertheless, I don’t begrudge the bearish Economists efforts. Maybe their discourse can be viewed as providing the political “jaw-boning” that is needed to effect the needed change in Washington’s politics.

We continue to remain substantially invested as we believe in the adage that “profits are the mother’s milk for a rising stock market”. And, I identify my approach to investing as comparable to the “Investor” / bullish “Economist” types discussed above.

In the midst of the downturn, US corporations cut expenses so significantly, that good profits can be reasonably expected even if the economy only grows modestly at present.

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

July 6, 2010

Yet, modest growth will slow the ability to make significant progress in putting more people back to work. I believe that investors should not be disappointed with slow but steady growth – it is much better than fast and hard market ups and downs. However, until more fear abates, I'm afraid that the markets will be choppy – experiencing wide swings – until the recovery becomes more entrenched, less fragile and less influenced by persuasive pessimistic rumors or speculations.

Following my bullish view has not come without taking some lumps, our portfolio clients ended the month of May down 15.40% and June down 8.62% - we missed putting out our letter last month. Here are some comparative numbers for you to review:

	Jun 2010	3 Month	Y-T-D	1 Year
ELF's ETF Strategy (net)	-8.62%	-20.03%	-13.94%	8.19%
S&P 500	-5.39%	-11.86%	-7.57%	12.12%
Russell 2000	-7.88%	-10.19%	-2.54%	19.91%
MSCI EAFE Index	-1.16%	-14.91%	-14.72%	3.13%
MSCI All County World	-3.22%	-12.74%	-10.42%	9.53%

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.