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## **Interest Rates – Where Are They Going? If Up, How to Manage Portfolios?**

**6/07/10**

Perhaps the question most often presented to us today is, “How will you manage portfolios if interest rates rise?” Of course the fear is that interest rates will not only rise, but rise considerably. The following are points of discussion to which Hanlon turns when addressing this concern:

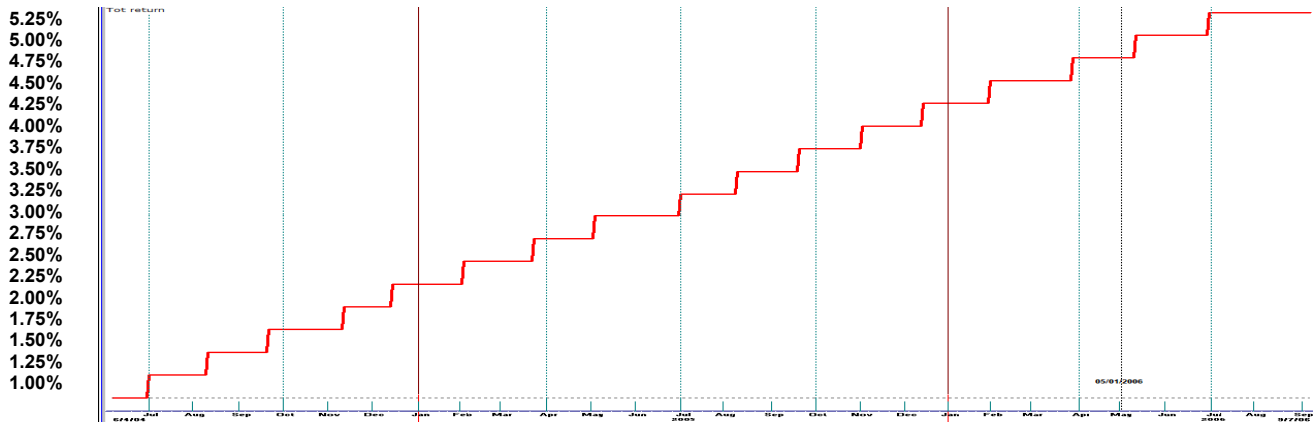
1. An old Wall Street adage says that *most* of the people are wrong *most* of the time when it comes to predicting the investment future. Be wary of the investor’s epidemic! When just about everyone fears rates will spike tomorrow, our adage tells us that such a dramatic change is *highly* unlikely to occur.
2. Did you know that the 300-yr. average inflation rate in the United States is less than 1.9% per year? Low inflation is common, not uncommon. We are in a period of low inflation.
3. Inflation and interest rates historically move together. With the current lower-than-low interest rates, and without forecasted rises in inflation, we have a long way to go before seeing higher inflation and therefore, higher interest rates.
4. The period 1970 through 1990 saw uncommonly high interest rates. Even the 1990’s had high rates by long-term comparison. Many of today’s investors have grown up in this high interest rate environment. Many home owners in the 1980’s had mortgage rates as high as 16% (yes, 16%, not a typo). Think about that experience and their lifelong perspective on the fear of rising interest rates.
5. Safety should keep investors hungry for US Treasuries and help keep interest rates low.
6. When interest rates do rise, there is no indication they will rise considerably.
7. When interest rates do rise, they usually do not rise in a straight line; they go up a little, down a little less, up a little more, down a little less. To state another Wall Street adage, “there are no straight lines on Wall Street”, which applies to the direction and flight of interest rates as much as anything.
8. Rising interest rates is not necessarily a bad thing. On the contrary, rising rates would potentially be an indication that sustained economic growth is back. There is also the benefit to fixed income investors to consider – they will be receiving a greater yield!

At Hanlon, we believe all good money managers must prepare to weather any storm – including a dramatic rise in interest rates. That said, let’s look back at the most recent period where interest rates rose considerably and see how the Hanlon Investment Management portfolios performed during that period. This is not to say that the past experience will be replicated and that we will be successful; this is only to provide you with an actual example of a rising interest rate period, for discussion purposes only.

On the next page is a chart of the Federal Reserve Fed Funds Target Rate for the period June 2004 through July 2006. As you can see, the Federal Reserve increased interest rates seventeen times during this period, starting at a Fed Funds rate of 1.0% and ending at a Fed Funds rate of 5.25%.



**June 2004 to July 2006 – Federal Reserve Raises Rates 0.25% 17 Times - From 1.00% to 5.25%**



How did Hanlon clients fare during this period? Our average “brokerage” allocation, the allocations for which we provide GIPS Investment Performance results, returned approximately 10% net of fees. Is 10% net investment return *great* for a 24 month period? Most investors would say no. But to navigate the above interest rate increases, and generate positive returns, is historical evidence of Hanlon’s ability to weather one of the most aggressive interest rate hike periods in our nation’s history.

Where are interest rates heading? Who knows?! But we believe having the ability to make substantial portfolio composition changes, during any and all interest rate environments, gives our client’s portfolios what we consider to be an advantage.

Thank you for the opportunity to be of service.

Thank you,

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