

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

November 10, 2009

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One Year Later - Is It Safe to Take More Risk Now?

A little more than a year ago, the sky was falling – it was hard to believe. In the fall of 2008, the events occurring in the US economy and stock markets seemed surreal. What can we learn from that to help us see where we are headed today?

Before refreshing my memory with research, all I could remember about last year was that I was glued to watching CNBC and felt very insecure about the future. Conversations with people who generally had little to no interest in economic events revealed that they were glued to the financial news networks as well. Everyone was looking for answers to understand what all of the bad news meant. Today, the outlook appears more optimistic and many are trying to determine what opportunities lay in the aftermath of the Great Recession. Is the danger really over and are we really in a recovery?

Looking Back

In order to refresh my memory of last year, I went to my monthly article archive. You can review my past articles too using this [LINK](#). Specifically, I re-read “Is a Strengthening US Dollar Good or Bad?” and “Depression Fears: It Doesn’t Have To Be”. While the article titles were very telling about the state of affairs back then, they only scratched the surface of what we were facing.

Currently, the US Dollar is experiencing a relatively steep and prolonged downward trend against major currencies. Yet here’s what was happening back then:

“During August, the USD appreciated most against the Australian Dollar (10.5%), the British Pound (8.8%), the Euro (6.2%) and the Canadian Dollar (4.0%). These are pretty big moves for one month’s action...It is also noteworthy that the price of WTI Crude Oil declined roughly 6.9% over the same period.”

“Since the US is the world’s largest importer of foreign goods and services, a stronger USD should help ease inflationary pressures. And, given the oil shock we’ve experienced this year, we could certainly use some relief, no matter how modest or gradual...”

In similar fashion, a strengthening USD disadvantages US exports of goods and services. It makes it harder for US companies to compete in the global marketplace. It also makes it less affordable for foreign tourists who are considering travel to the US. This spells potentially bad news for our struggling economy. If, as a result, US companies have to absorb price cuts or ... slash production, this will lower profits and ... increase job losses.”

“All in all, the strengthening US Dollar [in the long-run] will help to curtail inflation in the US. While an export-led recovery might have been the better path to prosperity, it has

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always been the US consumer and small business that has led us out of our recessionary cycles ... In that regard, a stronger USD is a good thing."

While the strengthening USD last fall was neither significantly positive nor negative, in retrospect it was the calm before the storm. Here's what happened in September of 2008:

"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 ... 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 ... what has happened this month has thrust us into uncertain times and the circumstances are similar to what precipitated the Great Depression in 1929."

"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... The take over decimated the common and preferred shareholders who invested [in them] and put their capital at risk."

"On September 14th, Lehman Brothers announced they filed for bankruptcy and Merrill Lynch agreed to sell itself to Bank of America ... Lehman was simply too big to fail and so was Merrill ... 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 that the Reserve Fund's primary money market fund had "broken the buck" ... this means that the value of each share in it had fallen below the standard of \$1 ... 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 ... R Fund reported that they had held Lehman debt and took too much of a loss when Lehman filed bankruptcy."

"The AIG problem was totally unexpected ... when AIG's credit rating dropped [had its rating downgraded], the [credit default swap] contracts [it insured] stipulated that AIG would have to put up additional cash as collateral...AIG had more than enough assets and capital, but not enough cash ... Given the size and breadth of AIG, if they filed BK, the damage would have been too extensive ... 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 ... the largest contributor to the Great Depression."

"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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The outlook last year was grim indeed.

Where Are We Today?

By October 2009, most US stock market indices have finished higher than where they were twelve months ago. And, the markets are significantly higher than where in March of this year – when all seemed at its worst. On a relative basis, the market's trend is now upward sloping as opposed to downward. Some would say that the market is predicting a recovery; I tend to think that the market's rally is helping the economy recover.

Also, the US Dollar is currently falling against other major currencies. While this brings with it a threat of inflationary forces over the long-run, the fact that commodity prices had fallen significantly over the past year might not be such a bad thing after all. Before the downturn, inflation was threatening US consumers who were on a spending binge that was unsustainable. And, much of that spending was done with borrowed money.

One popular definition of inflation is “too many dollars chasing too few goods”. In the past, the “too many dollars chasing” component had been significantly funded from borrowed money. Now the US consumer and the US banking system are going through a process of deleveraging and this process will take several years to work off. As a result, the US consumer has no choice but to spend less and this fact could possibly be sufficient to offset the inflationary impact of a falling US Dollar. At the same time, a falling US Dollar makes US goods and services more attractively priced for foreign consumers. The ability to increase our exports might afford us more benefit for now.

Most importantly, however, is that the banking system seems to have stabilized. The housing market is showing signs of improvement. Corporations have endured such significant cut backs that they are finding the ability to show increased profits from less sales revenues. And, the US consumer is beginning to modestly open their purse strings. These signals all point to the US economy going through rebuilding mode. The only signal that appears to be lacking is improvement in the jobs outlook. But as employment has historically been the most lagging economic indicator, we are usually far into a recovery before any marked improvement can be seen.

In my humble opinion, we are in a recovery that has sustainable potential. However, because of the “deleveraging” factor, I believe that any expansion will be far more gradual than how our economy contracted. For this reason, I am less concerned about having to plan for runaway inflation. Yet in the words of the famous economist, John Maynard Keynes: “When the facts change, I change my mind. What do you do, sir?”

To me, these signs are clear – from where we were earlier in the year, the “trend is your friend” for taking on a little more risk. And, the U.S. holding artificially low interest rates is our Government's way of promoting risk taking at present as well.

Market Update

While it seems all but certain that we are in recovery mode from the Great Recession, October dealt investors their first monthly loss in the past seven months. Some may say

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that we needed a correction as the markets had moved upward too far too fast and are significantly over-valued. Others are saying that we are in for a double dip recession due to a constantly falling dollar and an unemployed consumer who is “up to their neck” in debt. Maybe there is a little truth to both observations and, yet, neither explains why the markets are reaching new highs in the first two weeks of November.

At the end of October, Barron’s Vito Racanelli wrote that “The Easy Money’s [already] Been Made”. However, I don’t think it was easy at all. With the level of fear that was prevalent in early March, it took much effort to “read the tea leaves” and gather the guts to get invested by mid-March to capture most of this bull market run. Many missed it. If I had to edit his article’s title, I might have written it as “The Biggest Gains Have Already Been Made”. Unless Washington gets in the way of this recovery, it looks like the long term trend will continue upwards, perhaps, at a more modest pace. Yet, I do expect there to be many shallow corrections along the way. As long as the economic numbers and corporate profits keep showing improvement – and I’m optimistic they will – we should see the stock markets grind gradually higher.

Until some facts come along that prompt me to change my mind, I’ll be looking to buy equities on market dips (corrections) and take some profits (sell) into rallies. Getting greater international equity exposure is on our agenda as well. Yet, one must be mindful that the US Dollar might have fallen too much as well.

We sat in our hands for most of October. As a result, we continue to maintain average cash balances above 20%. Our ETF Strategy, in October, under-performed most indices except for the Russell 2000 index (U.S. small cap stocks). We were DOWN 3.96% (after management fees) for the month. However, on a year-to-date basis, we continue to look pretty good. Here are some comparative numbers for you to review:

	Oct 2009	3 Month	Y-T-D	1 Year
ELF's ETF Strategy (net)	-3.96%	4.09%	28.11%	15.82%
S&P 500	-1.98%	4.93%	14.72%	6.96%
Russell 2000	-6.87%	1.09%	12.68%	4.70%
MSCI EAFE Index	-1.29%	7.53%	23.87%	23.73%
MSCI All County World	-1.62%	6.18%	24.11%	19.68%

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.

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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