

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

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Is Political Risk the U.S. Stock Market's Biggest Challenge?

Traditionally, political risk is considered the primary challenge for investors seeking to invest in emerging market stocks or bonds. Some of the most dramatic examples of political risk can be characterized by the Latin American Debt Crisis of the 1980's, or the Asian Financial Crisis of the late 1990's.

Rather than trying to predict whether Portugal, Ireland, Italy, Greece or Spain (the "PIIGS" counties) will trigger a financial crisis across the globe, this letter discusses what political risk is and how it can cause a devaluation of stock or bond prices or derail an economy.

Did you know that the Latin American Debt Crisis was triggered by the global economic recession of the 1970's and 80's? And, it worsened the impact of those downturns. Back then, Mexican, Brazilian and Argentinean Governments were borrowing large sums from international investors to industrialize their economies and for infrastructure projects. Because money was considered cheap and these economies seemed to be doing quite well, investors felt comfortable loaning them money. When interest rates around the globe began to rise significantly in the late 70's, investors became concerned that these countries would no longer be able to repay their debts. In 1982, Mexico defaulted on their payments and the others soon followed suit. The result was the first time I can remember hearing the phrase, "the lost decade". Now we hear about "the lost decade" whenever someone refers to the S&P 500 index performance over the past ten years.

Today, we have seen the U.S. borrowing huge sums from the international community with little being spent on industrialization or infrastructure. And, there is the potential that these and other headwinds could be coaxing a devaluation of stock or bond prices and possibly impeding the economic recovery. How else might one explain the huge swings in the stock market this summer?

Case in point – what happened when markets around the world were concerned about a Greek debt default? Answer: Economic data reflected that the U.S. economy entered the second quarter of this year with plenty of momentum and exited with very little. Were Greek debt concerns the cause of the slowdown, or is there more to the story?

Political Risk

Political risk is defined as the risk to investors caused by changes in a country's political structure or changes in their fiscal policies. While it is rare for a country to change its political structure, a change in fiscal policy is more common. Harder to identify, political risk can also come in the form of continuing a policy that is unsustainable over time.

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

September 2, 2010

Policy concerns can come in many forms. Increased regulations, borrowing and taxes seem most relevant in the U.S. at present. Yet, changes such as increased tariffs, expropriation of assets or tightened foreign exchange rules can serve as headwinds to markets and to an economy as well.

Let me provide you an example of how political risk poses a challenge when investing in emerging markets. In the past 5 years or more, Russia's economy has been experiencing explosive growth due to exporting its vast energy resources. However, in its past, Russia had also exhibited a propensity for expropriating assets purchased by international investors. They were widely known for seizing private property for government purposes, with little or no compensation to the property's owner(s). Despite the potential for investors to participate and gain from their growth, their past practice of expropriating wealth represents an over-hanging cloud for investors.

Yet, political risk is not isolated to emerging markets. In the U.S., many are familiar with the practice of having one's property seized through the longstanding and little used concept of **eminent domain**. Under this legal doctrine, a state or local government has the power to take private property for public use – such as for roads, utilities or bridges. And, under this policy framework, the owner is usually reimbursed for the fair market value of the property. However, one major U.S. Government effort that occurred last year involved less equitable treatment for investors. In the General Motors restructuring, U.S. Government officials acted in a way that served to subvert our bankruptcy code – stiffing GM bondholders – and the result set a troubling precedent.

Uncertainties from Obama-care, Financial Regulation, a high unemployment rate and the upcoming November elections all serve as a fertile medium for incubating political risk here in the U.S. These and the current Administration's seemingly over-critical stance against business and class warfare rhetoric add to uncertainty.

It has been troubling to understand why the stock markets have been trading in such a volatile trading range since last April. It has also been troubling that the recovery has decelerated as well. The market swings have been quite wide and I'm sure they have been gut-wrenching for the average investor.

In a recent article by John Mauldin – one of my favorite thought provoking bloggers – he explained how P/E ratio (price to earnings) multiples had a greater impact on stock prices than economic factors. He tends to use historical statistics as the basis for his thoughts and I can't say that I always agree with his conclusions. Nevertheless, his article provoked me consider how traditional stock valuation analysis factors relate to P/E multiples and stock prices in the current market place.

How Risk Impacts Stock Prices and P/E Multiples

When I began working in this business in the early 1980's, the belief was that individual investors represented 80% of the market's participants and institutions represented 20%. Since then, through the proliferation of mutual funds and hedge funds, now the belief is that institutions represent more than 80% of investors and individuals, less than 20%. So the first concept to consider is that the majority of the investor public consists of

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

September 2, 2010

professional analysts with plentiful tools and resources who guide market prices after performing some form of valuation analysis.

For these analysts, one of the most commonly practiced valuation theories starts with the premise that the value of any stock should be determined by the present values of that stock's expected future cash flows. To determine a stock's value, analysts may use any variation of the basic *dividend discount model* (DDM) depicted as follows:

$$\text{Projected stock value} = \frac{\text{Expected future cash flows}}{\text{Discount rate}}$$

Using DDM, the professional analyst would then follow this investment decision process:

1. Estimate the amount and timing of expected future cash flows;
2. Determine the discount rate based to be used;
3. Calculate the stock's value based on the above model;
4. Compare the calculated value with the current market value to determine if the stock is over-priced or under-priced by the market place;
5. If the stock if it is under-priced, buy it; or, if it is over-priced, sell.

It is important to note that while the above process is commonly used to value a single stock, it can also be applied to the stock market as a whole. Whether valuing a single stock or any larger segment of the market, the **discount rate** used greatly impacts the outcome. In valuation analysis terminology, the **discount rate** is also referred to as the **required rate of return** from the investment.

In deriving the **discount rate**, professional analysts will consider:

1. The current risk free rate – U.S. Treasury Bills are most commonly used to establish this rate; plus
2. A premium for inflation – usually estimated from the current trend; plus
3. An additional premium for RISK taken.

The most difficult aspect of determining an appropriate **discount rate** is determining how much of a **risk premium** to add. When valuing a single stock, many analysts will simply “back into” this number. They use a short-cut that simply compares the overall current market RISK premium and apply it to the single stock.

This, however, doesn't explain how the market's **risk premium** has been established. To tackle this bigger challenge, the professional analyst will need to consider:

- Current economic trends;
- The financial health and outlook for the majority of companies in the overall market;
- The liquidity of the market;
- And, Political Risk.

Now, with this basic explanation of valuation analysis reviewed, let me create an example for you to follow:

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

September 2, 2010

Let's say that analysts expect \$85 of future cash flows from the S&P500 next year and believe that 7.50% is a reasonable discount rate. Following this logic and using the formula above, one should expect the S&P500 index to be fairly valued at approximately 1,133 ($85 / .075$).

If Political Risk causes analysts to require just $\frac{3}{4}$ of a percentage point more to 8.25% - just 10% more of a risk premium added to the discount rate ($7.50\% + 0.75\% = 8.25$), the market is then considered fairly valued at a level of 1,030 ($85 / .0825$). By the way, this is roughly the 10% trading range we've been stuck in for most of the summer.

So, how does this also impact P/E ratios? The P/E Ratio is calculated as follows:

$$\text{P/E Ratio} = \frac{\text{Market Value per Share}}{\text{Earnings per Share}}$$

Therefore, if increased Political Risk causes Market Values to drop while all other factors remain constant, then the market's P/E Ratio multiple will drop also.

These concepts are important to remember when observing the market going through large swings. Perceptions of risk in the marketplace can offset the fair value of a stock even when the underlying company, industry or market is experiencing growth. As such, one always needs to consider whether the perception of risk in the marketplace is fleeting or with just cause.

Is Political Risk the Biggest Challenge?

Several European governments are challenged with the debt they've amassed over the years and investors are raising concerns. Sound familiar? And, we have challenges in the U.S. with the significant growth in our debt and reforms recently passed.

While the U.S. must get its fiscal house in order and deal with our debt, reforms (policy changes) may pose a bigger challenge to our economy. Not only have we seen massive health care reform, we added massive financial reform changes as well. As the effects of these efforts phase in over the coming years, many employers will be scrambling to determine how to comply with the new requirements and more job losses could be a result. Businesses that operate on tight (small) margins are under the biggest threat of failing under the new regulations and the taxes that will result. And with the rate of fiscal policy changes occurring, many businesses are challenged to plan for the future.

The severe economic downturn provided a hand delivered invitation to politicians. U.S. voters were so scared that they elected a unified presence (a majority of Democrats) in the House, Senate and Presidency. This created an environment that negated the impact of allowing differing political ideologies to debate and compromise and opened the door for rapid evolutions of lopsided regulations – regulations that may very well fuel the U.S. Government to continue growing faster than the private sector.

In addition, we now have to keep our eyes on the regulators as much as the lawmakers. The reforms passed under the current Administration gave significant power to regulators

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

September 2, 2010

to interpret and write the rules. As well, the President's Administration can now act with more centralized authority, in an abundant number of ways, with little to no Congressional input required. This new authority was "baked into" the reforms passed.

These events do not portend disaster. Yet, they do create multiple vantage points for uncertainty.

All too often, when I engage in conversations with other investors or business owners or listen to media pundits, short shrift is given to the concept of risk and how current events or forecasts factor into the equation. Seldom do we hear about how risk factors into the Market's valuation.

$$\text{Projected stock value} = \frac{\text{Expected future cash flows}}{\text{Risk free rate} + \text{Inflation} + \text{Risk premium}}$$

This concept does, however, offer a better realization why the stock markets are prone to moving up and down when uncertain events are occurring here or abroad.

ELF's Outlook and August Performance

During August, it became confirmable that the pace of the recovery had slowed significantly and might stay that way. While initial indications of a slowdown could have been considered fleeting signals, more and more data points dampened any optimism.

As it became evident that the potential for renewed momentum was dim, the concern was less that we would dip back into recession and more that the markets could drift lower due to the potential for shrinking P/E multiples over the near term. Lessened economic growth prospects seem insufficient to offset risk headwinds at present. After arriving at that conclusion, I began to take risk off of the table and raise the level of cash in our portfolios.

Until the risk reward relationship skews more favorably, our current thinking is to maintain 50% or more in cash. We'll be on the look out for improving economic indicators, a perception of reduced risk or an oversold market to put this cash to work.

Our portfolio clients ended the month of August down 8.60%. Here are some comparative numbers for you to review:

	Aug 2010	3 Month	Y-T-D	1 Year	2 Year
ELF's ETF Strategy (net)	-8.60%	-8.08%	-13.39%	-0.22%	-4.72%
S&P 500	-4.74%	-3.68%	-5.90%	2.81%	-9.56%
Russell 2000	-7.50%	-9.00%	-3.73%	5.24%	-9.79%
MSCI EAFE Index	-3.34%	4.53%	-9.81%	-4.89%	-13.04%
MSCI All County World	-3.69%	0.68%	-6.80%	1.44%	-8.70%

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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ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

September 2, 2010

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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.

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