

The National Christian Foundation

Investment Strategy Report

December 31, 2008

NCF Investment Pool Overview

The NCF investment management team has been working to reduce the risk characteristics of our investment pools since the 3rd quarter of 2007, while still honoring the targeted allocations of 80%, 60% and 40% equities in the Growth, Balanced and Conservative pools, respectively. As a result of those modifications, the 4th quarter, one-year and three-year numbers of all the pools are dramatically better than their benchmarks. Over the course of the year, our caution was increasingly effective in limiting losses.

It is difficult to overstate the problems in the stock market over the past year. The S&P 500 declined by 21.9% in just the last three months of 2008, bringing its full year loss to nearly 37%. International markets fell even more sharply with the MSCI EAFE Index, which measures developed markets, declining by 43.4% for the year and the MSCI Emerging Markets Index posting the worst calendar year performance in its history, falling 53.3%. Because the credit crisis had such a severe impact on financial companies such as banks, securities brokerage firms, insurance companies and other lenders, the corporate bond market was also hurt. The Merrill Lynch Corporate Master Index declined by 6.8% for the year and the Merrill Lynch High Yield Master Bond Index declined by 26.15% for the year.

Among traditional asset classes, only US Treasury Bonds had positive returns in 2008, benefiting enormously from the so-called “flight to quality” in which fearful investors sold whatever they owned and purchased government bonds. One to three year treasuries gained 6.59% for the year while longer-term, 10 to 15 year treasuries gained 17.23% for the year. While good news for the holders of such bonds, it also meant that yields on cash dropped to record lows. Yields on the 90-day US Treasury bill were near zero in the fourth quarter. It is against this background that we want to briefly revisit portfolio changes the NCF Investment Management team has made over the last 18 months so we can highlight the benefit of those changes.

NCF Portfolio Reductions

In the third quarter of 2007, NCF began repositioning its portfolios for a more defensive stance. Our first action was to reduce our allocations to long-only equities by approximately 25%. We did that by selling completely out of our real estate investment trust (REIT) positions as such securities tend to perform very poorly during recessions. REITs, as measured by the NAREIT index, have lost roughly 50% of their value since we moved out of those positions. We also reduced our exposure in the Growth pool to small capitalization US stocks and in the balanced and conservative pools to our core, all capitalization US equity holdings. Those positions have declined by 38% to 40% since we reduced our exposure.

Secondly, we also reduced our holdings of corporate debt in all pools by liquidating our investments in the bonds of financial companies. We have already noted above the difference between the losses that occurred in corporate bonds and the gains earned in US Treasuries. One reason for the strong performance of our laddered bond portfolio and of our actively managed fixed income portfolio was the absence of corporate credit exposure and the heavy reliance on US Treasury bonds.

In that same vein, we greatly reduced our investments in the shares of financial companies such as banks and other lenders. As poor as the equity performance was in our portfolios, it would have been considerably worse had we not reduced our exposure to financial stocks. The NYSE Index of financial stocks declined by an unbelievable 53.53% in 2008 **after** having lost roughly 10% in the 4th quarter of 2007. We have been blessed to not be so deeply involved in those losses.

NCF Portfolio Additions

With the funds we had available as a result of the just described reductions, we then added a 10% exposure to hedge funds in January of 2008, which we subsequently increased to 20% by October of 2008. These allocations also proved their defensive mettle, declining very modestly in comparison to the stock market allocations they replaced. Our first investment was with Common Sense Investment Management LLC, headquartered in Portland, Oregon. Common Sense (CSIM) manages more than \$4 billion entirely in funds of hedge funds. The particular entity through which we invest places its funds into Common Sense Partners, which is their longest established fund of funds dating back to 1991.

Our second allocation, made later in the year, was to Alpha Titans, another fund of hedge funds headquartered in Santa Barbara, California. Unlike Common Sense Partners which has allocations to 38 mostly smaller hedge funds, Alpha Titans makes fewer allocations and restricts them to very large, very well established, industry-leading multi-strategy hedge funds. Alpha Titans currently has allocations to eleven managers, each of whom, on average, has \$14 billion in assets under management and each of whom, on average, has been in business for 19 years. Across all three of NCF's equity holding pools, we have 10% to 12% invested with Common Sense Partners and a comparable percentage with Alpha Titans. As these are both fund of funds, our pools' largest single position in any one hedge fund is less than 1.5% of the value of any pool, with most of the allocations considerably smaller. This represents excellent diversification and an added layer of safety.

Both of our fund of hedge fund managers had outstanding performance for 2008. Alpha Titans was down just under 11% during the time we were invested with them, which happened to coincide with the largest declines in the market. Common Sense Partners, meanwhile, was down a mere 3.81% for the full year of 2008. To put this performance in perspective, every dollar invested with these managers was taken from "long-only" equity managers whose performance was roughly in line with the S&P 500. We exchanged "down 37%" for "down 4% and 11%," respectively. As an interesting and encouraging aside, both hedge fund managers were up by 2% or more in the first month of 2009, when the S&P 500 was down a further 8%. We are very pleased with these additions to our investment pool environment.

Conclusion

We are committed to creating an investment environment for NCF donors with choices that focus primarily on capital preservation. We hate losing money! But in order to have a reasonable chance of protecting and preserving longer term funds, it is necessary to have investments that can grow at a rate greater than long-term inflation. Therefore, we have equity allocations that sometimes, in years like 2008, lose value. We will continue to do our best to strike the right balance between the need for safety and the need for future growth. In that regard, we will be making additional portfolio changes in the near future so please check our website periodically to watch for our next New Allocation Report. Thank you, as always, for allowing the National Christian Foundation to help support you in your charitable giving.

Additional Information

This Market Overview is part of a more complete performance report that is available on-line in the "Forms & Reports" section of the NCF website: www.nationalchristianfoundation.com.