

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

December 9, 2009

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Commercial Real Estate, Credit & Taxes

If you've been watching the financial news networks, particularly CNBC, you've heard that it might be a great time for investing in REITs (real estate investment trusts) right now. Geez, I've got to admit that the hype sounded pretty enticing as this was a sector that I hadn't put any money to work into this year. Is it really a good time to invest in REITs?

Whenever someone passes along a "hot" investment tip, you always have to ask yourself whether you are arriving early or late to the party. When investing, the best gains are awarded to those who come early; while late attendees more often than not find themselves "picking up the tab". And, it is always smart to do a little homework first - especially, when you manage OPM (other people's money).

So, is it a good time to be investing in commercial real estate? As with any topic that is not so easily explained, the simple answer would be: "it depends".

In this month's letter, we'll take a "top down" look at the commercial real estate sector and briefly review some facts for you to consider. We'll also discuss the role of credit in our recovering economy and offer up some last minute thoughts about year end tax planning.

Is it a Good Time to Invest in Commercial Real Estate?

Currently, commercial real estate vacancies are high and many are experiencing weakened cash flows. Federal Reserve Chairman Ben Bernanke said in a speech last month that demand for commercial property is down, causing a "sharp deterioration in the credit quality of commercial real estate loans on the banks' books and on loans that back CMBS (commercial mortgage-backed securities)."

In addition, Bernanke warned that many banks will be facing decisions on whether they will need to roll over maturing debt or foreclose on loans. At the same time, Ben also said, however, that he didn't think the overhang of CRE loans was much of a threat to the economy - not a potential cause for there to be a double dip in the economy.

In an article written by Sibley Fleming, of the National Real Estate Investor, it was discussed that "mortgages originated in 2006 and 2007 are experiencing the most significant shortfalls in current cash flow relative to current debt service obligations." The article highlighted two of the largest concerns facing the CRE loan market at present. First, the number of loan delinquencies has inched up in the 3rd quarter of this year; and, second, many of the loans that were written in 2006 and 2007 will be maturing in 2011 and 2012. It might be helpful for me to note that, while most CRE loan terms allow for

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payments to be made based upon a 30 year amortization, the majority of them will balloon (mature) in 5 years and a lesser amount balloon in 7 or 10 years.

Not only does the CRE sector have vacancy rate challenges, additional challenges could arise when the existing mortgage loans balloon and need to be refinanced. If a CRE property has little or no equity left in it – from falling property values – then investors may have to pony up additional capital – if they have it – or face a potential foreclosure event. And, foreclosures would definitely cast a prolonged dark cloud over the CRE sector.

While these concerns are valid, negative outcomes are less than certain and positive developments could definitely occur between now and 2011. As a rule of thumb, CRE fortunes are thought to be inextricably linked to the health of the labor market. And, last month's labor report reflected that there were significant increases in temporary labor hiring. After a recession, increases in temp hiring often signal that the employment market is turning for the better. This could be due to holiday season hires, yet it is a fairly significant indicator none the less. As well, given how REIT securities have been trading since mid-summer, I think "Mr. Market" has given the CRE sector the benefit of the doubt.

According to Barclays PLC investment banking head Bob Diamond, "it is really clear that there's serious money coming into good [CRE] opportunities over the last three to four months, which is the first time we are seeing that since the crisis began." And, publicly traded REIT securities appear to confirm that sentiment. Over the past few months, the real estate sector has been outperforming analysts' expectations and surprising investors. This recovery in prices has also boosted exchange traded funds that track the sector.

When you put these puzzle pieces together, it would seem that there are some opportunities to invest directly into CRE at the moment. There have been plenty of "green shoots" in the second half of this year that strongly suggest the economy is turning the corner and these signals can only be optimistic for the sector.

However, it would also seem that the biggest gains have already been made if you were seeking to invest in publicly traded REITs for now. At current levels, it looks like investors have already discounted that the sector will recover and it may be safer to see the real health of the sector improve before chasing this asset class. Yet, if REIT stocks trade down 10% or more over the next couple of months, I might have to reconsider investing in them as I'm a long term believer in the asset class.

The Importance of Credit

In reviewing articles for this month's letter I came across an interesting passage, providing a vivid explanation of the importance of credit in an economy, to share with you. The following was found in an article written by CB Richard Ellis' research:

"Metaphorically, the economy runs like the human body. We both have our parts – feet (autos), hands (technology), mind (information), etc. – as well as a circulatory system. Without the circulatory system, neither the human body nor the economy can function.

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The financial system is the economy's circulatory system. Like the arteries that carry blood within the human body, the financial system circulates credit that nourishes our economy. For instance, retailers borrow to buy inventory to sell, manufacturers borrow to buy raw materials and other inputs, and families borrow via mortgages to buy homes, or for loans to finance cars or higher education. If the circulatory system fails, so does the body, and if the circulatory system is slowing and pressure drops, a slowing or malfunctioning financial system leads to recession or worse. This is precisely what happened in the Great Depression of the 1930s to which the current crisis is sometimes compared."

"The word credit is derived from the Latin "to trust". Lenders give funds to borrowers charging an interest fee, and trust that they will be paid back... when trust is eroded in the financial system, the arteries of the circulatory system are clogging..."

Last Minute Tax Planning Thoughts

It's widely expected that in 2011, the current capital gains and dividend tax rates will be higher. This is pretty certain whether our elected officials in Washington, DC enact new legislation or not. This is because the legislation enacted by former President George W. Bush is set to expire at the end of next year.

As such, it will be important to consider the 2009 and 2010 tax years together as you mull over your potential options. The best strategy is one which assists you in cutting your total tax bill over both years, not just the current one. Most filers will benefit by accelerating their deductions from 2010 into 2009 and deferring income into 2010. But if you expect to be in a higher tax bracket in 2010, you might want to consider the reverse – delaying deductions and accelerating income. Income tax rates won't change in 2010 as the Bush tax cuts are set to expire after 2010 – raising the top tax rate back to 39.6%. I don't expect that Congress will act to accelerate that change and it is unlikely that any surtax on high income earners won't arrive until after 2010. Yet, you can expect that the new health care overhaul will only add to the tax rate burdens on high income earners.

For more specific ideas to consider before year's end, my November 2008 tax planning letter is still valid. You can review that article at this [LINK](#).

Lastly, get your books in order early. While this goes without saying, you'd be surprised by the number of taxpayers who wait until the very last second to start pulling their financial lives together. For business owners, make sure all business expenses have been paid and entered into your accounting system as well as final invoices sent out. Check to be sure all details surrounding payroll are in order and your tax and other important papers are organized heading into the New Year. If doing your own books takes too much time away from your business efforts, you might consider hiring someone to help. Their expertise might more than pay for itself.

Market Update

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Media pundits have been preaching that the US stock market is fairly valued at present and that gains could be modest from here into early next year. And, when looking at the indices for the S&P500 (US large cap stocks) and the Russell 2000 (US small and mid cap stocks), the trailing twelve month P/E multiples are reported at 16.05 and 17.04 respectively – as of this writing.

Yet, for a market that is clawing its way back from the worst recession in many of our lifetimes, these P/E ratios appear quite modest. For a quick primer on P/E ratios, you can look at my June 2009 article [P/E Valuation 101: Beauty is in The Eye of the Beholder](#). If you believe that the economy is recovering, the potential for P/E multiples to expand from these levels appear probable and, at the same time, companies currently have significant operating leverage from all of the cost cutting they've done over the past year and a half. This operating leverage only serves to set the stage for above average earnings growth over the near term should the US economy continue to achieve modest GDP growth.

Until some facts come along that prompt me to change my mind, I'll continue a strategy of buying equities on market dips (corrections) and look less to take profits (sell) into rallies.

We modestly added to positions during the month of November. And, we rebounded nicely this month after registering a loss in the prior month of October. Our ETF Strategy, in November, was UP 5.71% (after management fees) for the month. And, on a year-to-date basis, we continue to look pretty good. Here are some comparative numbers for you to review:

	Nov 2009	3 Month	Y-T-D	1 Year
ELF's ETF Strategy (net)	5.71%	7.66%	35.42%	35.85%
S&P 500	5.71%	7.32%	21.27%	22.22%
Russell 2000	3.01%	1.34%	16.07%	22.53%
MSCI EAFE Index	1.75%	4.04%	26.03%	33.50%
MSCI All County World	3.92%	6.75%	28.98%	33.45%

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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