

### 2007 Year in Review

This newsletter is coming to you in advance of our usual quarterly correspondence, which will contain your quarterly statements. We wanted to provide you with our thoughts and comments on the past year and our expectations for the coming year and not wait until you receive your quarterly statements, which because they are year-end sometimes take a little longer to reach you. As the CEO and Chief Investment Officer at Hanlon Investment Management (HIM) your overall portfolio returns are very important to me and the rest of the team at HIM.

Our investment discipline is one that attempts to identify “productive” periods in the equity and bond markets and then invest during those periods. Alternatively, when the markets are displaying “unproductive” periods we seek the shelter of conservative investments such as money markets. There are no assurances that the periods we anticipate to be productive will turn out that way and alternatively that the periods we anticipate to be unproductive will result in market declines. We do not always get the timing correct, especially when the markets are so volatile, changing direction as significantly and rapidly as they did in 2007. This is not to say that we cannot handle volatile markets – we can – but typically they do not swing this many times in this short a period of time.

For the full year 2007 we experienced another profitable year in our all bond portfolios (called Managed Income) as well as the bond component of our blended portfolios. We continue to deliver good investment results with limited risk in our bond allocations and anticipate 2008 to be no different.

On the other hand, we were not satisfied with the results of our equity portfolios. Q4 2007 especially was as challenging a quarter as we have ever seen. The markets have been volatile enough to trigger defensive and then offensive strategies in our client portfolios, but not volatile enough for those movements to yield positive relative investment performance. The goal of our equity portfolios is to exceed the investment returns of a passive buy and hold portfolio, but with less volatility and therefore less risk, over a full market cycle. A market cycle is typically considered four to five years or more, something parallel to the cycles of the economy. Investing in stocks is a long-term proposition and therefore if there are expectations for immediate, excellent results, no matter what the investment strategy, it can lead investors to be disappointed short term. Patience is important in all types of investing, even more so in stocks. Markets do not always accommodate every investment discipline, but investors typically select one type of investment discipline or another, and then stay the course. Often times, when the markets are volatile and the results are below long-term trend, investors may find they are more conservative than their investor profile questionnaire result. Year-end is a good time to review your portfolio results, your investor profile questionnaire and your associated portfolio allocation.

The equity markets have been unusually volatile this year and range bound. A picture speaks a thousand words. On the next page you will see a chart of the S&P 500 Index for the year 2007, showing how volatile and range bound the equity market has been. Specifically, since February 20, 2007, the S&P 500 Index has been **down 5.86%, up 13.02%, down 9.43%, up 11.26%, down 10.09%, up 7.73% and then finished the year by falling 4.62% in the last couple weeks** - and all this in ONLY ten and one half months!

# Research Perspective

Think about that - **six** peak to trough / trough to peak moves in ONLY nine months that averaged about 10% each, concluding with another peak to trough move of 4.62%! I have never seen market activity like this and our Research Department could not find a market like it, as we looked backward in our historical equity index database. Historically a peak to trough 10% range bound market, such as the one we have been in now for one year, does not last much longer than this, but only time will tell.



FROM	TO	Market Days	Return
21-Feb	5-Mar	9	-5.86%
6-Mar	19-Jul	95	13.02%
20-Jul	15-Aug	19	-9.43%
16-Aug	9-Oct	38	11.26%
10-Oct	26-Nov	33	-10.09%
27-Nov	10-Dec	10	7.73%
11-Dec	17-Dec	5	-4.62%

## Research Perspective

With respect to the portions of our client portfolios that are invested in equity (fund) investments, as opposed to those portions that may be invested in our bond (fund) investments, this type of market activity is the type that many trend following investment management disciplines, such as ours, can struggle short term. So what might be causing this? The obvious answer is that at certain moments there is quite a substantial change in market opinion where the buyers and sellers display a significant and quick shift in the majority opinion.

### Recession Fears

Some of the positives are as follows. P/E ratios are not that high. Stock valuations are very attractive as compared to 10-year Treasury Bonds, which are yielding only about 4.0%. Job growth has slowed but continues and corporate balance sheets remain healthy. But the “recession” word is all over Wall Street these days. The news about the credit / mortgage situation worldwide has dropped bombs on this market in a rather consistent pattern for the last ten months.

The Federal Reserve has many jobs. Explained in the simplest definition, the role of the Federal Reserve is to set monetary policy that will result in *price stability and full employment*. We have had no real inflation problem and no unemployment problem yet. But the Federal Reserve must continue to act because the bond markets are screaming at the Fed to keep lowering rates. Why you ask? It is not unusual for the Fed Funds rate to track 2-year Treasury Notes, but with the current 4.25% Fed Funds rate versus the current 2.90% 2-year Treasury note rate, clearly the bond market wants to see Fed Funds rates lowered. So we have, and will continue to have, this battle between what the market wants the Fed to do and what the Fed actually does.

### Tough Market for Trend Following

“Tough stock market for anyone to make money in”, that’s what a client of ours said to us recently. We agree. As a firm whose investment discipline is based upon the “messages” from the market, we are getting multiple messages these days, practically changing weekly! Our trend following discipline has observed quick 8-10% up and down movements in the various asset classes that we invest in. But we must stay the course. Yes, it has been a very challenging year and the equity component of our models has underperformed. But it was not a very good year for equity investment returns in general as the S&P 500 Index ended the year up a paltry 3.5% after all of the multiple approximately up 10% - down 10% swings! The chart on the prior page makes it easy to see why anyone invested in equities this year may be dissatisfied. But one year does not an investing lifetime and / or career make.

Our investment discipline is rooted in applying technical and quantitative measurements to the movements of the markets and reacting accordingly. We have back-tested these methods going back some 30-40 years in some cases, and of course they show good results. There are periods where our strategies will under perform and those periods require patience. They can last a week, a month, a quarter and even a year. Anyone invested in an equity strategy should be patient enough to see that strategy through a period of about 3-5 years, at a minimum. Certainly it is challenging to stay the course, but the day-to-day ups and downs are to be expected in the investing profession. Our strategies historically have provided our clients with good results over time.



## Research Perspective

We are fighting the battle every day to attempt to preserve our client's accounts against a "large drawdown", yet participate in the long term potential of these equity and bond markets for potentially solid profits. There are no guarantees to that end as you are aware, but believe me we are working very hard to achieve success for you.

We remain vigilant and steadfast in our pursuits. I am anticipating better times ahead and I appreciate your patience.

Here's to a successful 2008!

Thank you,

Sean Hanlon, CFP®  
CEO and CIO

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