



## The NCF Investment Strategy Report May 15, 2010

The NCF investment pools reflect our commitment to creating an investment environment that focuses primarily on capital preservation. We have long-believed, and stated in previous reports, that there is no glory 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 our lower-risk approach to portfolio construction continues to deliver superior long-term investment results, as described in our quarterly Investment Performance Report.

### **Investment Management and the Walls around Jerusalem**

In this quarter's report, we will also consider some of the similarities between Nehemiah's work in the Old Testament, when he rebuilt the walls of Jerusalem, and our work in building the "walls" of our portfolios. While the language of Nehemiah is about dignity, "let us rebuild the wall of Jerusalem, and we will no longer be in disgrace," the expression of that dignity was the ability to live safely and securely. Without a wall, the city was not viable. No one could live or work there. In a similar way, our donors need walls to protect and preserve the funds that are the basis for future giving. What is particularly fascinating is that Nehemiah's seemingly mundane work of making Jerusalem safer, ultimately led to an outpouring of generosity! Read on to see the ways in which we are "building the walls" of our portfolios.

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### **Global Market Overview - Why we need Walls**

The global equity markets continued their advance during the first quarter. The U.S. stock market, as measured by the S&P 500 Index, posted a quarterly gain of 5.4% - boosting its trailing 12-month performance to a remarkable 49.7% gain. Globally, developed international markets rebounded by comparable amounts, while shares in various emerging markets soared even more.

Meanwhile, most commodity markets slumped during the first quarter, despite early signs of inflation appearing in several different price indices. The Producer Price Index is up 6% year over year; import prices are up 11.4%, and the ISM's Prices Paid Index has more than doubled during the last 12 months. These price trends warrant close scrutiny, and may become increasingly important influences in the financial markets during the next several quarters.

The biggest story of the moment however is the Greek debt crisis, and the threat of a "sovereign debt contagion." What began earlier this year as merely a "Greek problem," has rapidly become a European problem, on the verge of becoming a global crisis. This is but one example of "threats" to our portfolios that we would like to "wall out," if possible.

At the heart of issue lies the simple fact that most European governments are heavily indebted and are increasing their indebtedness at a catastrophic pace. After decades of dispensing services and benefits that tax revenues failed to cover, the moment of truth has finally arrived.

The truth, in this case, is very simple: Many governments are bankrupt. And it is too late for austerity measures or tax hikes to restore solvency. Therefore, without some combination of bailouts and money-printing, several governments might default.

As this seemingly unthinkable possibility becomes "thinkable," every heavily indebted government is starting to worry that they might be next. This situation is very serious, very pervasive and very unlikely to be cured by any sort of "rescue plan." As successive rescue plans fail, we should expect financial market volatility to increase.



## The Stock Market

During the first quarter, the U.S. stock market continued the powerful “snap-back” rally it began last March. After touching a 12-year low on March 9, 2009, the Dow Jones Industrial Average soared more than 70%. Over the same timeframe, the S&P 500 gained 84% and the NASDAQ doubled. These dazzling performances have led many investors to conclude that all is right with the world...or at least that all is much better.

This optimistic conclusion may be misguided. While it is true that many gauges of global economic vitality have improved during the last several months, most of these gauges remain well below levels that would indicate a healthy economic condition. Therefore, the bullish stock market action of the last several months may have very little to do with underlying economic conditions. Instead, stocks may be drawing a lot of their vigor from a lack of appealing investment alternatives. The commodity markets have been languishing; money market funds yield next to nothing and; long-term bonds offer unappealing yields relative to inflationary threats. In this context, stocks have seemed to be the "least unattractive" choice.

After the substantial rally of the last 12 months, however, stocks have lost much of their relative appeal. At 16 times earnings, the US stock market may not be overvalued, but it is certainly fully valued. Going forward, therefore, underlying economic conditions will become an increasingly important influence over stock market trends.

## But what about the economy?

In general, the main gauges of economic vitality are improving. At the same time, however, many of these gauges remain far below pre-crisis levels.

### First, the good news:

- The April jobs report showed the second increase in non-farm payrolls since the end of 2007.
- Both new and existing home sales are rising.
- Industrial production and factory utilization are both increasing.
- The Conference Board's Index of Leading Economic indicators has been on the rise for several months.
- The ISM's Index of Manufacturing Activity has also been on the rise for several months.

### Now, the *other* news:

- Even with the benefit of tax incentives (that recently expired), the pace of home sales remains far below the levels of three years ago.
- Similarly, industrial production and factory utilization remain well below the levels of three years ago.
- Due to the Greek debt debacle, a serious crisis of confidence is beginning to roil the sovereign debt markets. This crisis possesses the potential to derail economic growth throughout the world.

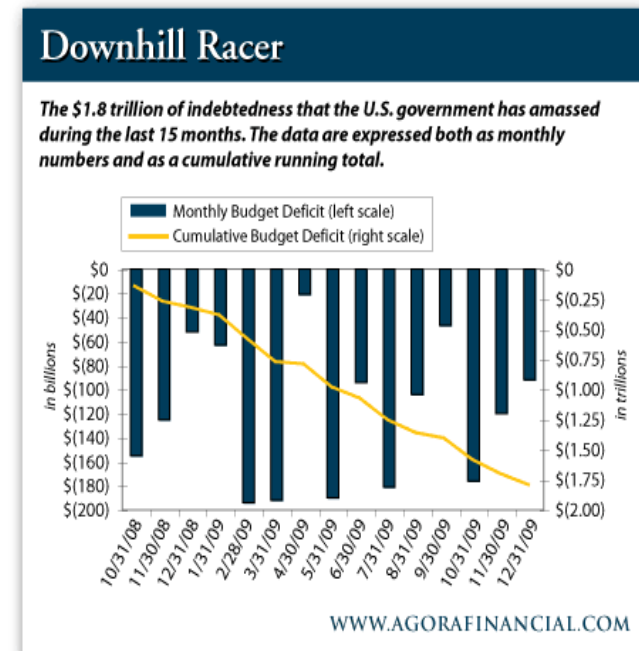
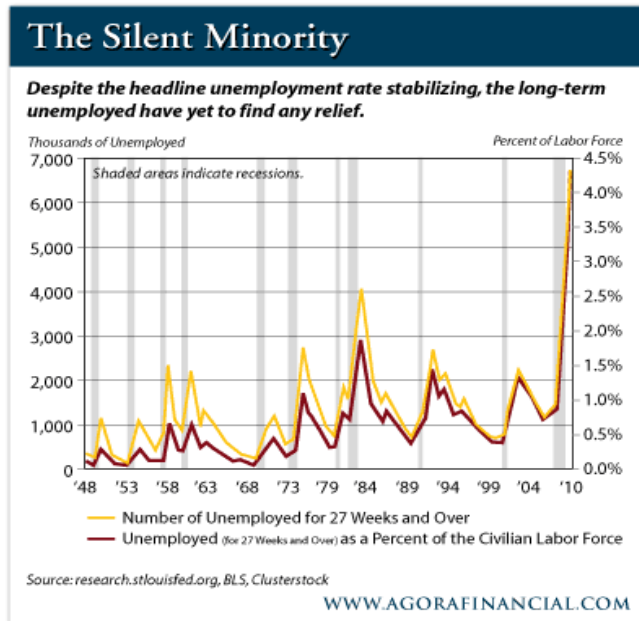


- Despite the "strong" employment reports for the months of March and April, the number of long-term unemployment and "under-employment" laborers has *increased* to a record 17.1% of the workforce. Furthermore, the percentage of unemployed individuals who have been jobless for more than 27 weeks has also *increased* to a record 4.3% of the workforce. To express this statistic another way, nearly half of all unemployed individuals have been out of work for more than six months.

The panic of early 2009 may be gone and the "crisis mentality" resulting from the Lehman Bros. bankruptcy may have vanished. But the seeds of the next crisis are germinating already. Excessive debt – or "leverage" – remains a very serious problem in almost every corner of the global economy. Here in the U.S., consumers remain very highly leveraged and U.S. banks continue to hold enterprise-threatening levels of impaired loans.

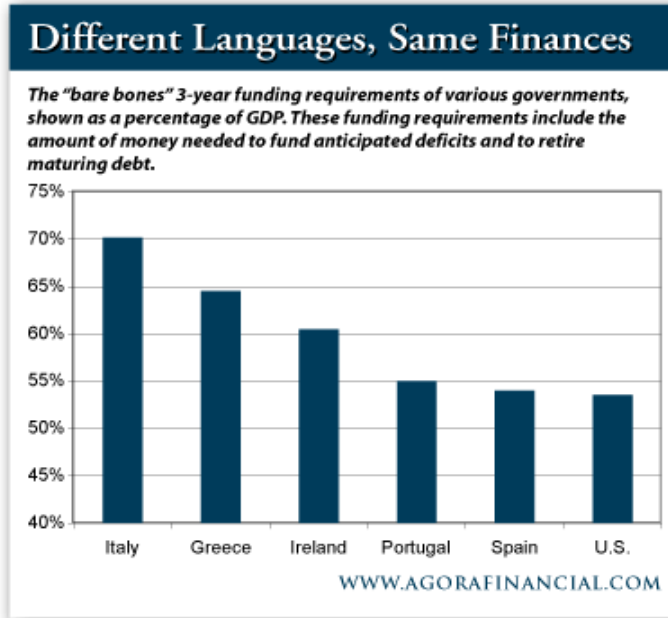
Meanwhile, sovereign borrowers from Greece to Portugal...to America are struggling with unsustainably large liabilities. For the moment, the Greek debt crisis has sparked substantial "flight to quality" buying of U.S. Treasury securities. But "quality" may be in need of a re-definition as the finances of the U.S. government are not dramatically better than those of Greece – the poster child of profligate sovereign borrowers.

In the process of amassing \$1.8 trillion of new debt since the 2008 credit crisis began, the US government has run a deficit each and every one of the last 19 months, including the tax-collection months of April 2009 and April 2010. Prior to last year, the month of April had produced a surplus for 26 straight years. The velocity and magnitude of America's growing indebtedness seems incongruous with 30-year Treasury bonds yielding 4.20%. For perspective, America's \$1.8 trillion of new indebtedness is equal to about about 13% of US GDP. \$1.8 trillion is also about double what the IRS collected from all individual taxpayers last year.





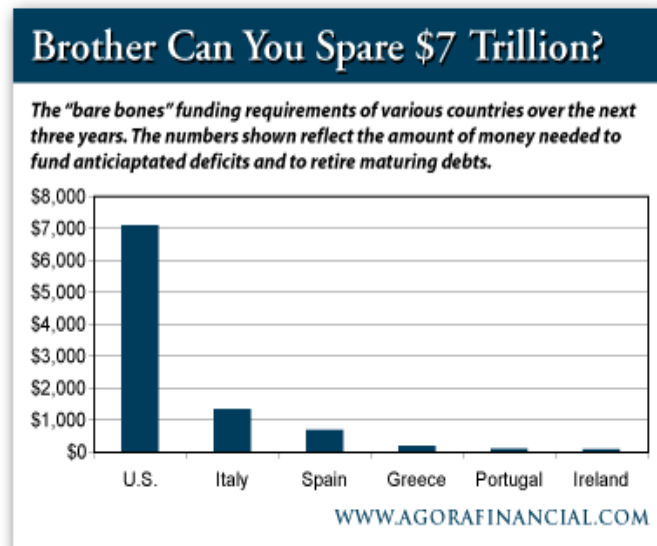
Unfortunately, America's finances are not unique; they are emblematic. Sovereign borrowers throughout Europe are suffering from a toxic combination of sky-high debt and overly generous entitlement programs.



The nearby charts place the Greek crisis in a global context. The first chart shows the total "bare bones" funding requirement for various countries during the next three years. Specifically, this chart shows the amount of borrowing that would be required by each country to fund anticipated deficits during the next three years and to re-finance all government debt coming due in the next three years. The resulting sum is expressed as a percentage of annual GDP.

As expected, countries like Italy and Greece are high on the list. But surprisingly, the U.S. is on par with Spain and Portugal. The chart below presents the identical data in absolute terms, rather than as a percentage of GDP. America's three-year funding

requirement seems much more ominous when viewed in absolute dollars. These charts clearly show that no indebted country is immune from the kind of investor scrutiny that could produce a debt crisis...or a currency crisis.



Most central bankers of the world realize this fact. That's why they all wish to support Greece – not because they care about Greece, but because they care about avoiding close scrutiny of their own finances.

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.

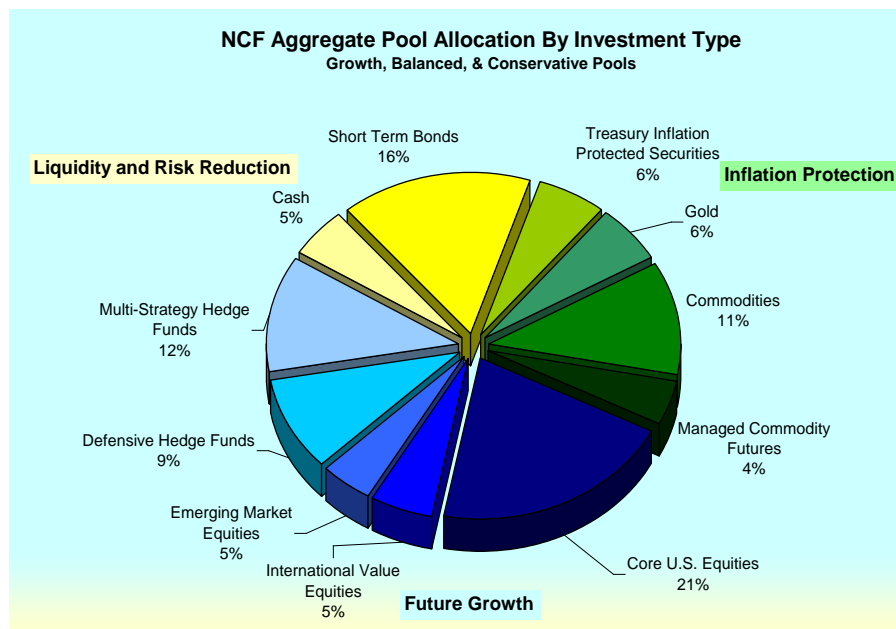
## The Walls of our Portfolios

The threats to Jerusalem were foreign armies and local bandits; the first could destroy the city quickly and the latter more slowly over time. The principal threats to our portfolios are the risk of substantial drawdowns – our “foreign army” that can lead to large and debilitating capital losses - and the erosion of value through the “bandit” of inflation. Though different in some respects, both risks share the common characteristic of uncertainty, as we never know for sure when their “attack” might come. In the investment world, that uncertainty is called “volatility” and means, simply that prices and values can fluctuate very quickly. So you have to build defenses *ahead of time*, as we never know when the problem (the attack) may occur.

To do that, we have equipped the NCF investment pools with allocations that should produce solid and steady results over 3- and 5-year timeframes, despite the volatility of the markets. Taking a longer-term, risk-averse strategy, allows us to be less concerned when the market rockets ahead for a season, or if new risks, such as those currently unfolding in Europe, approach our “city”. We have confidence in our walls.

Today, 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. The Growth pool, by contrast, has the highest weighting to equities and the lowest to fixed-income and cash.

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 on the NCF web site.)



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 under-taken 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 for NCF donors that focuses primarily on capital preservation. We do not believe that losing hard-earned charitable funds to the “foreign army” of stock market declines or to the “bandits” of inflation, 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.

Investing - like a faith-based lifestyle - is a marathon, not a sprint. This perspective underlies the investment strategy at NCF - a strategy that seeks superior risk-adjusted returns over three- to five-year timeframes. What does that mean? It means investing in a way that achieves steady capital appreciation, without incurring the risk of very large capital losses.

As such, the Pools have performed exactly as hoped. They fell very little during the harrowing selloff of late 2008 and early 2009. On the other hand, the Pools trailed their benchmarks during the last 12 months, as global stock markets bounced vertically off of last year’s bear market lows. However, at the end of all of this volatility, the NCF Equity Pools have closely tracked (or exceeded) their benchmarks during every time frame beyond one year...and have done so with much lower volatility. The walls have worked!

## The Spiritual Benefits of Safety and Security

The most remarkable aspect of the entire story of Nehemiah rebuilding Jerusalem’s walls is the amazing response of God’s people. In the first instance, they all joined in the work together with entire families pitching in and taking responsibility for different parts of the wall. We are similarly mindful of the ways in which we are working, daily, with our donors in what is very clearly a collective effort to make funds available for Kingdom purposes.

Beyond that, however, we read in the story of how the people of the city began treating their fellow citizens more kindly, forgiving debts, lowering interest obligations and sharing their wealth. A spirit of greater generosity flourished within the safety and security of the city.

Finally, the city became once again a focal point of spiritual renewal as we learn that Ezra, the prophet, read the law to all those who could now live in the city and its surrounding towns. Though aware of their weaknesses and failings, the people of Jerusalem ultimately celebrated the rediscovery of their spiritual roots. The result was a week-long party that Nehemiah describes as Israel’s biggest celebration in more than 600 years!

We don’t expect our donors to party for a week every time they read our investment strategy or performance reports! But we do hope you will share our joy in celebrating all that God has done for us . . . and continues to do for us . . . in providing the means to be generous and in protecting those assets inside the walls of our portfolios. As we build and maintain those walls, we remain deeply grateful both to God and to you for allowing all of us within the National Christian Foundation to help support you in your charitable giving.