



# Investment Strategy Report

September 30, 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. This guiding philosophy does not prohibit risk-taking, it merely demands that each unit of risk offers an acceptable measure of potential reward.

We are delighted that the NCF pools have delivered superior investment results over 1-, 3- and 5-year timeframes 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 other words, we did not subject your charitable gifts to extreme risk in the pursuit of investment returns.

In this quarter's report, we will discuss in greater detail some of the portfolio design components that grow out of our investment philosophy. We hope you enjoy the opportunity to look behind the numbers at some of our thinking and analysis. Before getting there, however, we will first "set the table," by describing the world in which we operate, including a look at the global stock market and the economy in general.

## Global Market Overview

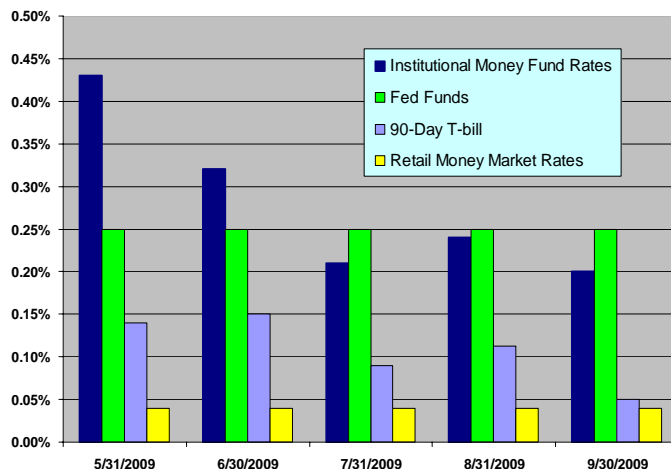
Many of the key investment themes that we discussed in our last Investment Strategy Report continued unabated in the third quarter of this year – in particular, the striking difference between the soaring U.S. stock market and the weakness in the underlying economy. As measured by the Standard & Poor's 500 Index, the stock market posted a very strong quarterly gain of 15.6%, boosting its year-to-date

performance to 19.25%. At the same time, however, the US unemployment rate surged to a 26-year high of 10.2% in October - breaking into double digits for the first time since 1983. In the balance of this report, we will review the markets and examine some of the major fundamental trends in the US economy, as they relate to the investment strategies of the NCF Investment Pools.

## The Stock Market

The market's strong performance in the quarter and year-to-date reflects a number of factors. First of all, the federal government has very actively created "liquidity" by keeping short-term interest rates near zero and by providing abundant credit to major banks and finance companies. Partially as a result of those efforts,

the interest rates individuals can earn on cash also remain very, very low, as shown in the adjacent chart. So when cash earns next to nothing, investors look around for investments that offer the hope of higher returns, even if those investments are much riskier than cash.

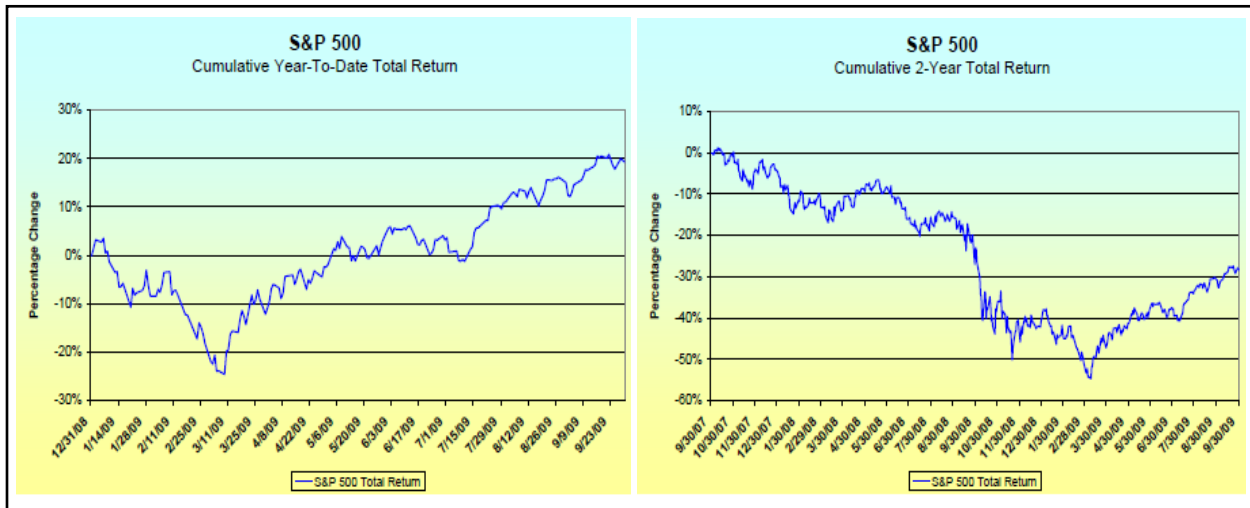


Therefore, a re-allocation from cash to stocks is an important part of what is driving stock prices higher. Along those same lines, the weak dollar (and the resulting threat of inflation) may also be helping to increase stock prices. Since stocks tend to "re-price" in line with inflationary trends over time, the possibility of greater inflation is one solid reason to move funds out of cash or bonds and into stocks. At the same time, a weak dollar can, by boosting exports, provide an indirect benefit to the stock market by facilitating sales and, ultimately, earnings for American exporting companies.



In terms of fundamental support for the stock market, many companies are now showing greater profits than one year ago when the credit crisis was in full swing. These improving year-over-year profit comparisons may also be supporting stocks. The financial sector, in particular, has benefited from these comparisons. Our only other comment about the on-going rally is to see it in context, as shown in the following charts. The first chart presents the

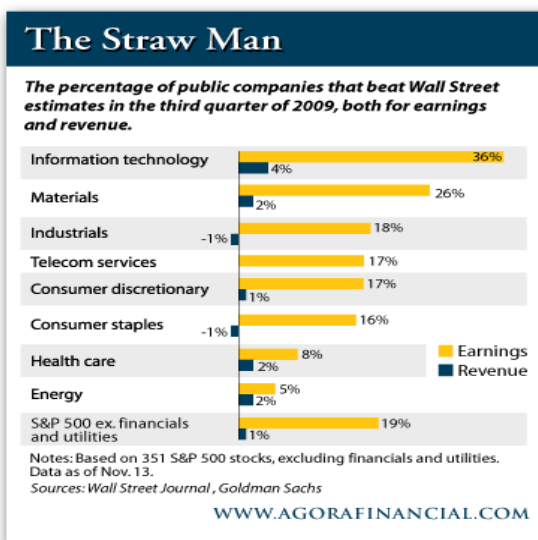
market's year-to-date performance, while the second chart places this recent performance in the context of the last two years. Net, net, the stock market is up 20% year-to-date, but still down about 30% over the last two years. This does not mean that the market cannot soar to new heights from here, only that the recent run up may not be the start of a long-term trend.



**But what about the economy?**

It has been widely reported that the US economy grew by 3.5% in the third quarter, as a result of which, "the recession is very likely over at this point," according to Ben Bernanke. We hope Mr. Bernanke is right, but serious

challenges remain. What we are probably seeing (and measuring) in the recent GDP numbers is the impact of massive government spending and subsidies in the form of Cash for Clunkers, first time home buyers credits, effectively free loans to major banks and various other forms of direct stimulus.

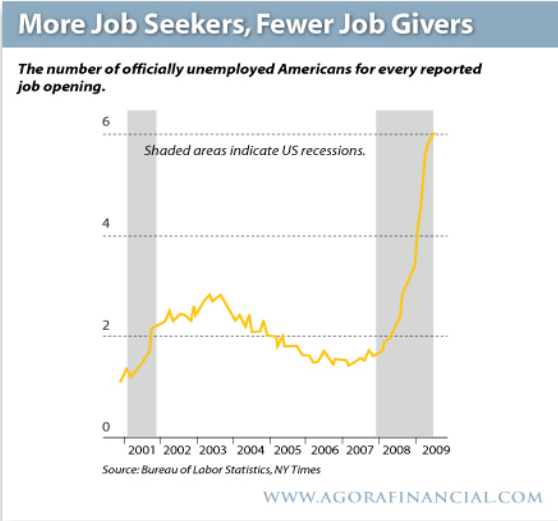


In the corporate sector, for all of the "better news" that reporting companies are producing, there is still very little top-line revenue growth, as shown on the chart to the left.

Rather, profits are "up" largely as a result of comparisons to a very poor 2008 or as the result of sometimes dramatic cost cutting. But obviously, no economy can grow by shrinking itself. In fact, most of the current cost-cutting measures in Corporate America feature job-cutting measures. That has not only led to very high official unemployment rates, but also to a record number of individuals seeking work relative to the number of reported job openings, as shown in the following chart. It seems



unlikely that the employment picture is going to improve in the near term.



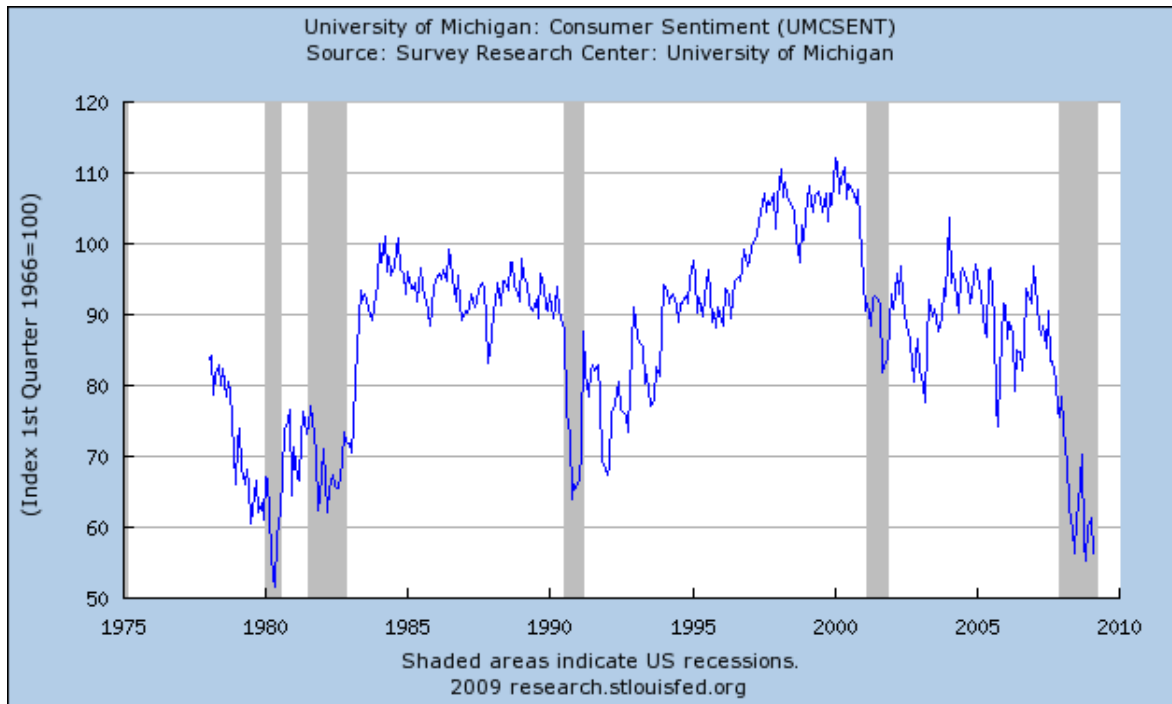
The lack of employment growth has led, in turn, to a continuing decline in consumer sentiment, as shown in the graph below, which details a study by the University of Michigan. Neither the lack of jobs nor the lack of consumer confidence is necessarily fatal to the idea of a recovering economy. But it does mean that the man on the street may not yet be experiencing the benefits

of a growing economy – a fact which could affect future spending and stock growth. All in all, we remain concerned that the market may be anticipating a rosier near-term future sooner than is likely.

### The Global Economy

Broadly speaking, the BRIC economies (Brazil, Russia, India and China) along with natural resource-based economies, such as Australia and Canada, are recovering from the recession more quickly than the developed market economies of the U.S. and Europe. To some extent the relative strength of these economies represents the continuing secular bull market in commodities and, in some cases, the maturation of the emerging economies to a better mix of domestic and foreign demand.

Because these economies are still very dependent on the US consumer and therefore, exposed to any extended recession, we have carefully crafted the way in which we invest in these more rapidly growing economies of the world. Specifically, we are investing directly through emerging market stocks and we are gaining indirect exposure through commodities. We believe that this approach will be less volatile (less risky) than investing in only the stocks of these economies.



## NCF INVESTMENT PORTFOLIOS

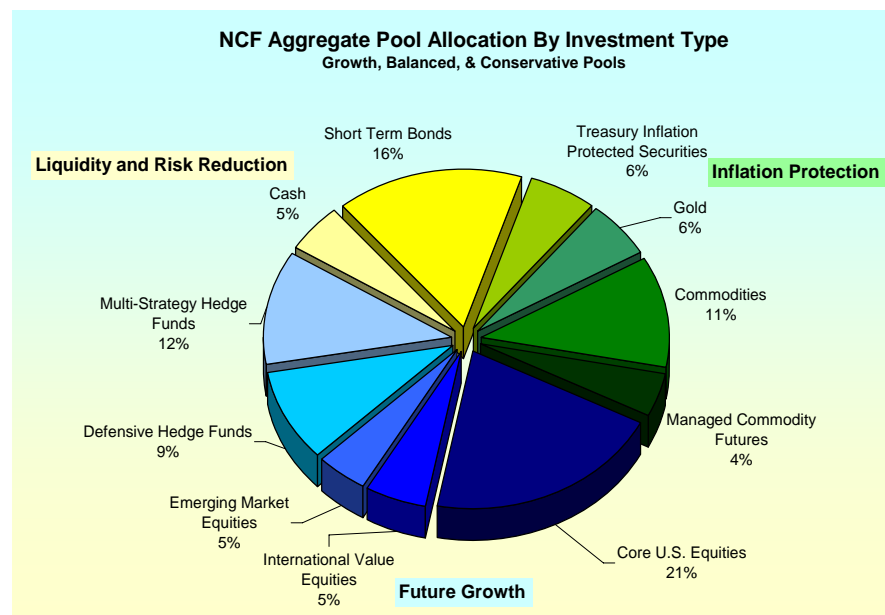
We construct the portfolios in the NCF Investment Pools to achieve strong capital appreciation, consistent with capital preservation through all market cycles. With that objective in mind, we focus on containing the kinds of risks that can imperil a long-term investment strategy. Specifically, we guard 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 1-, 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.





## NCF Portfolio Modifications

Over the last few months, we have made a number of changes to the overall allocations, either by adding of replacing managers. Specifically, we:

- Replaced our former international manager with International Value Advisors;
- Added an allocation to inflation-protected US Treasury bonds, also known as TIPS, by purchasing an exchange traded fund (trading symbol TIP); and,
- Made an allocation to Pinnacle Natural Resources.

This quarter, we are introducing International Value Advisors, where the key manager is Charles de Vault. For nearly 20 years, Mr. de

Vault was one of the principal managers with the First Eagle Funds (formerly SoGen Funds) where he worked with Jean-Marie Eveillard. In that role, Mr. de Vault became well known for a rigorous and cautious value-based approach to international investing. Our management team has known Mr. de Vault, and other members of his team, for many, many years. Consequently, we were pleased when our allocation objectives allowed us to invest funds with this outstanding team. Our funds are invested in the lowest cost institutional shares (I Class) of the International Value Fund. For more information on that fund please see <http://www.ivafunds.com/iva-international-fund>.

The following table identifies the managers, mutual funds and exchange traded funds that we use to implement the allocations in each asset class.

Asset Class	Fund Name
Commodities	Powershares Commodity ETFs
	Pinnacle Natural Resources
Core U.S. Equities	FPA Crescent
	iShares S&P Natural Resources ETF
	Stewardship Partners
	Earnest Small & Mid-Cap Equities
International Value Equities	IVA International Value Fund
Emerging Market Equities	iShares MSCI Emerging Markets ETF
Defensive Hedge Funds	Common Sense Partners
Higher Beta Hedge Funds	Alpha Titans Multistrategy Hedge Fund
Cash	Insured Bank Deposits and Institutional Money Funds
Short Term Bonds	Short-Term Bond Ladder
Treasury Inflation Protected Securities	iShares Treasury Inflation Protected Securities ETF
Gold	SPDR Gold Trust ETF

## 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. So while we seek to generate investment returns in ways that minimize potential losses, we nonetheless do take risks (as opposed to burying our talents in the ground). But we try to be sure that each unit of risk offers an acceptable measure of potential reward.

We are very pleased that the NCF pools have delivered superior investment results over 1-, 3- and 5-year timeframes. And we are encouraged that our investments have achieved these results without subjecting the pools to extreme risks. You may rely on us to continue taking this cautious and prudent approach in the future.

We will modify allocations in the future as macro-economic conditions dictate. Therefore, we will undoubtedly be making additional portfolio changes from time to time. 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.