

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

August 2, 2008

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Headwinds and Tailwinds in the US Economy

In a bear market cycle, like we're experiencing now, the emotion of fear is often exacerbated. And, decisions made from a position of fear rarely bring any good. How do you feel about the economy right now?

My good friend and colleague, Dr. Dan Elash, suggests that the best remedy for fear is education as fear stems from one's uncertainty about what the future brings. (Dan is a behavioral psychologist whose career has been focused on helping business owners and executives navigate organizational change or management challenges.) Once we become familiar with the facts, we can then begin to focus on solutions.

In this month's letter, I'll set out to plainly recap the headwinds and tailwinds influencing the US economy and the investment markets. Given the amount of "noise" in the media these days, I thought it might be useful to help my gentle readers focus. Then I'll discuss some "free-market" signals to look for that would boost confidence in the economy. But first, I need to make a quick announcement. On September 9th, I'll be speaking at the Symposium on Tax-Efficient Investing in New York City (details can be found at this link <http://www.worldrq.com/showConference.cfm?confcode=FW08005>). If you want to attend the conference, just mention promo code **MKF287** and you'll receive \$200 off the price of admission. Also, I've set aside some time, on the 8th and 9th, for meetings. If you'd like to meet, send me an email and we'll schedule a time to get together.

Now, for the subject at hand. If "headwinds" represent the "bad news" and "tailwinds" represent the "good news", I'll start with the "bad news" first.

Headwinds

The most significant headwinds now facing the US economy are: the oil crisis; the credit crisis; and, the housing crisis. Some might add that a weak US Dollar is a headwind also, but I believe that is more a tailwind. After reading, you decide.

The oil crisis. While more passionately discussed in my letter last month (see [Oil Paints the Landscape](#)), the rapid rise in oil this year, to \$147 per barrel, has significantly boosted inflation beyond tolerable levels for both individual and business consumers. We finally reached a breaking point. Individuals have responded by traveling less and reducing their oil consumption; while businesses began taking steps to mitigate profit erosion from oil related expenses that are rising faster than sales growth. The most impacted industry has been the airlines, with many carriers now just trying to stay alive. Headline seeking economists and media pundits have increased fears by predicting \$200 to \$300 per barrel oil by year end. High oil prices are also prompting investors to bet that a greater number of individuals will default on loan payments and have less to spend on discretionary items.

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Towards the end of July, oil prices had traded lower and, if the retreat continues, it can only be good for both consumers and stock market investors. However, the underlying problem of increased global consumption outstripping supply has not yet been solved. If consumers return to old habits, we may very well see oil run up again. Yes, consumers have reduced demand, but still drive the same cars and heat their homes in the same fashion. And, as for China cutting back, it is more likely that they are holding down consumption to reduce smog for the Olympics. This is “demand reduction”, not “demand destruction”. This is purely a supply and demand challenge that needs to be addressed.

The credit crisis and the housing crisis. I’ve combined them together as I believe they are intertwined. As well, both are representative of how fear and uncertainty can cause a vicious cycle. It is my opinion that these challenges have been more amplified by fear than by supply and demand dynamics.

It was not surprising that the housing market had to turn as home values rose too rapidly for too long. It finally reversed course after the Fed began managing it down by relentlessly increasing its target interest rate. What seemed less threatening, however, was the change in mortgage banking practices over the last couple of decades or so. Rather than holding mortgage loans on their books, banks enjoyed the ability to convert them into securities and sell them to investors in the form of CDOs (collateralized debt obligations). The mortgage lenders made money by collecting origination fees and keeping a portion of the interest in return for servicing the loans. By selling the loans, the mortgage banker’s investment was no longer at risk. This factor afforded banks an almost unlimited source of funding to lend from. So they believed. Unfortunately, CDO buyers and sellers relied too heavily on the ratings agencies and left themselves vulnerable. With the Fed’s prolonged raising of interest rates, investors began worrying about lower quality (sub prime) loans. They also came to realize that they really didn’t understand the CDOs they owned and many headed for the exits. Bearish economic pundits, joined by short-sellers, wasted no time in creating gloomy predictions. This created enough caution (fear) that potential buyers were encouraged to remain on the side-lines. With more sellers than buyers, market prices for these CDO securities dropped to unreasonably low levels. Seeing potential bargains, the banks, brokers and funds specializing in this market became the only buyers. This is the point at which things could have gotten better, but they didn’t. Fear overcame and the vicious cycle began.

The market didn’t stabilize and CDO prices continued to go lower. Promoters of fear and uncertainty had an easy time of seeing that their warnings became self fulfilling. As a result, the banks, brokers and funds who bought the CDOs had to then record “paper” losses even though the intrinsic values of the underlying CDO loans were believed to be worth more. Several funds went out of business – fueling even greater fear; and the banks and brokers now had little capital with which to originate new loans. In fact, they saw it as potentially more profitable to hold onto the CDOs, if they could. Anticipating that available financing was drying up, the already “top heavy” housing market began to fall further. This only served to add significantly greater distress to an already softening housing market. When home buyers sense a distressed market, they will wait to see how low prices will go before they decide to make a purchase. As new and existing homes are anything but scarce, there is now no urgency to buy one. At the same time, many jobs relating to housing have been lost and many of these people have mortgages to pay. This led to warnings that a greater percentage of mortgages will default, pushing CDO prices

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even lower. This, in turn, put further pressure on financial institutions and opened the door to rumors of impending bank failures. Confidence became so destroyed by fear that the Federal Reserve stepped in to facilitate an emergency sale of Bear Stearns to JP Morgan Chase in order to avoid a potential melt-down of the financial system. This brings us to March of this year and I've only attempted to give you the highlights.

Since then, we have been witnessing an important game of chess in the media between those who use fear and those who seek to build confidence. So far, those on the side of fear have been winning the match. Fear continues to threaten our financial system; it has pushed stock markets into bear market territory; and, it continues to threaten us with the possibility of a recession. The oil crisis hasn't helped either. However, the tide may be turning. And remember, it is my humble opinion that this all started with fear and uncertainty in the CDO markets.

OK. So let's take a break and discuss the insanity in the CDO market. On July 29th, Merrill Lynch announced that they were selling \$30.6 billion of CDOs, at 22¢ on the dollar, and raising additional capital. They decided to forego the prospects of profiting from their positions as, unless buyers come back to this CDO market, the risks of collecting profits through the de-leveraging process were too great. By doing this, they "took one for the team" and put themselves (hopefully) on the path of reversing the vicious cycle and mending the financial system. That's not to say that the Fed Governor Bernanke and Treasury Secretary Paulson haven't done positive things to help as well – they have. But, that is a whole other story. Let me put the 22¢ on the dollar price in perspective. Most of the outstanding CDOs represent pools of residential mortgages. And, each of these residential mortgages is collateralized by a home. In order for the new buyer, of these CDOs, to take a loss, the entire pool of mortgages would have to default (not very likely) and, after foreclosure, they would have to recover less than 22% of the home's original loan value after expenses (less likely). Even though I've oversimplified the example, it is not far from being representative.

A weak US Dollar. This is a rather complex topic to try to explain in this letter. Sufficed to say, the main issue here is that a weak US Dollar is considered inflationary. The US consumer buys a lot of imported items and a lower USD makes it more costly to import them. Think oil...

Tailwinds

The most significant tailwinds facing the US economy are: relatively attractive asset valuations; Ben Bernanke and Hank Paulson are the "good guys" at the "chess" table; and a weak US Dollar.

Relatively attractive asset valuations. So far, non-financial large company earnings have exceeded expectations. And, relative to inflation and interest rates, equities look attractive at these levels. Also, we have witnessed multiple large up and down stock market swings in the last week of July, which may be signaling that we are in a bottoming process. There is also a significant amount of investor cash on the sidelines waiting to come into the market.

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Ben Bernanke and Hank Paulson. The Federal Reserve Bank Chairman and Treasury Secretary have done a good job in averting several possible “melt-down” disasters. The complexity of challenges they have faced has been significant and the creativity and stamina that they have shown, in the fog of economic war, is nothing less than remarkable. On top of all this, despite receiving many politically motivated insults, their patience in working with Congress has been quite commendable. With them in place, I have complete confidence that “the sky won’t fall”.

Exports and a weak US Dollar. A weak US Dollar has made exported US goods and services attractive to the rest of the world. And, the rest of the world has been buying from us. This has significantly helped our economy while the US consumer has been slowing spending. This might be a good thing as, over the long term, spending from income is healthier for our economy than spending down savings or from over-borrowing.

Confidence Boosting “Free-Market” Signals

Oil. As I’ve written about before, the US has potentially the largest oil and natural gas reserves on the planet. It makes sense that we should be exploiting these natural resources for ourselves and the rest of the world. The bottle-neck, keeping us from exploiting a solution, is exploration and production restrictions imposed by politicians in Washington. If we can see government move towards removing restrictions on exploration and, more importantly, production, then we will see greater economic prosperity. Good fiscal policy would also provide incentives for developing alternative energy sources and for affordable implementation by our citizens.

The US would be better served by developing enough of our own oil and gas resources to become a net exporter rather than a net importer. In my humble opinion, there seems to be no greater threat to national security than our energy dependence and I don’t understand why Washington is bickering over the issue. Keep up the pressure on your political representatives to ease restrictions on drilling and production!

Credit. It would be a huge breakthrough to see a return of confidence to the CDO market. The crisis started with the CDO market and the CDO market is the levered solution (think simple machines) with confidence being the fulcrum; otherwise, other measures are simply “band-aids” while we drag the credit crisis up an inclined plane. Fed Chairman Bernanke and Treasury Secretary Paulson have done, and continue to do, their part in working to bring confidence back to the markets. It would be very encouraging if Wall Street stepped up and did more to help solve the problem also.

In the early 1990’s, when I played a role in helping pioneer the CBO market (collateralized bond obligation), credit enhancement was important in drawing the initial investors to the product. This was long before the “street” coined the, catch-all, term of CDO. While we utilized a financial insurer and the ratings agencies, the greatest form of enhancement came in the form of including active portfolio management in the mix. Back then, the CBOs were collateralized with junk bonds, or mortgage derivatives, or variable rate bank loans. Yester-year’s CBO structure greatly simplified the need for analytical research and the administrative support required to successfully invest in those asset classes. After management expenses, investors were able to receive a yield greater than corporate bonds comparably rated. Some CBOs even had zero coupon US Treasury securities

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included in them for clients who desired principal protection. However, the active management component ensured that the collateral backing the CBO was “hand-picked” and substitutions were made whenever a portfolio security no longer met the criteria for holding. In today’s version of the CDO, the portfolio manager role no longer seems to be included in the process to protect investors by rejecting lower quality loans. Maybe history offers a lesson.

If we can see Wall Street taking more steps to redevelop confidence in the CDO markets, it would go a long way in boosting confidence in the economy. Merrill took the first step and it was a drastic one! In fact, Wall Street could find itself generating profits through the re-engineering of existing CDOs in more transparent wrapping paper. The market for it exhibits both need and scale. So, the incentives are significant.

What can you do as consumers and as investors? Recognize that oil is the biggest headwind. The best thing that you can do is to continue being conservative with your oil consumption while putting pressure on your political representatives to ease restrictions on developing our oil and gas resources. Shift your spending from oil to other things, keep current with any loan payments and save a little. Have faith that, while the stock market looks pretty ugly right now, markets do recover and equities offer the best opportunities over the long run. Once the CDO dust settles, financials will offer the best growth opportunities. Those who do their homework in the CDO market will do great also and, despite the claims of some media pundits, that market will not go away.

During July, we held high levels of cash in our client portfolios. We will continue taking our cues from oil prices and international economic data. We continue our belief that we are exporting slower growth while importing inflation. Slower growth and the solutions described above will tame inflation. We think the US stock market will remain in a trading range until we work through some of the challenges discussed above. Other than positions currently held, we are shifting greater focus to US markets are not expecting to add to or makes changes in our international holdings.

Our performance for July was down 1.81%.

More info is available at this link: www.hwkfs.com/Content/IM_Performance.htm