

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

January 14, 2009

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Your Top Risk Adjusted Money Idea for 2009: Fund Your Retirement Plan!

Are you concerned about preserving wealth? Are you re-evaluating your spending habits? How about your retirement plans? You're not alone. The current economic climate is prompting many households into looking for ways to spend less and save more. So, what do you think is the single largest expense for most households?

If you haven't already guessed, it is income taxes! Did you know that the average wage earner, in Virginia, pays more than 38% of their earnings in taxes; and business owners pay more than 46%? Don't believe me? Here are some charts to help you see how:

Single filers		Married filing jointly	
If your taxable income is over	The marginal federal tax rate is	If your taxable income is over	The marginal federal tax rate is
\$ 0	10%	\$ 0	10%
\$ 8,350	15%	\$ 16,700	15%
\$ 33,950	25%	\$ 67,900	25%
\$ 82,250	28%	\$ 137,050	28%
\$ 171,550	33%	\$ 208,850	33%
\$ 372,950	35%	\$ 372,950	35%

*Based upon federal income tax rates for 2009 under current law.

Social Security & Medicare taxes		Virginia rates (2008)	
For those who are wage earners	For those who are business owners	If your taxable income is over	The marginal state tax rate is
7.65%	15.3%	\$ 0	2%
If over \$102,000, the rate lowers to	If over \$102,000, the rate lowers to	\$ 3,000	3%
1.45%	2.9%	\$ 5,000	5%
		\$ 17,000	5.75%

If you total up the **bolded percentages**, it becomes easier to see how the average Virginian pays 38% in income taxes or 46% as the case may be. Now, look over the charts and adjust for your own income and local tax rates – where do you find yourself?

As we draw closer to April 15th, that special date when individual tax reporting comes due, there are still things you can do to reduce you 2008 taxes and get a head start on 2009 as well. And the way that you can lower your current tax bill is by maximizing your allowable contributions into whatever qualified retirement plan that you have at your availability. It is this writer's belief that, under the current tax laws, qualified retirement plans offer the single most formidable and flexible tax sheltering opportunities available. And, while the

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tax code seems to favor higher wage earners over lower, there is a little known advantage for lower wage earners as well. Have you ever heard of the Saver's Credit?

The Saver's Credit affords low and moderate income American's an ability to save on taxes by saving for retirement. If you are a single filer with an Adjusted Gross Income under \$26,500, married filing jointly with an AGI under \$53,000 or head of household with an AGI under \$39,750, you can receive a credit against tax from 10% to 50% of your qualifying contribution amount. The credit is capped at \$1,000 and there are rules about taking distributions in the prior two years. Also, to be eligible for the credit, you must be at least 18 years old, not a full-time student and cannot be claimed as a dependent on another person's return.

In my regular work as a CPA and investment advisor, I'm always having discussions with others about their personal and business finances. This work exposes me to a broad number of occupations and I wind up preparing client tax returns in more than seven states. As well, from experiences gained when involved in international finance, I also work with US citizens living and working abroad. In the past six months, there have been a number of common themes in these discussions. Many have concerns about the sour economy, want to position themselves defensively and hoard cash, and have lost money in the markets. Over the past couple of months, two retirement planning conversations seem to stand out the most. Here's what I can share with you:

The first involves a law firm partner who learned that he was being required to make a larger than expected contribution to his defined benefit plan for 2008. As a result, he was considering not making any contribution to his defined contribution plan. Sorry for the technical jargon, but the tax codes create a terminology that we all must learn in order to understand how we may pay our fair share.

A defined benefit plan is an employer-sponsored retirement plan where the eventual post retirement benefits are defined by some formula and the employer is solely responsible for making sure the plan has enough money to meet its defined obligations. And, a defined contribution plan is any type of retirement plan that does not guarantee a particular post retirement benefit. Instead, both the employer and or employee can contribute to the plan up to the limits defined by a particular tax law formula(s) for the plan. Among the most common DC plans are Individual Retirement Account's and 401(k) plans.

In the above case, the law firm partner is both an employer and employee. And, due to the plan's poor investment performance, he was being advised that he would have to contribute substantially more than he had in prior years to make up for the current shortfall. At the same time, he was very concerned that his firm's earnings would be negatively impacted by the current economic downturn and was mildly unhappy. He was also spooked by how the economic downturn was impacting his friends and clients.

He stopped by for an open discussion of his retirement plan challenges, his household budgeting and the current investment environment. During the exchange, I laid out his alternatives as I saw them and then listened while he brainstormed his way into developing an action plan that he could be comfortable with. In summary: He chose to fund his defined contribution plan and became content with his defined benefit plan obligation. Despite being spooked by the economy, he felt confident that the investment

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markets would recover in subsequent years and, when it did, his future required DB plan contributions would likely be lower. This same regained confidence helped him decide that funding his defined contribution plan was a good idea as he was buying the market cheaply and could still achieve tax savings through doing so. He was also content that his family lived well within their means and, if needed, he would access his available credit to make up any emergency shortfall. One month later, he learned that his firm's earnings in 2008 had exceeded expectations and he was more than happy with his prior decisions.

The second story involves a business owner who desires to defensively build cash reserves and is concerned about further investment declines. This has kept him from making regular contributions to his company's 401(k) plan. In addition, he has managed the business cash flow well and while sales were down, profits for 2008 were better than expected. Before the end of the year, we discussed his option of making capital asset purchases and taking advantage of allowable accelerated depreciation and expensing elections available to him. He didn't really need to increase his capital assets, nor did he want spend the cash. We had discussed my optimism in the future of the financial markets and that my optimism was not guaranteed to prove out over the near term.

After a lot of listening and testing ideas, the key issues were clear and unwavering: a strong desire to build cash reserves over the next 6 to 12 months; and to keep that money safe from market volatility. So, where do you think the conversation went from there?

It happens that he qualifies and the plan documents allow him to borrow money from his retirement plan. The statutes governing plan loans place no specific restrictions on what the need or use will be for the loans, except that the loan provision must reasonably be available to all participants; subject to limitations, a participant can usually borrow up to 50% of their account balance to a maximum of \$50,000; the loan must bear interest and the interest rate set can be as low as 1% over the "prime rate"; unless used for the purchase of a home, the loan must be repaid within 5 years; and, the loan must require substantially level re-payments at least quarterly over the life of the loan. While the loan must bear interest and those interest payments are non-deductible for tax purposes, he is paying the interest back into his own retirement plan account.

In our last discussion, I recommended that he take enough of a loan for the sole purpose of making his current year retirement plan contribution. The loan idea is not without risk or obligation. If he decides to take the loan, he will be committing to make the payments as described above. And, if he defaults on the loan he will pay taxes and a 10% penalty on the unpaid balance of the plan loan. On the other hand, a default it will not impact his credit unless he can't pay his taxes. In return for this risk, he could take more than a third of the amount borrowed off in tax savings.

To pay more taxes than one has to, or not to pay, that is the question...

As for the economy and capital markets, my current thinking and strategy remains substantially consistent with [my 2009 predictions letter](#). I'm looking for a large US stock market recovery by mid year, but think we have to make it through the middle of February first.

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By mid February, most of the 4th quarter 2008 economic data will have been released and we will be able to quantify just how bad things got. Also, it is quite possible that we could see more hedge fund redemptions hit the market like we saw in November. However, if we see it, another round of hedge fund redemptions might not be as bad because the lion-share of redemptions may have already occurred in November and the money already raised could also be readying to re-enter the market. We will also begin to see greater indications of how the Government's monetary stimulus is having effect – the Federal Reserve Bank and US Treasury have been throwing monumental stimulus into the markets and this stimulus usually takes several months to show effect. As well, we will see the extent of fiscal stimulus that the Obama administration will deliver to the economy and whether Congress will support him or hang him out to dry. By early accounts, many think what Mr. Obama has been proposing might be way too much and lead to runaway inflation.

While I continue to expect unemployment will worsen over the first few months of this year, some good things are already showing up in the economy. Oil prices are staying around \$40 per barrel and if they can remain in that range, from the peak prices last summer, the annual savings at the pump is comparable to the US Government passing a \$425 billion stimulus plan. At the same time, historically lower interest rates are beginning to positively impact mortgage lending and corporate bonds are beginning to show improvement. Yet, we still need to see modest improvement in consumer sentiment before we can rest easy that the worst is over. And, by the time we hear that consumer sentiment has improved, the markets will have left us in the dust. As such, we have taken some of our “dry powder” and increased allocations to US stocks and corporate bonds.

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