

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

October 1, 2008

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Depression Fears: It Doesn't Have to Be

The events of this past month present no trivial matter to every man, woman and child living today. September 2008 will go into the history books as the beginning of the Great Depression II or how a brave nation took action to avoid it. Clearly, this crisis requires decisive action or we are destined to repeat history. Are you ready for the financial pain, sorrow and suffering that such would bring? How could you know? Many of us have not seen an economic threat this bad in our lifetimes.

We have heard grave warnings from our Federal Reserve Bank head, Ben Bernanke, US Treasury head, Hank Paulson and President Bush who believe we are heading for a complete failure of our banking system. As I've written to my clients several times during September, what has happened this month has thrust us into uncertain times and the circumstances are similar to what precipitated the Great Depression in 1929. While the causes may be slightly less similar, the effects could be the same. I am concerned.

For some time, I have had a passion for approaching finance from researching the economics side of the business. Economics, very broadly, is the study of how human behavior impacts finance, as well as, how finance may influence human behavior. It is more art than science and lends itself to probable, rather than certain, outcomes. Being a perpetual student of economics, it is painful for me to follow the path of current events and forecast into the future how bad things can become.

In this letter, I will discuss what happened in September to cause concern, how bad things could get, reasons for hope and why you should take action to alert our politicians to pass the Paulson TARP plan. Please read this one and if you agree with my analysis, please pass it along to many of your friends.

What Happened In September That Caused Concern?

Well, we already knew that the banking system was under stress from having to hold mortgage loans that were packaged for non bank investors. We already knew that the manner with which they packaged these loans was too complicated. And, due to fear and uncertainty, non bank investors lost interest in wanting to buy or hold these loans. This forced the banks to sit with more mortgage loans on their books than they could reasonably hold. And, in turn, this tied up most of the banking industry's capital available for them to be able to make new loans.

While the banks were hoping that investors would come back to purchase these loans, they didn't. So, many tried to lower prices to find buyers for them. Still, not enough people wanted to purchase this debt and price for these complex securities went much

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lower. Because current accounting rules require banks to mark these loans to “market prices”, banks had to write them down and reflect losses against their capital. Here’s where the vicious cycle began. A vicious cycle occurs when one trouble leads to another that aggravates the first. To understand this, here’s a quick lesson in how banking works.

Banks make most of their revenues from lending money. Banking regulations and best practices limit how much a bank can lend. The limit is roughly 12 times their capital base. This means that for every \$1,000 of capital, they can loan out \$12,000 to consumers and investors; and, for every \$1,000 of capital lost, they have to either call in loans made, sell them or wait until they pay down before they can make new loans. Even if the losses are on “paper”, under current accounting rules, they have to mark them down to where they can be sold. Customer deposits with banks also play an important role in the banking system. Since banks can’t immediately turn their capital into 12 times leverage, they depend on customer deposits and use these deposits to make new loans. As banks pay modest interest on deposit accounts and lend that money at higher rates, they earn the difference between what they receive from borrower and what they pay to depositors. So, since much of this deposit money is loaned out, when depositors demand their money back – on a large scale – the banks need to call in loans or sell them in order to return the deposited money. This is a very simple explanation, but it gets to the root problem.

Since many of these mortgages are collateralized by homes, we also have to factor in how housing impacts this all. Most, if not all, of these mortgages are secured by homes. Unlike an unsecured credit card loan, we pledge our home as collateral to secure the loan. If we default on the mortgage, the bank can take our house and sell it to get their money back. This factor makes these mortgage loans among the safest loans to invest in aside from US Treasury debt. Yet, as home prices keep coming down, the level of collateral protection reduces also. We’ll use this in an example later in this letter.

OK, so what happened this month?

On the 7th of September, the US Government took over running Fannie Mae and Freddie Mac. While Fannie (1938) and Freddie (1970) were created by Acts of Congress to insure home mortgages and lower borrowing rates, anyone could buy and sell their stocks and bonds in the open market for a profit. At the same time, because they came into being as a result of Congress, this insurance was implied to be guaranteed by the US Government. It is estimated that they guaranty approximately 50% of the entire US home mortgage market at present. When the Government took them over, it also took full responsibility for Fannie and Freddie’s debt. The take over decimated the common and preferred shareholders who invested and put their capital at risk. And, many banks held preferred stock in both of these entities.

Without going into how the implied guaranty gave them an unfair advantage and that the US Government did a poor job of monitoring their exposure, the US Government is already now on the hook to guaranty 50% of all mortgages issued in the US on top of Fannie and Freddie’s debt. Please remember this when we discuss, later in this letter, the Paulson TARP Plan that was voted down on September 29th by Congress.

On September 14th, Lehman Brothers announced they filed for bankruptcy and Merrill Lynch agreed to sell itself to Bank of America. Despite the increased safety to mortgages

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as a result of the Fannie and Freddie take over, investors didn't come back to buy the mortgage paper and clients began to withdraw business from these firms. So, they and needed to act. While the average person might say "so what" to both of these events, Lehman was simply too big to fail and so was Merrill. Not being regulated like traditional banks, both Lehman and Merrill had levered themselves more than 25 times. And, due to the interconnectedness of Lehman to the entire banking system, the bankruptcy filing only served to accelerate the vicious cycle. And now, losses to banking capital were becoming real losses instead of "paper" ones.

Next, on September 16th, we learned of the near bankruptcy filing of the world's largest insurer, AIG; and we learned that the Reserve Fund's primary money market fund had "broken the buck".

When a money market fund "breaks the buck", this means that the value of each share in it had fallen below the standard of \$1. In this case, the fund valued its shares at \$0.97; which means that each customer lost 3%. The bad news is that people consider money market funds as very safe; and we should. The good news is that the Reserve Fund was the only money market fund that reported such a loss. The R Fund reported that they had held Lehman debt and took too much of a loss when Lehman filed bankruptcy. Are you beginning to see the interconnectedness to the system?

The AIG problem was totally unexpected. Due to the increasing stress in the banking system and its negative effect on credit, the ratings agencies announced that they were going to lower AIG's credit rating. Because AIG insured an immense amount of credit default swaps ("CDS"), the downgrade would require AIG to immediately post more than \$40 billion in cash as collateral supporting these contracts. A CDS is a type of insurance policy that protects an investor against a specified loan or loans from being defaulted upon by the borrower. However, this insurance is only as good as the insurer's ability to pay. And when AIG's credit rating dropped, the contracts stipulated that AIG would have to put up additional cash as collateral. Note: they had to put up cash, not spend it. AIG had more than enough assets and capital, but not enough cash. And, as they had no time to come up with it, this would have forced them to file bankruptcy as well. Given the size and breadth of AIG, if they filed BK, the damage would have been too extensive to save us from a Depression. In my mind, there would be no question about that outcome.

These two events, created such panic that we were beginning to experience a modern day run on all banks. And, a run on all banks is precisely what happened in 1929 that was the largest contributor to the Great Depression. We were rapidly heading in that direction until Bernanke and Paulson announced that they would take a number of major actions: First, they would loan AIG \$85 billion for 2 years (I'll go into the details of the loan later.); next, the US Treasury would temporarily guaranty all US money market funds; and, lastly, they would propose to Congress an immediate comprehensive rescue plan that would seek to stop more individual "dominos" from falling and save the banking system.

What followed has been high drama on Capital Hill. Not only has Bernanke and Paulson had their hands full trying to educate legislators about the complexities of the matter, but they have been engaged in significant debate with politicians that are challenged to remove themselves from partisan politics and the looming Presidential election. All while Rome is burning.

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This is a simplistic overview of our challenging environment and I've left out much of the complexity and financial jargon to help more of my gentle readers understand what we are facing. Hopefully, this purpose has been served.

How Bad Could Things Get?

Imagine going to the gas pump and inserting your credit card, only to find it has been declined. Even though you thought you had more than enough credit available, your account was frozen. You get a notice several days later that all of your credit cards have been frozen. At the same time, no banks are making home loans, auto loans, student loans or any other type of loans you can think of. The banks simply have no money to lend. This scares the heck out of you and every one of your neighbors and you stop all spending. Next, business cash flow drops off dramatically and wide scale layoffs begin to occur. Some people have stored some cash, but few stores are remaining open.

This all comes in a matter of a week and lasts for a month or two. Lawyers and accountants get into full gear to begin working on bankruptcy filings and police and firefighters are on high alert for increased activity due to public discontent.

It all shakes out over a month or three and we begin to pick up the pieces. It would be kind of like rebooting your computer, but restarting the economy again takes more time. The rebuilding process takes five to ten years and everyone living comes away with a lasting memory of financial pain. This is what happened to some of our parents and most of our grandparents. The Great Depression began in 1929 and is said to have ended around 1939 with the onset of the World War II war economy.

But this does not have to happen again! It is neither certain to happen and we have history as a guide to keep ourselves from it. In fact, decisive action could reverse our course and have us emerge from this light, but frightening, recession we are in.

Reasons for Hope

The greatest reason for hope is that, today, we are in an amazing age of information. We have access to events occurring across the globe at amazing speed due to sophisticated financial media and the internet. In a worst case scenario, if we did have to experience another Depression, I believe our information age would help get us through it much more rapidly than our nation did before. Second, we have very smart and proactive people in the US Treasury and at our Federal Reserve Bank. Next, we have the SEC and FDIC, both of which didn't exist in 1929, taking proactive steps to protect us as well. I could add to this list but want to focus on why we should support the efforts of Paulson and Bernanke.

But, before I do, let me say that the FDIC currently provides insurance up to \$100,000 per depositor (and up to \$250,000 for retirement plan accounts) in each bank or thrift it insures. And the US Government is now also temporarily guarantying money market accounts. You may have to juggle some of your cash around but do not have to take it

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out. The banking system needs that cash to keep functioning and, as I wrote above, running on the banks was the largest contributor the Great Depression of the past.

Now back to Bernanke and Paulson. Bernanke is a PhD in Economics who spent much of his career in studying the Great depression. He has taught economics at some of our nations finest schools (Stanford Graduate Business, NYU and Princeton) before joining the Federal Reserve Bank in 2002. Paulson, on the other hand, had been employed by Goldman Sachs for more than 30 years and was CEO of that firm for approximately 7 of them. Goldman, founded in 1869, has been one of the world's top investment firms and has been a leader in handling complex transactions. Paulson has been the US treasury Secretary since mid 2006. It is my humble belief that we have some of the brightest minds trying to steer this boat; and, they are significantly more prepared for our crisis than those in office back in 1929. And, I believe they are more committed to this nation than most people have given them credit for. Remember, we are in an election year! One only has to see the commitment they have given in trying to work with Congress to earn them my belief. And, I have been glued to the financial news networks throughout last month.

On September 18th, Paulson and Bernanke proposed their TARP (Troubled Asset Relief Plan) plan to Congress and the White House. The White House immediately supported the plan, as the President should have, and Congress undertook to put the plan through great debate. With as much media coverage as possible. The basic function of TARP is to have the US Treasury authorized to purchase up to \$700 billion US taxpayer dollars of the mortgage debt described above and to use that purchase to revive and restructure the market for these securities. My view is that TARP cuts right to the "meat" of the challenge that got us here and could work. Let me tell you why:

The US government is already guarantying more than 50% of the US mortgage market and many of these packaged loans are already priced way below what these loans are expected to repay. The US banking system would be tremendously helped by selling these loans to the US Government, even if they pay above "market" for them, and the US Government will have plenty of room to profit. Also, let me make this very important point. The US Treasury would not be spending \$700 billion, they would be investing it!

Let's go through some math together to illustrate why I think we'd make money on this investment. Let's say that 80% of the mortgage market is considered Prime and 20% is consider less so (SubPrime). And let's say that, in a worst case scenario, 25% of Prime mortgage loans go into foreclosure and 60% of SubPrime loans foreclose as well. These are rather extreme default rates by historical standards. Let's say that Prime loans pay, on average 6% and SubPrime loans pay on average 8.5% of the original mortgage loan amounts and, that the US Government can borrow at an average rate of 3.75%. These are quite reasonable approximations. Then, let's say, in our worst case scenario that the US Government could recover only 50% of the original loan amounts from foreclosed property. Lastly, let's say that Washington buys an even mix of Prime and SubPrime mortgage loans at an average price of \$0.78 on dollar of original loan amount. Indeed, these are all very conservative numbers.

By these estimates, in my worst case scenario, the US Government would profit at least \$70 billion in the first year; and if successful, would more than likely earn more than \$180 billion in the first year. Here's an illustration of the worst case scenario:

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Cost to US Treasury to finance purchase:						
Purchase Cost (billions)	Average Interest Rate	Annual Interest Cost				
\$ 700 X	3.75%	= \$ 26.25 billion per year				
Expected cash flows from this investment:						
Purchase Price Scenario:			Average		Original	Average
Mortgage Type	%age to Buy	Amount Invested	Price Paid	Avg Price Proof	Loan Amt Purchased	Interest Rate Paid
Prime	80%	\$ 560	\$ 0.825	\$ 0.660	\$ 678.79	6.0%
SubPrime	20%	\$ 140	\$ 0.600	\$ 0.120	\$ 233.33	8.5%
Totals	100%	\$ 700		\$ 0.780	\$ 912.12	
Worst Case Interest Income Projection:						
	Original Loan Amt Purchased	Worst Default Rate	Original Loan Amt in Default	Original Loan Amt Paying	Average Interest Rate Paid	Annual Interest Received
Prime	\$ 678.79	25%	\$ 169.70	\$ 509.09	6.0%	\$ 30.55
SubPrime	\$ 233.33	60%	\$ 140.00	\$ 93.33	8.5%	\$ 7.93
	\$ 912.12		\$ 309.70	\$ 602.42		\$ 38.48
Worst Case NET Interest Income Projection:						
	Annual Interest Received	Annual Interest Cost	Net Interest Income			
	\$ 38.48	\$ 26.25	\$ 12.23 billion income per year			
Worst Case Principal Recovery Projection:						
	Original Loan Amt in Default	Original Home Equity Collateral	Recovery Rate	Recovered Amount	Original Loan Amt Paying	Total Loan Amt Recovered
Prime	\$ 169.70	\$ 169.70	50%	\$ 84.85	\$ 509.09	\$ 593.94
SubPrime	\$ 140.00	\$ 140.00	50%	\$ 70.00	\$ 93.33	\$ 163.33
Totals	\$ 309.70	\$ 309.70		\$ 154.85	\$ 602.42	\$ 757.27
Worst Case NET Principal Income Projection:						
	Total Loan Amt Recovered	Original Loan Amt Purchased	Net Principal Income			
	\$ 757.27	\$ 700.00	\$ 57.27 billion gain on principal			

Let me add one more thing. One more reason for my faith in Paulson and Bernanke is how they benefited taxpayers in the AIG deal. Remember that AIG got an \$85 billion, two year loan? Are you aware what we got in return? The US Government is earning roughly 11.5% per year in interest and received 79.9% ownership in AIG. AIG, as last reported, had a book value of approximately \$78 billion which means that on top of the loan due of

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\$85 billion, plus interest, the US Government also got \$62.3 billion in value. Since AIG remains a very viable company, I'd say that Paulson and Bernanke very shrewdly protected Government funds.

If you can find yourself comfortable with my analysis, please do two things. First, get on the phone and call your elected representatives and request that they vote to pass the TARP plan. Second, please pass this plain language analysis to as many of your friends as possible to get them to rally support for the TARP plan! Given how fast events are occurring, a rescue plan may already be passed by the time you read this. If so, I would be elated; if not, please act!

Our Investment Strategy and Other Observations from September

While we were becoming pretty optimistic at the end of August, we had begun to reinvest into the market and became 85% invested. Then, by mid September we reversed course and moved back into roughly 80% cash. Now, we have taken advantage of some extreme dips and are roughly 40% exposed to equities and are holding approximately 60% cash. This is an average of all our portfolios under management. If we can see a rescue plan passed and action taking shape, we may very well begin to cautiously increase our exposure to US equity markets. A well crafted plan would be a big positive for financials as most have written down the mortgage loan investments well below my worst case scenario above. If you remember, Merrill Lynch had sold some of these loans at \$0.22 on the dollar over the summer.