

**ELF CAPITAL MANAGEMENT, LLC**  
*(ENDOWMENT LIKE FUND MANAGEMENT)*

December 20, 2011

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## **It's a Bah! Humbug! Market This Year**

Have you thrown your hands up in disgust over gyrations in the stock markets yet? Are you puzzled by hearing financial media pundits talking about “risk on” trades on one day and “risk off” trades the next. If so, you might not be alone. This has been one tough investing climate for the average investor as well as for professionals.

Immortalized by Charles Dickens, A Christmas Carol, Ebenezer Scrooge declared Christmas to be a fraud accompanied by the words, “Bah! Humbug!” In present day, Wikipedia notes that this saying refers to something small and inconsequential that makes a lot of noise. Many stock markets around the world will likely close down or flat for the year and the frightening volatility created great noise. Bah! Humbug!

In this week's Barron's feature article, it was reported that “84% percent of large-cap growth fund managers were trailing their respective benchmarks this year”. And, “most mutual-fund managers have underperformed year to date, following a similarly disappointing 2010.”

Traders – those who buy and sell based upon the momentum of the markets – have found themselves challenged with the ever changing trends. Normally, traders find pleasure in a volatile market because of the continual opportunities that it brings. And this would be an accurate assumption if not for constant news about sovereign debt challenges in Europe causing rapid changes in momentum that was not anticipated. Many found themselves on the wrong side of the market.

Fundamental investors – those who try to gauge the earnings dynamics of a country, industry or company to guide their investing activities – have also been perplexed. In a relatively stable economic environment with interest rates as low as they are now, stock market prices can be considered to be attractively low. Like the Pavlov's Dog experiments, fundamental investors are conditioned to desire buying stocks when faced with what appears to be bargain prices. However, evolving risks from the Euro-zone can cause valuations to waffle wildly and many have found themselves having to reset their expectations on an almost daily basis.

This article highlights the significant forces that have unsettled the markets this year, what will be important for any improvement to occur next year and why politicians across the globe should either read a copy of Dickens, A Christmas Carol or watch one of the movie versions there from this holiday season. My personal favorite film was the 1951 version starring Alastair Sim as Scrooge.

## **Why All the Volatility?**

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Two significant forces were battling each other this year: Without the specter of a sovereign debt crisis, stocks can be considered to be very inexpensive right now. While U.S. and Asian economies appear to be on a modest growth path, any negative outcome from the Euro-zone's sovereign debt crisis poses significant risk to Europe's economy and economies across the globe. Risk plays a significant role in the mathematical stock valuation process and the resultant calculations can go from believing the market is cheap to believing it is expensive in seconds.

Let me illustrate using a simple discounted cash flow valuation model. The DCF model is one of the most widely used and accepted valuation methods adopted by most professional analysts. In its simplest form, the model looks like this:

$$\text{Calculated Value} = \frac{\text{The expected future value of cash flows projected from the investment}}{(1 + \text{Risk Free Rate} + \text{Risk Premium})}$$

For the sake of time and efficiency, let's only focus on the "Risk Premium" and how it can impact the calculation. The "risk premium" can be explained as the extra return investors demand to be compensated for the risk that the "expected future cash flows" might not materialize as projected.

Let me do some of the math for you.

First, let's say that the stock market index is currently trading at 1,220; that the projected future value of cash flows is \$1,510; that the risk free rate is 1%; and there is a 10% chance that the expected future cash flows won't materialize as projected (the "risk premium"). The "calculated value" for the index would be 1,360 and when compared to the current market's trading value of 1,220, the market would look underpriced by approximately 11% - which would be considered relatively cheap.

Alternatively, let's say that the "risk premium" became elevated to 40%. Then, the "calculated value" for the index would be 1,070 and when compared to the current market's trading value of 1,220, the market would look overpriced by approximately 12% - which would be considered relatively expensive.

Couple this concept with the proliferation and challenges posed by High Frequency Trading ("HFT"), as so eloquently discussed in this month's letter from my friends Liam Molloy and Bethany Carlson over at Galway Investment Strategy, and the effects of changes in "risk premium" become factored into market prices very rapidly.

"There must be some easier way to get my wings."

Quoting Clarence Oddbody, the angel from Frank Capra's 1946 version of "It's a Wonderful Life"

## **What to Look for Next Year**

The sovereign debt crisis in the Euro-zone is currently the most visible challenge overhanging the markets. Half or more of the EU member state economies have been unable to effectively compete in the global marketplace and the growing weight of government funded social programs have created what appears to be a debt trap.

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Several counties are arriving at the end of their ability to borrow and service their accumulated debt.

Europe's politicians are challenged to determine the reforms necessary to reverse course. None of the options I've read about offer a solution without pain. The question is whether the pain will be contained or whether it will cause harm to other economies around the world. So far, Europe's politicians have just "kicked the can down the road" hoping for a more palatable solution to surface. However, the walls of debt continue to close in.

Media analysts have discussed that one of the less disruptive strategies involves monetizing the debt – printing money. This would likely cause the Euro currency to become devalued and create inflationary pressures within the EU. Yet, it could also boost European tourism and exports to the detriment of their trading partners – including the U.S. So far, it appears to be the least of all evils. However, this strategy hasn't gained any traction among the EU political elite.

When and if the Euro-zone can solve its sovereign debt challenges, the focus could possibly change to Japan and the U.S. where government overspending and bulging debt loads may also be perceived as being at threatening levels.

Yet, again, as reflected in this week's Barron's feature article "Buckle Up!" "Good surprises could happen too. If Europe gets on firmer footing, a catch up trade could ensue as investor's acknowledge this year's [positive] earnings growth and the possibility of a stronger economy next year. And if the U.S. housing market finally finds a bottom and becomes a net contributor to GDP, that would also be an enormous plus."

### **Some Closing Thoughts**

In early 2012, several European nations will be dealing with a rolling over (a refinancing) of large portions of their sovereign debt. In the U.S., 2012 is a Presidential election year and many important fiscal matters have yet to be resolved. Unless politicians can make significant headway in hammering out reforms, investors concerns over economic and political uncertainties are likely to intensify.

Perhaps government officials could learn a lesson from Charles Dickens', A Christmas Carol. In Dickens short novel, Ebenezer Scrooge, a man of wealth and influence was visited by three ghosts on Christmas Eve. The First was the ghost of Christmas Past who reminded Scrooge of a time when he was more innocent and less rigid in his beliefs and ideologies. The next was the ghost of Christmas Present who subjected Scrooge to several radically different scenes in an effort to provoke a sense of responsibility to his fellow man. And, the last was the ghost of Christmas Yet To Come who presents Scrooge dire visions of the future if he does not learn and act upon what he had just witnessed.

While Ebenezer could have been labeled an ultra-conservative, I would hope that both conservatives and liberals could embrace the ghosts of fiscal policy past, present and future; lest we all may be Scrooged!

Happy Holidays!

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## ELF's Outlook and Performance

September and October exhibited the greatest monthly volatility experienced in all of 2011. From May through September, stock markets around the globe ended each month lower than the month before. Then, in October, markets rebounded with great vigor and then drifted lower once again in November. The struggle between U.S. economic data exceeding expectations – in all but housing and labor sectors – versus the European debt crisis continues pose challenges for investors. For us too! After October's strong rebound, we undertook to raise our cash levels up to the 40% range.

Our portfolio clients ended the month of November down 1.91%. Here are some comparative numbers for you to review:

|                                 | <b>Nov 2011</b> | <b>3 Month</b> | <b>Y-T-D</b> | <b>1 Year</b> |
|---------------------------------|-----------------|----------------|--------------|---------------|
| <b>ELF's ETF Strategy (net)</b> | -1.91%          | -2.17%         | -3.49%       | 0.67%         |
| <b>S&amp;P 500</b>              | -0.51%          | 2.30%          | -0.85%       | 5.63%         |
| <b>Russell 2000</b>             | -0.49%          | 1.46%          | -5.90%       | 1.43%         |
| <b>MSCI EAFE Index</b>          | -5.16%          | -6.32%         | -13.93%      | -7.03%        |
| <b>MSCI All County World</b>    | -3.22%          | -3.27%         | -9.13%       | -2.57%        |

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.

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.

Broad market index information provided is solely for the purpose of comparison. This index data was obtained from third party sources believed reliable; however, ELF does not guaranty its accuracy. An investment account managed by ELF should not be construed as an investment in an index or in a program that seeks to replicate any index. In most cases, investors choose a market "index" having comparable characteristics to their portfolio as a benchmark. An ETF is a security that tracks an index benchmark or components thereof. As ELF actively manages a strategic allocation of primarily ETFs, selecting a comparable benchmark poses significant challenges. Over time, the broad market indices provided above may exhibit more, similar or less variability of returns and risk than ELF's strategic allocation. As well, the broad market index information provided above reflects gross returns and have not been reduced by any estimated fees or expenses that a person might incur in trying to replicate an index.