



# Investment Strategy Report

December 31, 2009

The NCF investment pools reflect our commitment to creating an investment environment with choices for NCF donors that focus primarily on capital preservation. There is no glory or benefit in losing hard-earned charitable funds. Therefore, we seek to generate investment returns in ways that reflect our very low tolerance for capital losses.

We are delighted that the NCF pools continue to deliver superior investment results, as described in our quarterly Investment Performance Report. We are also pleased that the pools have achieved these results as a direct result of having taken a lower-risk approach to portfolio construction.

In this quarter's report, we will discuss in greater detail some of the portfolio design components that grow out of our investment philosophy. In particular, this report will highlight some of the ways we remain hopeful and continue to invest in the face of sometimes daunting economic news. We hope you enjoy the opportunity to look behind the numbers at some of our thinking and analysis.

## Global Market Overview

The global equity markets continued their advance during the fourth quarter. The U.S. stock market, as measured by the S&P 500 Index, posted a quarterly gain of 6.0% - boosting its full-year 2009 performance to 26.5%. Globally, developed international markets rebounded by comparable amounts while shares in various emerging markets soared. The exchange traded fund, EEM, through which our pools gain exposure to emerging markets, was up more than 50% for the year. [And up more than 80% from our entry point in Mid-March].

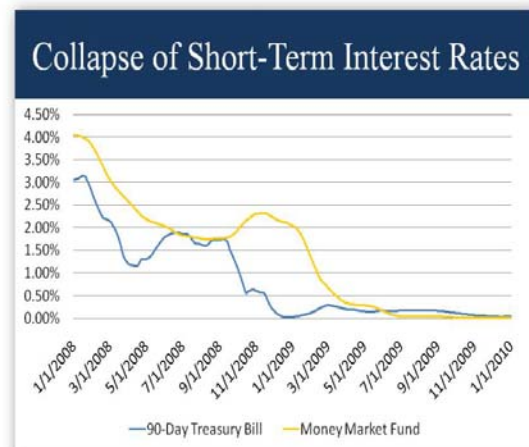
At the same time, however, the underlying US economy continued to struggle, threatening not just the sustainability of the rally in domestic share prices, but also the global recovery from the recent recession. The most pressing concern in the US is an unemployment rate that remains stubbornly in the 10% range - near a 26-year high. All told, 1.7 million people left the work force in the last six months of 2009,

representing the biggest percentage decrease since 1961. Many other dismal data points – like falling home sales, industrial production, consumer credit and income tax receipts – complete the mosaic of an economy that seems unlikely to support additional consumer spending any time soon. As a result, even the emerging market giants of China and India remain vulnerable to correction as their economies are still heavily export dependent.

Therefore, we remain skeptical of the stock market's ability to continue its advance of the last nine months. We trimmed our equity allocations slightly during the fourth quarter and will await additional evidence of economic recovery and/or corrective stock market action before re-deploying capital to equities. At the same time, some problems which might derail a bull market in equities, nonetheless present opportunities for success in other asset classes, as we discuss elsewhere in this report.

## The Stock Market

During the fourth quarter, the U.S. stock market continued the powerful “snap-back” rally it began last March. Market dynamics, more than underlying economic realities, appear to be the main factors driving share prices higher. Specifically, the rapid compression of yields to almost zero on money market funds and short-term Treasuries, as shown in the neighboring chart, appear to be “chasing” investors out of cash and into the stock market. Additionally, a stock market that is set in motion tends to stay in





motion – mostly because investors fear “missing the boat” and, therefore, continue to bid stocks higher.

Despite the US stock market’s impressive advance, fundamental support for the rally remains both sparse and suspect. While true that some companies have been reporting year-over-year earnings growth, very few companies have been reporting year-over-year **revenue** growth. In other words, the earnings “growth” has emerged from some combination of cost cutting and income statement manipulation.

The fourth quarter earnings report at Goldman Sachs provides an illuminating case in point. Goldman’s record fourth-quarter profit was the direct result of trimming allocations to its bonus pool. Goldman allocated “only” 57% of net corporate earnings to its employees, rather than the “normal” 70% of net earnings. If Goldman had added the “normal” amount to the pool, fourth quarter earnings would have been very disappointing.

It is also important to view stock market rallies in the context of a full market cycle. The accompanying charts of the S&P 500 Index over different time frames help tell that story. The first chart presents the market’s stunning advance off the March 2009 lows, while the second chart places this performance in the context of the 27 months since the stock market peaked in early October of 2007.

Net-net, the stock market soared nearly 70% from its March lows to its year-end high. But to put this rally in perspective, the S&P is still down 23% from the end of the third quarter of 2007. During this identical timeframe – September 2007 to December 2009 - the NCF Growth Pool and Balanced Pool lost only 12.4% and 6.5% respectively, while the Conservative Pool posted a slight gain! The 10% to 20% benefit that the NCF pools achieved relative to the S&P 500 is a direct result of our more cautious approach.



### But what about the economy?

It has been widely reported that the US economy grew by an amazing 5.7% annualized rate in the fourth quarter. That’s very welcome news. Unfortunately, many key measures of economic vitality have merely bounced off multi-decade lows, yet still remain far below levels that are consistent with sustainable economic growth.

Two **very** critical economic gauges have not improved at all: Employment and consumer credit are both continuing to decline, month after month.

### Unemployment and Consumer Credit

The “headline” unemployment rate is nearly 10%. But this figure, as bad as it is, does not include “underemployed” or “discouraged” workers. After adding these two categories to the tally, the “all-in” unemployment number soars to 17%.

Workers who don’t work have a tough time getting a loan. Not surprisingly, therefore, consumer credit shrank for a record eleventh month in a row in December.

Consumer credit drives a big chunk of consumer spending, which drives a big chunk of the



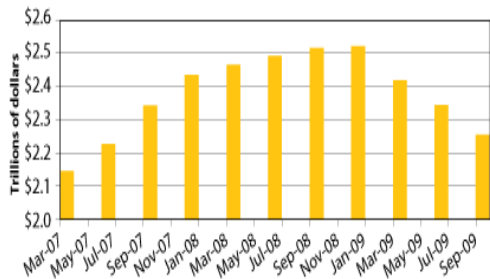
American economy. Ergo, no credit; no economy. Therefore, as the owner of one of the nations' largest shopping malls quipped recently, "Flat is the new up."

But consumers are not the only borrowers between the Atlantic and the Pacific who contribute to economic activity. Commercial and Industrial (C&I) borrowers also play a large role. When C&I lending is growing, businesses are expanding. And that means rising profitability and employment. When C&I lending is falling, however, businesses are contracting.

This is the unfortunate condition that now prevails. The combined total of C&I and consumer loans outstanding contracted by nearly \$300 billion during the first nine months of 2009. And this downward trend shows no sign yet of reversing itself.

### The Death of Credit

Commercial and consumer loans outstanding in the U.S. banking system, based on FDIC data from about 7,000 depository institutions.



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Tellingly, many of those individuals who are closest to the front lines of economic activity provide discouraging reports. Late last year, during a presentation at the Goldman Sachs US Financial Services Conference in New York City, Capital One's Chairman and CEO, Richard D. Fairbank, presented a grim collection of economic assessments and forecasts. In no particular order, Fairbank observed:

- 1) "The storm is not over and we continue to face several significant risks."
- 2) "With respect to commercial real estate, I

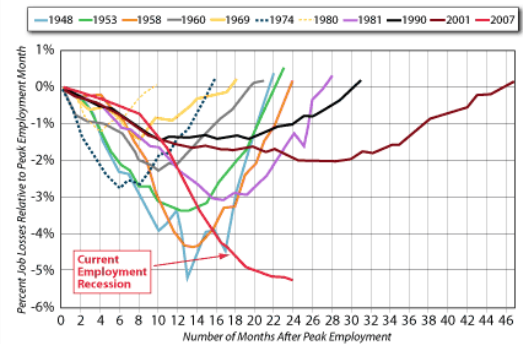
believe we cannot see line of sight to the peak yet... I kind of feel it's going to get worse before it's better."

3) "The housing market remains severely dislocated."

Fairbank placed this last observation in the context of an economy that is still wobbling on its feet and unable to generate employment growth. "The average time to find a new job remains very high," he observed, "a sign that the job market is more frozen than in past recessions." The following chart supports that observation.

### Not Good

The depth and duration of job losses in the current recession, compared to the depth and duration of job losses during previous recessions.

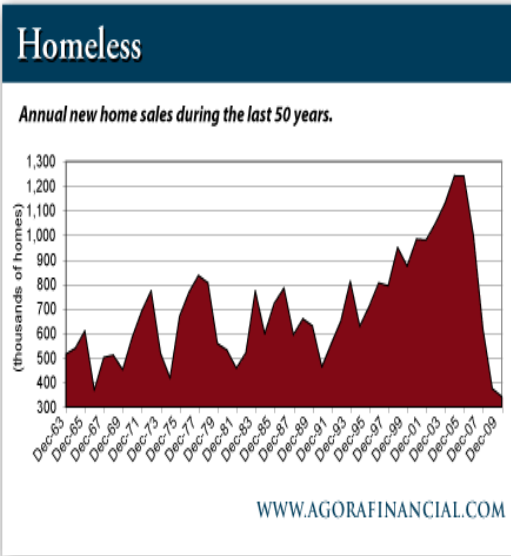


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### Housing Also Struggles

"Similar to labor markets," Fairbank continued, "the housing sector remains severely dislocated, despite some signs of stabilizing home prices. There is a growing backlog of foreclosures. Inventories of homes in foreclosure or with severely delinquent mortgages are increasing. This is likely to put downward pressure on home prices, as the foreclosure inventory hits the market. Continued weakness in housing puts pressure on the broader economy and makes any emerging recovery fragile."

To be sure, some bits and pieces of the housing market are showing signs of life. But a genuine recovery still appears to be more hope than substance. Existing home sales languish at levels last seen in 2001; while new home sales have plummeted to levels we have never seen during the last 50 years!



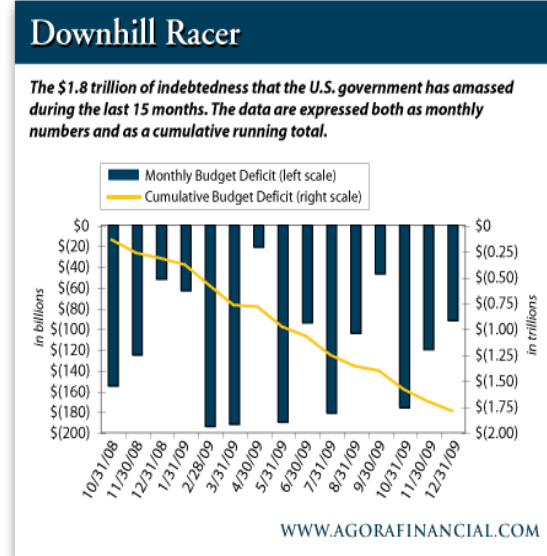
Therefore, given the persistent signs of economic weakness here in the US, we should not be surprised if the global recovery were to continue to proceed very slowly. And the possibility certainly exists that the global economy could decelerate once again. If this were to occur, long-term bond yields might fall once again...for a little while anyway.

But the explosion of government borrowing worldwide suggests that long-term interest rates are likely to head higher over the next few years.

#### Debt Concerns and Possible Inflation

Runaway government borrowing creates a frightening context for any would-be buyer of government bonds. That's why long-dated bonds may be some of the riskiest assets on the planet at the moment. (And why rising interest rates may become one of the most important investment influences over the next several years.)

As the chart below illustrates, the US government has amassed \$1.8 trillion of new indebtedness during the last 15 months. Astonishingly, each and every one of the last 15 months produced a deficit, including the tax-collection month of April, which had produced a surplus for 26 straight years.

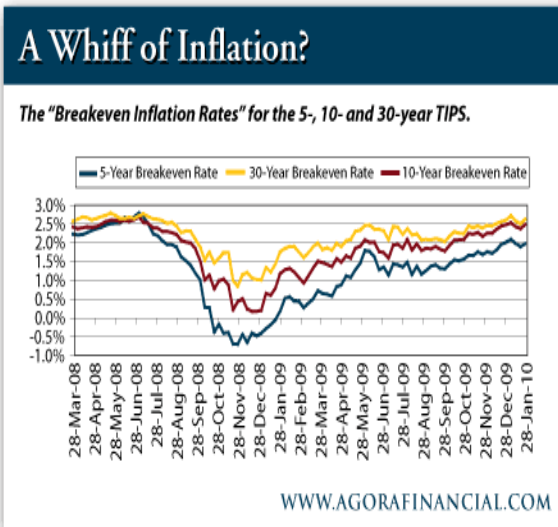


For perspective, \$1.8 trillion is about 13% of US GDP. \$1.8 trillion is also about double what the IRS collected from all individual taxpayers last year. The velocity and magnitude of America's growing indebtedness seems incongruous with 30-year Treasury bonds yielding less than 5%. Although near-term economic weakness may exert some downward pressure on bond yields, we suspect bond yields will rise significantly over the next few years.

TIPS investors seem to agree. The inflation rate implied by TIPS prices shows an expectation of rising inflation.

A little explanation may be in order here...

The yield differential between TIPS and a conventional Treasury security of the same maturity is called the "breakeven inflation rate." This rate reflects investor expectations about future inflation. The higher the yield differential, the higher the implied future inflation rate. The chart below tracks the breakeven inflation rates during the last two years for the 5-, 10- and 30-year TIPS.



You will note that inflation expectations collapsed during the depths of the credit crisis in late 2008. At one point, 10-year TIPS were pricing in almost zero inflation! But inflation expectations have been rebounding ever since. Today, 10-year TIPS anticipate an inflation rate of 2.39% during the next ten years - the highest anticipated inflation rate since July of 2008.

Admittedly, 2.39% is a relatively tame rate of inflation. And that's just the point. If, as seems likely, the inflation rate accelerates over the next few years, TIPS investors will fare relatively well, while the holders of conventional long-dated Treasury bonds will be donning sackcloth and repenting of their faith in deflation.

On the plus side of rising inflation, hard asset investments tend to perform well, as do the companies that operate in natural resource industries. Therefore, if inflation resurfaces over the coming months and years, we would expect investments in commodities and natural resource stocks to perform well, at least on a relative basis.

Even for fixed income investors, inflation is not all bad, provided that one owns mostly short-term bonds as inflation begins to take hold. In such a circumstance, fixed income investors can re-invest the proceeds of their maturing short-term securities into new bonds and/or money market funds that pay a much higher rate of interest.

### NCF INVESTMENT PORTFOLIOS

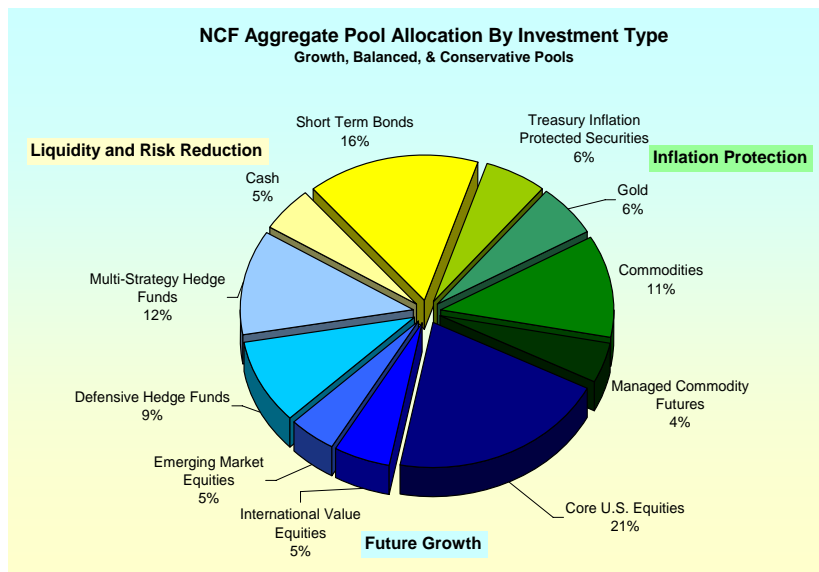
We construct the portfolios in the NCF Investment Pools to achieve strong capital appreciation, consistent with capital preservation through all market cycles. With that objective in mind, we focus on containing the kinds of risks that can imperil a long-term investment strategy. Specifically, we guard against two principal risks: 1) large drawdowns (large, debilitating capital losses) and; 2) Inflation. We believe this risk-averse strategy will serve our donors well over a complete stock market cycle. (And, in fact, this has been the case, as our Growth, Balanced, and Conservative pools have all outperformed their respective benchmarks over 3- and 5-year timeframes.)

The components of NCF's three equity pools – Growth, Balanced, and Conservative – are nearly identical. But the weighting of each component varies according to the risk profile of each pool. The Conservative pool, for example, has the lowest risk profile of the three pools and, therefore, the lowest weighting to volatile components like equities and commodities. The Growth pool, by contrast, has the highest weighting to these volatile components.

The following pie chart describes the allocations of these three pools in the aggregate. (To see how these allocations are actually implemented in each of the three longer-term pools, please see the Investment Performance Report that is also on the NCF web site.)

## Reasons for the Allocations

You will notice that the asset allocation pie chart has three labels associated with the various asset classes. Those labels, Inflation Protection, Future Growth and Liquidity and Risk Reduction, reflect some of our thinking on the purposes for which these allocations exist. These are imperfect labels, as there is clearly overlap between the categories. Our allocation to Commodities, for example, while undertaken primarily for inflation protection purposes, should also provide portfolio growth in a strong economic environment. Similarly, some of our US equity allocations, such as those to natural resource stocks, while undertaken primarily for growth purposes, also provide some protection against inflation. The labels, then, are merely guides to the primary reason for each allocation.



## Conclusion

As we noted at the beginning of this report, we are committed to creating an investment environment with choices for NCF donors that focus primarily on capital preservation. We do not believe that losing hard-earned charitable funds to stock market declines benefits God's kingdom. At the same time, good stewardship requires putting capital to work – as Jesus himself made clear in his parable on the talents – and putting capital to work requires risk.

But the fundamental point is that we never try to “beat the other guys” or even “outperform the market.” What we do instead is look forward with humility, asking ourselves, “what are the forces at work in the world from which we need to protect our donors' funds?” That fundamental question leads us to three, very concrete and specific decisions. First, we fill the fixed income bucket (the yellow pie slices) primarily with short term US government securities and cash. Doing so reduces the returns from this allocation at

times, but it also eliminates the risk of large drops in value that happen to long-dated bonds when interest rates rise. Secondly, we act to protect the funds from inflation by adding investments in commodities, gold, inflation-protected US Treasury bonds (TIPs) and other assets. Finally, we seek future growth in the safest way possible by using a mix of US and international equities, along with hedge funds that can generate positive returns in both up and down markets (the blue slices). The result is an allocation that can provide significant protection against adverse stock market trends, without inordinately sacrificing potential growth.

We will modify allocations in the future as macro-economic conditions dictate. Therefore, please check our website periodically to watch for additional information. Thank you for allowing the National Christian Foundation to help support you in your charitable giving.