

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

November 1, 2008

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Testing the Small Investor Theory

Not only was October a gut wrenching month in the markets, it was also a very interesting study case for financial theory. The most notable of which, being the Small Investor Theory. After a month when almost every class of investment, except for government bonds, drops quite dramatically to new lows and trades like distressed securities, this topic needs to be dusted off and looked at anew. October seemed to precipitate from an overwhelming expectation that the sky was falling. For some, it may have felt that way; and for others, there existed only the fear that the sky might fall. I'm sure the next generation will learn much from it and, yet, I suspect that many important observations may never make it into the history books.

As the theory goes, a "small investor" buys – purchases investment assets – when prices are high and sells when prices are low. This was generally thought to be a result of "small investor" being more likely to follow the crowd rather than follow a disciplined approach. They invest when they hear of the successful experiences of friends and neighbors – usually after a significant run up in the market – and sell when they hear that market prices are falling. This is the parenthetical opposite of what investors need do to create wealth – to do so, one should buy low and sell high.

From the dynamics of this month, I think we saw the small investor theory undergoing great testing and few seemed to be excluded from it. This time, both professionals and novices couldn't keep themselves from the small investor mentality. Only history will tell. And optimists like myself, need realize that we are more than likely experiencing a time that is both extreme and short-lived. At the same time, I am also aware that the market can remain irrational longer than one can remain solvent. However, most of the invested money I oversee, including my own family's, is either long term retirement money or taxable accounts that represent long term money. Most of these accounts are approximately a third in cash and **none** are borrowing on margin. So, there is a high probability all can remain solvent.

How Bad Did It Get in October?

As far as October's market return numbers reveal, we experienced a market capitulation. Investopedia.com describes a market capitulation as: "the point in time when investors have decided to give up on trying to recapture lost gains as a result of falling stock prices... Many market professionals consider it to be a sign of a bottom in prices and consequently a good time to buy stocks."

Why do people capitulate? Fear. From recent events, what seems to bring the most fear causing "small investors" to capitulate? Job losses and rising unemployment concerns.

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That's perhaps how the "Small Investor Theory" came to be. Some "Small Investors" may feel that they need their savings to help them through the potential of experiencing a job loss, while seeing their investments go down in value. On the other hand, those who feel more secure with their financial situation can keep a long-term prospective on their invested assets and see opportunity when the "small investor" reacts with a capitulation.

To give you an idea why I think we saw a capitulation, the following reflects some of the market lows that we saw in October:

The Dow Jones Industrial Average fell 25.5% during the month; the S&P500 fell 27.9%; Russell 2000 fell 35%; using EAFE (non-US developed country stocks) fell 33.4% and the emerging markets index fell 39.7%. These are for October; and not the lows for the year! Yet, on a positive note, crude oil also fell to 39.6% low during the month.

If these numbers don't reflect capitulation, I don't know what does. And, in my mind, a capitulation is a validation of the Small Investor Theory. Yet, if this theory was generally thought to be a result of "small investor" being more likely to follow the crowd rather than follow a disciplined approach, now we can add the concept of selling due to job loss fears to that list.

How did the capitulation manifest itself in October? Well, if you believe the media, the selling stemmed from mutual fund and hedge fund selling to meet redemption requests. Yes, even though hedge fund investors are supposed to be sophisticated, high net worth persons not among the mental image of the typical "small investor", it is apparently hard for these people to not follow the crowd as well. When fear is rampant, it is very hard to be a contrarian.

Is History a Reliable Guide?

You know, following long standing theories is usually profitable. It has also proved worthwhile to look back over the statistics of history to give us guidance on how to invest in the markets. These methods have good records of success over long periods of time. However when the market has dealt a big loss, as we have seen this year, seemingly sound theories and analytical work can fall on deaf ears. This is because emotions cloud rational or disciplined thought and play a more dominant role in the behavioral side of investing. When emotions take over, even the hardest working professional can appear to be wrong – especially when investor behavior is driven by fear and uncertainty. Nevertheless, history can give us some clues as to how highly emotional investor behavior finally plays out also. In fact, in every major downturn, history has shown to repeat itself in one way or another. And, the nuances can be described in terms of how the government responds.

In this downturn, the government is throwing a great deal of stimulus at the problem; much more so than in any instance since 1929. It will take a little time for this stimulus to work through the system, and I suspect that it may create much more impact than we need. If this belief proves accurate, the economy should be humming before a year passes. Then, they will need to figure out how to slow things down again. This is what history tells me.

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More notable observations came from the NYSE floor traders – courtesy of CNBC coverage. Hasn't everybody been watching CNBC these days? When the market was going down, trading volumes were fairly light; and when US markets staged their biggest one-day rally on October 28th, the volume was light again. For me, the floor trader comments were valuable as they represented spontaneous reactions to what was happening at the time; as opposed to the various speculative and self serving opinions we have been hearing lately. The comments reflected that while the markets were selling off, very few investors were willing to step up and buy; and, when the market staged its huge rally, days before the end of the month, few investors were willing to sell into it. This leads me to believe that emotions are guiding the markets more than anything else right now. And that the stocks are downright cheap as a result. I also believe we have overshot the downside and the market is offering us opportunity. Yes, I know it is very easy to doubt my reaction given all of the events we've experienced since last October.

Add to this, that in looking over historical stock market charts since the 1929 crash, and considering the economic factors we are facing now, these charts suggest that prices have reached an extreme and that the trend is setting up to change. This is supported by how the October 28th stock market rally played out. At the same time we have tested market lows for a third time and while we penetrated the prior two lows, this one came with my sense of capitulation having finally occurred. In studying these historic charts, the only time prices went dramatically lower afterwards, was subsequent to the 1929 crash. At that time, factors that drove the markets and the economy lower were significantly different than now. Specifically, the US had far fewer safety nets in place and the government stimulus response was far less than it is now.

If you believe, as I do, that this capitulation downturn is ebbing, this is a time for opportunity.

Why I think it is Time to Become Greedy

I've said this before and generally receive criticism for it by my colleagues in the investment industry: markets are always driven solely by supply and demand dynamics. At the end of the day market prices go up because there are more buyers than sellers and prices go down when there are more sellers than buyers. Everything else is just a reason why buyers or sellers, as the case may be, should react in a certain way.

Those in the investment management business who make their living from short-term trading strategies tend to study the momentum of investor behavior; and those who make their living from pursuing longer term investment strategies spend their energies studying why investors should behave in a certain fashion. My style falls in the latter category as, over time, longer term investment themes have proven more reliable. Yet, there are a few trading firms that are very good at beating the odds and ply their strategy with great success. And, something can be learned from considering behavioral momentum and when that behavior might be overdone.

In the words of Warren Buffet: "Be fearful when others are greedy and greedy when others are fearful".

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First, we were frightened by the sub-prime crisis; then, we were frightened by that crisis causing a broader financial crisis; then, we were frightened because oil prices went to almost \$150 per barrel; then, we were frightened by the financial crisis momentum causing real damage. Now, we are being frightened by potential job losses exacerbated by seeing a stock market capitulation; all this while the US government is applying the biggest fiscal stimulus program in history. The stimulus package was passed before mid-month; and by the end of October, we began seeing the stimulus begin to trickle into and modestly ease the credit markets.

With fear growing more intensely from summer through October, many have reacted by capitulating and others are perhaps exhausted by the fear and are looking towards the future. High levels of fear just do not seem to be sustainable and at some point, optimism will kick in. From my past conversations with clients and acquaintances, most people are already turning their focus more optimistically towards the future. Playing the odds, optimists are not only more fun, but they are the people that take the appropriate risks that make them more successful. In fact, the optimism I have been seeing in others has helped me through penning this letter. And, I'm now sharing that optimism with my gentle readers.

As I'm starting to see more positive pricing action in the stock markets, I'm sensing that we should be turning the corner. That's not to say, that I don't still see selling come into the markets in the last 5 minutes of the trading day. However, early buyers seem to be coming back into the markets. This may not be a "maven" buying signal, but my young sons came to me this month and asked to be able to cash in their savings bonds that we have been holding for them since their births. When asked why, they commented that their friends have been discussing that the stock market is very low and they wanted to invest in stocks. We did it for them.

No one knows how long it will take for the markets and economy to recover, but I certainly believe we are near bottom and believe that we will begin to see the market creep upwards from here. We have seen the most volatile prices that I can remember in my lifetime and those swings have lost their newness for most investors. So, I can't guaranty that we've seen the last of volatility. In fact, I expect continued volatility until things become clearer that we're headed towards greater prosperity. By that time, the market will have already reacted upwards. I'm remembering the October 28th rally and when the sellers didn't want to play, the market rapidly rose 10% that day on light volume. Does that give you any hint about how fast the stock market recovery could be? It should.

One Last Note Involving the Election

My financial publisher, InvestorsObserver.com (www.iotogo.com) had asked me to participate as a weekly contributor to their paid subscribers. Previously, I had only supplied them my monthly newsletter to publish on their Home Page open to the public. Each week, they supply a topic and in my second article I was asked to write about how the Presidential Election would impact your taxes. In these articles, they desire me to put on my CPA hat for them. Researching the article to write, I came across some interesting information about each candidates tax proposals and wanted to share it with you. If not for the article, I would have not known myself. Here's an excerpt:

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We've heard a lot that Obama is proposing to reduce taxes for households earning less than \$250,000 per year and increasing taxes for those above that amount. And, if McCain was able to be more articulate, we'd learn that he was proposing to reduce taxes across all income levels as well. To get an idea of the scale of these changes, the TPC's recent executive summary states: "Compared to current law, TCP estimates the Obama plan would cut taxes by \$2.9 trillion over the 2009-2018 period. McCain would reduce taxes by nearly \$4.2 trillion." What is clear is that the Obama plan relies on a redistribution of wealth and the McCain plan does not. All we are hearing is that the Obama plan favors the middle class and that McCain favors the wealthy. Isn't it all about how these issues are being spun?

Note: TPC stands for the Tax Policy Center which is a joint project of the Urban Institute and the Brookings Institution.

Each candidate's tax proposals go beyond individual income tax returns; they also include estate taxes and corporate income taxes. These other taxes do have a significant impact on the economy. Yet, I get the impression that most people are concerned with the individual income tax impacts. So, rather than go through each and every proposed detail, I'm going to cut to the chase and use data from the TCP study to quantify both positions:

Summary Table Using TCP Data of Obama vs McCain's Tax Proposals Expected Federal Tax Change by Cash Income Level for 2009 Tax Year					
Cash Income Level 2008 Dollars (000's)	Obama Plan		McCain Plan		Dollar Difference
	% Change in After-Tx Income	Average Federal Tax Change	% Change in After-Tx Income	Average Federal Tax Change	
Under \$10	8.2%	\$ (444)	0.3%	\$ (13)	\$ (431)
\$10 to \$20	4.6%	\$ (668)	0.2%	\$ (29)	\$ (639)
\$20 to \$30	3.8%	\$ (860)	0.4%	\$ (94)	\$ (766)
\$30 to \$40	3.2%	\$ (997)	0.6%	\$ (178)	\$ (819)
\$40 to \$50	2.9%	\$ (1,098)	0.7%	\$ (262)	\$ (836)
\$50 to \$75	2.2%	\$ (1,114)	0.9%	\$ (446)	\$ (668)
\$75 to \$100	1.7%	\$ (1,236)	1.4%	\$ (975)	\$ (261)
\$100 to \$200	2.0%	\$ (2,125)	2.5%	\$ (2,662)	\$ 537
\$200 to \$500	0.7%	\$ (1,591)	3.4%	\$ (7,293)	\$ 5,702
\$500 to \$1,000	-3.9%	\$ 19,745	2.3%	\$ (11,621)	\$ 31,366
Above \$1,000	-7.9%	\$ 175,117	4.1%	\$ (91,286)	\$ 266,403
All	0.6%	\$ (331)	2.1%	\$ (1,230)	\$ 899

While the Obama plan may be more material for those households earning less than \$50,000 per year, it seems fairly immaterial to most of the middle class and very important to those households earning over \$200,000 per year. In fact, I expect that the over \$200K crowd will be pretty angry. To understand this anger, here is an email from a friend of mine who recently tried an experiment. He wrote me this:

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“Today, on my way to lunch, I passed a homeless guy with a sign that read: [Vote Obama, I need the money]. I laughed. Once in the restaurant my server had on an [Obama 08] tie. Again I laughed as he had exhibited his political preference. Just imagine the coincidence. When the bill came I decided not to tip the server and explained to him that I was exploring the Obama redistribution of wealth concept. He stood there in disbelief while I told him that I was going to redistribute his tip to someone who I deemed more in need - the homeless guy outside. The server angrily stormed from my sight. I went outside, gave the homeless guy \$10 and told him to thank the server inside as I've decided he could use the money more. The homeless guy was grateful. At the end of my rather unscientific redistribution experiment I realized the homeless guy was grateful for the money he did not earn, but the waiter was pretty angry that I gave away the money he did earn even though the actual recipient deserved money more. I guess redistribution of wealth is an easier thing to swallow in concept than in practical application.”

My friend works in sales and produces great results for his employer. His efforts bring profits to the company and those profits enable the company to hire other people. To me, it seems that creating resentment and promoting a class war, especially among those who help create jobs, just doesn't seem to be worth the difference in proposed tax plan payments. At the same time, McCain's proposals seem to be more tax friendly to business as well. And, business creates jobs also.

Under poor economic conditions, as we are experiencing now, McCain's proposal is more attractive to someone like me. Yet, there is more to the President's job than just taxes. I'll not go into the other platforms of both candidates as I've promised a brief article and was asked to only focus on taxes – thank goodness!