

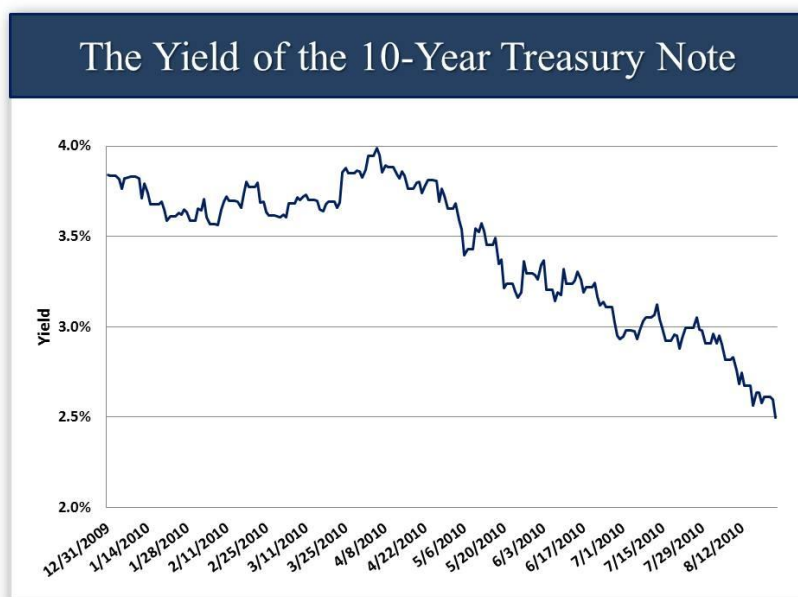
The NCF investment pools reflect our commitment to creating an investment environment that focuses primarily on capital preservation. As we continuously reiterate, there is no glory in losing hard-earned charitable funds. Therefore, we seek to generate investment returns in ways that reflect our very 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.

Not All Risks are Created Equal

All of us tend to have ideas about investment risk and what it means. Normal people tend to think of risk as the possibility of losing money. So-called investment professionals, on the other hand, like to discuss risk with phrases such as the “volatility of returns.” We are investment professionals who believe that volatility and other measures of risk sometimes mask the fact that some risks may be “riskier” than others. Since we often feel more “normal” than “professional,” as we really do not like losing money, we are constantly seeking investments that have a better chance of earning a real return – no matter what the historic “volatility of returns” may tell us. In this report, we will look at some of the ways in which not all risks are created equal. But first, let’s look at what has been happening in the world.

Global Market Overview

The euphoric global stock market rally off the March 2009 lows finally ran out of steam in April of this year. As anxieties about the strength of the global economy began to increase, enthusiasm for equities decreased. Thus, the U.S. equity markets struggled throughout the second quarter – more than erasing their first-quarter gains.



Meanwhile, the fear of an economic slowdown – aka, a “double dip” recession – lit a fire under the bond market. Since a slowing economy usually suppresses inflationary pressures, bond prices usually climb (and yields fall) during such moments. The present moment is no exception. Since peaking at 4.00% five months ago, the 10-year Treasury yield has tumbled to 2.50%, as shown in the nearby chart.

Such a dramatic and rapid drop in long-term interest rates is a relatively rare occurrence. Therefore, the bond market has become *the* investment story of the moment. Bond yields do not usually tumble when economic conditions are improving.



Maybe this time is different...Probably it is not. The latest U.S. economic data clearly reflect an economy that lacks vigor.

The Stock Market

The U.S. stock market entered the “reality check” phase early in the second quarter. After the Dow’s dazzling 77% rally from the lows of March 2009 to a high of 11,258 one year later, a little “give-back” was to be expected. But now that this give-back has lasted an uncomfortably long period of time – and now that most economic data are coming in “weaker than expected” – prudence requires a thoughtful reassessment of global economic prospects and of stock valuations relative to those prospects.

An easy way to begin that reassessment is to put last year’s 77% Dow rally in perspective. Seen from the vantage point of the market low to the present, the S&P 500 is now up only 50% after this year’s modest retreat. If we make our starting point January 1st of 2009, the market is up only 10% and if we back up a mere 24 months, to June of 2008, the market is *down* almost 25%. The extended slow decline of the market in recent weeks confirms our suspicion that the big move last year was actually a “bear market rally,” as opposed to the beginning of a new, long-term bull market.

Many of the market measures that professionals watch and discuss now confirm that analysis. Stock market trading volumes, for example, tend to rise in bull markets. Over the last few months, trading volumes have been extremely low. Similarly, funds tend to flow into equity mutual funds during bull markets. This year, funds have been flowing out of such funds and into bond funds. For reasons that to us make perfect sense, no one seems enthusiastic about the stock market at the moment, other than the occasional paid cheerleader on Wall Street. We remain cautious.

But what about the economy?

Economic growth here in the U.S. is clearly decelerating as evidenced by a wide range of economic data. All major gauges of economic productivity, employment, credit, capital investment, and consumer or business confidence have been in decline since the spring.

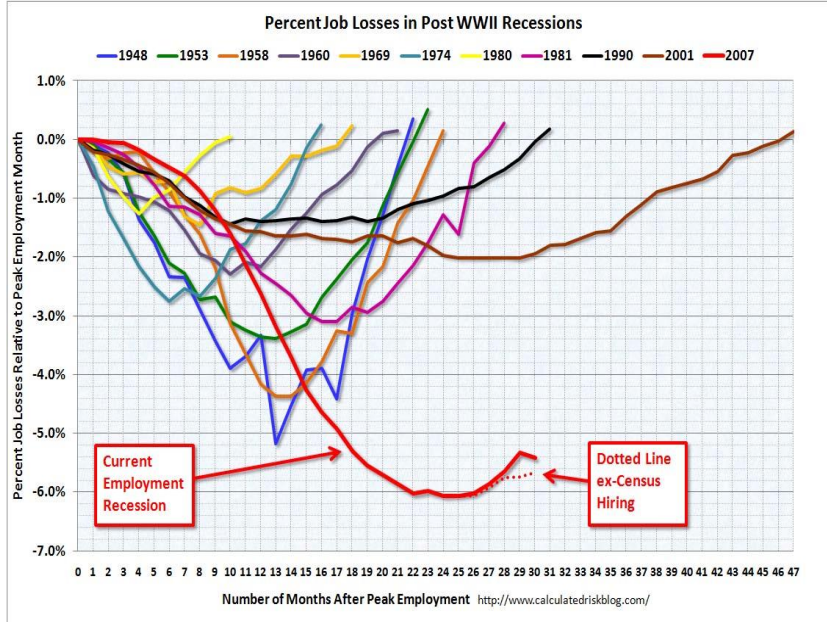
In our prior Investment Strategy report, published on May 15, 2010, we noted that the stock market’s strong performance during the preceding year *“had led many investors to conclude that all is right with the world...or at least that all is much better. This optimistic conclusion may be misguided. While 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.”*

With the benefit of subsequent economic data, our thoughts of last May seem well-founded, as it is now widely apparent that America’s “non-recovery” is in full swing. Although the US economy added about 1,000,000 jobs during the first five months of the year, 350,000 jobs have disappeared in just the last two months, according to the Bureau of Labor Statistics. This disappointing employment data corroborates equally disappointing reports on consumer spending, personal income, new and existing home sales and factory orders.



It is always a little tricky to know exactly what an economic recovery looks like or when it has begun in earnest. But of all the indicators of economic health, job creation is perhaps the most important. Our ability to live well as a people is dependent on our ability to work.

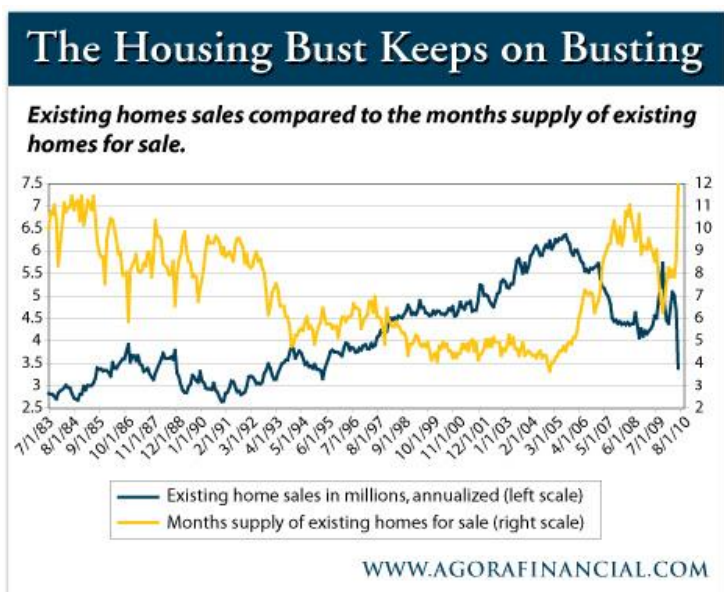
So we find most of the arguments in favor of an on-going economic recovery somewhat underwhelming in light of the jobs picture. Our economy is simply not creating jobs at the rate we need to maintain historic levels of employment. As a result, the current recession is more severe – particularly from an employment perspective – than any other Post WWII recession. As



shown on the accompanying chart, we are still nearly 6% below peak employment in the US, fully 31 months from the employment high-water mark. By comparison, at this point in every previous recession the job market had fully recovered, with the exception of the 2001 recession which, ironically, was described at the time as a “jobless recovery.” The continuing struggle to generate employment is likely to be a long-term burden on economic growth.

The housing market also continues to struggle

America’s residential real estate market provides some of the most poignant – and troubling – images of the economy’s continuing distress. “Bottom line,” says Mark Hanson, Managing Director of the real estate advisory firm that bears his name, “[at the current rate of foreclosures], it would take 101 months to clear the pool of 6.4 million loans [now] headed for liquidation.” In other words, as shown on the nearby chart, both the drop in non-distressed sales and the continuing increase in foreclosed properties, is creating a tremendous supply of available homes which may in turn further depress prices.





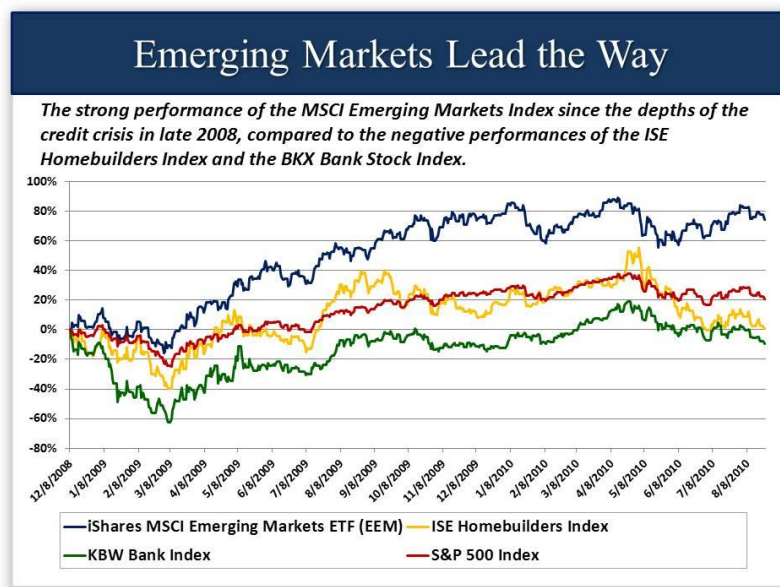
In all of this, it is our strong conviction – particularly in light of the employment and housing struggles - that a genuine economic recovery leading to growth and increasing income is going to take time. As one market commentator, Bill Bonner, observed in the May 20th edition of the Daily Reckoning, “We are still in the early stages of what is to be a long period of restructuring and re-adjustment – a Great Correction.” We remain completely convinced that the economy will recover, but we do not believe it is going to happen very quickly.

Fortunately, the vast global economy does not improve or degrade all at once. Consequently, even in the midst of difficult conditions, some areas of the globe may continue growing and some facets of the economy may even manage to flourish. It is for this reason that we now turn to our theme of this report, which is that not all risks are created equal.

Risky Stocks v. Emerging Markets

An interesting aspect of the current recession is that not all the traditionally high-risk stock market sectors are behaving the same way. In fact, Emerging Market stocks have been conspicuous for their strength, relative to other “high-risk” stock market sectors. Specifically, Emerging Market stocks are *advancing*, even when US stocks with comparable historic volatility are not.

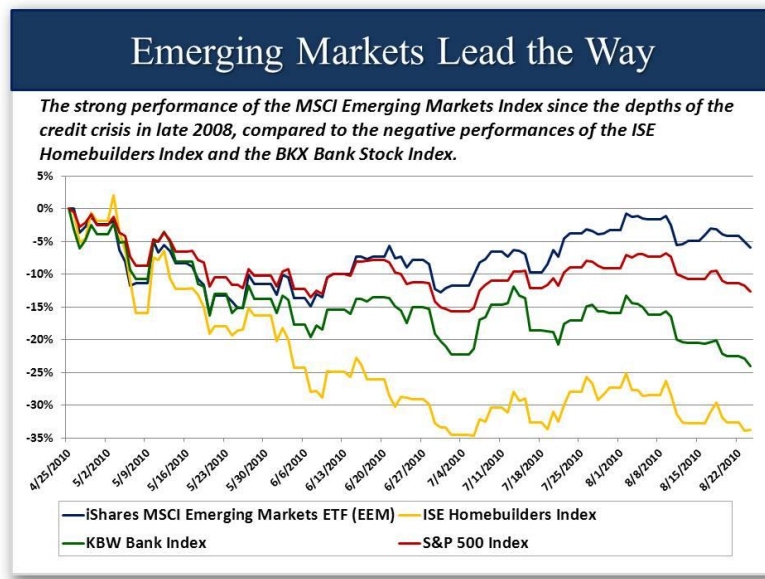
Usually, “risky” stocks track one another, particularly during periods of market turmoil. During the crisis conditions of late 2008, for example, Emerging Market stocks tumbled tick-for-tick with US financial stocks and with US Homebuilder stocks, which are two sectors of the US stock market that are perceived to be high-risk due to higher-than-the-market historic volatility. Since reaching their crisis lows in December, 2008, however, Emerging Market stocks have diverged from the performance of their risky American cousins (financial and homebuilder shares), as shown in the nearby chart.



Notice, in particular, that the Morgan Stanley Emerging Market Index (the blue line) has risen by 72% since December 8, 2008, while the major indices of US financial stocks (the green line) and US homebuilding stocks (the yellow line) have produced losses during the identical timeframe. And they have produced those losses *despite spectacular rallies in 2009.*

This substantial 18-month-long divergence between “risky” foreign stocks and “risky” US stocks makes the recent mini-divergence between these two groups all the more intriguing.

Once again, Emerging Market stocks are going their own way and ignoring the disappointing trends in the US economy and stock market, as shown in the nearby chart.



The recent divergence – modest as it has been – may not mean anything at all. But it might signify an important shift in long-term investment trends. Perhaps the global financial markets are in the process of discounting the improving economic profile of the Emerging Markets, relative to US economic prospects. We believe that is in fact what is happening and we have been repositioning NCF’s investment portfolios for some time, as discussed below, to take advantage of this trend.

Back in 2000, most investors believed U.S. stocks to be an all-weather capital-accumulation machine. But the buy-and-hold strategy that offered such promise ten years ago has delivered far more disappointment than delight. During the last ten years, the S&P 500 Index has produced a *negative* total return.

Despite that fact, many, many investors – both professional and individual - carry massively “overweight” positions in U.S. stocks. There may be good reasons to do so, but we believe at least part of the reason is that it is simply natural for us to favor investments in our own country. Even more importantly, however, our perception of relative investment risks tends to be more backwardly focused than forward looking; we are heavily influenced by the past. As a result, when we think, for example, of South America from an investment perspective, the first thing that comes to mind is the Argentine government’s debt default in 2001. Ten years later, that event colors our thinking and arguably overwhelms a more reasoned, forward-looking analysis.



The NCF Investment Strategy Report

June 30, 2010

To illustrate that point, consider a comparison of Brazil, the economic powerhouse of Latin America, to the United States, *today*.

The United States is the nation with:

- Budget deficits above 10% of GDP;
- Debt-to-GDP above 85%; and,
- Three years of 0% GDP growth.

Brazil is the nation with:

- Budget deficits below 4% of GDP;
- Debt-to-GDP below 40%; and,
- Three years of 4% GDP growth.

Based on numbers like these, much that we have thought about the relative investment risk of US versus Emerging Market equities may be incorrect or at least overstated. At a minimum, it is difficult to make the case for the investment world's habitual overweighting of US stocks.

But of course, we all know that solid facts sometimes produce flimsy deceptions. So the point of this discussion is not to condemn U.S. stocks for all time, but merely to ask the question: "Are we getting paid adequately for the risks we are assuming?" This question is easier to answer clinically, than it is to resolve emotionally. Even if a dispassionate analysis of the data would lead an investor to allocate the majority of his portfolio to Brazilian, Indian and Norwegian stocks, most of us would have a hard time pulling the trigger. Despite all, U.S. stocks simply *feel* safer. In response to such anxieties, William Shakespeare's Measure for Measure provides an insightful counterpoint:

"Our doubts are traitors, and make us lose the good we oft might win, by fearing to attempt."

We do not know the future, of course, but we can see the present and are resolved not to let our fears keep us from responding to the investment trends and opportunities that the present is providing. Emerging Market equities are one such opportunity, and an opportunity we have been pursuing for the last several years as we discuss in the final section of this report.

Portfolio Construction

Up until late 2007, we maintained traditional allocations in all of our investment pools. The Growth pool, for example, was allocated 80% to equities and 20% to bonds. Of the 80% allocated to equities, three quarters were allocated to US equities, one quarter to international equities and *none* to Emerging Markets. As we looked out at the world in October of 2007, we wrote:

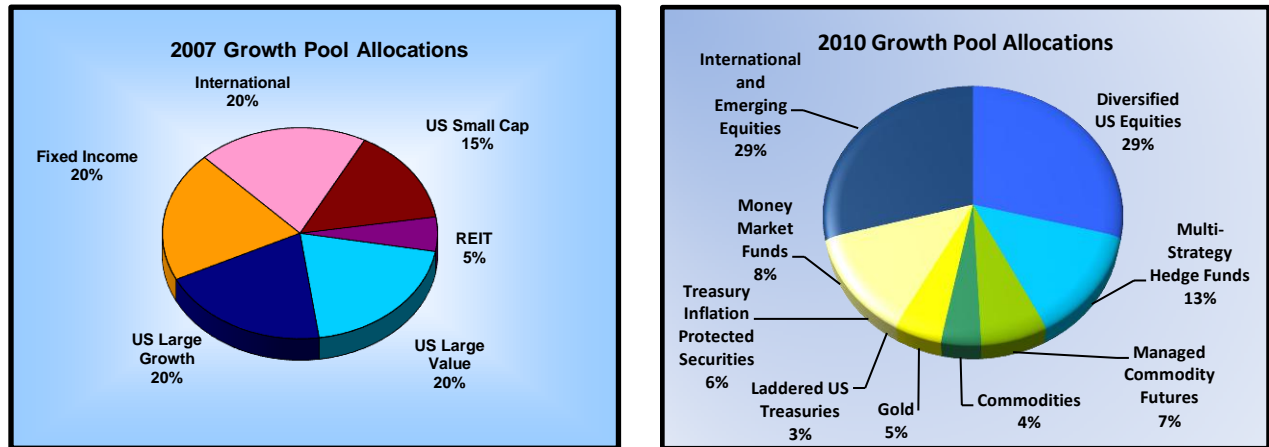
"In response to the wide-spread credit problems discussed above, NCF took a number of actions to reduce risk in its pool investments.

. . . we made some modest changes to eliminate any exposure to sub-prime mortgage-backed securities.

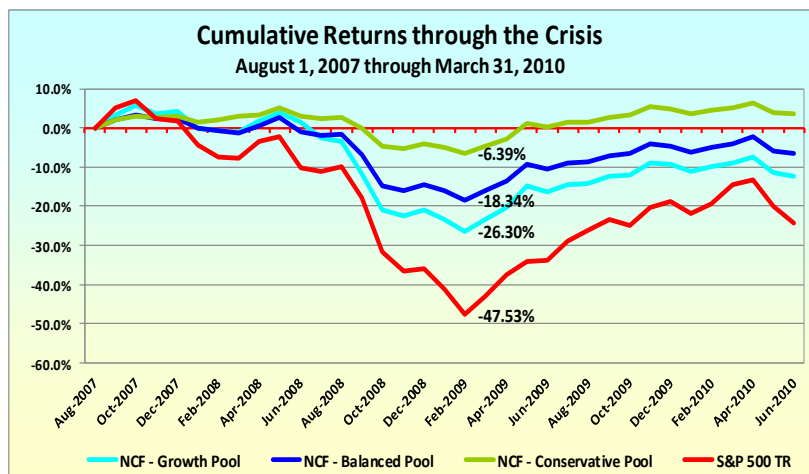
. . . we reduced our exposure to the financial sector.

. . . we also temporarily reduced equity allocations in the Growth, Balanced and Conservative pools . . . to prepare for new allocations to investments that offer more attractive risk-reward profiles in turbulent markets."

The result of our forward-looking analysis in 2007 was a substantial change in allocations, as illustrated by the following Growth Pool Allocation charts. You will notice, in particular, that we now have allocations to Emerging Markets as part of our equity allocations, in addition to multi-strategy hedge funds, commodities and gold.

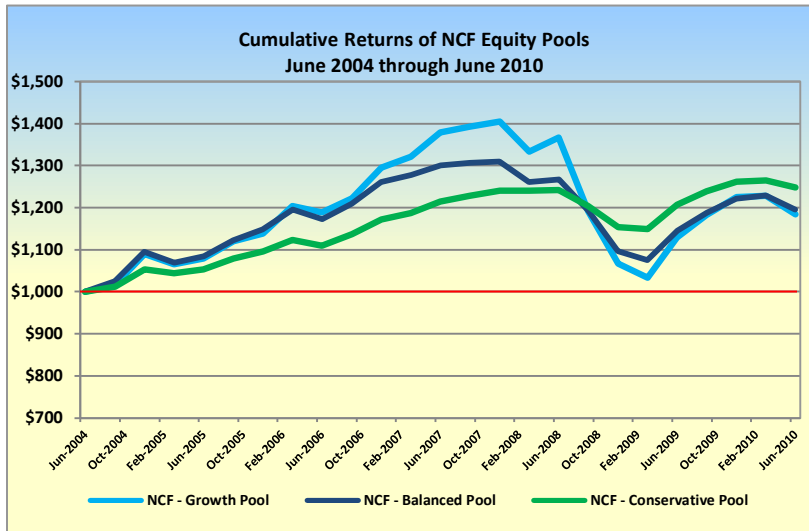


The components of NCF’s three equity pools – Growth, Balanced, and Conservative – are essentially identical to those shown in the 2010 Growth Pool Allocation pie chart, above, but with the weighting of the components varying according to the risk profile of each pool. The Conservative pool, for example, has the lowest risk profile of the three pools and therefore the lowest weighting to volatile components like equities. The Investment Performance Report on the NCF web site shows the exact weightings of each pool. These allocations reflect our continuous examination of the risk and return characteristics of each asset class, as we strive for investments that consistently deliver an acceptable measure of return for each measure of risk.



This approach has in fact produced lower risk portfolios, particularly in times of crisis, as shown in the adjacent chart. Here we have a picture of how our pools have held up through the credit crisis and subsequent recession. The chart portrays cumulative net returns from August 1, 2007, when the credit crisis began, through the end of the most recent quarter. The numbers in black

next to the low point of each line represent the maximum decline. Thus, the S&P 500 was down 47.53% while our most cautious equity pool, the Conservative Pool, declined a mere 6.39%.



Quite importantly, as a result of our intentional approach to investment risk management, all of our equity pools have produced positive returns over the last five years, as shown in our final chart. We are also confident that the pools are well-positioned to produce positive returns whenever the global markets rebound and to survive without critical losses through the next crisis, should that be what comes our way next.

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. 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. And our pools have taken risks in pursuit of long-term investment returns. But those risks have been, and continue to be, reasonable and muted in comparison to an uninformed allocation to US equities.

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 - producing solid gains during up markets, while preserving capital well in down markets.

We 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 the assets you have set aside for Kingdom purposes. We remain deeply grateful both to God and to you for allowing all of us with the National Christian Foundation to help support you in your charitable giving.