

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

January 15, 2010

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## **Will ESO's Gain Popularity?**

Since the New Year began, this is the first time I've had the ability to ring in 2010 with many clients and friends who read my monthly letters – So, Happy New Year to you all. Please accept my best wishes for a happy and prosperous 2010!

For many business owners and employees, January is time when bonuses are awarded to those who've helped their company achieve profits. It is a time when a firm's human capital (AKA, its people) is rewarded for helping the firm increase its financial capital. And, after a frightening year, these bonus payments may be more meaningful than any year prior!

If you've been following the financial news media, you've heard that the banking sector has been posting a strong profit recovery since last year. Washington and the news media have been firing up populist sentiment about how well employees of this sector are expected to be paid. In fact, one financial news commentator who promotes himself as a conservative free market capitalist seemed to be begging for more financial regulation over how bankers should be paid this bonus season.

Larry Kudlow, I greatly admire your work – which I've followed since you were chief economist at former Bear Stearns in the 1980's. Yet, the dialogue since your January 11<sup>th</sup> show confuses me as to whether you are seeking to manage populist sentiment or are becoming more liberal in your beliefs.

Before Larry's evening tirades, however, several major banks were already planning to pay bonuses this year in a more creative way – part cash; and part equity that vests over a period of time. And, these payments have the potential of being taken back (clawed back) under certain circumstances. With this type of pay plan, the equity portion is supposed to reward employees for past performance in a way that incentivizes/motivates them to create sound profit performance over the longer term.

This sounds a lot like the ESO programs that are fairly common to employees in the technology sector. So, are ESO's soon to be popular again?

## **What Are ESO's and Why Might They Gain Popularity?**

Before I continue, it probably helps to explain that ESO is an acronym (abbreviation) for Employee Stock Option. Unlike the tradable option contracts that are created by financial institutions and traded in the open markets, these are stock options issued by a company granting an employee the right to buy its shares at a stated price (the exercise price) on or before a certain period of time (the exercise period).

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ESO's can be an excellent tool for providing a number of financial advantages to a company. And two prominent uses, as this economy recovers from a harsh downturn, seem to be the ability to: (a) tie employee compensation to company performance and (b) provide a cost efficient capital raising mechanism for the employer to finance growth.

The popular thinking today is that cash bonuses only serve to reward employees for taking undue risks in their efforts to generate profits. Management consultants commonly refer to this as an "agency problem". This conflict, or agency problem, arises when people (the company's employees) entrusted to look after the interests of others (the company's shareholders) use their power and authority for their own benefit instead. However, this is not only a problem that pervades corporations, such can be found in clubs, churches and in Government as well.

As we look at what contributed to the worst economic downturn in most of our lifetimes, I think we all might agree that it came about as a result of a "bursting" of a credit lending "bubble". It's been explained that "greedy" people facilitated lending other people's money without regard to whether or not the borrowers could repay. This problem fell apart when investors began to realize that no one was looking out for their interests and, as a result, headed for the exits. What ensued was a loss of confidence in our financial system which brought us to where we are today. This is an over-simplification of the cause and blame should be spread quite broadly amongst individuals, business and Government.

Despite this, if employees are awarded equity, or options on equity, their interests become aligned with the interests of the shareholders. So, using ESO's might offer a great "free-market" way of ensuring against the kind of short-term thinking that contributed to the busted credit lending bubble we are experiencing.

Another result of the current economic downturn is the lack of available credit for new and recovering small to medium sized businesses. Yes, we are hearing that demand for credit is at an all time low. However, those statistics include all borrowers – both businesses and individuals. While the personal savings rate is on the rise, overly strict lending standards are challenging small and medium sized businesses ability to access capital. And, in each economic recovery over the past century, it is small business that led us out of recession and created the jobs needed to sustain economic recovery and growth.

For a growing company, ESO's can align employees with shareholder interests and offer a viable source of cost efficient capital to finance that growth. How so?

### **An ESO Example**

Let's take a look, through a simplified illustration, at how an ESO creates alignment with employees and shareholders as well as providing the company a source of capital.

In this example, let's say that XYZ Company awards stock option contracts to one or more of its employees. XYZ's stock is currently worth \$10 per share and the Company's Board and shareholders have adopted a plan that allows it to issue stock options. XYZ's stock is publicly traded. Each currently issued stock option gives the holder the right to purchase

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1 share of XYZ Company's common stock for \$10 (the exercise price) within the next ten years (the exercise period), subject to a vesting schedule requirement. XYZ awards 1,000 stock options to Employee A in reward for his/her positive efforts over the past year and as an incentive to continue such successful performance in the future.

By the way, vesting is contractual term that limits the number of options available to be exercised until some period of time passes. In this example, let's assume that 10% of the stock options are immediately vested and the remaining amount vests 30% annually over each of the next three years. Hence, 100% of the stock options currently awarded are available for conversion into common stock after three years.

So after the stock options are awarded to Employee A, assuming XYZ's stock price is still at \$10 per share, the 1,000 options awarded have zero intrinsic value. For this scenario, intrinsic value is the difference between XYZ's Stock price (\$10) and the options exercise price (\$10) – because \$10 minus \$10 equals zero. However, the option does have value to Employee A because of the 10 year right to purchase XYZ stock at \$10 per share.

Now, let's fast forward three years and assume that XYZ's stock is trading at \$25 per share. Employee A's fully vested stock options now have an intrinsic value of \$15,000 ( $[\$25 - \$10]$  times 1,000 share options).

At this point, I hope it is easier to see how Employee A's financial interests are aligned with those of the shareholders. As the Company's share price increases in value, so does the value of Employee A's stock options.

But, how does this help XYZ Company raise capital? Let's say that Employee A wants to convert the stock options into cash; or, he/she wants to manage his/her future income tax burden. In order for Employee A to pursue either of these avenues, the options need to be converted into stock. When the option is exercised, Employee A will pay \$10 per share to XYZ. If all are exercised, Employee A will pay \$10,000 ( $\$10$  times 1,000 options) and XYZ will issue Employee A 1,000 shares of its stock. Then, Employee A can sell the shares in the open market or hold them longer term to achieve potential income tax savings. In short, the exercise price goes into XYZ's coffers.

### **ESO's and Income Taxes**

Above, I discussed how Employee A might want to manage the income tax effect. This supposes that Employee A is a US citizen. ESO's do have some income tax advantages; and, under the US Tax Code, the advantages vary. The degree of tax savings are greatest if the ESO plan qualifies under certain rules and the employee follows the prescribed procedure upon exercise and sale.

Under the tax laws, when you receive an option to buy stock as payment for your services, you may have income when you receive the option, when you exercise the option, or when you sell or otherwise dispose of the option or stock (acquired through the exercise of the option). Generally, the timing, type, and amount of reportable income depend on whether you receive a non-statutory stock option or a statutory stock option. Statutory stock options are also referred to as Qualifying Stock Options (QSO's) or

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Incentive Stock Options (ISO's); while non-statutory stock options are often referred to as Non-Qualifying Stock Options (NQSO's). So that you don't fall asleep on me, I won't go too deeply into tax law.

However, before going any further, it is important to impress upon you that the rules for characterizing ESO's on an income tax return are quite involved. Due to the complexity, it is important that you speak with a tax professional soon after you receive them to determine what your tax obligations are. With ESO's, it is always wise to plan in advance if you want to maximize the value.

To keep this simple, let's continue with the facts of the illustration above:

Example A: the ESO's are Non-Qualifying Stock Options

We already know that the ESO's had no intrinsic value when granted and we'll just assume that the time value of the options was not determinable when issued. In this case, there is no reportable income when the options were granted. Instead, Employee A will have reportable income when he/she converts (exercises) the options for stock.

Let's suppose that Employee A converts all 1,000 options after 3 years – when XYZ's stock is trading at \$25 per share. Upon exercising the option, Employee A will have \$15,000 of reportable income – this income will be taxed as compensation that is subject to Social Security and Medicare taxes (AKA employment taxes). Also, at conversion, XYZ can expense \$15,000 as compensation expense, pays the employer share of payroll tax and receives \$10,000 in cash (the exercise price times the number of options exercised).

As a result, Employee A owns 1,000 shares of XYZ stock with a cost basis of \$25 per share (the \$10 paid plus the \$15 included in income). Employee A can either immediately sell the stock for cash or hold the shares as an investment. In either scenario, he/she would report the sale as a Capital Gain or Loss transaction on Schedule D. And, the holding period begins on the date Employee A exercised the option.

Example B: the ESO's are Qualifying Stock Options

Now, let's suppose that XYZ crafted their stock option plan in accordance with US Code section 422 (of Title 26) relating to Incentive Stock Options.

For Qualifying Stock Options, no income tax or employment taxes are due when the options are granted or when they are exercised. Instead, the tax is deferred until Employee A sells the stock, at which time he/she is taxed on the entire gain. As long as the sale is at least two years after the options were granted and at least one year after they were exercised, they'll be taxed at the lower, long-term capital gains rate. If these rules are not followed, the sale is considered a "disqualifying disposition" and the transaction is taxed as if they were Non-Qualifying Stock Options.

There is one important caveat, however. While there are no income or employment taxes due when QSO's are exercised, any gain would be recognized as a tax preference item for figuring the Alternative Minimum Tax (AMT). This may trigger AMT in the year that the

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option was exercised and any AMT tax paid, as a result, would not be used to increase the taxable basis of the stock like in the NSQO example above.

It is also important to note that stock options are not only granted to employees. Some companies grant these options to non-employee Board members and independent contractors for their services. In these cases, the options granted to these parties are always treated for tax purposes as Non-Qualifying Stock Options.

So, while the taxation of ESO's are a little challenging to grasp, they can be an excellent tool for their ability to: (a) tie employee compensation to company performance and (b) provide a cost efficient capital raising mechanism for the employer to finance growth.

### **Market Update**

Despite the continual warnings from media pundits that US stock markets were fairly valued since the end of November, the markets rose higher in December and in the first week of the New Year. These pundits had been creating a "wall of worry" that Mr. Market just seemed to ignore. We ignored the worry as well.

To us, the optimistic factors are those leading economic indicators that appear to be reflecting we are in a recovery, coupled with the belief that corporations have cut expenses so efficiently that even modest revenue increases will provide significant profit growth over the next quarter or two. As we are just beginning to receive corporate earnings reports for the December quarter just ended, we remain optimistic that they will show signs of a recovery gaining momentum.

At the end of the first week of 2010, the Dow Jones Industrials and every other major US stock market index rose strongly. In the Dow's history, this type of market action has led to further gains for three out of every four years. While we tend to give short shrift to these types of indicators, sometimes it just does not pay to fight the tape.

We'll continue to assess economic indicators as the data rolls in over this year's first quarter and reassess our optimism. The only events that draw concern for us is – what will happen when and if Washington begins to dial back its monetary and fiscal stimulus efforts? Until some facts come along that prompt me to change my mind, I'll continue a strategy of optimism.

Our current allocations, including our special situation stocks, gave us a nice boost in December. As a result, we ended 2009 solidly besting each of the major market indices we compare ourselves to. We ended the month of December UP 5.83% and finished 2009 UP 43.31% - turning in our strongest yearly performance yet. Here are some comparative numbers for you to review:

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	<b>Dec 2009</b>	<b>3 Month</b>	<b>Y-T-D</b>	<b>1 Year</b>
<b>ELF's ETF Strategy (net)</b>	5.83%	7.43%	43.31%	43.31%
<b>S&amp;P 500</b>	1.78%	5.49%	23.45%	23.45%
<b>Russell 2000</b>	7.88%	3.49%	25.22%	25.22%
<b>MSCI EAFE Index</b>	1.36%	1.80%	27.75%	27.75%
<b>MSCI All County World</b>	1.96%	4.25%	31.51%	31.51%

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.

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.