

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

October 15, 2006

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Is Investment Transparency Important?

When you invest your money, what guides your decisions? What guides your expectations? How do you assess risk? Is there adequate information available? Will you receive regular updates? What kind of information should you receive? How do you develop trust in the information you're receiving? Can too much information work against you? Are you even paying attention to the information you are receiving?

This past month, one of the world's largest hedge funds reported that it was taking a 35% year to date loss as a result of being on the wrong side of a trade. Did investors know that that could happen? Did they believe that they would be exposed to such risk? I bet not.

In case you hadn't followed the story, on September 18th, the Greenwich, Connecticut based hedge fund, Amaranth Advisors LLC, reported to shareholders that the fund was down 35% year to date due to heavy losses from natural gas investments. This must have come as a big surprise to its investors as Amaranth marketed itself as a "multi-strategy hedge fund" that "deploys capital in a broad spectrum of alternative investment and trading strategies in a highly disciplined, risk controlled manner."

When news of this unfortunate situation spread throughout the financial community, reports of the chaos created opportunity for quick minded arbitrageurs. This, in turn, caused further pain to Amaranth's hedge fund investors. A week after the news hit, the \$9.5 billion hedge fund announced that its losses grew to 70% and that it was holding a going out of business sale as investors sought to redeem what was left of their investments in the fund. Did Amaranth's investors realize that the fund had concentrated much of its portfolio exposure into the natural gas sector? Did they believe that once word got out, other investors would take advantage of their misfortune? From what has been reported in the media, it doesn't sound like the fund provided much transparency of information to its investors. Or did it?

Now, the need for greater transparency "cry" is being touted in the media and on Capitol Hill again. But not with the same level of fervor as when Enron went bankrupt.

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.

With help researching this topic from our new intern, Jonathan, this month's newsletter will discuss the nature of transparency, how much might be enough and how too much transparency may not be productive for investors and their fiduciaries. 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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The Investment Transparency Concept

When we look up the word transparency, depending upon the context of its use, we can observe it defined many ways. In fact, I count many more metaphorical uses of the word than literal. In a literal sense, transparency describes the physical characteristic of being able to see through an object that has clear or translucent properties. Metaphorically, it can be used to describe a desire for having accurate and timely disclosure of information for public consumption and decision-making. This latter explanation is more relevant as applied to investing.

To create a level playing field, transparency seems necessary from the following sources for informed decision-making: from governments and governmental agencies regarding matters of law-making, monetary and fiscal policies and when reporting economic data; from corporate issuers regarding the disclosure of financial data and in giving earnings guidance; and from investment managers in reporting performance statistics and or changes in their style, strategy, structure or personnel.

To expand on this a little bit, let's consider the impact from each.

Today, it is less unusual – actually, more the norm – to have international exposure in one's portfolio. The benefits of diversification to mitigate market risk and maximize return opportunities compel us to do so and investors large and small have grown comfortable with the notion of investing outside our borders. In a November 2001 WTO staff working paper, authors Drabeck and Payne discuss the importance of governmental transparency and its impact on attracting investment in the following context: "Non-transparency is a term given ... to a set of government policies that increase the risk and uncertainty faced by ... foreign investors. This increase in risk and uncertainty stems from the presence of bribery and corruption, unstable economic policies, weak and poorly enforced property rights, and inefficient government institutions. Our empirical analysis shows that the degree of non-transparency is an important factor in a country's attractiveness [or lack thereof] to foreign investors. High levels of non-transparency can greatly retard the amount of foreign investment that a country might otherwise expect." From their work, it should come as no surprise that most professional investors understand the negative implications of this, but do you think the average investor considers this risk? Probably not, and I'd bet many take the benefits of this type of transparency for granted.

With regard to corporate issuers, whether foreign or domestic, investors must be confident that a company has told them everything they need to know to make an accurate assessment of the company's current performance and prospects. And, investors need to trust the information they are receiving. When investors lack confidence, stock and bond prices can suffer significantly. One of the most egregious acts against investor confidence in the recent past was the failure of Enron. In an April 2003 policy brief from the Brookings Institution, Wei and Milkiewicz write: "At the beginning of 2002, Enron was the seventh largest company in the United States ... Telecommunications giant Global Crossing operated in twenty-seven countries and two hundred cities on five continents ... both companies collapsed last year under the weight of financial problems created by the self-dealing of a few corporate insiders and masked by nontransparent accounting. These ... failures deprived millions of company employees and shareholders of their lifetime savings and retirement benefits. Stock prices of other U.S. companies also took a beating, partly in response to the

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revelation of these scandals ... The practice of opaque self-dealing by a few insiders ... has contributed to the meltdown of the financial markets around the world.”

When we consider the role of investment managers, we’re discussing a more personal level of fiduciary care and a more intimate relationship with investors than the prior two sources. Whether through a separate account relationship, purchasing mutual fund shares or investing in a private investment company – often referred to as a “hedge fund” – investors rely on these professionals to deliver wealth creation within a certain level of managed risk. This requires investors to have a great deal of trust. It also requires that investors understand the manager’s capabilities, strategies, leverage to be used and the potential risks and rewards to be expected from that relationship. For the manager, credibility is the name of the game and more often than not, investors hire a manager for mismatched reasons. Yet, for those doing more thorough homework, the reliance on accurate and timely information can be of utmost importance in creating and maintaining that credibility factor. And, it doesn’t help the industry one bit when a manager, whether intentional or not, doesn’t foster that trust as in the case of the Amaranth debacle cited at the beginning of this letter.

By now, I’m sure you would agree that transparency is important for investor confidence and the industries that serve them. When investors allow opaqueness – too much privacy – or “smoke and mirror” information, it undermines the public’s trust and creates disadvantages for everyone involved over the long term. However, as too much information may have hurt Amaranth shareholders, you may also want to consider that having the ability to look through a clear glass window – as revealing as that may be – also may not always be in your best interest either. Lest we remember, glass windows also come in varying degrees of translucence. How much do we really need to see?

How Much Transparency Is Too Much?

As discussed before, transparency can be used to describe a desire for having accurate and timely disclosure of information for public consumption and decision-making purposes. We have already reviewed how it is important to investors that governments and their agencies, corporate issuers of securities and investment managers practice some level of transparency. But how much is really needed and how much is healthy?

It is undeniable that a certain level of transparency should be required of corporate issuers and investment managers so that novice and professional investors alike have adequate and reliable information to assess past performance data and future prospects. However, creating additional levels of transparency for investors does not come without costs. Every new angle of transparency to be undertaken brings layers of administrative cost. In addition, requiring greater levels of transparency can force a company or investment manager into stripping itself of basic privacy rights to proprietary research and potentially lose its competitive advantage. Who do you think pays for this?

Investors pay for this, of course. But not only investors pay the price. Employees and other stakeholders bear these costs as well. For both parties, the costs associated with providing transparency are not variable costs, they are fixed costs. Variable costs are considered the part of a company’s costs that can change flexibly with varying levels of production; whereas, fixed costs remain the same at any given level. So, added transparency laws often saddle a

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corporate issuer or investment manager with added fixed costs. These costs reduce overall profitability and can tie up capital otherwise used for organic growth, research or innovation.

Consider the case of corporate issuers – companies that issue economic interests in themselves in the form of stock and bonds. The failures of Enron, Global Crossing and WorldCom, is said to have lost tens of billions of investor dollars. And, the US Government's response was to put new laws on the books in the form of the Sarbanes-Oxley Act of 2002 ("SarbOx"). Now, there is significant debate surrounding the fact that the costs of conforming to these new SarbOx laws will dwarf the investor losses that precipitated their enactment. Does that sound equitable for investors on the whole? Did corporate America really need greater transparency laws because of a few corporate scoundrels who lacked integrity to begin with? Weren't existing regulations adequate deterrence for these fiduciaries?

And, what will investors do with additional transparency?

At the University of Minnesota's Carlson School of Management, Professor John Dickhaut is reported to be one of a growing number of academics who is researching "neuroeconomics" – how people make economic choices. In the July 2005 edition of Insights@Carlson School, an article about Dickhaut states: "his lab tests prove that transparency can cause worse outcomes than in a market with poorer information. In other words, transparent doesn't equal clearly understood." And, as quoted by Dickhaut himself, "People fail to coordinate understanding ... They don't communicate their expectations, and they might think that they understand more than they do about a company."

Now, I'm sure there are plenty of securities analysts that would choose to challenge Dickhaut's experiments and the applicability of his findings to their own work. So, let me introduce another argument from a Senior Fellow at the Brookings Institution regarding how too much transparency can be detrimental to investors by fostering price volatility.

In an October 2002 paper presented to the International Monetary Fund, Shang-Jin Wei argues "The notion that transparency may not necessarily reduce volatility is reflected in the recent literature on corporate transparency." Wei refers: "In particular, Bushee and Noe (2000) report a positive association between corporate transparency and the volatility of the firm's stock price. Firms with higher levels of disclosure tend to attract certain types of institutional investors which use aggressive, short-term trading strategies which in turn can raise the volatility of the firm's stock price." Did you ever hear, in investment circles that "the trend is your friend"? Well, volatility is not a friendly trend for investors!

When we discuss the various types of investment management relationships, both mutual funds and separately managed accounts offer the most transparent types of relationships available to their investors. Not that the transparency in these relationships is perfect, but it comes pretty darn close. With mutual funds, transparency issues usually revolve around their fee disclosures, trading and broker distribution practices, board governance matters, and less than timely disclosure of holdings data. Whereas, with separate account arrangements risk disclosures and performance records are sometimes not fully discussed, however, this is often mitigated by the fact that all positions are disclosed and therefore trading activity can be closely monitored. As mutual funds and separate account relationships are already highly transparent, it doesn't make much sense to discuss how much transparency is too much.

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When it comes to hedge funds, however, the desire and debate for transparency take on a much different tilt. Unlike mutual fund shares, which are among the most strictly regulated marketable securities, hedge funds are private investment pools that are subject to far less regulatory oversight. These regulatory exemptions are only afforded funds that limit participation to highly sophisticated investors meeting the SEC's definition of an "accredited investor". As such, the level of transparency offered is measured by how effectively it facilitates the marketing process instead of being a regulatory compliance matter. In fact, many young or small hedge funds offer higher levels of transparency and the larger ones commonly give far less information. And for investors in the larger funds, it is hard to walk away if you believe in the people running the fund and their strategy and style of investing.

How Much Transparency Is Enough?

At the start of this letter I asked several questions. When you invest your money, what guides your decisions? What guides your expectations? How do you assess risk? Is there adequate information available? Will you receive regular updates? What kind of information should you receive? How do you develop trust in the information you're receiving? Can too much information work against you? Are you even paying attention to the information you are receiving? Your answers elucidate your appetite for transparency.

In the final analysis, from an investor's perspective, transparency is all about trust. When you choose to put your money with someone to manage, you want to be able to make a reasoned decision. How will the money be handled in relation to your issues regarding risk and volatility? Once you, as an investor, make a decision, you should be able to trust that the management of the company, its fee and compensation structure, and its investment strategies are as they are purported to be in the disclosure documents. A promise has been made. Is it trustworthy? What do you need to know in order to invest your money?

The CFA Institute recommends that hedge funds offered to retail investors should offer disclosure requirements relating to:

- A description of the strategy or strategies used by the fund
- A description of risks inherent in these strategies at offering and on an on-going basis
- Fund performance, both on absolute basis and against appropriate benchmarks.
- Historic fund performance by strategy
- Fund manager's experience and background
- Regular audits by independent audit firms
- A description of valuation methods applied to specific securities
- A list of securities owned at regular intervals.

The rationale for this information is that it is needed to enable investors to determine whether the fund meets their risk/return requirements. As fiduciaries, the fund managers have an obligation to do what they say or to inform investors of a change in their fundamental strategies.

If you can invest with this fundamental level of trust then you have the right amount of transparency for your needs without putting the fund's operational strategies at risk. It is my opinion that the greatest concern among investment managers, in the public's quest for transparency, involves the push to disclose current holdings data. As the investment

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management business is quite competitive, most managers desire to protect themselves and their investors from the potential of free-riding or sabotage by others. Free-riding occurs when one party who fails to come up with their own new ideas or opportunities, benefits freely from the work of another; and, sabotage occurs when one party takes deliberate action to weaken or reduce the probability of success of another. For an example of sabotage, think back to my observation of how the publicity of Amaranth's troubles added to the losses of their investors. Increasing transparency so that competitors can anonymously observe the efforts of another can only serve to encourage theft and misuse of intellectual property. As such, investors should measure the effects of this concern as well.

ELF Capital Management Investment Performance Update

Nothing like lower oil prices to stimulate greater consumer confidence. Since the summer, investors found it hard to believe that high oil prices, high commodity prices and the lagging effect of Fed Funds rate increases weren't going to precipitate a recession here in the U.S. And, that such a recession would be felt around the world. Even the bond market seemed to confirm that view and longer term interest rates still seem to be delivering that signal. But the stock market signals a different view and we have to take that seriously.

During the month of September and into this month, the U.S. stock markets have seemed to have a run that found us too cautious to participate in. By all reports, there remains significant money on the sidelines, so we don't seem to have been alone in our cautious view. We played it on a "better to be safe than sorry" basis and the result seemed to find us both safe and sorry. Now, we are slowly and cautiously legging into the market and still believe a certain amount of defensiveness is warranted. However, like the Fed, we are watching each piece of economic data as it comes in and believe there are some signals that the Fed might have maneuvered a soft landing.

For the month ended September 30, 2006, our one-month performance is up 0.57%, our three-month return is down 2.15% and our one-year return is up 4.29%.

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.

ELF is an independent discretionary investment management firm established in February 2003. ELF manages a strategic allocation of primarily exchange-traded index funds (ETFs), and may invest in other carefully selected securities. ELF may also employ hedging techniques, through the use of short positions and options. ELF manages individual portfolio accounts for both individual and business clients.

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.