

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

July 22, 2006

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The Fed and It's Powers

How did your investment portfolio do during the months of May and June? How about into July thus far? Did you see the Fed train coming down the tracks? Did you buy into the market weakness? Did you sit and watch? Or, did you get scared off and raise cash or go short? What do you think about the volatility we just experienced? Did you play it right?

As I wrote last month, when markets move dramatically, both professional investors, and those served by them, will test their beliefs and convictions about how to be invested.

It is my theory, that the correction and significant volatility experienced in global equity markets was a direct result of anxiety promoted by the rookie chairman, Ben Bernanke, flexing his muscles and exerting his newly appointed monetary policy leadership powers. And, he had a little help from his friends within the Federal Reserve System. Little else could explain such a dramatic turning point for financial markets across the globe.

According to the US Congress' Joint Economic Committee Report, dated March 1997: "Although the Federal Reserve—our Central Bank (or monetary authority)—is one of the country's most powerful economic institutions, it is also one of the most misunderstood. For Congress, the Federal Reserve is relevant because (1) the U.S. Constitution (Article I, Section 8) explicitly gives Congress the power over money and the regulation of its value and (2) this responsibility was delegated by Congress to the Federal Reserve... Congress has important responsibilities for overseeing the Federal Reserve and monetary policy."

In this same "white paper" intended for Members of Congress, it counsels that "Congressional oversight of the Federal Reserve and monetary policy is important because:

- Monetary policy can dominate fiscal policy in certain circumstances.
- Inflation is determined by monetary policy.
- The Federal Reserve influences interest rates.
- The Federal Reserve stabilizes the financial system."

So, why is it that the global markets reacted as volatile as they did?

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 discuss monetary policy, the Fed, it's powers and explore what caused fear in the markets these past couple of months. Whether you think those at the Fed are brilliant or incompetent, you'll want to read this before drawing any conclusions. 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 navigated through the market's turbulence. It should be well worth the investment of time.

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Monetary Policy

Most macroeconomic textbooks define monetary policy as the regulation of a nation's money supply to influence its economic activity to be in line with its political objectives; whereas, fiscal policy involves legislating governmental taxing and spending policies to achieve similar goals. As opposed to fiscal policy, monetary policy can be implemented more rapidly, it is considered more flexible, and possibly a more dominant means to impact economic activity.

To understand the regulation of money supply, we should take a little time to understand money. Why does it exist and how come it impacts our lives the way it does?

Money – currency – exists for our convenience. It serves as a medium of exchange so that we can acquire goods and services without the challenges of bartering – instead of having to exchange goods or services for goods or services; it allows us to exchange goods or services for money for goods or services. Also; it serves as yardstick for pricing goods and services and can be saved or loaned and it can be expected to retain its value – except from the diminishment from inflation or from rising foreign exchange rates.

So, how does the regulation of money impact economic activity?

According to Harvard University economics professor, N. Gregory Mankiw, “a long tradition in macroeconomics (including both Keynesian and monetarist perspectives) emphasizes that monetary policy affects employment and production in the short run ...According to this view, if the money supply falls, people spend less money, and the demand for goods falls... the decreased spending causes a drop in [aggregate demand, which leads to a drop in] production and layoffs of workers.”

On the other side of the equation, National Bureau of Economic Research analyst, Anna Schwartz, comments: “An increase in the supply of money puts more money in the hands of consumers, making them feel wealthier, thus stimulating increased spending [or, increased aggregate demand]. Business firms respond to increased sales by ordering more raw materials and increasing production. The spread of business activity increases the demand for labor and raises the demand for capital goods...If the money supply continues to expand, prices begin to rise, especially if output growth reaches capacity limits. As the public begins to expect inflation, lenders insist on higher interest rates to offset an expected decline in purchasing power over the life of their loans.”

This all sounds simple. Right? Well, to me, both of these explanations seem too simple. At the same time, it might lead some of us to believe that monetary policy is an exact science with a cause and effect relationship that is absolute and easily managed. This couldn't be further from the truth. So, how does one begin to understand the impact of monetary policy on economic activity?

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Concepts of Aggregate Demand and Quantity Theory of Money

While there are many schools of thought in economics, those considered to be monetarists believe that a change in the money supply will lead to a change interest rates causing a change in aggregate demand which impacts economic activity. Did you follow all of that? OK then, let's take a few steps backward and discuss some basic concepts.

Quoting from Investopedia.com, "Supply and demand is perhaps one of the most fundamental concepts of economics and it is the backbone of a market economy. Demand refers to how much (quantity) of a product or service is desired by buyers. The quantity demanded is the amount of a product people are willing to buy at a certain price; the relationship between price and quantity demanded is known as the demand relationship. Supply represents how much the market can offer. The quantity supplied refers to the amount of a certain good producers are willing to supply when receiving a certain price. The correlation between price and how much of a good or service is supplied to the market is known as the supply relationship."

So, what is the rationale for interest rate and aggregate demand changes occurring as a result of changes in the money supply?

One theory hinges on the belief that, when a central bank, like the US Federal Reserve Bank, increases the cash reserves held by its member banks, those banks will have more money available to loan and can reduce their interest rates to encourage borrowing. At lower interest rates, consumers and firms are likely to be more willing to borrow to make purchases, and aggregate demand can increase. Alternatively, when a central bank decreases the reserves held by its member banks, the banks will have less money available to loan and will increase their interest rates in an effort to coordinate with the central bank's desires. At higher interest rates, consumers and firms are more apt to repay debt, begin saving and reduce purchases. This should have an effect of reducing aggregate demand.

By definition, aggregate demand is considered to be the total demand for goods and services in any given economy. And, when defining aggregate demand as a measurable macro-economic value, it is considered to be equal to the sum of all personal consumption, business investment and government expenditures during or within a particular time period.

In equation form, $AD = C + I + G + (X - M)$ which is also the equation for **GDP**, or gross domestic product. In this equation, **C** represents consumers' expenditure on goods and services; **I** represents investment spending by companies; **G** represents Government spending on publicly provided goods and services including public and merit goods while excluding transfer payments like welfare and entitlements (a substantial increase in government spending would be classified as an expansionary fiscal policy); **X** represents exports and **M** represents imports of goods and services to other countries. (**X-M** is the current account of the balance of payments.)

While a highly criticized concept, the Quantity Theory of Money offers yet another expression of aggregate demand. In equation form, $M \times V = AD$. This theory is derived from the Fisher Equation of Exchange, $MV = PT$, named after Irving Fisher (1867–1947), where **M** is the supply of money, **V** is the velocity with which money is spent on final goods and services (also referred to as final output, or **T**) during any given time period, and **P** is the average price level of this output. The equation simply suggests that the quantity of money spent

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equals the quantity of money used. The quantity theory, in its debut as a popular theory, assumed that **V** and **T** were both constant. Thus, it was argued that any change in **M** leads directly to a change in **P**. In other words, increase the money supply and you simply cause inflation. Haven't you heard the adage that inflation is the result of "too many dollars chasing too few goods"? The roots of that old saying come from this equation.

Yet, I don't for a moment believe that velocity (**V**) or final output of goods and services (**T**) ever remain constant. Didn't we just discuss that increasing the money supply is supposed to increase spending? As well, doesn't it seem logical that companies will increase capacity to supply goods and services to meet demand? That is, until resources start becoming scarce and profit margins have reached a point of diminishing returns. Then price inflation would be reasonable resultant expectation. Right?

So, now with this understanding, what does the Federal Reserve Bank do and how do they influence economic activity?

The Federal Reserve and Its Powers

The Federal Reserve System (the "Fed") was created by Congress on December 23, 1913, with the signing of the Federal Reserve Act by President Woodrow Wilson. This Act was government's response to a number of financial panics that plagued the nation since the establishment of the first US banking institution in 1791. And, it laid the framework for the structure of the Fed as we know it today.

The structure of the Fed is comprised of (a) a Board of Governors who provides national level leadership; (b) twelve regional Federal Reserve Banks that serve as the operating arms of the Fed; and, (c) the Federal Open market Committee (or, "FOMC") which acts as the monetary policy decision-making unit. It is an independent agency of the US federal government and its Board consists of seven governors, including Chairman, Ben Bernanke. All members are appointed by the President of the United States and confirmed by the Senate. The Board oversees the activities of the Fed Banks and guides monetary policy through them. And, the FOMC is comprised of the Board of Governors and five of the twelve presidents from the Fed Banks.

Controlling the money supply and credit is substantially accomplished through three formal methods or tools. The primary and most frequently used tool is known as open-market operations and is employed to alter bank reserves and influence short-term interest rates. When the Fed buys US Treasury and federal agency securities on the open market, the money it uses to pay for these purchases expands the money supply. Conversely, when it sells these securities, the money it receives from these sales shrinks the money supply. To a lesser extent, the Fed can also employ adjustments to the discount rate (the rate it charges member banks for over-night loans) and changes in reserve requirements (the portion of deposits that cannot be extended for loans) as policy tools. The Fed uses these tools to influence the Fed Funds Rate (the rate member banks charge each other for over-night loans) which serves as its key monetary policy instrument. Movements in this rate, in turn, influence a wide array of financial and economic variables with differing time lags.

The Fed also has an informal tool that can be rapidly implemented. It is called **moral suasion**. Moral suasion is a persuasion tactic used by the Fed to influence and pressure

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banks, investors and consumers into adhering to desired policy goals. It is the Fed's way of exercising the persuasive power of talk rather than legislation. The "moral" aspect comes from the pressure for "moral responsibility" to operate in a way that is consistent with furthering the good of the economy. In Japan, it is known as "window guidance" and in the US, it is known as "jawboning". Most importantly, however, is that its impact can be both immediate and formidable and can send global financial markets falling or flying.

Some Concluding Thoughts

Two years ago, mid April, then Fed Chairman Greenspan provided his most optimistic assessment yet on the US economy, saying, "growth has come into a period of more vigorous expansion...As I have noted previously, the federal-funds rate must rise at some point to prevent pressures on price inflation from eventually emerging," Greenspan told the Joint Economic Committee of Congress. Not being known for making often use of his Fed powers of moral suasion, he startled fixed income investors – into taking losses – and prepared them for rising interest rates and the possible threat of inflation.

Prior to Ben Bernanke being sworn in as our new Fed Chairman on February 1, 2006, he advocated that the Fed should begin to operate in a manner that would be more transparent to the public. Little did he realize the challenges of doing so not being misconstrued as exercising moral suasion.

After the minutes from the Fed's March meeting were released, it was believed suggested that the Fed would soon pause on lifting their target Fed Funds rate. This seemed to be reinforced when Bernanke he hinted that policy makers may soon pause during testimony before Congress on April 27th. The markets rallied to new highs. Then, a few days later in an interview with CNBC's Maria Bartiromo, Bernanke began to create massive uncertainty by stating that his comments were misinterpreted. It wasn't long after the April CPI figures came out in mid-May that Fed officials came out hawkishly in force to state that: "If inflation turns out to exceed ... our target range, I do not believe we can count on a slowing economy to bring inflation down, by itself, quickly". This prospect incited a sell-off in stocks, globally, as investors seem wary that the Fed will lean toward risking a recession rather than gamble that the last 17 interest rate increases, together with record oil prices, will tame the inflation outlook.

At present, there seems to be great doubt that the new Fed will pull the US economy through this period softly; especially, when they've already contributed to great volatility in the financial markets. It may be clear that the Fed can regulate money supply and short-term interest rates with pin-point accuracy. But, can they regulate velocity and prices with similar precision? I'm not sure they can. How about you?

ELF Capital Management Investment Performance Update

What started in May, continued into June and, because we are so late in getting out his month's letter, we can report, is continuing into July. It doesn't take looking at the VIX – the Chicago Board Options Exchange Volatility Index – to see that volatility has gone "through the roof" these last couple of months. It is sure keeping us on our toes and we are working

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double shifts just to stay on top of the fast pace of world geopolitical and economic events. I can't remember when we've worked harder remaining chained to our desks. At the same time, we are adding to staff.

While there seems to be a great deal of uncertainty circulating in the markets at present, we are making some interesting observations that we are hoping to take advantage of. It seems that an over-sold condition exists in a number of market sectors that are delivering good results that we expect should continue through this economic environment. At the same time, other sectors that we would expect to under-perform appear rich in value. We are positioning our accounts accordingly.

For our taxable accounts, we are very much positioned in a market neutral strategy, with a slight long bias, at present and our plan accounts are approximately 45% long our best equity ideas with the balance in cash and high yielding floating rate notes. As a result, portfolio turnover is running higher than normal, yet we do not expect to continue at this same pace going forward.

For the month ended June 30, 2006, our one-month performance is down 1.23%, our three-month return is down 2.31% and our one-year return is up 9.42%.

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.

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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.