

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

September 8, 2006

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How Greed Undermines Wealth

Have you ever scrambled to chase a hot investment tip and found yourself late to the party? Did this happen to you when the tech bubble burst in 2000? Or when the mini commodity bubble burst this past May? Beyond your home, are you long residential real estate now?

Fear and greed are two emotions strongly coloring the decisions of many investors. These two emotions are the main reasons why people fall prey to the small investor theory – buying high and selling low. Why does the average investor often do the exact opposite of what he or she should be doing?

During the late nineties on into early 2000, the stock markets were on fire. It wasn't very hard to pick a stock that was rising, splitting and then rising some more – especially in the technology sector. This phenomenon caused a lot of novice investors to enter the markets. With visions of easy money and great wealth, investors charged ahead. Everybody wanted to clean up. Their greed added further fuel to the fire and sustained a growth cycle far beyond its natural life. Investors continued to invest until the inevitable happened. The bubble burst. A tremendous amount of wealth was lost in a very short period of time. Investors sat back and could only blame their greed for their losses.

This period went down in the history books as the era of “irrational exuberance” – the infamous phrase that was uttered by then Fed chairman Greenspan in 1996 when describing that the markets were greatly overvalued at the time. Do you know anyone who listened?

What makes people invest when a particular market or a specific investment opportunity has already experienced a significant run up? And, what makes these same people sell after a significant correction has already occurred? Conversely, why do others feel compelled to stay with a poor investment rather than change course? Is it because they deliberately choose to lose money? Rather we might explain it as “herd mentality,” absence of enough information, or a lack of comprehension. The real answer lies deeper than that. It lies in our emotions and their power to overwhelm our reason while driving us to poor decisions.

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.

In last month's newsletter, our Dr. Dan Elash educated you about the effects of fear, its impact on investment decisions and then spelled out a strategy for how to use fear productively. In this month's letter, Dan focuses on another powerful emotion that negatively affects our investment decisions, GREED. Once you've read his enlightening piece, please be sure to spend some time looking over our market comment and performance for the month past. It will be well worth the investment.

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Just What Is Greed?

According to Webster's New World Dictionary greed is: "the EXCESSIVE desire for getting or having something, especially wealth." If look up the word excessive, that same dictionary defines it as, "characterized by excess; being too much or too great; immoderate, or inordinate." While these definitions characterize the nature of greed it's difficult to know when you cross the line from enthusiasm to greedy. That's always a judgment call.

Greed in the marketplace is not just a new phenomenon. Have you heard of the Tulip Mania that swept through the Netherlands in the 1600's? It started with a fad that grew out of the ability to breed tulips of exotic colors and designs. Tulip bulbs were traded in local markets and their value increased astronomically for a number of years. People even sold bulbs from tulips as yet unplanted – as if an early form of the futures markets. Some people sold everything they owned and bought bulbs in an effort to make or increase their fortunes. People traded houses, livestock, and great sums of money in order to acquire rare bulbs. By 1637 the fad began to wane. Dealers could no longer get the inflated prices. People began to fear that the bubble would burst and panic ensued. Prices plummeted. Consumed by their greed, thousands of aristocrats and businessmen were ruined. Enough simply hadn't been enough.

You can find a great deal written about the role of fear in the stock markets. Greed is always thrown into the mix as the other key motivator influencing behavior, but its workings are seldom discussed in depth. We want to help you become mindful of the insidious workings of greed and possibly save you from sizable losses in your own investments.

Greed implies selfishness that comes at the expense of others. In this case, you would do well to think of this concept of "expense" not just to other people, but to other issues as well. Is your portfolio over weighted in an area where you are seeking super returns? Do you fail to periodically take profits from your successes and diversify your holdings? Are you so focused on your investment performance that other pursuits are given short shrift? The theme that runs throughout these questions is lopsidedness. Your life, your energies and your investments become unbalanced. When this happens, like a drunk staggering out of a bar, you are headed for a fall.

There are some signs that you can look for to help you identify a destructive pattern as it emerges. Perhaps I should say listen for, because you identify them by learning to listen to your internal dialogue, the mental conversations you have with yourself as you think. We'll identify four keys in your thinking that should alert you that your emotions, primarily your greed, are ruling your logic and setting you up for disappointment. These four keys are listed below as follows:

- Frantic Hope
- Over Complexity
- Over Simplicity
- Sclerosis

Let's look at each of these keys in detail to gain a better understanding.

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Frantic Hope

Listen to yourself as you look over conditions in the world that influence markets, or conditions within the markets themselves that can affect the value of your holdings. When we find ourselves desperate in our desire to achieve hoped for outcomes we have crossed the line. When you are working a well reasoned strategy there is no need to pursue a level of desperation that earmarks a risky position. There is no need to start by bargaining with God, or making promises to ourselves; and, there is also no need to fly into a rage or a depression when things don't work out. When we are well balanced, we can emerge hopeful about the effectiveness of our strategy without the emotional intensity described above.

This state of emotional arousal is apparent in the conversations that you have with yourself and in the feelings that you have when thinking about your particular position. Feelings are designed to move us to action. When we stick with the same plan in the face of raising emotional alarm bells, we are being ruled by our greed and our position is likely to be highly unreasonable. When we work hard to discount contrary opinions or avoid researching new sources of relevant data, we are frantically hoping whether we realize it or not.

Listen to the wisdom of your subconscious mind. Draw back. Rethink your current course and start over on a more reasoned path. There is an old Chinese proverb that applies here, "No matter how far you've walked down the wrong road, stop." If you are counting on one brilliant move to make your fortune, you're on that wrong road.

Over Complexity

Our plans and strategies are built upon assumptions. These assumptions can vary in their accuracy from unreasonable, or ill-formed to spot on. Our assumptions come from our perception of the way we think the world works, the lessons we've drawn from our past experiences, and our basic temperaments. Pessimists tend to see the glass as half empty and wait for the water level to drop off. Optimists see the glass as half full and look for a bigger container as they are sure that more water is coming. The fact of the matter is that when we make assumptions, we are acting on limited information. We assimilate the facts that we know and we fill in the blanks with suppositions. Then we act on our beliefs. Obviously, there is the potential for a large margin of error in these suppositions.

When we are dealing with the markets we are trying to make accurate decisions (to buy, sell, or hold) based on information that is less than complete. This is true for all investors, but it is particularly true of those who "play" the markets part-time. When greed drives us, we begin to add more assumptions to buttress our shaky logic. Our assumptions become overly complex. We often pay more attention to the facts that support the position we want to take and ignore or dismiss information that doesn't. We find ourselves so invested in a particular choice that we cook the data. Our plans can become illogical based on containing a large number of unchecked assumptions. Success will come if and when a large number of unknowns fall into place just as we had assumed. The rational mind might see these odds as infinitesimally long, but the greedy mind convinces itself that the mental house of cards that it has concocted will endure the forces of the marketplace.

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If you find yourself in a position where you are trying to justify a shaky strategy to yourself, then detail your plan on paper. Identify the facts that you're using to create your case. Identify the assumptions you're making. Recheck your facts. Validate your assumptions as best you can. See how well your thinking holds up to this scrutiny. You might even show your plan to a friend or advisor to obtain a dispassionate assessment of your thinking in this particular case. Remember, greed causes an imbalance in your logic as well as in your focus.

Over Simplicity

The human mind is often unsettled by ambiguity. When we don't understand something important to ourselves and our security, we look for an explanation that makes the world seem predictable again. The history of humanity is rife with examples of people acting on superstitions, or engaging in rituals designed to appease the gods or the forces of nature that seem to be out of whack. The vestiges of this thinking still linger in our modern, rational brains. We are driven to find explanatory causes and often, the simpler the better. A simple explanation restores our tenuous feelings that we are back in control of our lives and this is highly reassuring.

It is wise to recognize that market forces are extremely complex within today's global economy. With the rise of technology and the explosion of data we are inundated with more information than most people can process. One common tendency is to simplify it. And when we do, we leave far too much to chance. This leads me to a story from my past:

In an earlier time before I began to surround myself with brilliant financial people, I had a particularly weak investment advisor who was quite serious when recommending that I buy stocks in casket companies. His rationale was that, as the baby boomers aged, there would be boom in the market for caskets. On the surface I could see his reasoning, but as an investment strategy for building wealth I recognized that he was thinking too superficially. It's my contention that many investors similarly adopt superficial strategies out of greed.

Think of the people who paid one, two, or even two hundred and fifty dollars a share in the late 1990s for the stock of tech companies that hadn't yet turned a profit. This is where herd mentality fits in. We invest based on a magazine writer's hot tips. We can't abide the idea that others have made money on a stock that's already risen significantly in value and so we jump on the bandwagon to get our share. There is little research, thought or work that we put into or efforts before we commit our funds. Winning market strategies are based on information and analysis of a wide range of data and they are continuously evolving as new facts emerge. Oh, there are examples of dumb luck and fortuitous picks in a given instance, but this is a sucker's bet and your odds for beating the house in Vegas would be a safer choice. It is greed that drives us to make these impulsive decisions to climb aboard a winner when the race is almost over. Since emotion has driven our choice to get onboard, logic seldom steps in and tells us when to get off until it is too late.

Sclerosis

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When physicians speak of arterial sclerosis they are talking about a hardening of the arteries. The walls of those arteries harden, become less flexible and have difficulty responding to changes in blood flow. Over time they can become so brittle they break. People can also become sclerotic in their thinking. They can become rigid and close-minded. They fail to adjust to changing conditions or even acknowledge that conditions are changing. They keep thinking the same way because that thinking worked for them in the past. Yesterday's successful strategies worked yesterday because they were attuned to the forces operating at that time and in that place. Most have a limited shelf-life. Yes, in finance, history has an uncanny way of repeating itself. However, economies cycle from peak to trough and back and this often creates vastly changing conditions.

In the later stages of an economic expansion, investment themes and strategies undergo more rapid change. The shelf-life of a successful strategy can move in and out of favor quite easily. Mental flexibility becomes the key to making good decisions today. Yet it can be as difficult for us to abandon old strategies as it is for us to abandon old friends. In the eighties, American businesses learned that working an obsolete process harder or more efficiently only delayed the inevitable. The same wisdom holds true for our investment strategies. Some people hold on to losing investments because they don't want to acknowledge or realize their loss. Or some people will stick with outdated advice because things have gone well so far and they don't want to hear that the landscape has changed.

The point here is that these people are being greedy in not wanting to take the risk of changing course. Logic has little to do with the decision to stay put. It's an emotional decision and it is based on the feeling that they can recover more if they stay the same. These are the people who will continue to work a played out mine shaft because there was once gold there and they are loath to walk away if there could be more. They ignore the data. Their wants overwhelm their reason. Their greed is out of control.

Concluding Thoughts

A good plan has a definition of reasonable goals, recognition of your means and a balanced approach for success built into it. There should be benchmarks or milestones that let you know when you are "on target". With greed, benchmarks and milestones have no meaning. We are constantly seeking more. There is no such thing as enough and so we are constantly unfulfilled. We can't win because there is never enough.

Listen to yourself as you think about your investments and ask yourself the following questions. Are you ruled by logic or emotions? Are you making so many assumptions that your perceptions are skewed? Are you running on hope as opposed to data? Are you impulsively following "hot tips", or chasing stocks that have already made a significant run or investing heavily in highly speculative investments hoping to strike it rich?

Greed is a destructive emotional force. It leads to poor choices and unbalanced priorities. Step back and deal with the problems that have fostered your greed in appropriate ways. Don't let that greed cause you to squander good money on bad investments. Seek advice and input from others. Do the mental work required to make good decisions. Nothing worth having comes easily.

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Remember, greed is excessive desire for getting or having something, most notably wealth. It is not the mere desire for getting or having wealth that we should all have.

ELF Capital Management Investment Performance Update

August revealed some very interesting data that only seemed to keep us on the edge of our seats, yearning for more information. Nevertheless, I believe that we're trending toward the belief that the US economy is past its peak and less of a belief that it has a little more to go, or that it will remain on its trajectory of expanding at a slower pace. Let's update our economic tally from last month:

It is pretty clear that demand for new and existing housing is slowing down in mildly dramatic fashion. The numbers don't look good going forward and all of the major US homebuilders have already chopped their forward earnings guidance. Oil prices have been dropping dramatically as we draw near to the end of the summer driving season, and the significant potential from a newly found oil field in the Gulf of Mexico should allow pricing pressures to ease further. That is, if China doesn't dramatically offset these dynamics by increasing their demand for petroleum. The Fed paused and short-term interest rates remained unchanged, but falling long-term treasury bond yields only served to widen the yield curve inversion. If history repeats itself, the chances for an economic recession in the US increases as the yield curve further inverts. And, the markets rallied on fairly light volume...

Proponents of the "Fed Model" proclaim that the US stock market is undervalued. The "Fed Model" has become a very popular yardstick for judging whether the U.S. stock market is fairly valued. Essentially, it is a methodology for comparing the stock market's earnings yield (E/P) to the yield on long-term government bonds. Yet, the Fed Model is not forward looking and does not consider factors such as an inverted yield curve. It also doesn't factor in the 17 Fed Funds rate increases that haven't yet impacted consumer wallets. We think the markets remain vulnerable to bad news and continue to position our portfolios defensively.

For the month ended August 31, 2006, our one-month performance is down 0.63%, our three-month return is down 3.90% and our one-year return is up 5.07%.

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 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.

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.