



HANLON

INVESTMENT MANAGEMENT, INC.

Quarterly Report – December 31, 2009

In the late 1990's I was disappointed with the volatilities and returns that the buy and hold strategies were providing for my clients. After countless hours of research I embarked on a different investment management approach, an approach that would attempt to identify "trends" in the market and hopefully, invest in only positively trending markets. Of course, you cannot do that perfectly all the time, but the goal was to get it right most of the time and to make certain that a large loss was not experienced by my clients. I felt it was imperative to avoid experiencing a large loss in an ever increasing volatile investment world.

Now, ten years later, I ponder "What do people really know about our investment management strategies"? If a friend, relative, neighbor or professional associate was to say "Tell me about Hanlon Investment Management", what would you say? Most likely you are familiar with our style of investment management however I thought that a good way to start the 2010 New Year was to provide you with a few simple descriptions of our investment management strategies:

- ✓ We do not "buy and hold" anything! Instead we look for good, positive trends (funds that are going up), invest in those funds and monitor them closely. When they begin to falter enough, we sell. To repeat, we attempt to avoid large losses.
- ✓ When we sell, we could be reinvesting into conservative money markets or into another positively trending fund.
- ✓ In industry jargon, we use a combination of Modern Portfolio Theory and Trend Following.
- ✓ We offer a broad line-up of allocations to meet the needs of a range of investor types from conservative to the more aggressive.

Year-In-Review

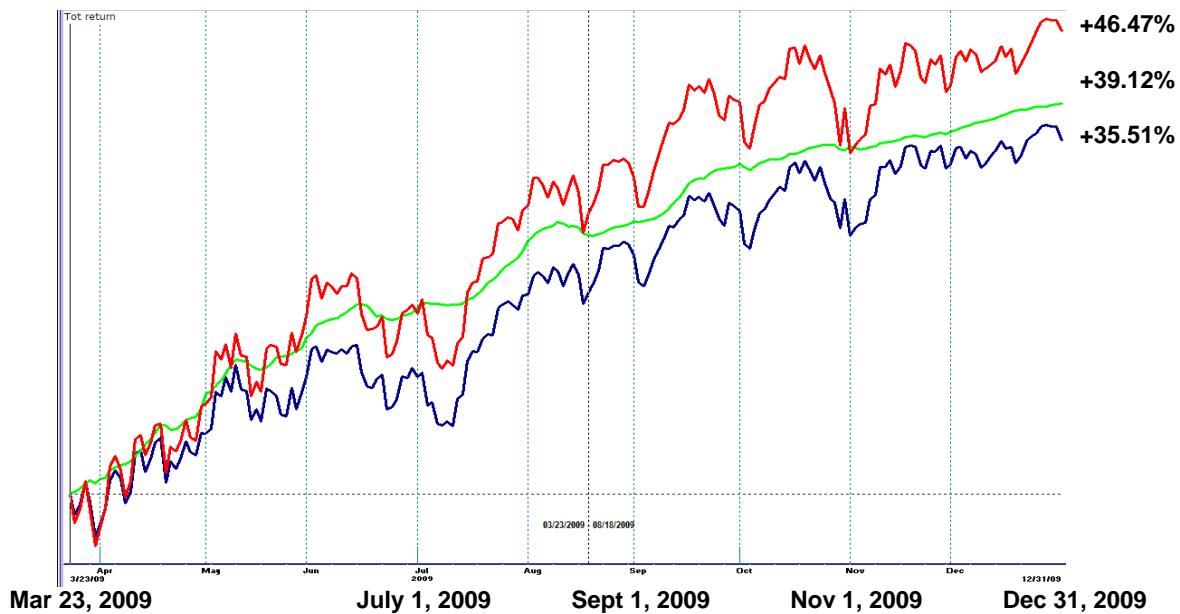
For the year, the NASDAQ Composite Index lead the way domestically, advancing 43.9%; the S&P 500 Index finished the year with a 23.5% gain, while the Dow Jones Industrial Average finished 2009 18.8% higher. Those figures do not include dividends. High yield corporate bond funds (HY) had their best year on record, with many of the high yield asset class indices appreciating well in excess of 40%. Of course our client accounts were primarily invested in HY (where available) for most of this past year and the results were good. Please see your specific account(s) and their performance report(s) for details.

This past March 2009 the equity and bond charts were telling us that the economy would eventually respond to unprecedented global fiscal and monetary stimulus, that distressed high yield bond 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 2009, HY also were declining from their higher prices of January and February 2009, but they did not fall to the lows set in December 2008. This movement 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. **We were correct!**

March 23, 2009 to December 31, 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 HY index we compose, displayed as the green line above, 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 bond funds”? “Is there a bubble developing in high yield bond funds”? Certainly the easy money has been made for this cycle. But even now our research and charts tell us that there’s still a compelling story for HY.

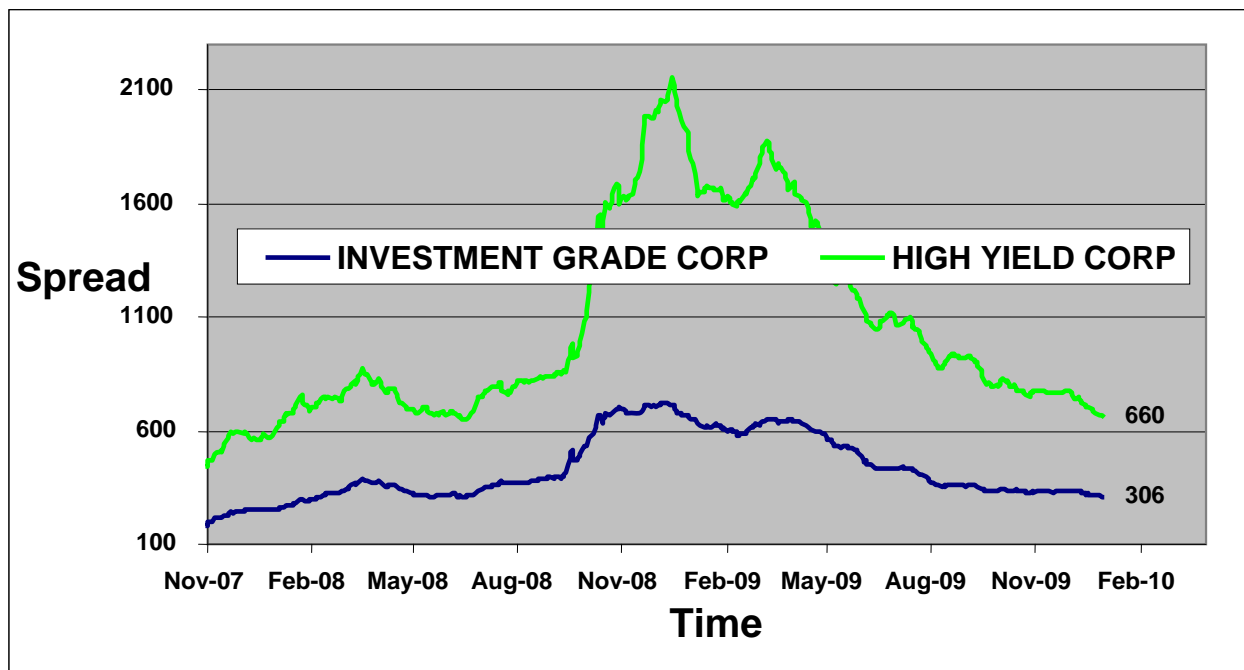
One compelling attribute is that HY interest rates versus US Treasury interest rates remain very attractive, with the **spread** on maturities of approximately 8 years at 6.60% (see chart on next page).

Historically speaking, the median spread level from 1986 through 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 31, 2009 level more than 67% of the time.

From an economic standpoint, the high yield corporate bond market is dominated by the survivors. These are the companies that should service their debt under **current** economic conditions, not the hoped for improving economic conditions. The default rates could drop to less than 5% within 6 to 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 to 4% range - this is one reason for the interest rate yield premium they command over high quality bonds.

We believe, by what the HY charts are telling us, defaults in 2010 may actually turn out to be lower than most think. 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.

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



History supports our belief that high yield bonds will continue to generate excess returns versus high quality bonds. In the aftermath of the prior two big bear markets for high yield bonds (1990 and 2002), 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 Capital High Yield Index returned 28.97% versus 4.10% for the Barclays Capital Aggregate Bond 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, some 15 months or so, to see the first pause in that rally. This current rally in HY is only 9 months old from our entry point in March.

We believe that high yield bonds will complete their 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 bonds 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 HY again in the future. There will come a time when HY 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. Of course high yield has always been a favorite asset class for our allocations and we limit our Managed Income to non-stock holdings, but what about stocks, when will we invest in them again?

What about Stocks?

Stocks continue to be a very important ingredient in our portfolio management. Now that the easy money has been made in HY, stocks are beginning to approach a more compelling risk-reward opportunity. Of course as usual we will rely on our chart analysis for our decisions, but as food for thought here are just a few reasons why stocks could continue to do well in 2010:

- ✓ Unemployment – Corporate America has approximately 7,000,000 fewer employees on payroll. If the average savings per laid-off worker per year is estimated at \$69,000 (why not after all the

salary, benefits, taxes, overhead, etc?) the result is an annual savings of almost \$500 billion. Basically there will be huge productivity gains as businesses do more with fewer employees.

- ✓ Lower dividend payouts – it has been reported that total dividends payable by America's public corporations has decreased by over \$250 billion per year in the last two years. That improvement in cash flow can go to reducing debt and making fresh investments into income generating assets.
- ✓ Lower energy costs – certainly the drop in the price of oil and natural gas from \$150 per bbl and \$14 per mcf, respectively, of two years past to the current \$80 and \$5.50 has translated into a significant savings on energy costs and improvement in cash flow.
- ✓ Lower financing costs – with today's low interest rates, America's largest corporations are the beneficiaries of some of the lowest interest rates in history, which translates into a huge improvement in their overall financing costs.
- ✓ Weaker dollar – this has the effect of America's Corporations becoming more competitive in the international marketplace for exports and could result in increased overseas sales.
- ✓ There are huge opportunities in emerging markets as the rest of the world's population positions themselves to join the "middle-class".
- ✓ The weakest corporations have been exposed and rooted out, making way for a more predictable business environment, as the weak guys who tend to over discount their services are gone.

As the risk-reward ratio of equity based funds improves as compared to high yield corporate bond funds we will be reallocating portions of our more aggressive portfolios back into equities sometime in 2010. We remain very optimistic about our abilities to navigate the volatile investment waters ahead.

I wish you and your loved ones the best of health, wealth and happiness in 2010. Thank you for the opportunity to be of service. Here's to a successful 2010!

Thank you,



Sean Hanlon, CFP®
Chairman, CEO and Chief Investment Officer

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