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2009 Year in Review

Domestic High Yield Corporate Bonds

12/21/09

This past March, Hanlon Investment Management made a large investment in high yield corporate bond funds (HY) where available in our client accounts after we saw a “generational” opportunity develop. That opportunity was brought on by the devastatingly sharp drop in HY prices experienced in late 2007 and all of 2008.

At the time of that investment the world was still very shaky. But the equity and bond charts were telling us something different; that the economy would eventually respond to unprecedented global fiscal and monetary stimulus, that distressed HY prices already were selling at or below recovery value and that the "survivors"—the companies that would make it through the downturn—were trading at extremely cheap levels.

How did we see that? HY prices set their low point in this correction in mid-December 2008 well before equities experienced their low in March 2009. Yes, in March of 2009, HY also were declining from their higher prices of January and February, but they did not fall to the lows set in December 2008. This **action** in the HY charts was very important and told us that HY had most probably seen the low point for this period in December 2008 and that the next move was not only up but that the move would exhibit a better risk adjusted return than equities. **Fortunately we were correct!**

March 23 to December 18, 2009 – Equities versus High Yield Corporate Bonds

The Red Line is a global equally weighted index composed of five major global equity indices (20% S&P 500 Index, 20% Russell 2000 Index, 20% Nasdaq OTC Composite, 20% iShares MSCI EAFE Index, 20% iShares MSCI Emerging Markets Index). The Green Line is a high yield equally weighted index composed of two hundred twenty domestic high yield corporate bond funds. The Blue Line is 100% weighted S&P 500 Index

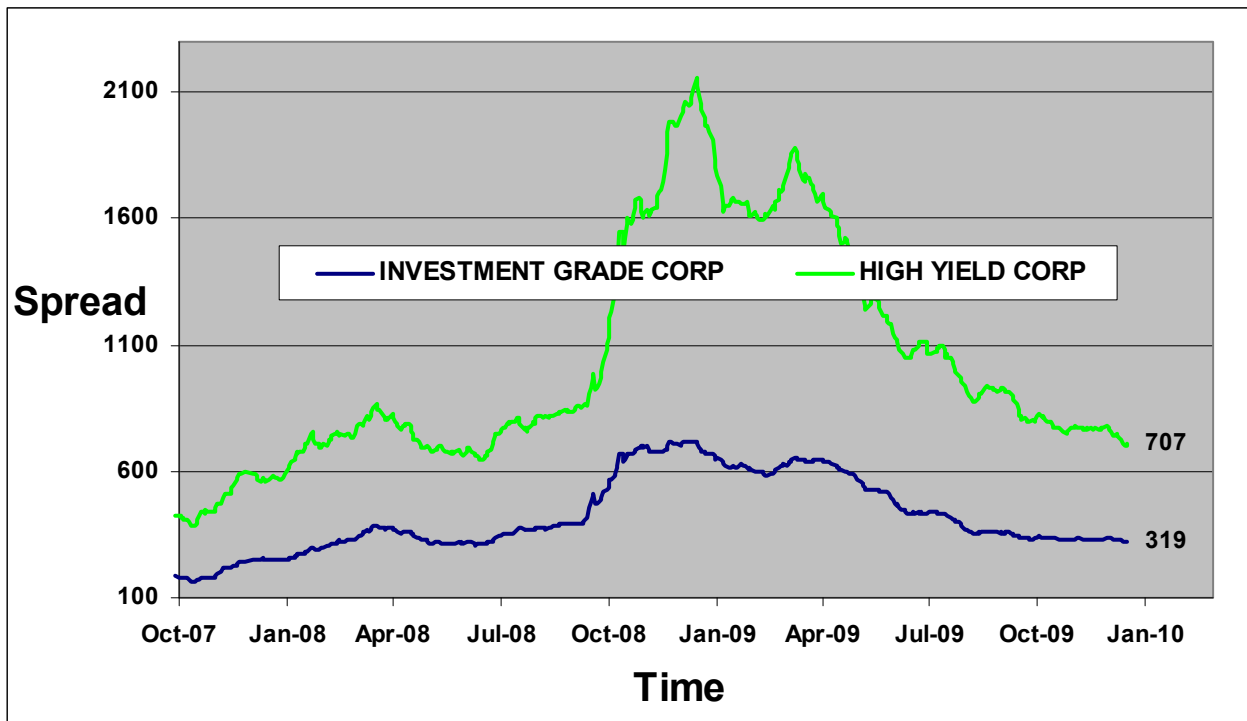


The high yield bond fund index we compose, as displayed as the green line on the prior page, continues to display one of the most stable charts in the investment universe, and of course HY continue to provide a very attractive current interest rate.

Now we are getting the normal questions – “Is that it for high yield bonds”? “Is there a bubble developing in high yield bonds”? Certainly the easy money has been made for this cycle. But even now the research charts tell us that there's still a compelling story for high yield bonds.

One compelling attribute is that HY interest rates versus US Treasury interest rates remains very attractive, with the spread on maturities of approximately 8 yrs still above 7.0%.

High Yield and Investment Grade “spreads’ versus US Treasury Bonds



Historically speaking, the median spread level from 1986 through November 2009 is approximately 5.00% leaving nice room for spreads to tighten further just to get to historical levels. In fact, over this time period, spreads have been lower than their December 18, 2009 level more than 70% of the time.

From an economic standpoint, the market is dominated by the survivors. These are the companies that can most likely service their debt under current economic conditions, not the hoped for improving economic conditions. Because of the make-up of the survivors, the default rates should drop to less than 5% within 6-12 months as compared to the current default rates of 10% plus. Long term high yield bond annual default rates are typically in the 3-4% range - this is one reason for the yield premium they command over high quality bonds. We believe defaults in 2010 may actually turn out to be lower than most think by what the HY charts are telling us. The HY charts and markets seem to

know that most of the bonds that will default in 2010 are most likely trading fairly close to recovery levels and therefore their default will have minimal total return impact.

History supports our belief that high yields will continue to generate excess returns versus high quality bonds. In the aftermath of the prior two big bear markets for high yield bonds, HY had one huge recovery year followed by several strong relative performance years. In 1991, the market returned 46.19% (as measured by Barclay's Capital High Yield Bond Index), far outdistancing the 16% return for high quality bonds (as measured by the Barclay's Capital Aggregate Bond Index). The high yield index then outperformed the aggregate index for six consecutive years from 1992 through 1997. Similarly, in 2003, the Barclays high yield index returned 28.97% versus 4.10% for the Barclays aggregate index, and the high yield market subsequently outperformed the high quality bond market the following three years. Finally, it should be noted that from the bottom in October of 2002 it took until early 2004 to see the first pause in that rally. This current move is only 9 months old from the last entry point in March.

We believe that high yield will complete its recovery phase sometime in 2010 with spreads returning to historical median levels in the 5%+ area. From there, the income only phase will begin, with high yield benefitting from low default rates, a growing economy and an implicit income advantage over high quality fixed income. Spreads will continue to tighten until greed overcomes fear, as usual, and credit quality eventually deteriorates again with the weakening of the economy. Yes, there will be corrections (price drops) in high yield bonds again in the future. There will come a time when high yield bonds will be over-priced and will lag in performance. We would hope to be a seller before then – with no guarantees of course. However, today we are comfortable in the belief that that time is some distance down the road.

Thank you,



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