



Market Commentary

February 8, 2008

Anatomy of Equity Investments during a Recession - part 2

In part 1 of this Market Commentary, published last week, we showed that the S&P 500 Index had an average drop of -24% from peak-to-trough leading up to or during the last nine recessions, dating back to 1950. Understanding what recessions can do to stock portfolios, I thought it a good idea to review in this Market Commentary the “actual” equity tactical portfolio moves that Hanlon Investment Management made during the most recent recession in 2001. Also herein, we will review the “hypothetical” moves that our research algorithms would have made during the 1990 recession and then finally we will review the “actual” defensive moves we made recently to protect portfolios now. Please know that optimistically speaking, recessions can be harbingers of fantastic investment opportunities. When our research indicates the coast is clear we will get back into the market. But getting “back in” will not be without its possible head fakes, so we must be prepared.

The Federal Reserve has now cut the Fed Funds rate by 2.25%, from 5.25% to 3.00%. At this writing the Fed Fund Futures, which trade on the Chicago Board of Options Exchange, are indicating a 100% chance that the Federal Reserve will cut rates again by .50% at their next regularly scheduled FOMC meeting March 18. That would reduce the Fed Funds rate to 2.50%. But the equity markets have not been relieved by these cuts as there is still worry about the worldwide credit crunch, economic slowdown, and potential earnings shortfalls.

At this stage of the business cycle there are three important points I want to make regarding the stock market:

- I. There is still more bad news out there to come
- II. Prepare for some "head fakes" in our market signals; it comes with the territory
- III. This market drop will ultimately present an opportunity, not a problem

Before moving into the charts please review Table 1 below which is an update on the performance of the equity markets so far this year. ***Fortunately our actively managed client portfolios have been defensively invested in money markets and earning a return every day so far in 2008, as opposed to the indices, which have dropped considerably.***

Description	Drop from 2007 high as of 02/08/08
Dow Jones Industrial Average	-14.00%
S&P 500 Dividend Adjusted Index	-14.40%
Russell 2000 CBOE Index	-17.36%
NASDAQ Composite Index	-19.39%
MSCI Emerging Market Index	-19.87%

Source: Investors Fast Track

Table 1



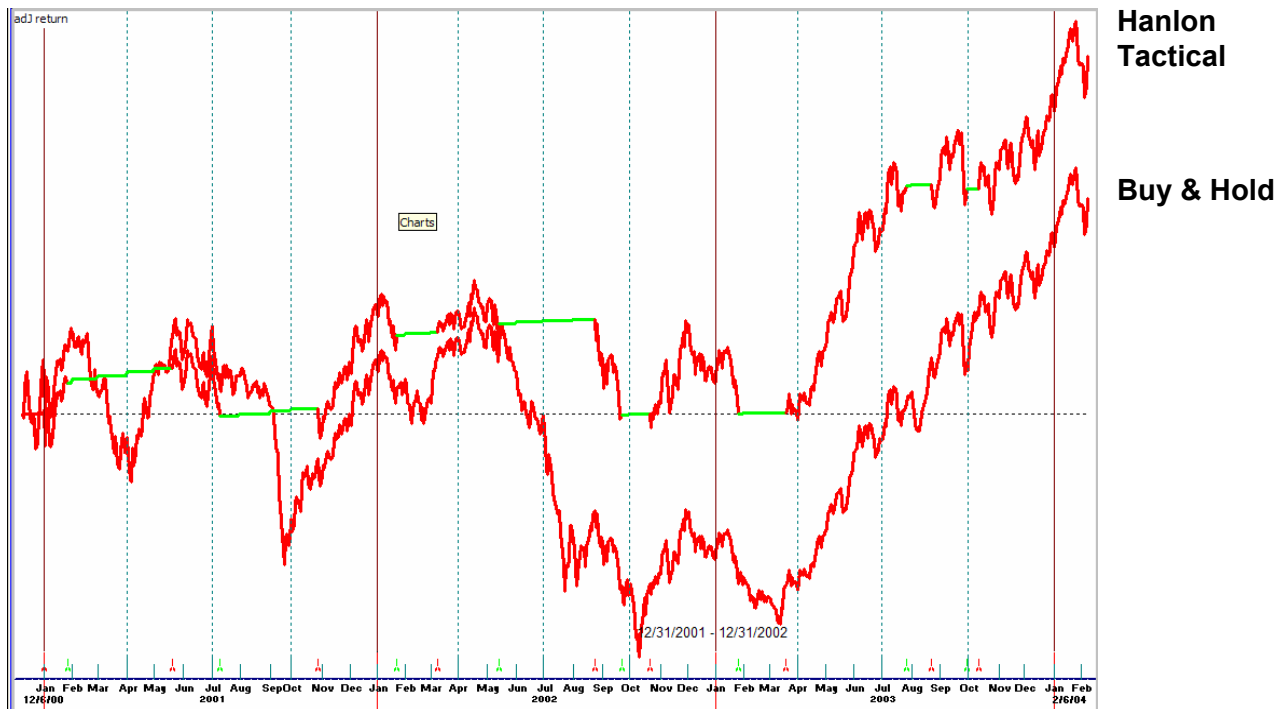
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Bear markets are typically defined as markets that experience a 20% decline from their top. Table 1 shows that clearly we are at or approaching that size drop now. If it walks like a bear, growls like a bear, it's a bear! This is typically one of the types of markets in which Hanlon Investment Management would shine, attempting to protect portfolios from the vicious bear (declines) and preparing to buy once the opportunity is obvious. Of course there are no guarantees we will be successful to that end.

What can we expect in the coming months?

Let's look at history to gain some insight. Below is a chart covering the period 12/00 to 02/04, a period that includes the last time the US economy experienced a recession. The chart shows two equity curves. The solid red line (the lower line) is the result of a buy-and-hold strategy in the Russell 2000¹. Alternatively, the red and green line (the upper line) shows the actual tactical moves that were made by Hanlon Investment Management in the equity portion of client portfolios to navigate and protect the portfolios from the large drop that occurred. We are showing the Russell 2000 Index as an example only and because in this period we were heavily invested in small cap stocks. The green flat looking periods are those periods that we were invested in money markets after getting a sell signal from our algorithms and research. Please recall that one of our core beliefs in our money management strategy is to attempt to avoid the very large drops in equity prices and preserve principal in an effort to deliver market-beating, reduced-risk investment returns when reviewed over at least one market cycle.

12/00 to 02/04 Russell 2000 Index – buy and hold versus HIM “actual” tactical moves



Source: Investors Fast Track

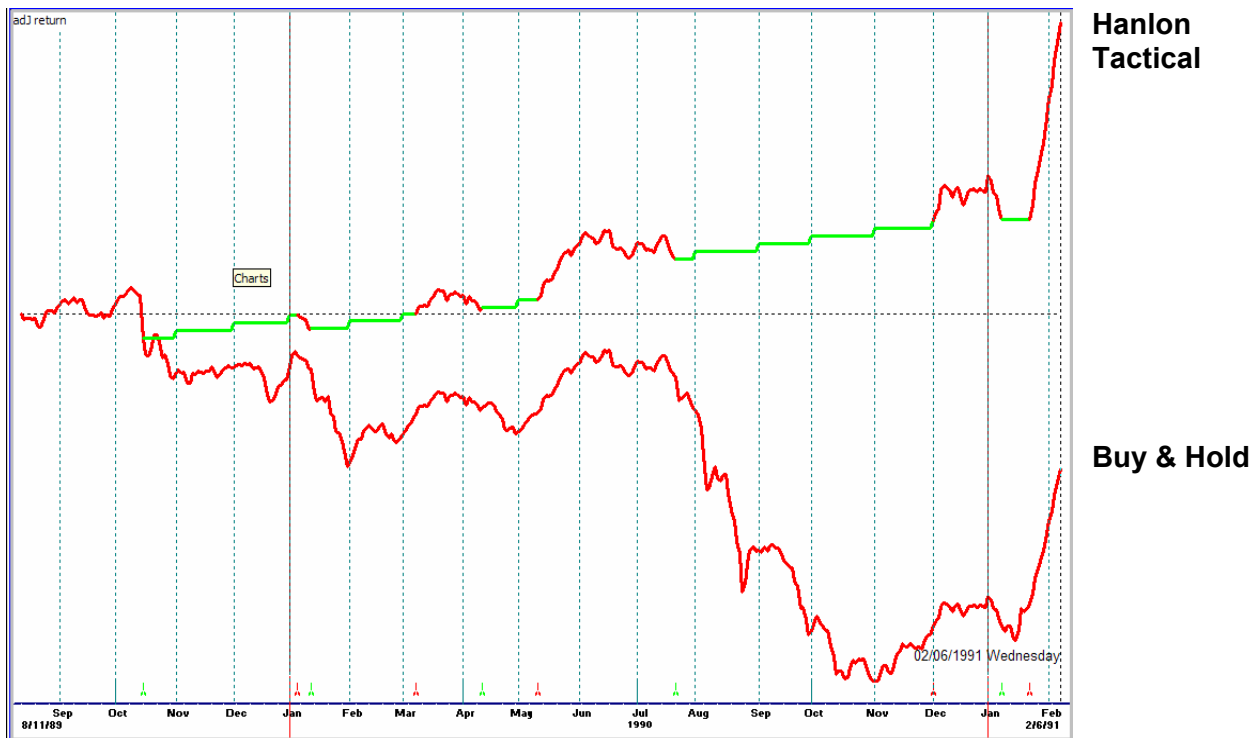


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Clearly an important point regarding the chart on the prior page is that we did avoid the large drops in the stock market. Also important, however, is that there were some “head fakes” where we entered the market and needed to get out, at a small loss, to avoid even further portfolio drops. But ultimately the market took off on a very large, profitable move in 2003 and we caught that move because our research determined it was time to buy stocks on 03/18/03.

Another period in history that may resemble the current period is the 1990 recession. When we “hypothetically” apply our algorithms and research to that period you can see in the chart below that we were able to navigate away from the large drop. The solid red line (the lower line) is the result of a buy-and-hold strategy in the Russell 2000 Index. Alternatively, the red and green line (the upper line) shows the hypothetical tactical moves that would have been made by Hanlon Investment Management in the equity portion of client portfolios to navigate and protect the portfolios from the large drop that occurred. This chart is hypothetical, please see disclosures.

08/89 to 02/91 Russell 2000 Index – buy and hold versus HIM “hypothetical” tactical moves



Source: Investors Fast Track

From the above chart you can see that contrary to the market activity that occurred in the 2001 recession, the 1990 market was less of a “head fake” on re-entry. The drop was clear and the recovery was clear and direct, no “head fakes”. What will the market result be for the Hanlon Investment Management “tactical” discipline this time? Of course we do not know. But so far we have experienced a decisive sell to the safety of the money markets. The chart on the next page shows the recent tactical move we made and the corresponding comparison to the S&P 500 Index. The solid green line is money market, where we are currently invested, showing superior returns to the S&P 500 Index stocks.



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12/07 to 02/08 S&P 500 Index – buy and hold versus HIM “actual” tactical moves



Source: Investors Fast Track

For now money market returns look awesome compared to the returns of stocks. At Hanlon Investment Management we take advantage of the periods of declining stock prices to seek the shelter of money market investments. Of course we will be on the lookout for the risk to fall and the market potential to increase. At that time we will make portfolio modifications accordingly. Now is certainly the time for active management – defensive and ultimately offensive moves. In part 3 of this Market Commentary, to be published next week, I will review high yield bond fund investing and management within our *Managed Income Allocation* and the bond portions of our *Growth and Income* and *Balanced Allocations* during similar market environments.

Thank you,

Sean Hanlon, CFP®
CEO and CIO

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