

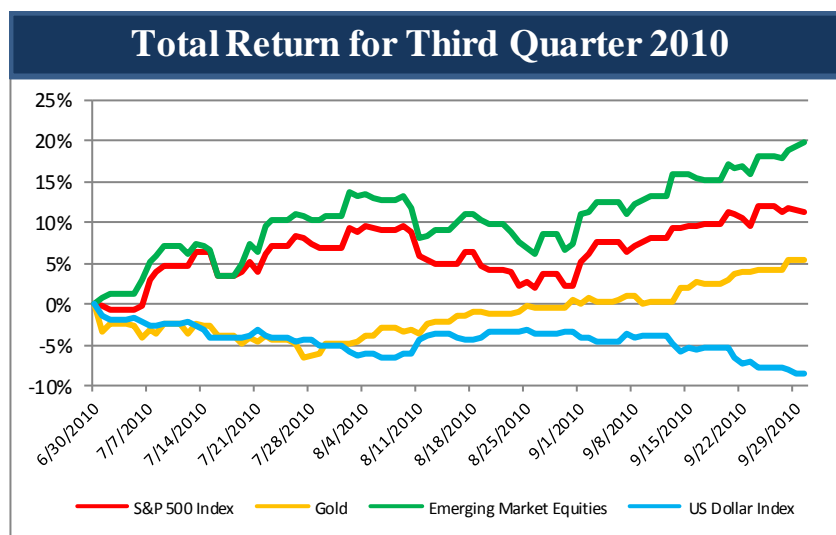
The NCF investment pools reflect our commitment to creating an investment environment that focuses primarily on capital preservation. As we continuously reiterate, there is no glory in losing hard-earned charitable funds. Therefore, we seek to generate investment returns in ways that reflect our very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

Great Divergences

In this month's Strategy Report, we examine a phenomenon that often confounds investors. Let's call it the "Great Divergence" – i.e., the occasional disconnect between the stock market's price trend and the economic realities we experience in our everyday lives. These disconnects – or divergences - can be confusing. Often, however, there are solid explanations for these seemingly inexplicable divergences. Understanding the underlying reasons for them can enable individuals to invest with greater confidence. But before we look at the Great Divergence between the price action on Wall Street and the economic conditions on Main Street, let's first consider what has been happening in the world at large.

Global Market Overview

While it seems like ancient history, the US stock market rose in July, dropped sharply in August and then rallied strongly in September to end the quarter up over 10%, as measured by the S&P 500 Index. Both developed and emerging international markets rose even more sharply, with



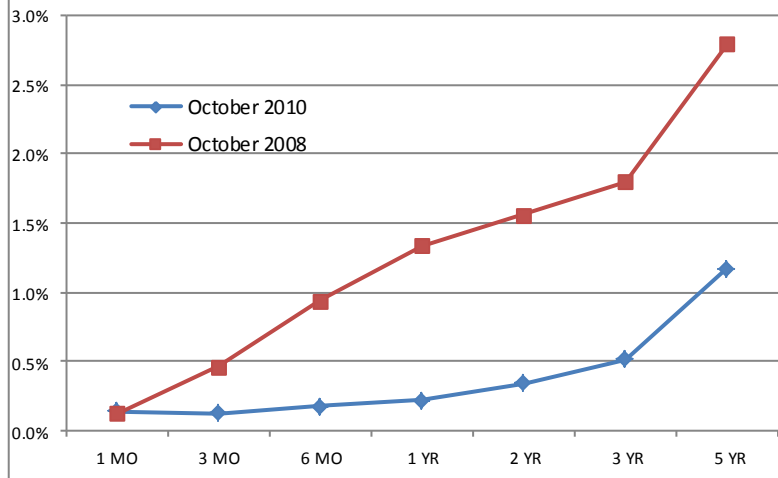
the MSCI, representing developed international markets, rising 18% and emerging markets jumping nearly 20% for the quarter. The rally was not, however, confined to financial assets. When we look across the commodity complex, we see that prices advanced briskly as well. The broad commodity indices like the Reuters/Jefferies CRB Index advanced more than 10%, led by agricultural commodities and precious metals. Palladium prices

climbed more than 28% during the quarter, for example, while corn and wheat prices both soared more than 40%.

When we then search for something that didn't rally in the 3rd quarter, the only thing we really find is the US Dollar. As measured against a basket of foreign currencies, the dollar declined by more than 5% during the quarter.



1 MO - 5 YR US Treasury Yield Curves



At the same time, interest rates continued to decline across the entire yield curve with the middle of the curve, represented by the 5-year Treasury, dropping more than half a percentage point - from 1.79% on June 30th to 1.27% on September 30th. As shown in the nearby chart, the 5-year yield has now dropped to 1.13% - a rate last seen in the Great Depression.

Therefore, it appears that a weakening dollar and very low interest rates are driving investment funds into asset classes - like equities and commodities - that offer the

prospect of higher investment returns and/or protection against a declining dollar.

Commodities – The New “Reserve Currency?”

Cotton, silver, palladium, nickel and corn all have one thing in common: They are not a dollar bill. And neither are they a euro or a renminbi or a rupee...or any of the other currencies that central bankers around the world are aggressively debasing.

It's not just our own Federal Reserve that is debasing its currency, many other countries are behaving likewise. As Eric Sprott, Founder of Sprott Asset Management, recently noted in his *Markets at a Glance* letter:

“By our count, no less than 23 separate countries have now intervened in the foreign exchange market in some way since Sept. 21, 2010. The goal for all is to increase the supply of their respective paper currencies in order to drive them down in value.”

In a world where every major currency is suspect, commodities offer a compelling alternative. Gold is, of course, the traditional alternative to paper currencies. But it is not the only one. As stores of value, a bale of cotton or a bushel of wheat also provide stiff competition to paper currencies.

China's recent investment behavior also supports the idea that commodities are becoming a kind of currency substitute. “This year, for the first time ever,” Barron's reports, “China has been investing more overseas in assets like iron, oil and copper than it put into US government bonds.

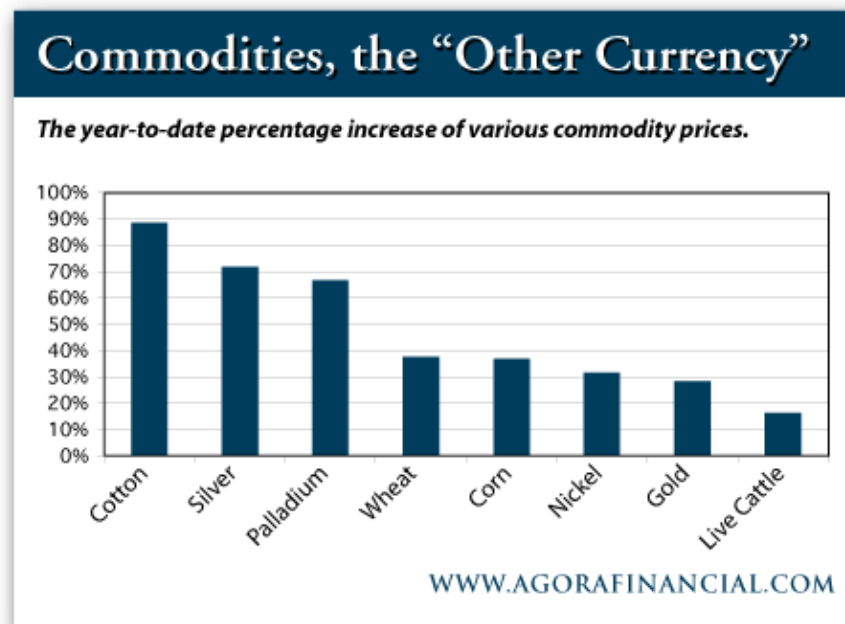
“China in this year's first half spent \$31 billion on hard assets,” Barron's continues, “compared with \$23 billion on Treasuries and other US government bonds. Experts say China's investments in each of these asset classes will total about \$55 billion for the full year. But even a tie marks a major turnaround from China's previous practices. For many years, the mainland spent next to nothing on hard assets abroad, while its purchases of US government debt ranged



as high as \$100 billion a year."

Monetary tastes and habits - like culinary tastes and habits - do not change overnight. But once these habits begin to change, they rarely regress to their previous condition. McDonald's opened its first restaurant in China in 1990 - trying to sell hamburgers to a populace accustomed to eating rice and chicken. Twenty years later, 1,100 McDonald's restaurants dot the Chinese landscape...and 1,000 more will open by 2014.

In the same way, China's monetary tastes and habits are also changing. As the world's largest buyers of Treasury debt, Chinese monetary tastes will not change overnight, but they are clearly changing...to the detriment of the U.S. dollar and the U.S. Treasury. If the Chinese – and other foreign investors – increasingly prefer hard assets to Treasury debt, we should expect the dollar to weaken over time and U.S. interest rates to rise.



But What About The Economy?

Economic growth in the United States remains very slow and not at all what one would expect or hope for at this point in a recovery. While there are areas that are growing, the overall picture is one of a very slow recovery, hovering on the edge of stagnation. In that regard, a selection of comments from the Federal Reserve's Beige Book, which summarizes the

Fed's view of the economy, is informative. In its August 30, 2010 report the Fed observed:

"Summary Reports from the twelve Federal Reserve Districts suggested continued growth in national economic activity during the reporting period of mid-July through the end of August, but with widespread signs of a deceleration compared with preceding periods.

Consumer spending appeared to increase on balance despite continued consumer caution that limited nonessential purchases.

Home sales slowed further following an initial drop after the expiration of the homebuyer tax credit at the end of June, prompting a slowdown in construction activity as well.

[Construction] activity in residential real estate markets declined further.

Demand for commercial, industrial, and retail space generally remained depressed.



Manufacturing activity expanded further on balance, although the pace of growth appeared to be slower than earlier in the year.

Activity was largely stable or up slightly for professional and other nonfinancial services.

Lending activity was stable to down slightly on net.

Demand for agricultural products continued to expand, and producers benefited from relatively tranquil supply conditions.

Demand and extraction activity increased for producers of natural resource products, including oil and other items used for energy output.”

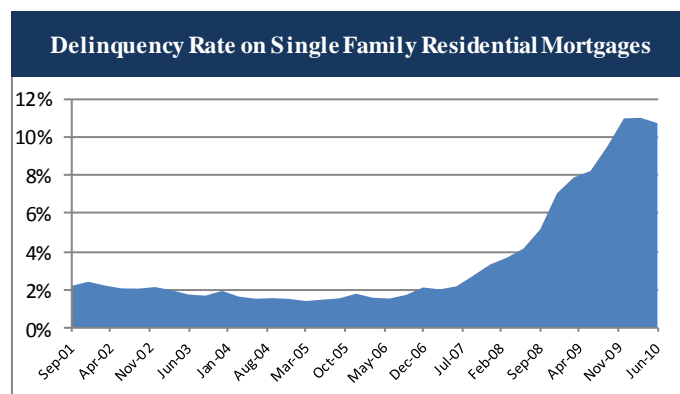
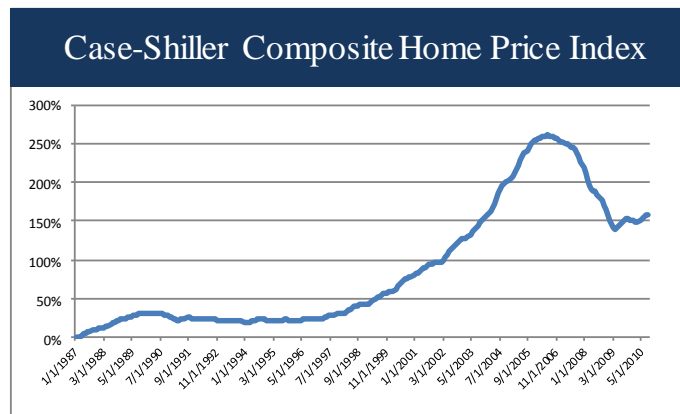
We quote from this report at some length, as it captures the overall tepid character of current economic growth in the United States. In light of the relatively strong stock market, we are left pondering the contrast between the two. Much of this contrast between the stock market strength and the economy's weakness can be explained by the fact that the US economy is only part of the story. Simply stated, our economy is domestic; our stock market is global.

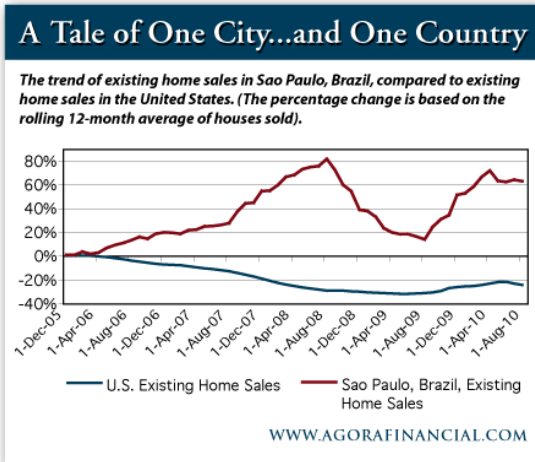
A Great Divergence: The Economy v. the Market

The US portion of the global economy is still dealing with substantial structural issues that cannot be quickly or easily mended. In the housing market, for example, prices remain very soft. Housing prices are still off more than 25% to from their pre-recession highs.

In a similar vein, the continuing very high level of foreclosures, as shown on the Federal Reserve's Delinquency rate chart, provides very clear evidence that the housing market is not yet in anything close to a recovery mode. While this problem will eventually be resolved, "eventually" could be a goodly ways in the future. In the meantime, we cannot expect to see the type of activity in the real estate sector that helps create wealth or, more importantly, domestic jobs.

The housing market in Sao Paulo, Brazil offers a very distinct contrast to the travails of the U.S. housing market. Property prices are climbing in Sao Paulo, as Brazil's GDP growth continues to hum along.



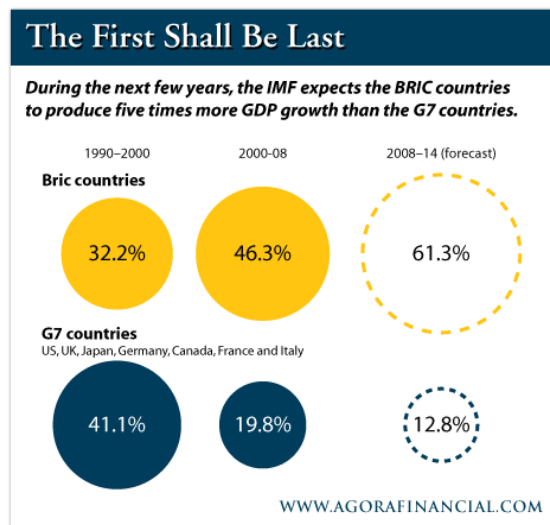


The robust Brazilian real estate market provides just one very clear picture of how differently some foreign economies are performing, relative to the US economy. In the case of Brazil, the economic trends are not merely "different," they are opposite. During the last three years, Brazilian GDP has grown at an annualized rate of 4%. During the same time frame, US GDP has not grown at all. In fact, it has dropped from \$13.36 trillion to \$13.26 trillion.

Global v. US Economy

The relative strength of many emerging market economies is playing an increasingly important role in the global economy and, therefore an increasingly influential role in our financial markets here at home. Over the next few years, the emerging economies are likely to continue growing much faster than the advanced economies.

According to projections from the International Monetary Fund, the economies of Brazil, Russia, India and China (BRIC) will produce more than 60% of the entire world's GDP growth between now and 2014. By contrast, the G-7 countries, combined, will produce only one fifth as much growth.



The rapid growth rates of various foreign economies bear directly on the financial results of many of America's leading publicly traded companies. Not only do companies like Apple, McDonald's, Coca-Cola and Johnson & Johnson generate at least 40% of their revenues overseas, but the international operations of these four companies are also growing at much faster rates than their domestic counterparts. Apple's U.S. revenues, for example, grew an impressive 22% during the last two years. But at the same time, the company's European sales jumped 43% and its Asia-Pacific revenues soared 85%.

This striking difference in growth rates – both actual and anticipated - partly explains why the U.S. stock market is able to advance, even when the U.S. economy is stuck in neutral.

A couple of brief examples from recent news items will help complete the picture. It has been widely reported in the financial press that 3rd quarter corporate earnings have been coming in quite strongly, with more than 80% of the reporting companies, "exceeding analysts expectations." But reports from two well-known companies are illustrative of the divergence we have been considering. Costco reported on October 6, that "increased revenue from selling



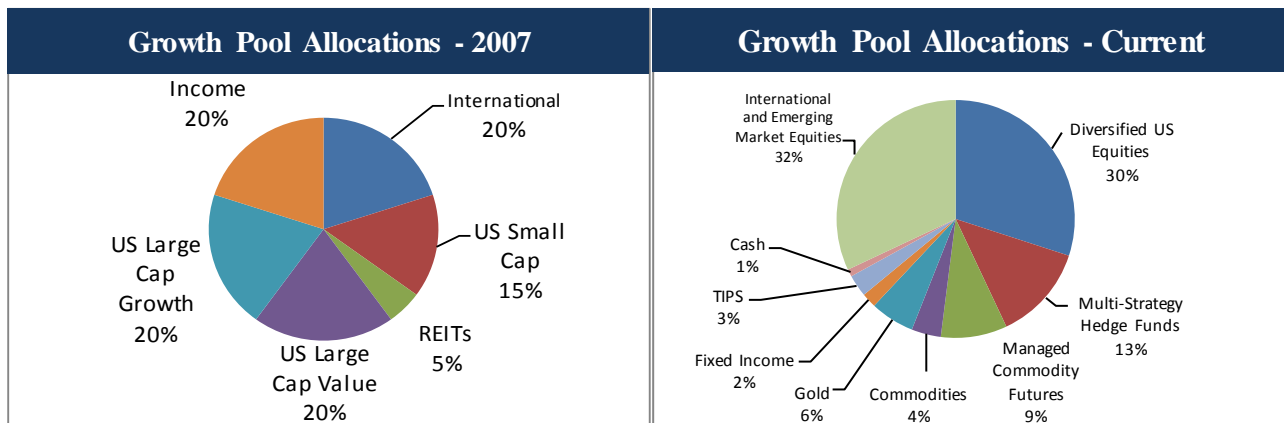
memberships and strength overseas helped push...net income up 16% in the quarter.”

The strength overseas part we get. The “selling memberships” part Costco attributes to “the [growing] number of customers in its clubs...as shoppers hunt for deals in the weak economy.” AP News. Costco has been helped, in other words, by distress at home and strength abroad. Similarly, but even more poignantly, Fed Ex, in reporting its earnings on September 16, 2010, stated that “strength in international shipments is driving profits, but also announced plans to cut 1,700 jobs in an attempt to fix its money-losing U.S. trucking business.” AP News Release.

So there is in fact a Great Divergence between the economy we experience and the economy to which stock markets may respond. Our challenge, then, is to recognize the economic trends and conditions that influence the financial markets, rather than the economic conditions that affect us directly. Truly, for everyone, it is difficult to take risks of any sort at a time when the economy is struggling. Nonetheless, a prudent and coherent investment strategy calls for a steady hand. We conclude this report by considering some of the ways we bake that “steady hand” into our portfolios.

Portfolio Construction

As you may recall from last quarter’s report, beginning in late 2007, we made substantial changes in our asset 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. 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.



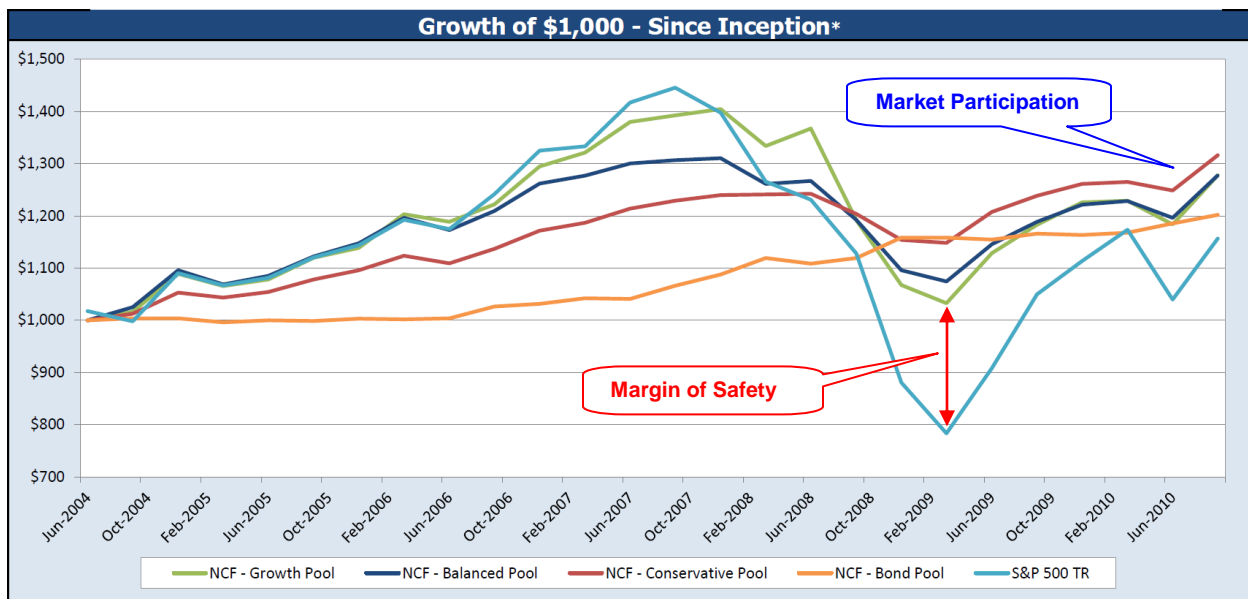
These allocations are representative of all three equity pools – Growth, Balanced, and Conservative – as the components of each are essentially the same but with the weighting of the components varying according to the intended investment time horizon of each pool. The Conservative pool, for example, has the lowest risk profile of the three pools, with the lowest weighting to volatile components like equities. As such, it is appropriate for minimum holding periods of one to three years. The Balanced Pool, because of its larger allocation to volatile asset classes, is appropriate for three- to five-year timeframe. The current Growth Pool allocation (shown in the pie chart above) has a 62% allocation to global equities. That is appropriately aggressive for our longest-term, highest risk portfolio. Therefore, we consider the



Growth Pool to be appropriate for holding periods of five years or longer.

Since many of our donors make very frequent grants, a majority of our pooled assets are actually held in the Money Market pool. The Investment Performance Report on the NCF web site contains detailed performance information on each pool, including the exact asset class weightings.

We have stressed in the past that our original purpose in seeking broader diversification was to produce lower risk portfolios, particularly in times of crisis, so that relative to the stock market, our pools would have a margin of safety. As shown in the long-term performance chart below, that has in fact been the case.



But to complete our discussion of the Great Divergence that in fact exists between the economy we experience personally and the forces to which stock markets respond, our investment portfolios also represent a commitment to maintaining a long-term investment approach that considers both domestic and international economic trends and influences.

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. Accordingly, the NCF investment pools have taken risks in pursuit of long-term investment returns. But those risks have been, and continue to be, selective and deliberate.

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.



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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 within the National Christian Foundation to help support you in your charitable giving.