



Humility Revisited

The NCF Investment Strategy Report December 2010

Humility is one of those nettlesome Christian virtues that is easy to praise but difficult to practice. No matter how hard we try, we often conduct our lives with a subtle form of arrogance. We act as if we know what's best for our friends or who should be elected President or what investments are going to give us the best returns. In the midst of this subtle arrogance, we usually don't discover the error of our ways until after the fact.

The apostle James recognized this problem when he wrote:

“Now listen, you who say, ‘Today or tomorrow we will go to this or that city, spend a year there, carry on business and make money.’ Why, you do not even know what will happen tomorrow. What is your life? You are a mist that appears for a little while and then vanishes. Instead, you ought to say, ‘If it is the Lord’s will, we will live and do this or that.’ As it is, you boast in your arrogant schemes. All such boasting is evil.”
James 4:13-16

Pretty harsh on the one hand, but pretty accurate on the other. And notice also that the example James uses of “arrogant schemes” is taken directly out of the business world. If he were writing today, he might just as easily have said,

“Listen, those of you who say, ‘I’m going to increase the allocation to small capitalization stocks in my portfolio because at this point in the market cycle small caps always outperform large caps, and therefore we will increase our returns.’ Why, you do not even know what Ben Bernanke is going to do tomorrow.”

Amen! Humility is an investment management tool that, when wedded to diligence, produces numerous practical benefits. But the reasons for this are not obvious because of the double-sided nature of “risk”. It is, on the one hand, something we wish to avoid. But on the other hand, it is unavoidable. ***All investing involves taking risk.***

So our effort is to only take those risks that make sense. In that regard, humility helps us avoid those risks, for example, that will only produce good returns if our predictions about the future are correct. Investments with very complicated structures, shares of highly leveraged companies or even long term bonds, can all fall into this category. In our pools, we do our best to avoid them.



The risks we do embrace are those that have a reasonable likelihood of generating solid returns, no matter what the future may hold. In this arena, we include some investments that look the same as everyone else's, such as short-term government bonds, US, International and emerging market equities, and cash. But we also utilize investments that are a good bit "different." This category includes broadly diversified, multi-strategy hedge funds, commodity funds that invest in raw materials such as corn, wheat, aluminum, copper and oil, and even gold. In the aggregate, we strive for a mix of assets that does not presume upon the future or rest too heavily on our prescience.

In some of our past writings, we have examined specific tactics that enable investors to embrace risk intelligently. Those articles have addressed:

- Avoiding leverage and complexity;
- Acknowledging our need to build walls around our portfolios in a manner similar to Nehemiah's need to build walls around Jerusalem; and,
- Steering clear of those risks that are inherently more dangerous than others.

The article on avoiding leverage and complexity is entitled, *The Beginning of Wisdom*, and is available in the Forms and Reports section of the NCF website. Similarly, our discussion of the way we emulate Nehemiah, by building walls around our portfolios, was part of our Q1 2010 Investment Strategy Report, that is also available on our website.

But the discussion of those risks that are more dangerous than others, and the very important reasons we try to avoid them, was published elsewhere . . . and it is to that idea that we now turn our attention.

Not All Risks are Created Equal

The idea that some risks are more dangerous and therefore "riskier" than others is sometimes described as "**asymmetrical risk.**" Asymmetrical risk exists whenever the potential cost of the risk, however unlikely, outweighs the more probable benefits. It is a subtle, but extremely important concept.

In October of last year, a key member of our investment supervisory team, Eric Fry, wrote about asymmetrical risks in an article entitled, *The Consequences of Risking Everything*. Here is an excerpt of his observations.

In life, there are things, and there are treasures...

Things are common. Treasures are rare. A few days ago, I lost one of my treasures – a cat named Uzi. Yeah, I know, Uzi was "just a cat." But that reality did not make her any less of a treasure. In so many different ways, that little cat made me smile...or laugh. She was just a cat, but she was precious to me...which is why I spent hundreds of hours during the last two years trying to keep her alive.

I live next to an open hillside that is home to a variety of wildlife, notably coyotes. But this same hillside is also home to rabbits, mice, lizards, birds and numerous other varmints that excite the



predatory instincts of a small feline. So it was next-to-impossible to keep Uzi off that hillside. She would hunt up there almost every day... And almost every day, she would return to the house with some sort of mauled “trophy.”

As long as Uzi conducted her hunting forays during daylight hours, the risks were very small that the hunter would become the hunted. But as soon as the sun dipped below the horizon, the balance of risk would shift dramatically against Uzi.

At nightfall, nocturnal predators like coyotes and owls make the rules for small felines. The problem was; at nightfall, felines still make the rules for mice. And so Uzi was never keen to abandon the thrill of the hunt to return to the relative ennui of watching prime time television from my couch.

Given the chance, she would roam the hillside at night. But she was rarely given the chance. I was obsessive about keeping her indoors at night. In fact, I was obsessive about locking her indoors well before sunset.

On those rare occasions when she remained outside after sunset, I would scour the hillside until I found her. Sometimes the search lasted a few minutes; sometimes a few hours. But I would continue the search until I found her. Only twice during her two-year life, did I fail to find her. Once, she spent the entire night outside. Once she returned about 1:00 in the morning with a mouse in her mouth.

On both occasions, I feared the worst. I assumed a coyote had found her before she found her way back to the house. Three nights ago, the worst came to pass. I searched for Uzi off-and-on from 5:00PM until 2:00 AM. Fifteen minutes after I walked back into the house the last time, I heard the chilling yelps of coyotes that had just captured prey.

Their prey was my cat...I was heartbroken, and I still am.

Why the big to-do about a cat?

The answer is two-fold – one part personal, one part universal. The personal part is that I loved Uzi. The universal part is that asymmetrical risks demand extreme vigilance.

Investors take note...

First, let’s define our terms: An asymmetrical risk has nothing to do with the odds of a given risk, but everything to do with the consequences of a given risk. In Uzi’s case, the odds that a coyote would kill her were relatively low, even on a hillside frequented by coyotes. In fact, the numerical odds were hugely in her favor. She spent more than fifty evenings on that hillside before finally encountering a fatal evening. So let’s say the odds were 50-to-1 in her favor. But the consequences of that risk were massively asymmetrical. In our hypothetical 50-to-1 risk, Uzi returns to the house alive 50 times out of 51. But one time in 50, coyotes kill her. By the numbers, that’s a good risk. In reality, that’s a horrible risk.



No investor would take a bet like that...at least not knowingly.

But investors take asymmetrical risks every day . . . they just don't know it. Investors accept miserly yields, for example, in exchange for buying the bonds or preferred stocks of bankrupt, or near-bankrupt, companies. In the "Bailout Era" of American finance, risks like these have tended to succeed most of the time. But when they don't succeed, as happened to those holding A-rated bonds of Lehman Brothers, investors lose everything.

We investors cannot afford to turn a blind eye to risks, especially not to asymmetrical risks. We investors cannot afford to take risks that are likely to work, but are likely to wipe us out if they don't work. Understanding your potential rewards is worthwhile. **Understanding your potential risks is everything.**

There are numerous practical applications to our passionate desire to avoid asymmetrical and other , inappropriate risks. And many of these can be found in different aspects of our investment portfolios, as shown in the adjacent Conservative Pool allocations chart. You will see that we use Treasuries, TIPS and money market funds to provide liquidity and returns that are unaffected by market volatility. We use international, US and emerging market equities to provide growth in good times and we use multi-strategy hedge funds, commodities and gold to provide potential returns in down markets and protection against inflation.

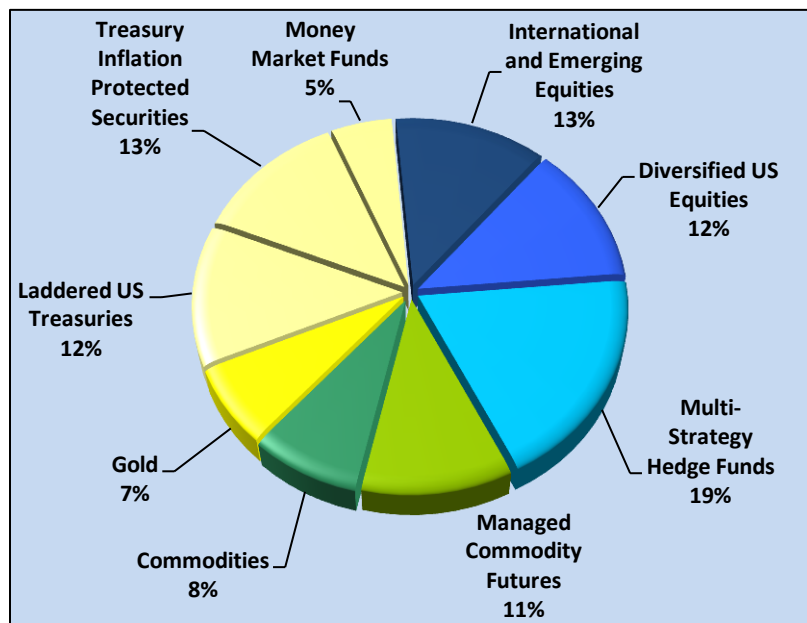
Each of the components serves a purpose – each is part of the Nehemiah wall that we build around our portfolios - to protect against the "foreign armies" of debilitating losses or the "robber" of inflation.

*But what is most interesting about the entire effort to avoid inappropriate risks, is that our work is often expressed **in the investments that we do not make.***

Consider, for example, the robber

of inflation. Often it arrives like a thief in the night, to steal wealth from investors by gradually "inflating away" the value of their holdings. But at times it arrives like a brazen daylight robber, to steal wealth by inflicting very large losses on vulnerable investments.

Consider the plight of a 30-year Treasury bond in an environment of rising inflation and interest rates. As this article goes to press, the 4.25% Treasury Bond of 11/15/40 currently yields 4.72%. If rates merely rise one percentage point – to 5.72% - the value of this bond would fall by 14%. A move to 6.72% would





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cause the bond's value to fall by 26%. In the context of the NCF Investment Pools, earning a 4.72% current yield does not adequately compensate for the risk of 14% to 26% capital losses. And in case this example seems farfetched, please note that the price of this exact Treasury bond – the 4.25% Treasury Bond due 11/15/40 – has already tumbled by more than 10% in just the last two and one half months!

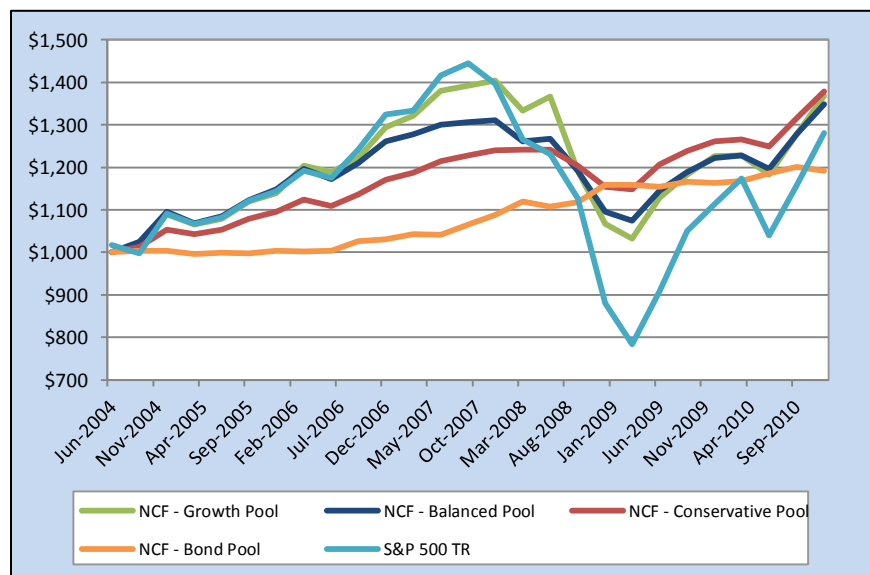
That is a very clear example of an investment you will **not** find in the NCF portfolios. The humility required to make this decision is only the willingness to admit that we do not know if inflation will heat up or if interest rates will rise. Our hesitancy to risk your funds on our prognostications of the future, leads us to simply avoid, so much as possible, investments that can hurt us badly if we are wrong.

The Practical and Spiritual Benefits of Safety and Security

The practical aspect of avoiding the most dangerous risks, is that our portfolios tend to maintain their value in tough times. The adjacent graph, taken from this quarter's investment performance reports, is a picture of the long-term benefits of this approach. (See, 4th Quarter Investment Performance Summary, under Forms & Reports at NationalChristian.com)

But the most remarkable aspect of pursuing safety and security is the amazing response of God's people. In Nehemiah's day, all the people of Jerusalem joined in rebuilding the walls around the city.

In our day, we are very mindful of the ways in which we are working with our givers every day in a collective effort to make funds available for Kingdom purposes.



We also read in Nehemiah, that 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 re-built walls.* And we have seen that same effect, as our givers have demonstrated amazing generosity, making 2010 our greatest year ever in terms of both contributions and grants to ministries. It is our sincere hope, that the walls we build around our portfolios will continue to provide that measure of safety and security that facilitates an outpouring of generosity. In doing our work, we remain deeply grateful both to God and to you for allowing all of us at the National Christian Foundation to help support you in your charitable giving.