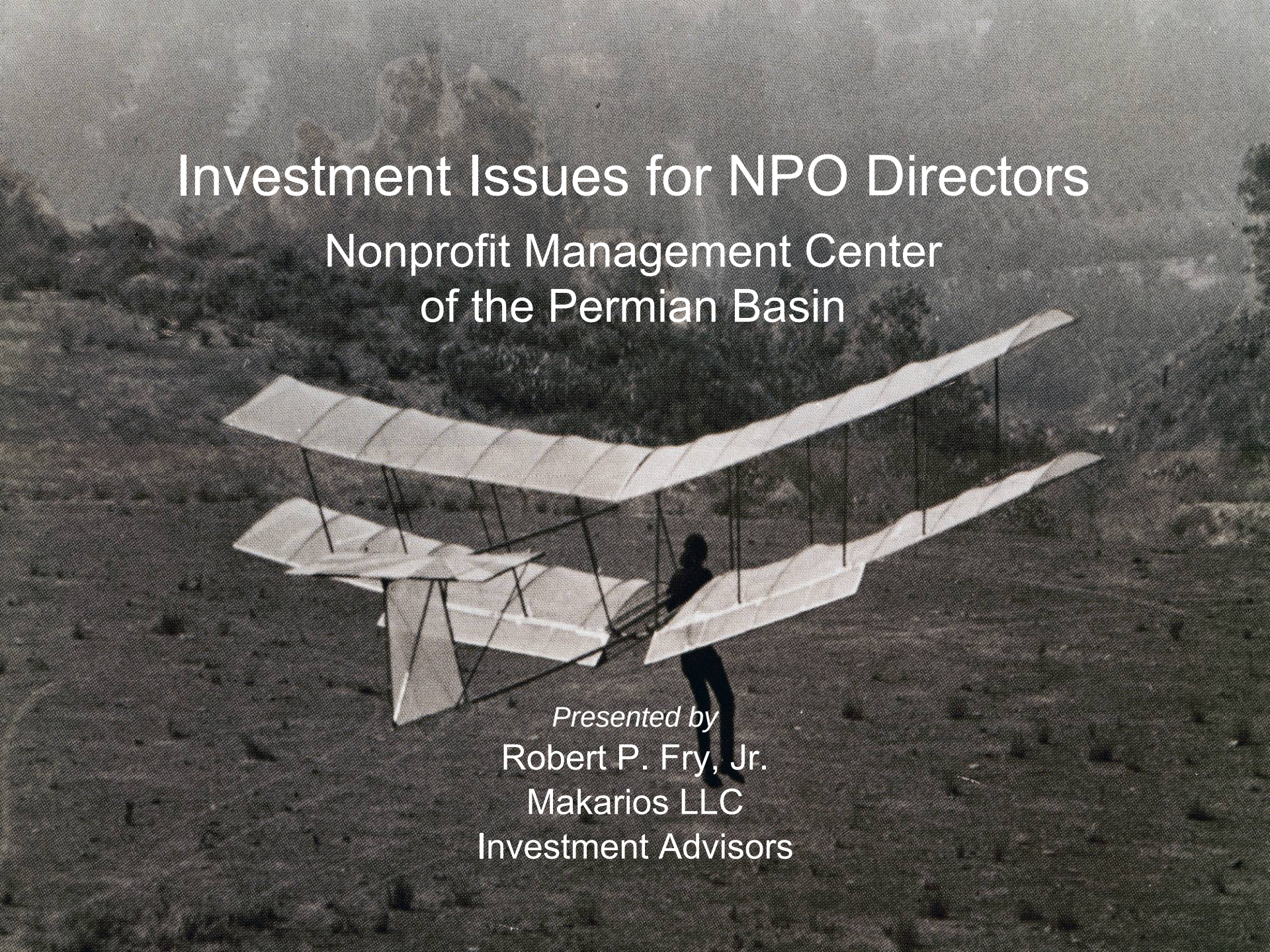
Investment Issues for NPO Directors

Nonprofit Management Center of the Permian Basin



Presented by
Robert P. Fry, Jr.
Makarios LLC
Investment Advisors

Outline of Today's Presentation

- NPO Investment Environment
  - Interest Rates, Credit Crisis and Credit Contraction
- Industry Trends
  - Spending Rates and Asset Allocations
- Practical Steps for Supervising Fiduciary Assets
  - Adopting an attitude of Humility
  - Creating appropriate Spending Policies
  - Assessing your tolerance for risk
  - Delegating authority
  - Reviewing the results

The NPO Investment Environment

- We live in a complex world
  - Life Styles
    - My work . . . her work . . . volunteer work
    - Sport's Club . . . Curves . . . AYSO
    - "Was that my cell phone, your Blackberry or my Trio?"
  - Finances
    - Is this the credit card with my frequent flyer points?
    - Why do I want to own Spiders?
    - Isn't the Hedge Fund a British environmental group?

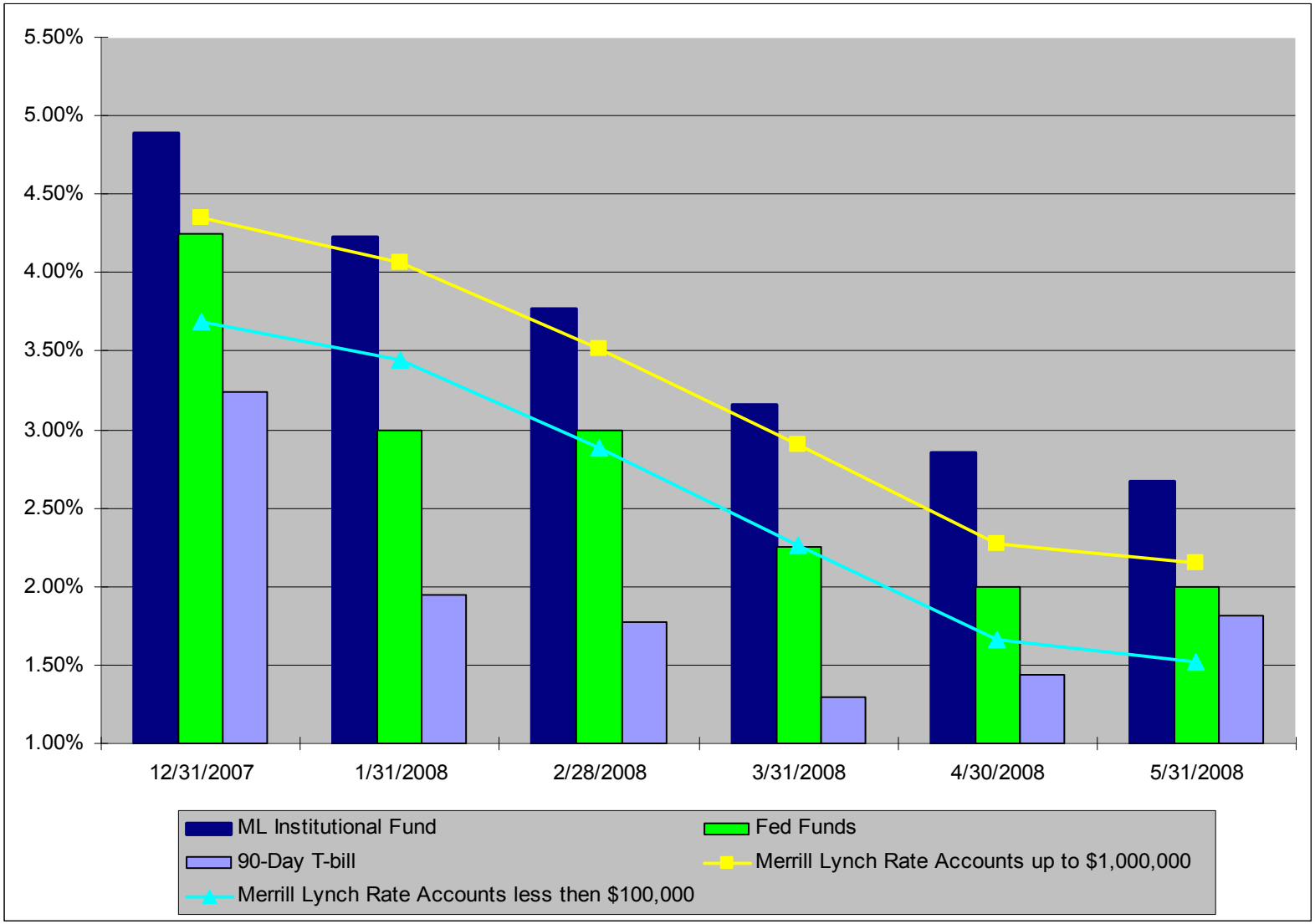
"Knowledge increases Vertigo," W. H. Auden

The NPO Investment Environment

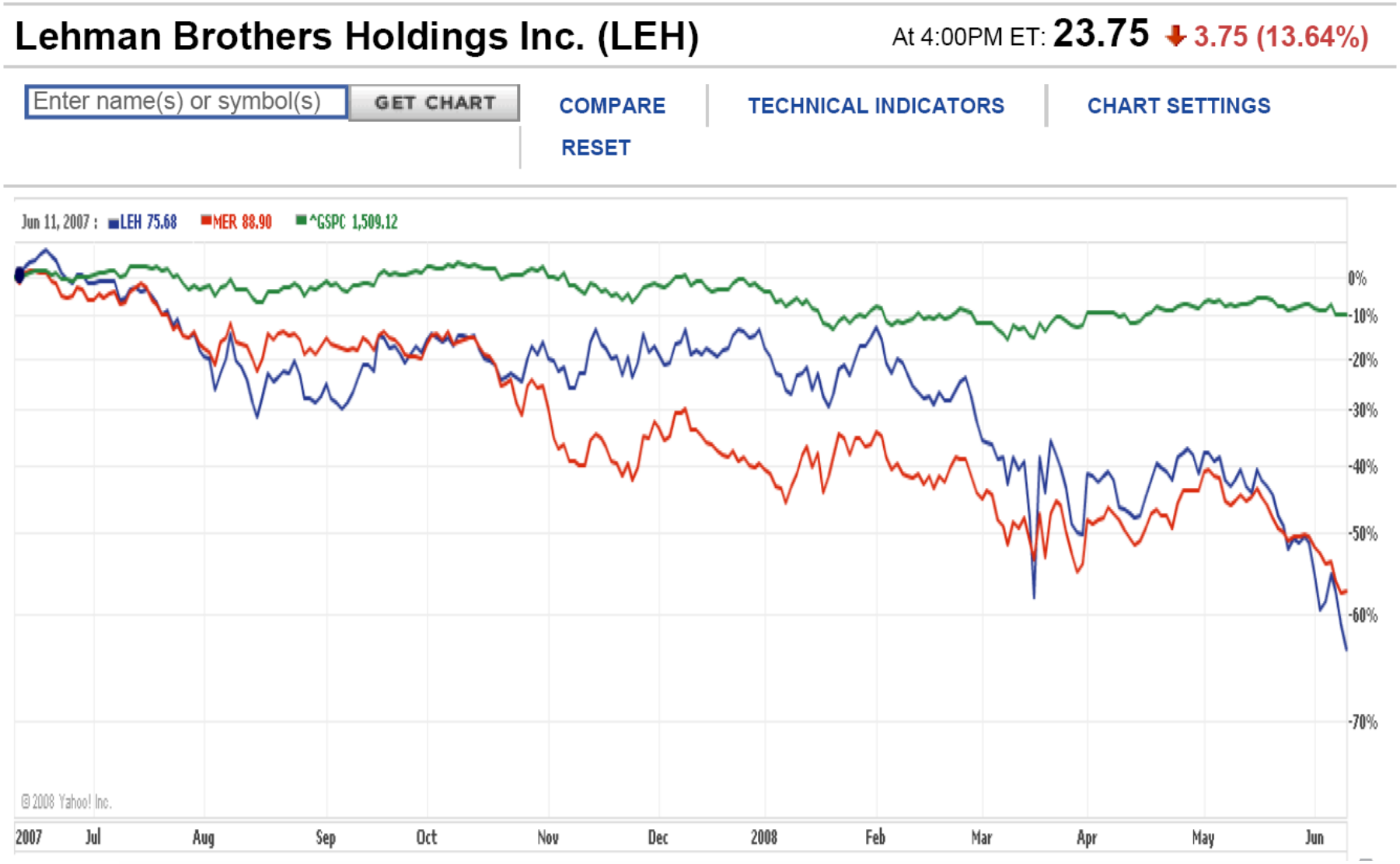
- We live in a world we can't control
  - Disruptive Technology
    - Cell phones and traditional long distance carriers
    - Internet and outsourcing
  - Random Acts of Government
    - Recent cuts in Fed Funds rates
      - Reduces interest on short-term savings
      - Increases likelihood of inflation
  - Nothing is Absolutely Secure
    - US Banks have ***LOST*** at least $250 Billion . . .

      . . . just in the last 12 months

Rapidly Changing Interest Rate Expectations



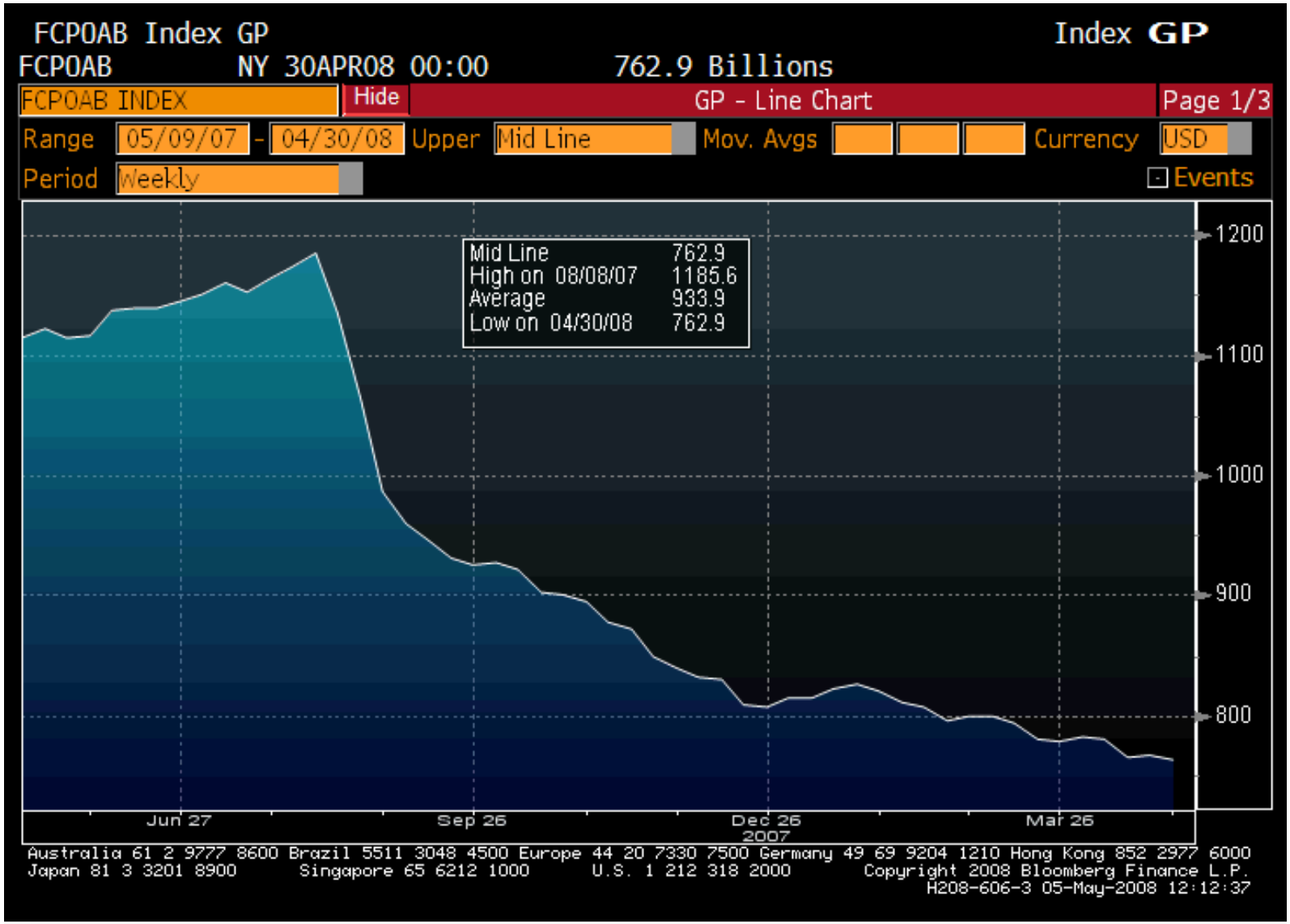
Unexpected Consequences at home . . .



. . . and Abroad

Depositors withdrawing funds at Northern Rock, the UK's one-time largest mortgage lender

Tremendous Contraction of Available Credit

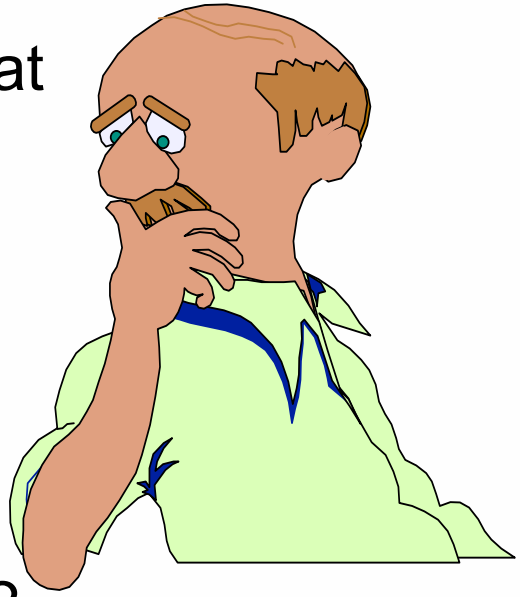


The NPO Investment Environment

- What does all this mean?
  - I don’t know!
- But it does suggest that . . .
  - There is always risk when investing
  - Stock market returns may be lower than we have come to expect
  - One can never be too humble in approaching money and markets
- Humility is a key step toward effective fiduciary investment management

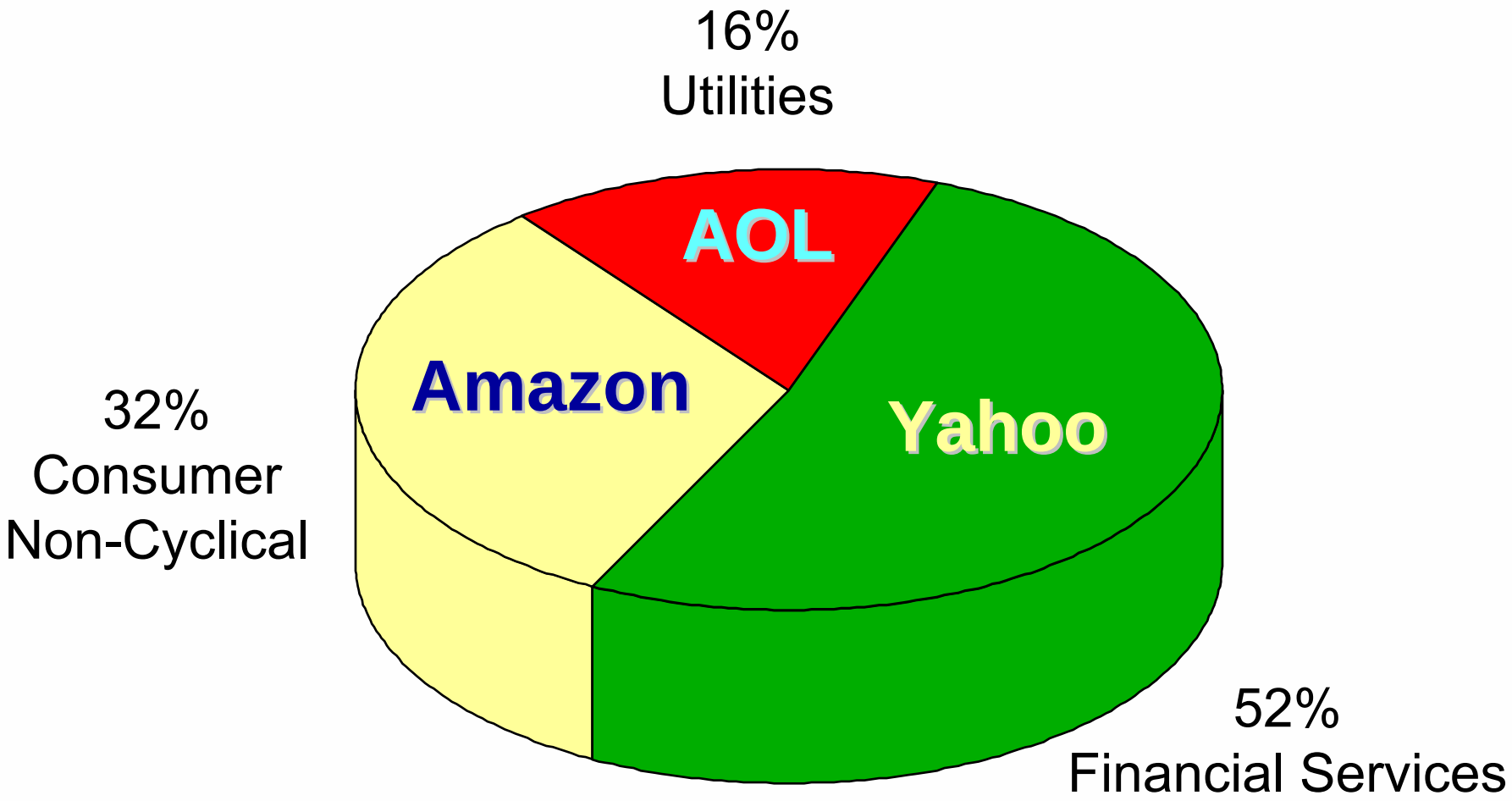
Practical Steps - The Case for Humility

- Think back to this time last year. . .
- Who predicted more than one of the following . . .
  - $50 Billion dollars in losses . . . just at Citibank and Merrill Lynch?
  - Hillary Clinton would say something nice about Barack Obama?
  - Oil at $140 a barrel?
  - The failure of Bear Stearns?
  - Odessa Permian 31, Midland Lee 7?



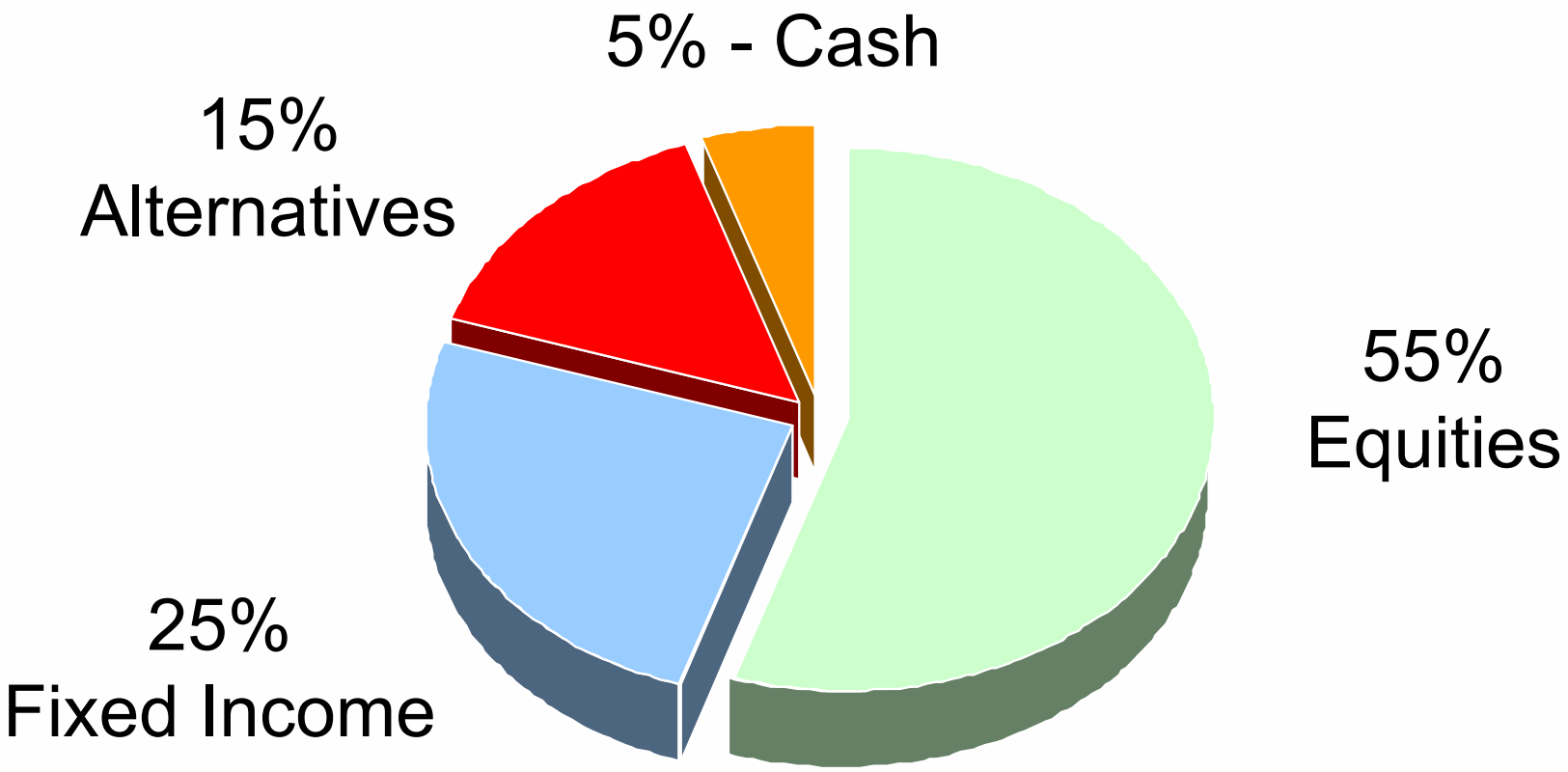
The Humility of Diversification

The "Fully Diversified" Yuppie Portfolio - Late 1990's



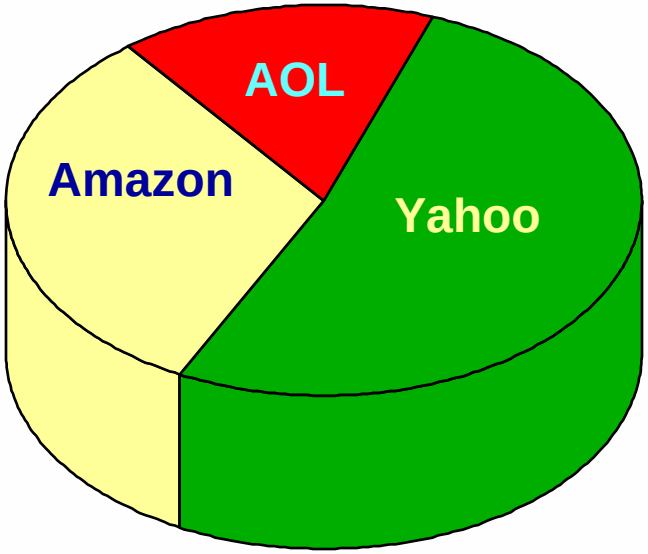
The Humility of Diversification

Sample Long-term Growth Portfolio - 1999

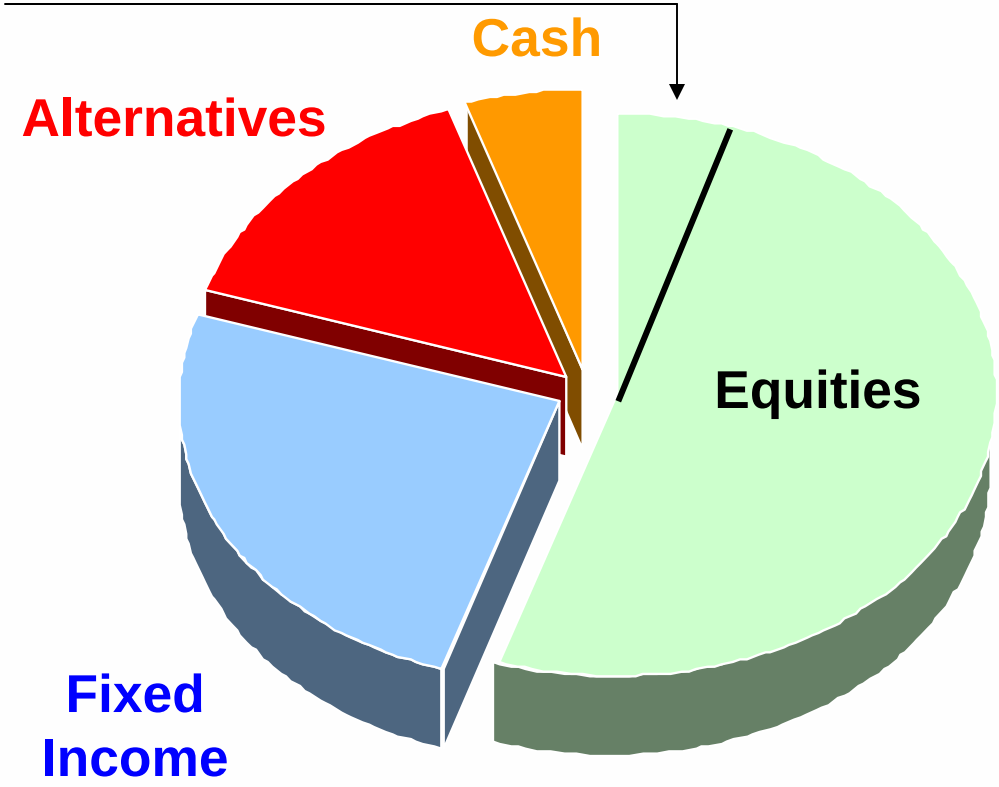


The Humility of Diversification

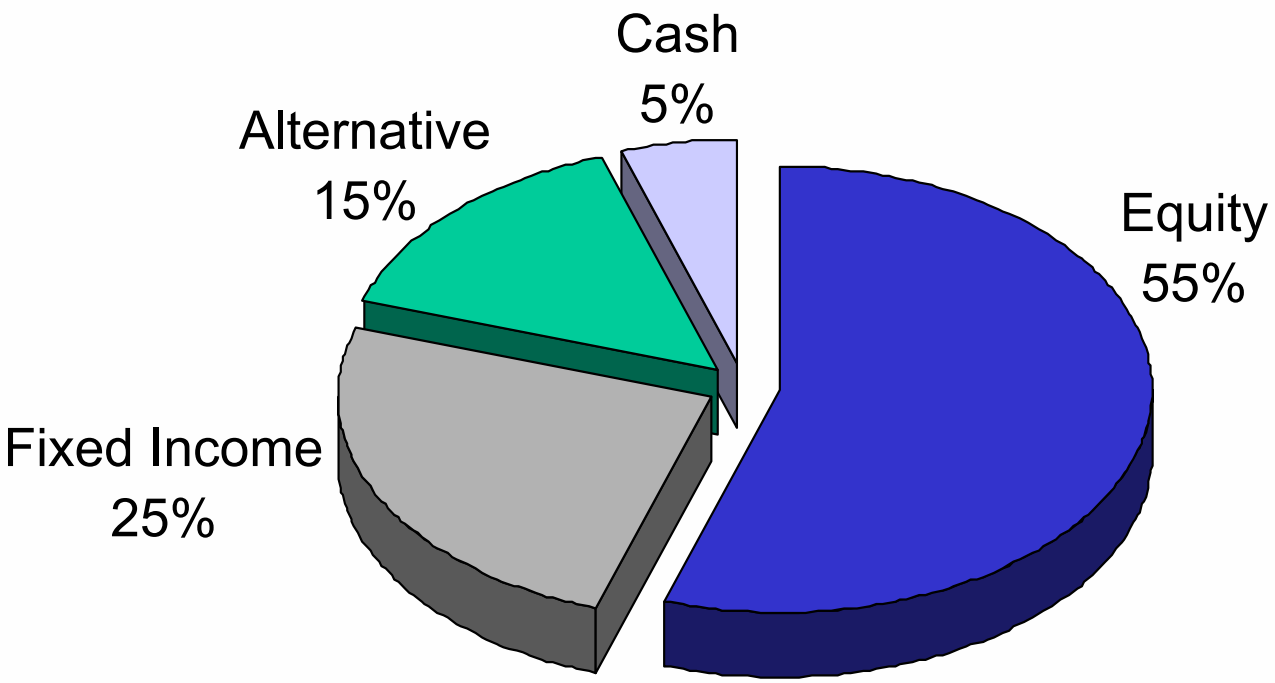
Intuitively, which is the lower risk approach?



A tiny slice of the potential pie!

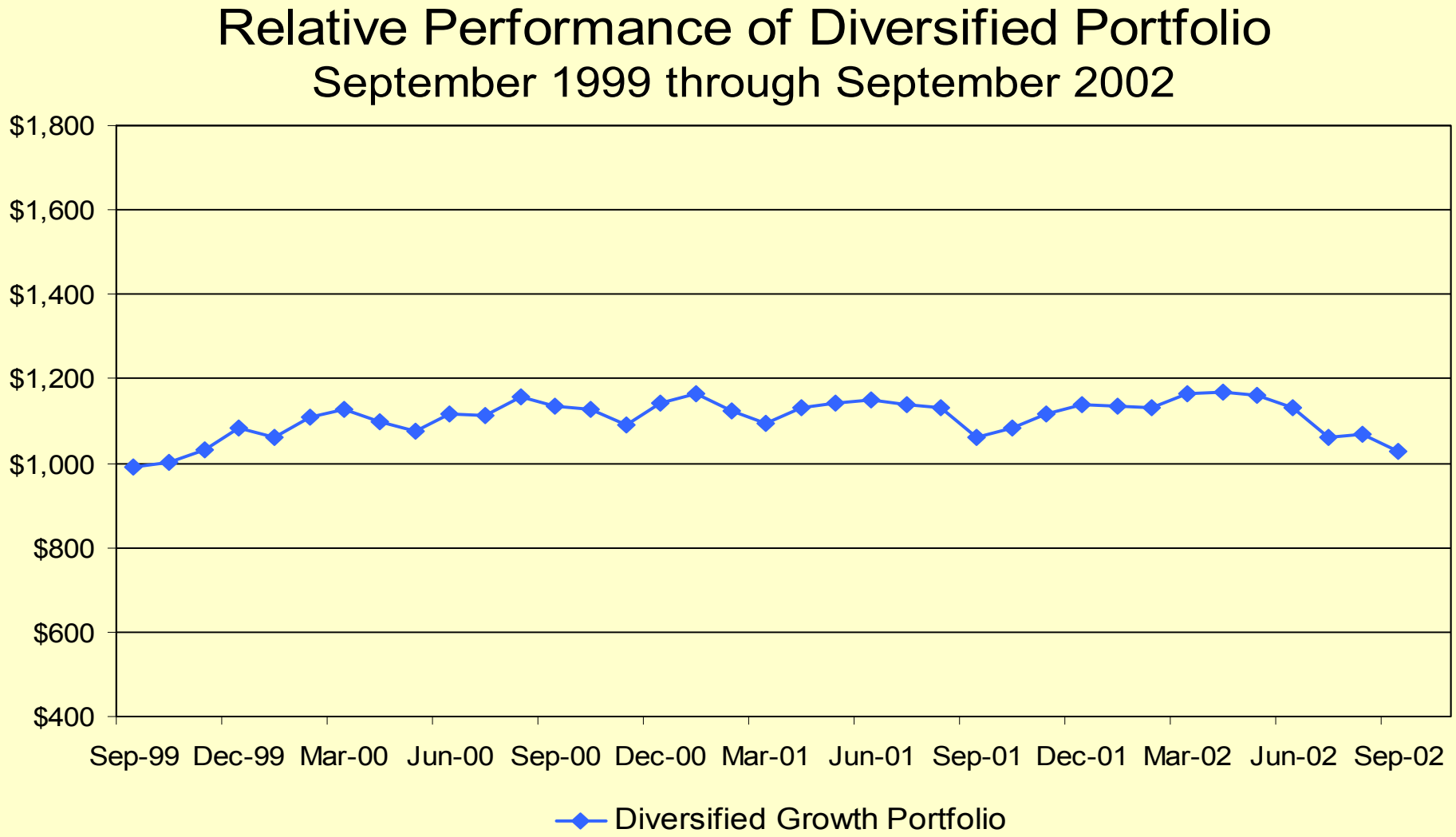


Asset Allocation – A Fully Diversified Portfolio



Sample Long-term Growth Investment Model - 1999

Three Year "Growth" of $1,000 Sample 1999 Portfolio



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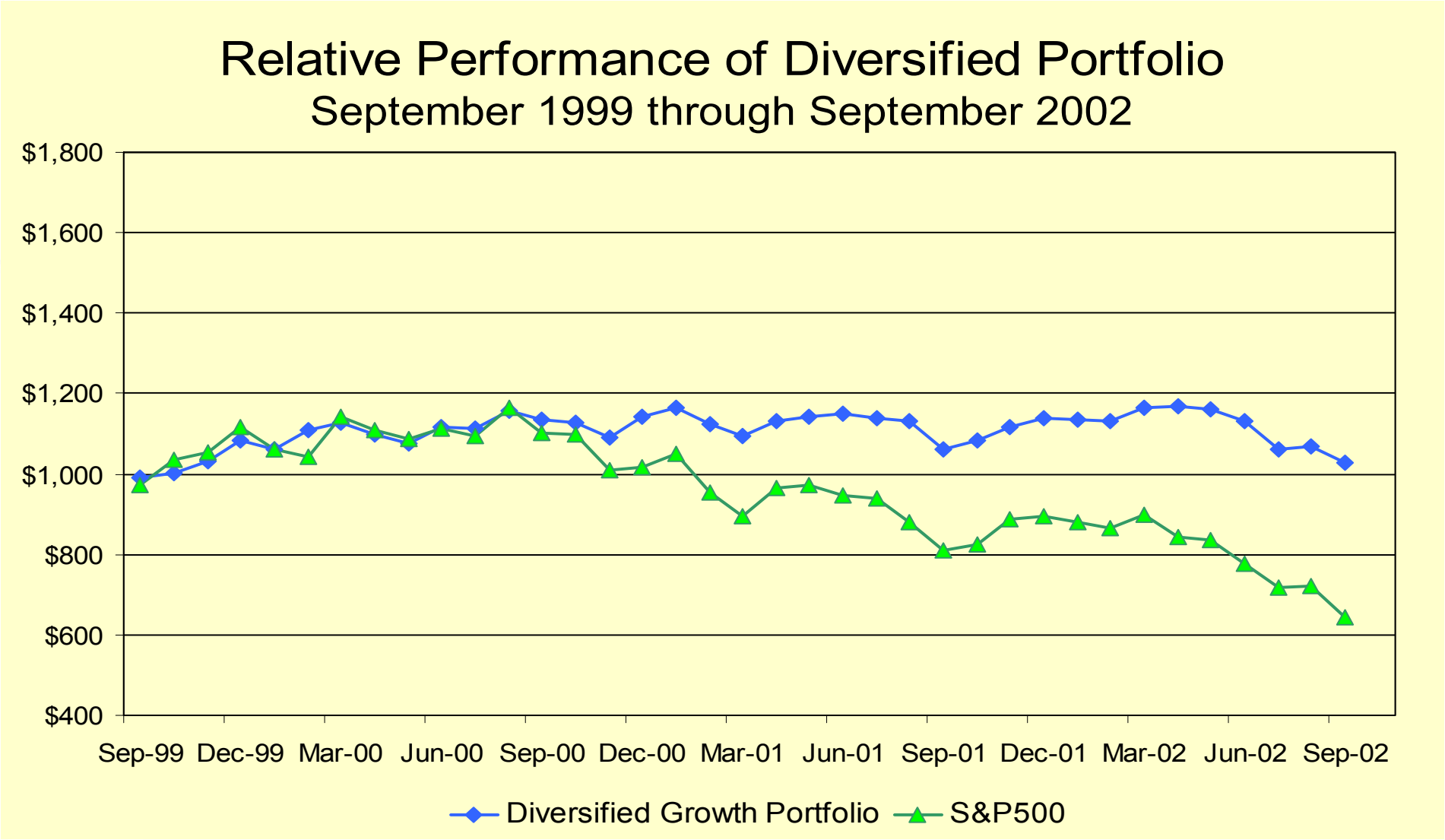

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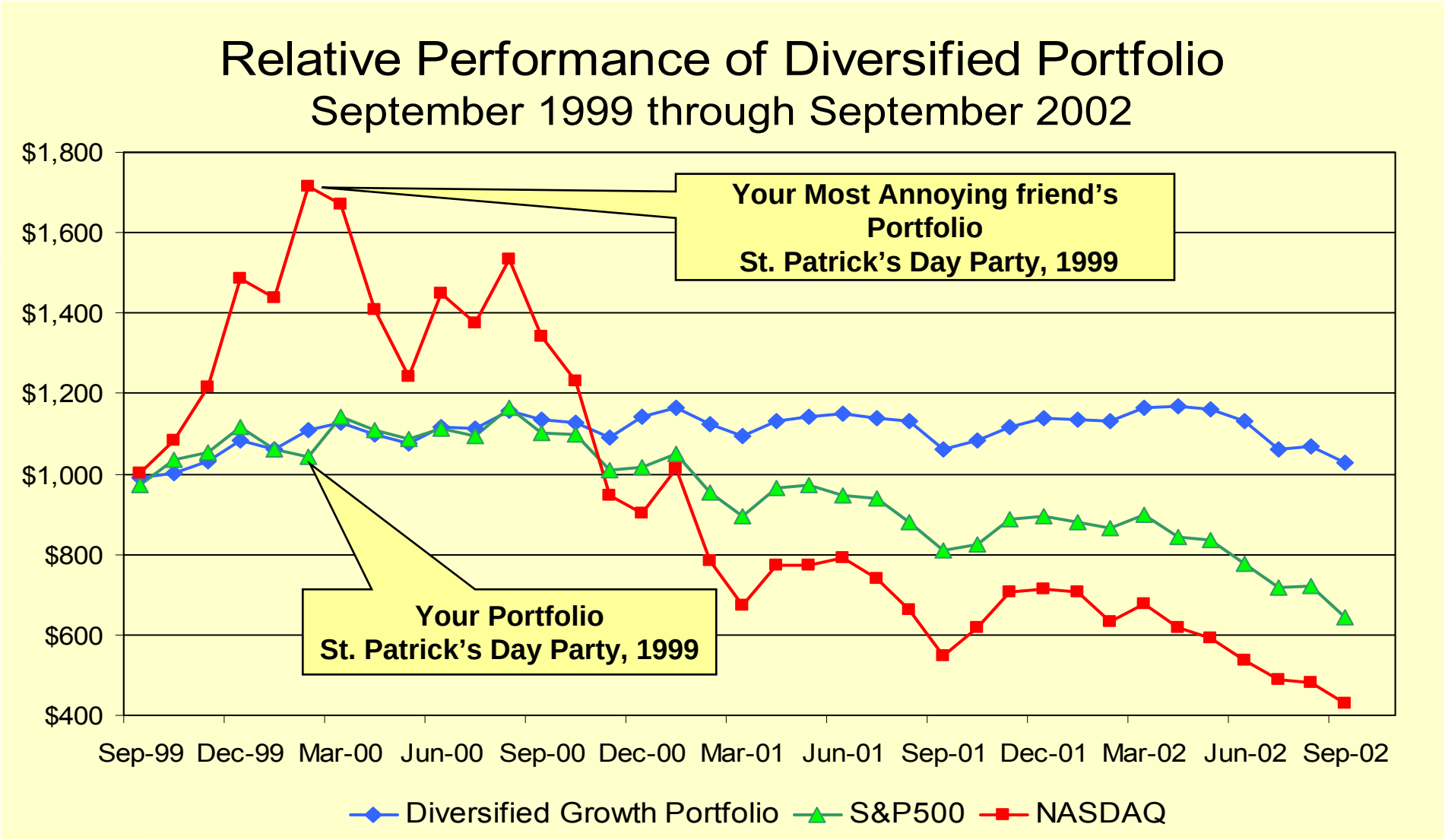
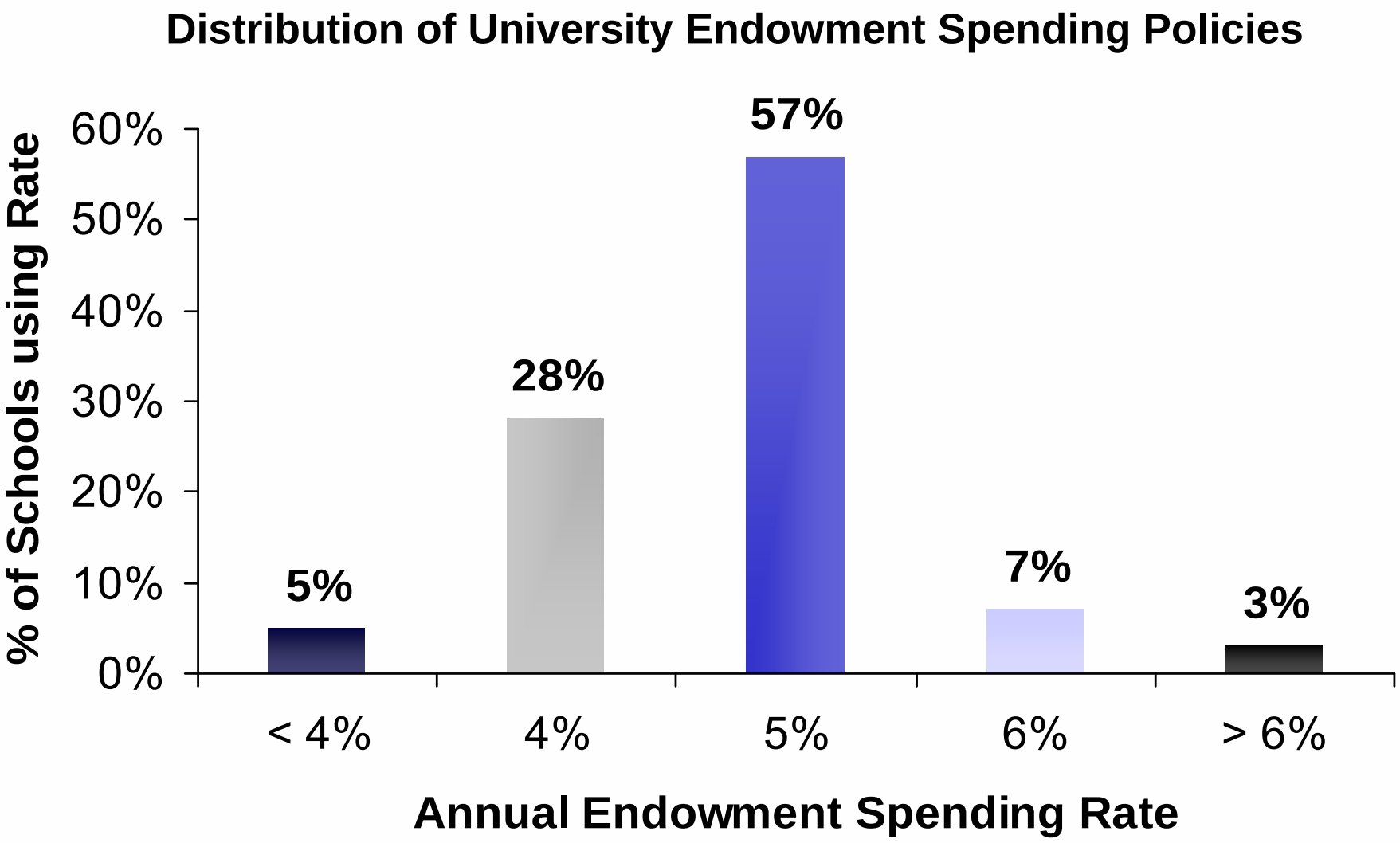
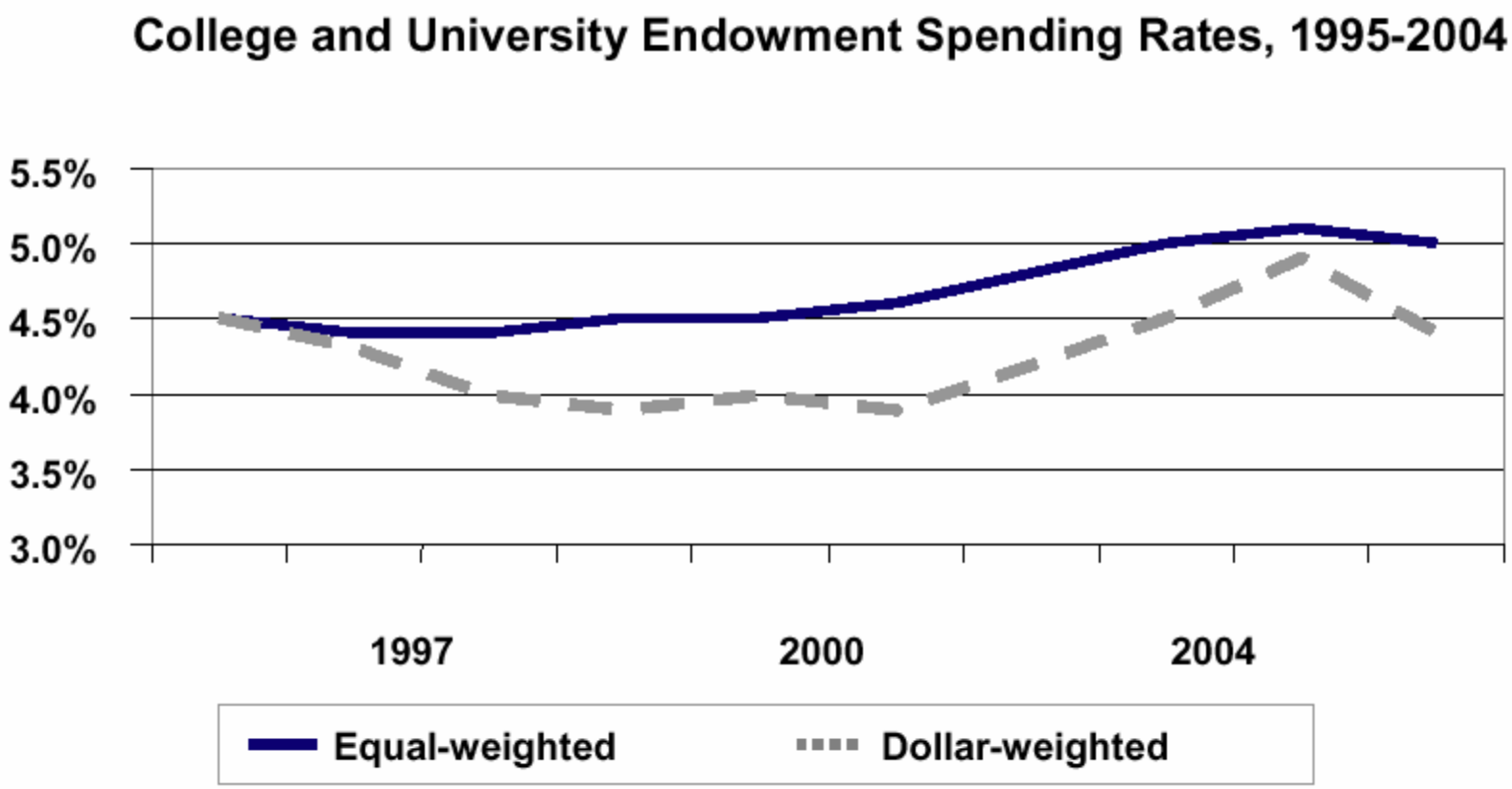


Industry Trend - Spending Rates



Spending Levels are Deeply Established

- Very consistent institutional desire to spend 5% of endowment Net Asset Value



Practical Response: Establish a Spending Policy

- Important to base spending on Total Return
  - Frees spending from yield objectives
  - Total Return is Different than Yield
    - Key concept in the professional investment world
    - Definition: Dividends and Interest
Plus Capital Gains
Less Capital Losses and Expenses
    - Includes unrealized gains and losses
    - Fundamental to all modern portfolio theory tools
      - Risk adjusted returns
      - Correlation
- Establish Net Asset Value Spending Policies
  - 1.25% per quarter
  - 12 trailing quarters

Sample Endowment Spending Policy

The fund shall annually distribute an amount equal to 5% of its then current value which shall include contributions to the fund, income earned on such contributions and all gains and losses on such funds, whether realized or unrealized. These distributions shall be made, quarterly, by distributing an amount equal to 1 1/4% of the: [Option]

- current fair market value of the fund on the first business day of each calendar quarter.
- average fair market value of the fund as of the first business day of each of the 12 preceding calendar quarters.

To the extent that it may legally do so, the organization shall interpret this policy as satisfying a gift provision which calls for retaining principal and distributing annual “income.”

Assessing Your Tolerance for Risk

- Most people, including directors, often over state their tolerance for risk.
- Why?
  - Bonds are Boring
  - Fear of not keeping up with others
  - Asset Allocation is counter-intuitive
  - Humility is a difficult “sell”
  - True goal is participation . . .

    . . . not out performance

Practical Risk Assessment Questions

- What is the purpose for which we are investing?
  - Does that purpose require inflation protected returns?
- What is the true duration of our funds?
  - Less than 1 year, 1 to 5 years or longer than 5 years?
- How much are we willing to lose without changing our strategy?
  - Maximum percentage loss over two years?
  - Maximum dollar loss over two years?
- What asset allocation is consistent with our true limitation on losses?

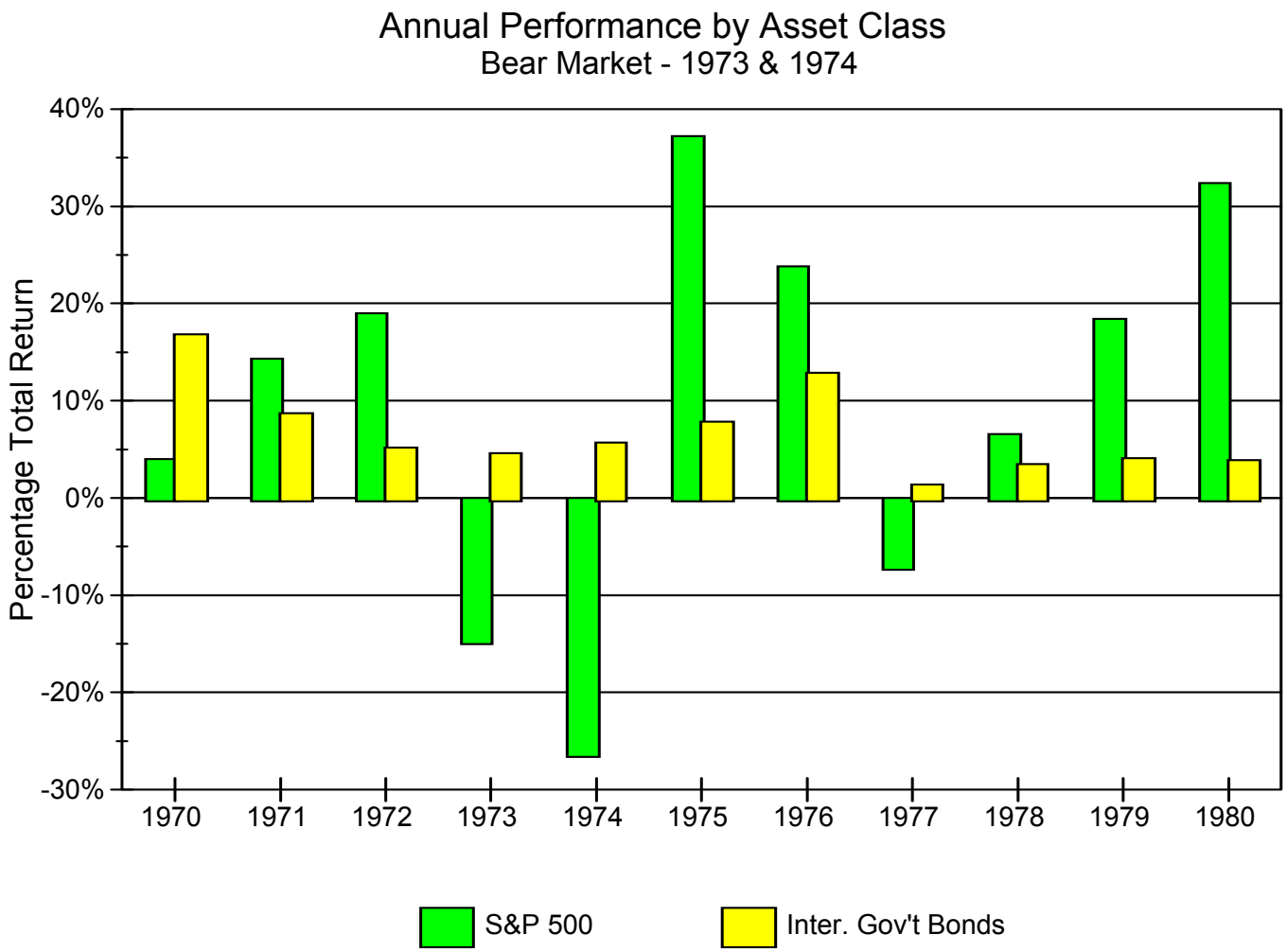
The Importance of Asset Allocation

- Asset Allocation is a form of diversification
  - Same underlying principals apply
- True value of Asset Allocation . . .

  is NOT in generating returns

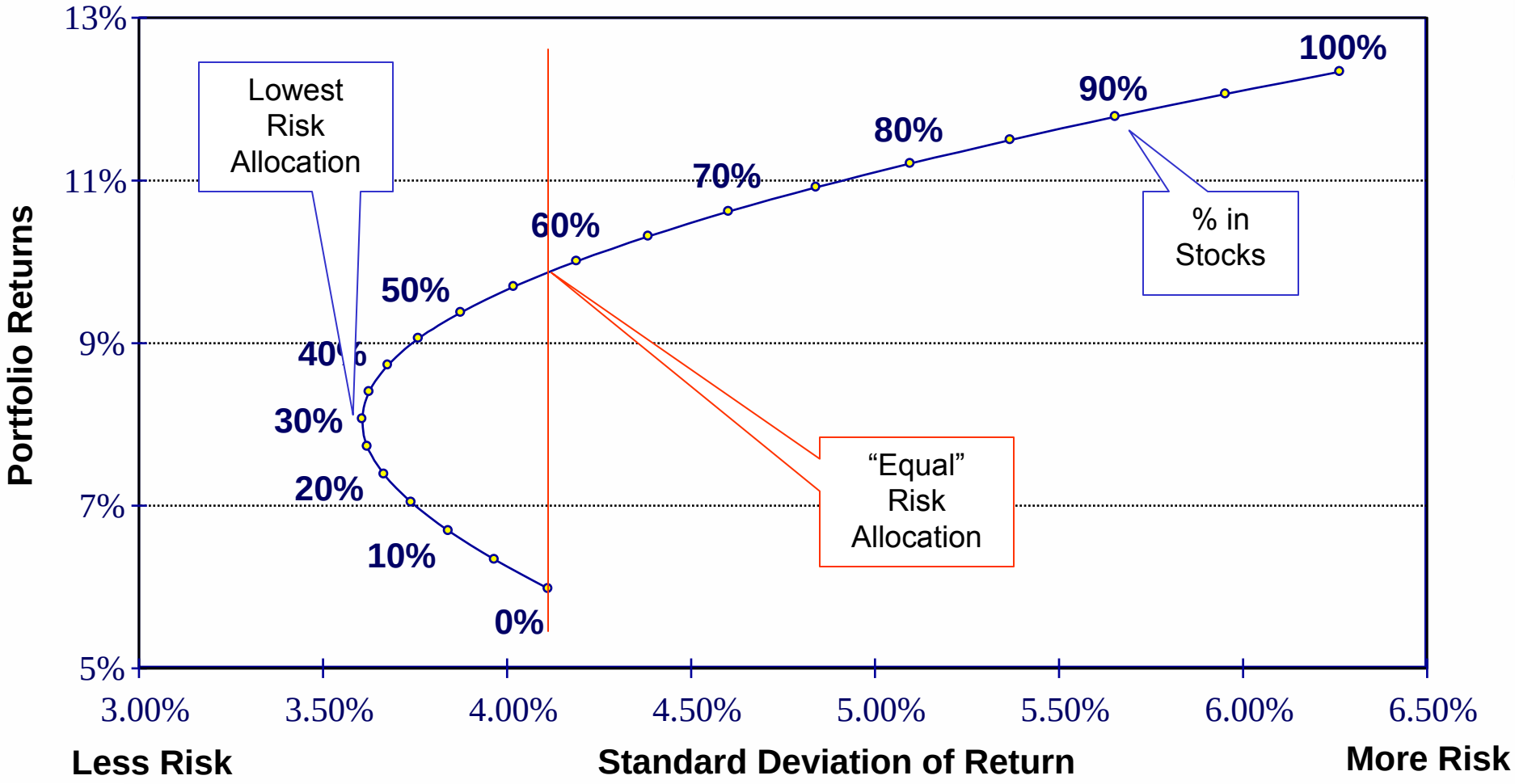
  it IS in controlling risk
- Non-Correlation
  - Airplane Stock and Oil Stocks
  - Stocks and Bonds
  - Financial assets and real estate
  - Traditional Investments and Hedge Funds

Asset Allocation as Risk Control

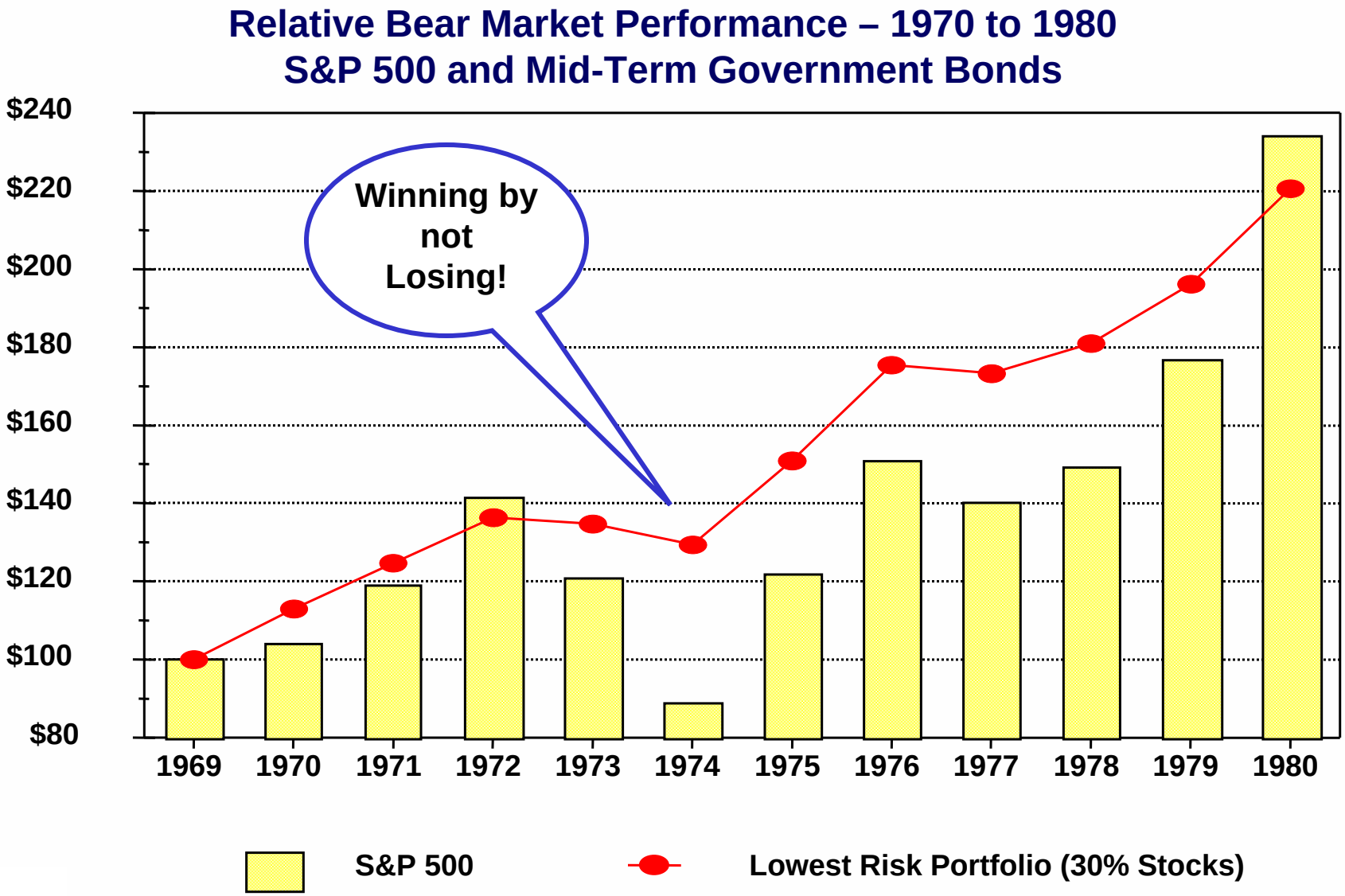


Asset Allocation as Risk Control

Plotting Return and Volatility ("Risk") in the Same Curve, creates the so-called "Efficient Frontier"



Asset Allocation as Risk Control



Industry Trend: More Aggressive Asset Allocations

- Growing use of Alternative Investments ***particularly*** among larger, long-term investors
  - For the 10 years ending June, 2007, total allocations by university endowment to alternative investments:
    - Hedge funds
    - Private equity
    - Venture capital
    - Natural resources

    increased from 4.1% to 15.4% of AUM
  - Fixed Income and Cash decreased from 30% to 22%

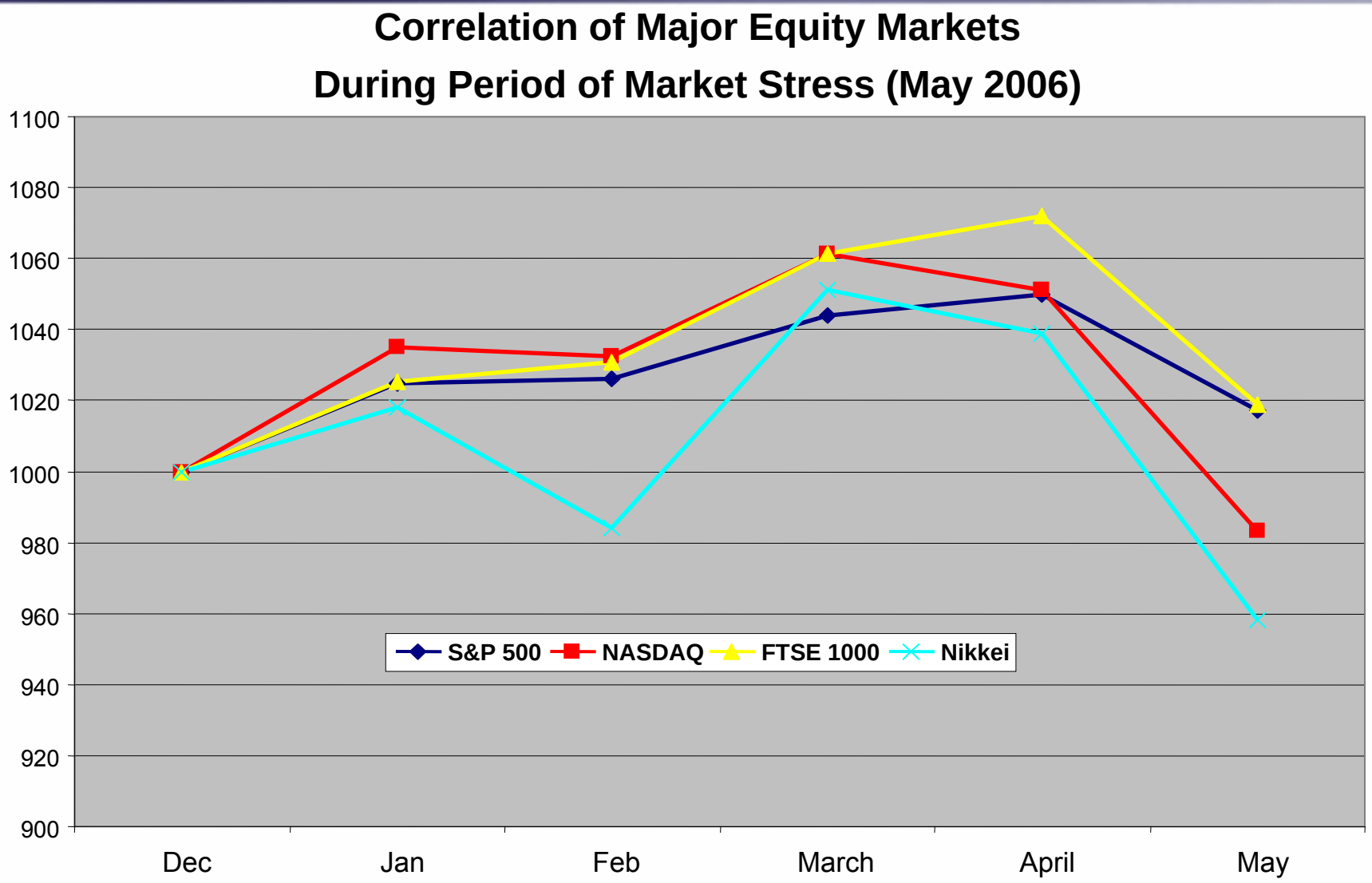
Source: TIAA-CREF, *Highlights of 2007 NACUBO Endowment Study,* April 2008

Industry Trend: More Aggressive Asset Allocations

Average Allocation to Selected Asset Classes, FY 1998&2007

Asset Class	1998 Allocation	2007 Allocation	Percent Change
Equity	63.5	57.6	-9.3%
Fixed Income	25.6	18.6	-27.3%
Real Estate	2.1	3.5	66.7%
Cash	4.3	3.5	-18.6%
Hedge Funds	2.8	10.6	278.6%
Private Equity	0.4	2.3	475.0%
Venture Capital	0.7	0.9	28.6%
Natural Resources	0.2	1.6	700.0%
Other	0.4	1.4	250.0%

Limitations of Long-Only Asset Allocation



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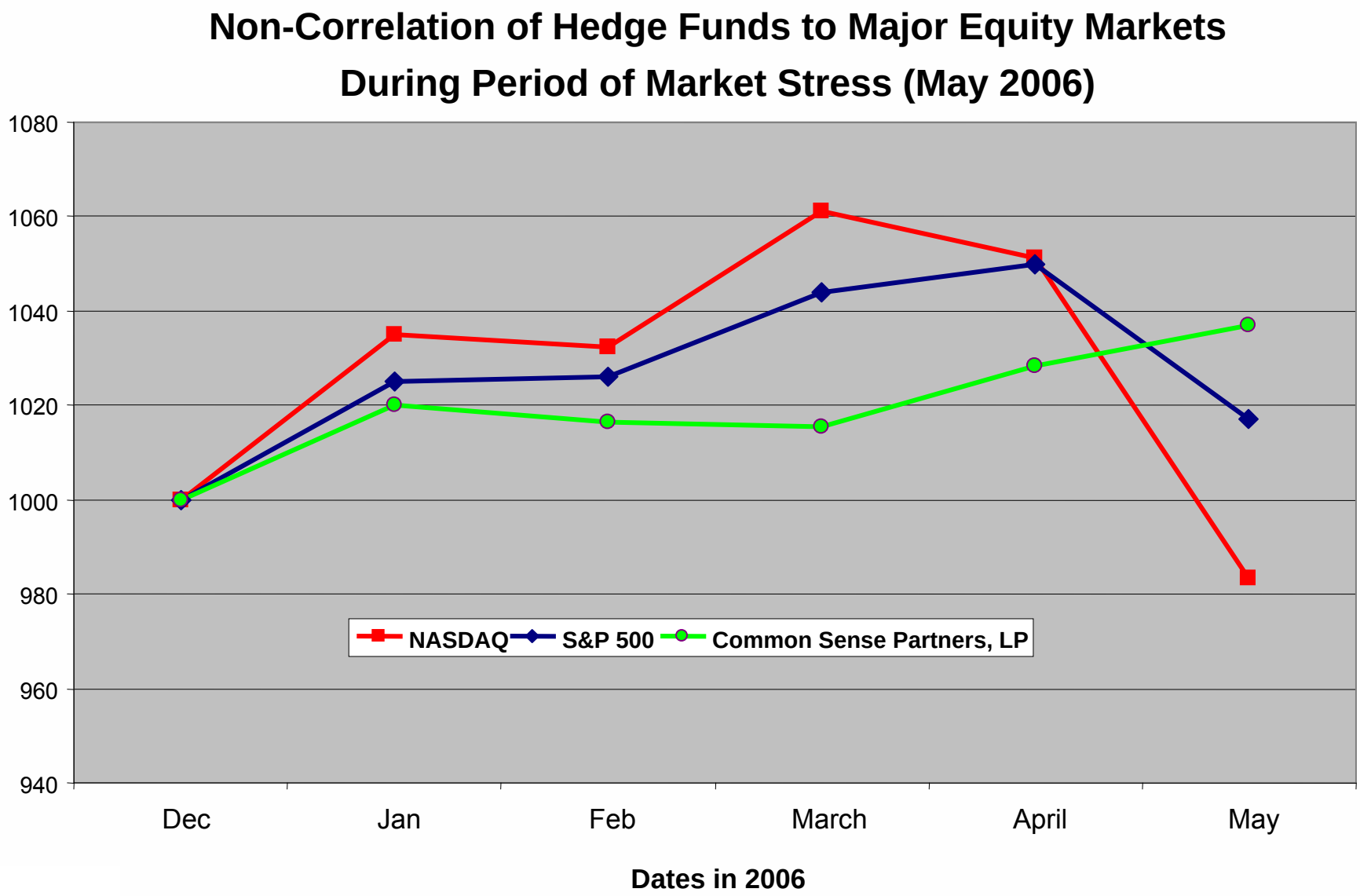
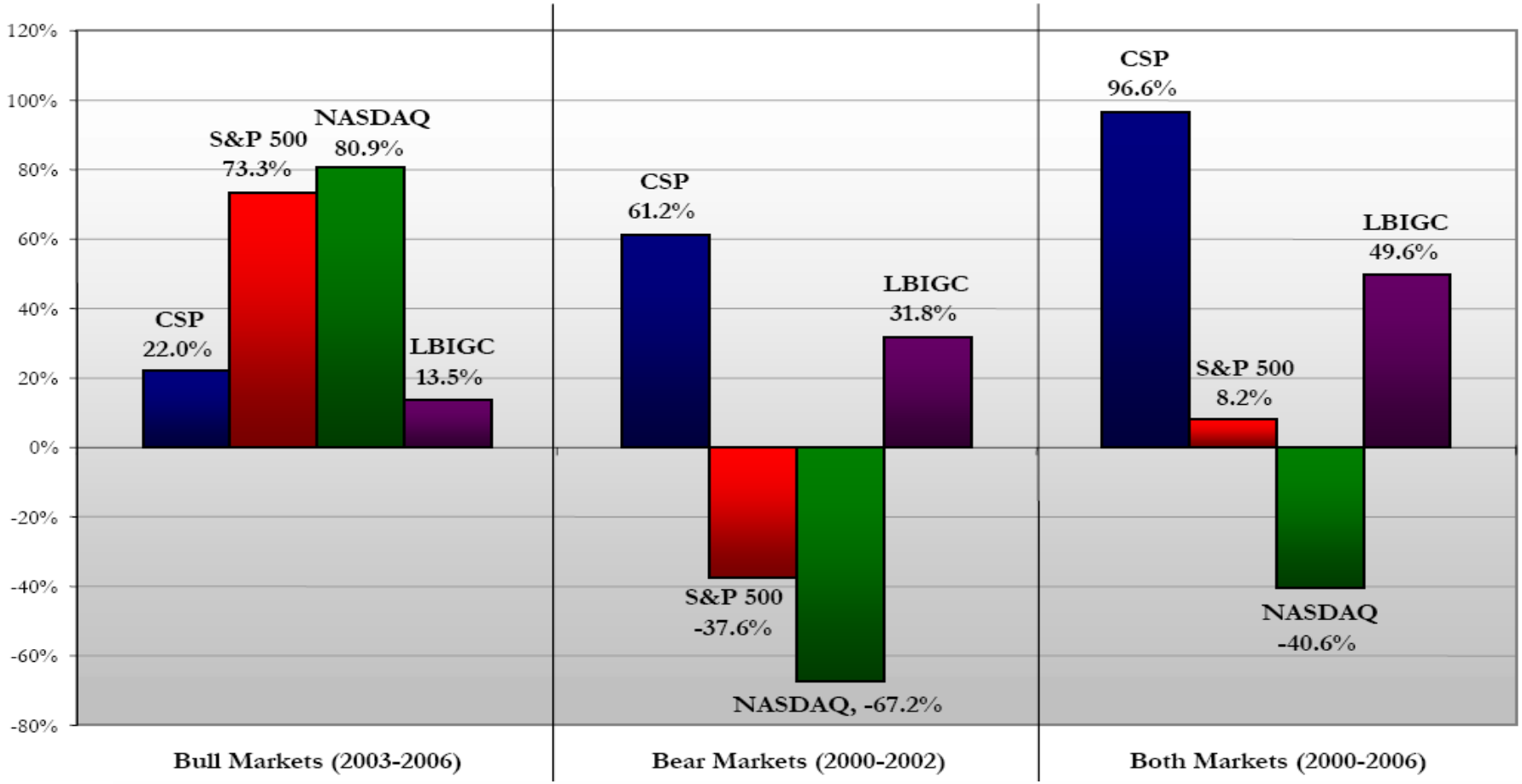


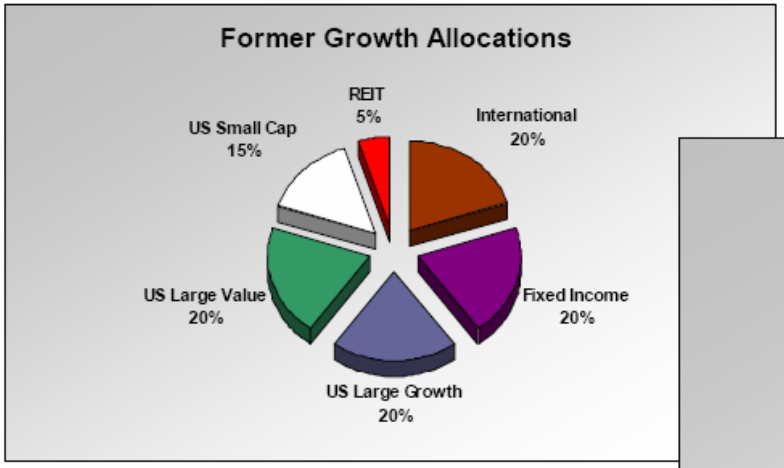
Up & Down Market Performance
Representative Hedge Fund Manager

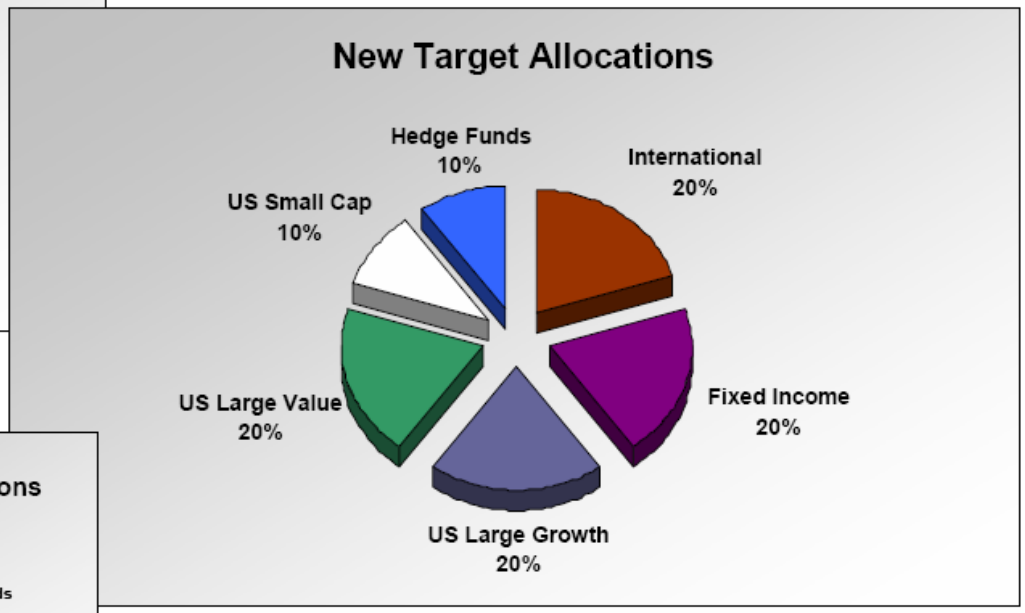
Performance Profile - Cumulative Returns

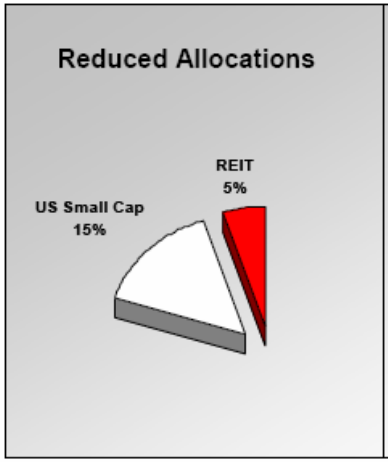
Most Recent Full Market Cycle (2000 through 2006)

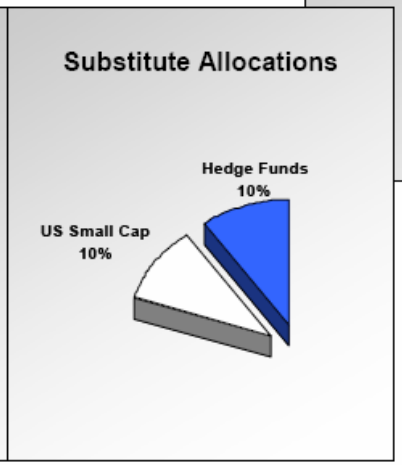


Sample Aggressive Investment Pool Before and after Hedge Fund Allocation









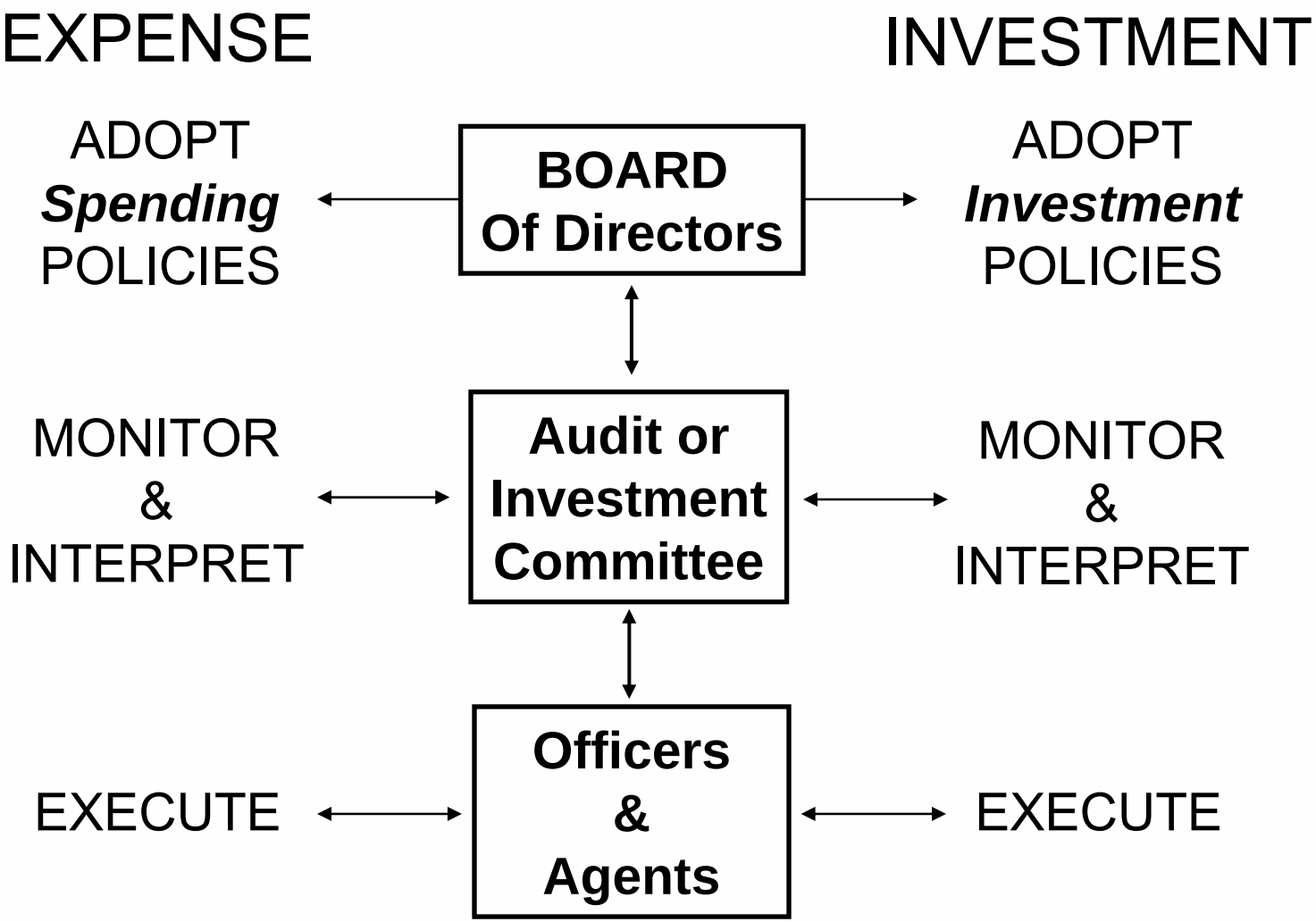
The Importance of an Investment Committee

- Investing is an “a-typical” discipline
  - No one “creates wealth” solely by investing
    - Wealth creators:
      - Start companies
      - Hit 310 drives . . . Straight . . . Every time!
      - Write children’s mysteries
    - Other paths to wealth are even less instructive
      - Inheritor of the carried interests in Dad’s oil leases
  - Absence of well-established academic path
    - MBA in Finance ≠ Knowledge of Investing
  - Therefore . . .
    - Rich people don’t necessarily know how to invest!

Delegation of Investment Authority

- Effective delegation relieves directors of liability
  - Reasonable Manager Search
  - Formal policies
  - On-going review
- Delegation facilitates acquisition of expertise
  - Consultant Role
    - Manager search and selection
    - Strategic Asset Allocation
    - Performance Reporting
  - Managers and Manager Substitutes
    - Specialization by sectors; e.g., small cap, emerging markets
    - Technique becomes tactical – funds, ETF's, direct portfolios
  - Lot's of room at the table
    - Custodians, RIA's, Brokers, Attorneys and CPA's

Delegation of Investment Authority



Performance Reporting

- Monthly Asset Statement
  - Custodial statement showing assets at cost, fair market value and all transactions
- Quarterly Performance Statements
  - Returns relative to benchmarks
  - Risk-Reward Analysis
  - Manager performance relative to appropriate Asset Class Index
- Annual Review
  - Portfolio Performance relative to Goals and Objectives
  - Asset Allocation Review
  - Manager Reviews

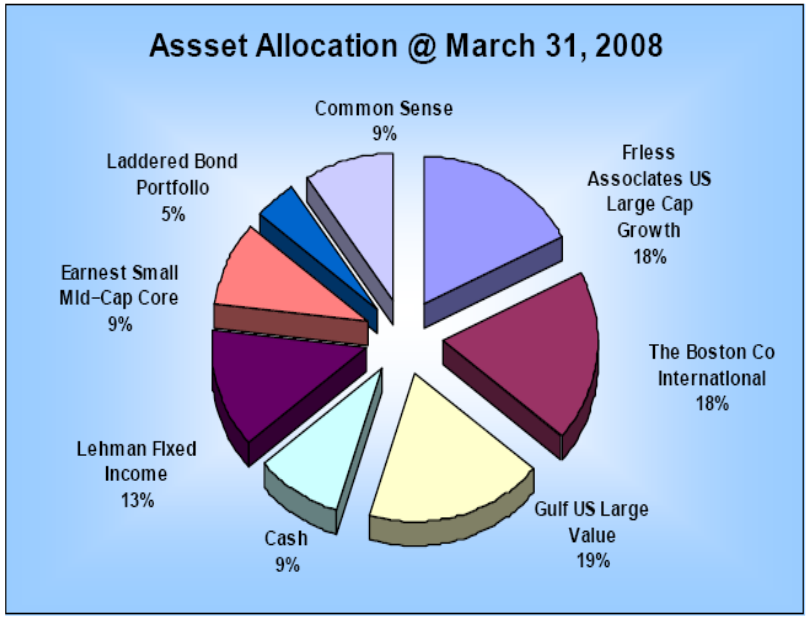
Excerpts from Recent Performance Report

Asset Allocation Targets

Representative Returns

Growth Pool	Last Quarter	One Year	Three Years
Actual Pool Performance (Net)	**-5.3%**	**2.0%**	**8.4%**
80% S&P 500 - 20% Bond (Gross)	-7.0%	-2.3%	5.8%

There is additional information on a subsequent page that describes pool performance and manager performance on a risk-adjusted basis relative to various indices.



	CURRENT QUARTER Return	ONE YEAR Return	THREE YEARS Return
COMPONENT ACCOUNTS (GROSS OF FEES)			
NCF Laddered Bond Portfolio	3.65%	10.62%	
CMA	1.73%		
Friess Associates_lcg	(11.98%)	8.03%	9.89%
OFI Gulf Investment LCDV	(6.28%)	1.95%	8.34%
Earnest Smid Core	(2.98%)	(1.21%)	7.00%
The Boston Company Asset Mgmt/	(9.87%)	(5.23%)	10.46%
Lehman Taxable Int. Mat.	2.81%	8.27%	5.22%
TOTAL PORTFOLIO (GROSS OF FEES)	(5.05%)	2.96%	9.47%
STYLE INDEX	(6.43%)	(3.64%)	7.61%

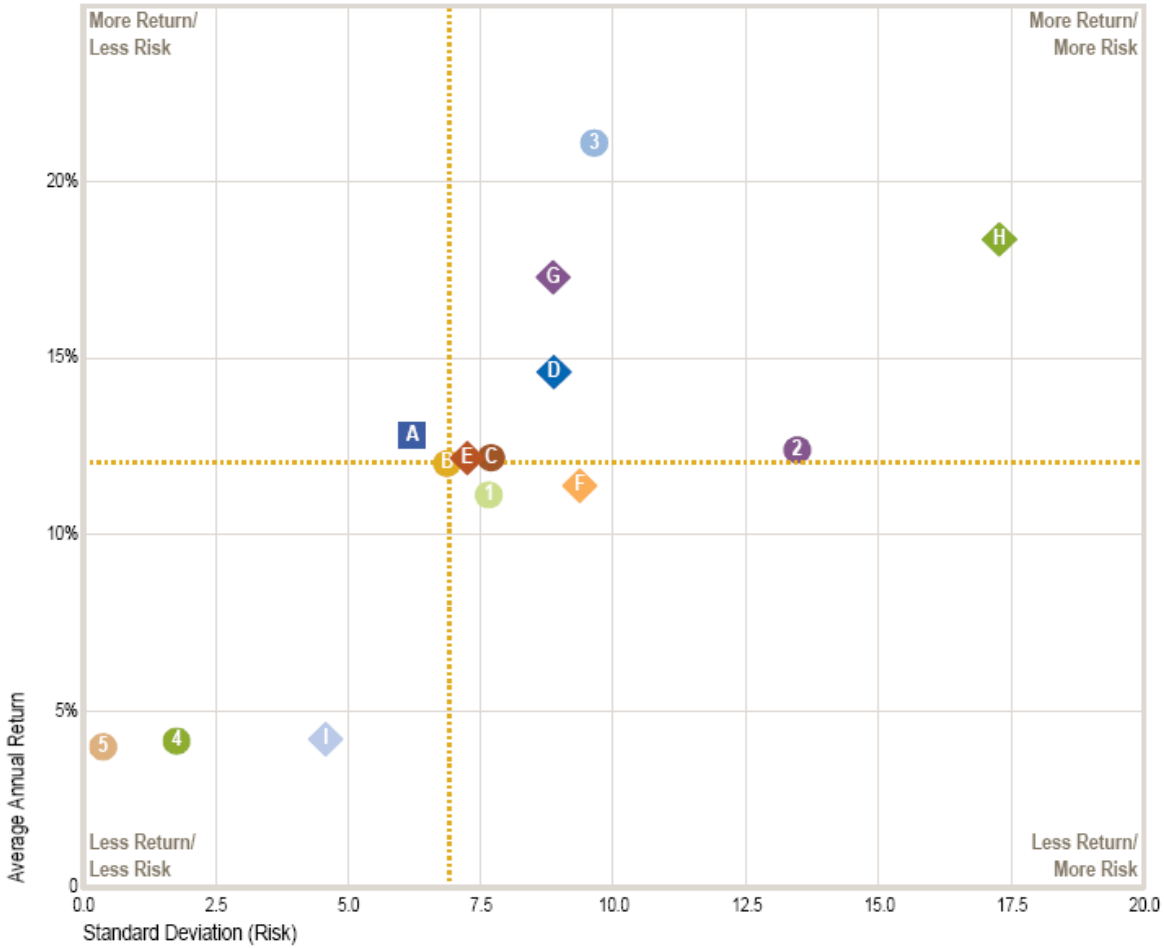
*The **Style Index** for this pool is 40% S&P 500 with dividends, 15% Russell 2000, 20% MSCI EAFE with Net Dividends in US$. 5% NAREIT Reits and 20% ML US Corp & Govt 1-5 Years.

Risk Adjusted Return Reporting

NATIONAL CHRISTIAN CHARITABLE FOUNDATION, INC.

Risk/Return Analysis (Gross of Fees)

July 31, 2004 to December 31, 2007



		Avg. Annual Rtn. (%)	Std. Deviation
A	Total Portfolio	12.81	6.20
B	Style Index	12.05	6.90
C	Custom	12.18	7.70
1	S&P 500 with Dividends	11.13	7.70
D	Friess Associates (spa)–lcg	14.62	8.90
E	OFI Gulf Investment LCDV	12.16	7.20
F	Earnest Smid Core	11.40	9.40
G	The Boston Company Asset Mgmt/	17.30	8.90
H	Invesco Inc Reits	18.38	17.30
I	Lehman Taxable Int. Mat.	4.21	4.60
2	Russell 2000®	12.41	13.50
3	MSCI EAFE with Net Divs in US$	21.11	9.60
4	ML US Corp & Govt 1–5 Yrs	4.16	1.80
5	T–Bills	3.99	0.40

Final Thoughts for Board Members

- Discipline beats wizardry over time
  - The key to most market returns is being in the game
  - True goal is measured participation not out performance
  - The judgment of “normal people” matters
- The most important investment decisions are independent of pure investment selection
  - Hard ball analysis of risk tolerance
  - On-going cash flow and spending planning
  - The humility to maintain broad diversification
- Active and informed supervision helps
  - Be careful what you ask for