



# HANLON

INVESTMENT MANAGEMENT, INC.

## Quarterly Report – September 30, 2010

The National Bureau of Economic Research announced that the recession, which started in December 2007, ended in June 2009. Most Americans continue to say “where was THE END screen to that ugly movie” called recession? For dozens and dozens of months the Hanlon Investment Management Research Department has been opining that the *Great Recession* started with housing and it will not end until housing has bottomed and shows some life. Why? It has been proven that the wealth of many Americans is tied to their primary residence. Owning a home and amortizing the mortgage is a considerable component of wealth build-up.

Two words can best describe the situation now – real and psychological. The reality of the situation is that many home owners now understand how troubling debt can be. The psychology of the situation remains that until home owners feel good about their residences again, they are not in the mood to head to the store and go on a buying spree.

Unfortunately there were some twenty million home purchases over the course of about a three-year period (2005, 2006, and 2007) where the purchasers paid very high prices and the lenders were all too willing to lend to those purchasers. We all now know that those home prices were artificially inflated by an overabundance of easy, and in many cases no-document, financing. Alan Greenspan & Co. thought that the lenders would never enter into millions of bad loans because it would damage the lenders and therefore subject the lenders to financial calamity, job losses, equity share deterioration, etc. Wow, was Greenspan & Co. wrong on that one; human beings can be awfully dumb at times, especially during a mania like housing.

Of course reducing unemployment is crucial to economic improvement as well. But much of our economy is tied to consumer behavior. Many consumers are those same people that have those homes that at one time were a source of wealth creation and now have become a source of wealth destruction. Yes, they will be back and homes one day will again become a source of wealth creation; but that time is still years away.

The uncertainty for investors remains high. In the short run stock prices are often determined by the economic and financial news flow, as well as the short term buyers and sellers. In the long, long term stock prices are generally determined by two things; interest rates and corporate earnings. Currently, the interest rate component is easy – rates are low and are going to stay low for at least the next twelve months and perhaps longer. As for corporate earnings, they actually appear to be better and improving; but

not so much as to provide anything to get excited enough about to begin to attract investors in any perceptible way.

The range bound nature of this stock market continues, with the April 2010 high remaining the top of the range and about 15% or so below that being the current bottom of this range.

Perhaps the best way to understand what stocks have done this year is to simply review the below table, where we have listed all the months this year in which stocks appreciated or declined approximately 5% or greater. Notice anything?

Table 1 – Selected monthly returns for the S&P 500 Index during the calendar year 2010.

March	+5.9%
May	(-8.2%)
June	(-5.4%)
July	+6.9%
August	(-4.7%)
September	+8.8%

In six of the nine months the S&P 500 Index has had alternating gain, loss, gain, loss movements of approximately 5% or greater. There have only been a couple of years on record that exhibited similar activity. This has been a year where it has been a challenging market to reap profits. Overall, many equity indices are showing, at best, low single digit gains, but to achieve those gains there has been untold volatility, as can be seen by the above table.

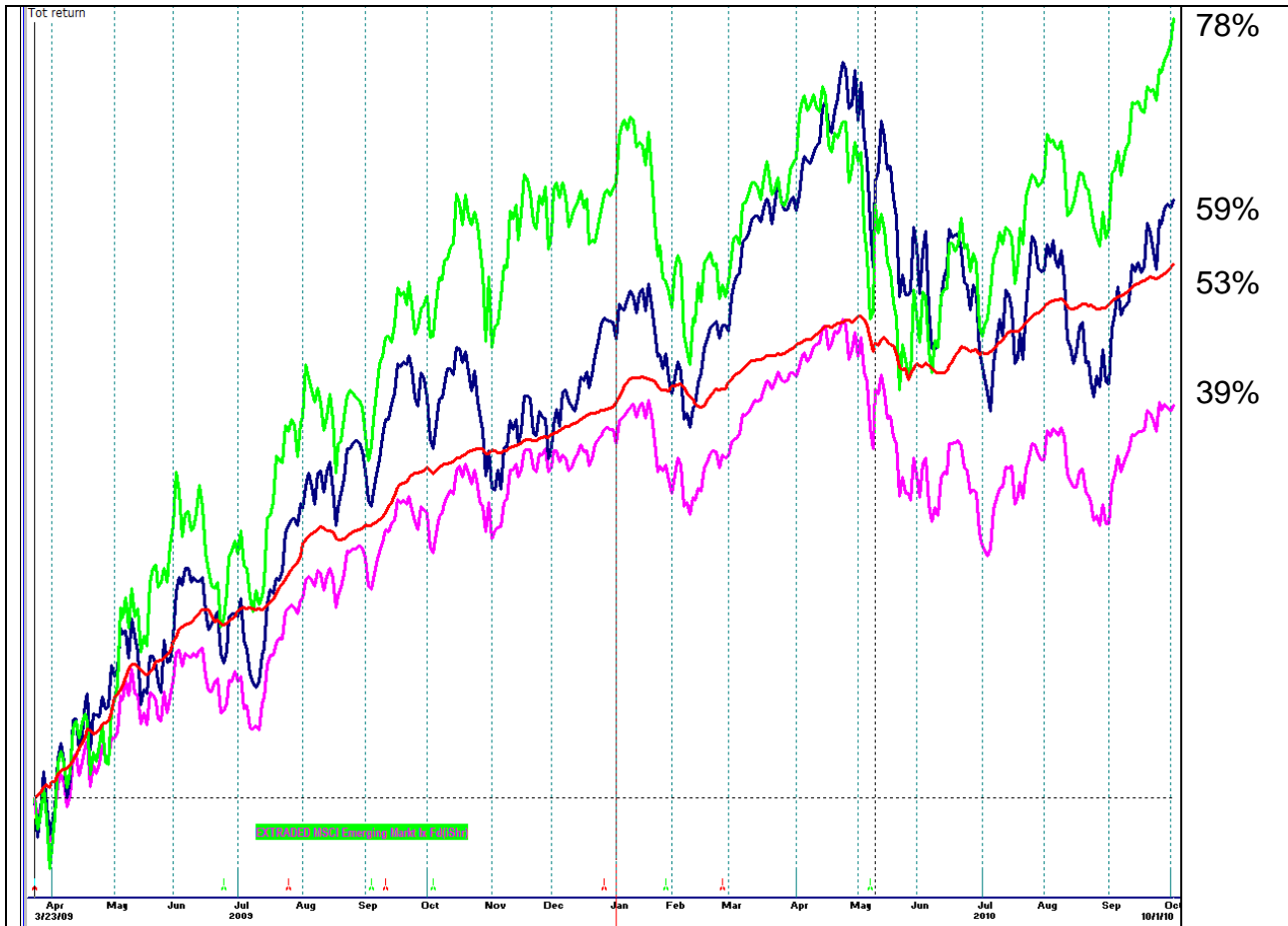
During the past quarter our research identified a positive trend developing in equities. We made partial portfolio investments into broadly diversified equity positions. Those positions reversed course during August, causing our research to issue sells and realize some losses. Sooner or later the equity markets will develop better trends, and profits should be achievable, but not in this market right now with all the negativity and uncertainty.

The other major asset class favored by most retail investors is bonds. This year has been a good year for bond investors as they have generally enjoyed profits, but more importantly they have done so without the extreme up and down volatility that equities have experienced.

Bonds continue to provide a very compelling return and during the past 18 months or so, since the bottom in March of 2009, our client accounts have generally had some exposure to bonds. Below you can see the lower volatility connected to high yield bond funds compared to the volatility experienced by equity investors. In some of the below equity indices the draw downs from peak to trough have been as much as a drop of 20%!

## March 2009 to September 2010 – Equities and High Yield Corporate Bonds

The Red Line is an equally weighted index composed of two hundred twenty domestic high yield corporate bond funds. The Green Line is the iShares MSCI Emerging Markets Index, an index of emerging (international) market stocks. The Blue Line is the Russell 2000 Index, an index of primarily smaller US companies. The Pink Line is the S&P 500 Index, an index composed of the largest US company stocks.



3/23/09

07/31/09

11/30/09

3/31/10

6/30/10

9/30/10

Without any consistent GDP growth, companies domiciled and doing the majority of their business in the major industrialized economies around the world are having a difficult time building equity. Sure, many companies have trillions sitting on their balance sheets. Oddly enough in this day that does no good, because corporate cash cannot even find a home that provides decent returns. It actually burns a hole in the income statement and margins for the company due to the return on investment (ROI) of that corporate cash being so low. These are very odd times indeed. But for retail investors like our clients, bond funds continue to provide an adequate risk-return today.

What does the future hold for investors? Here are some considerations for the short term:

- October earnings season has begun, which shall provide more clear insight of corporate earnings.
- The mid-term elections are only weeks away and the expectation is for a considerable change in the make-up of the House of Representatives.

- The Bush Tax Cuts are definitely on the table to be extended. The debate at this time is focusing on the extension of the tax cuts for the top brackets, as the middle and lower bracket tax cuts are almost a certainty to be extended.
- China – two things.

Do they allow their currency to inflate to avoid the potential for the United States to begin imposing tariffs? Historically, tariffs have been bad for business in general, and have led to further deterioration in stock markets.

Will their economic expansion, which has been the best in the world for most of the past decade, continue?

Of course these are only some of the known considerations and always it is the unknown that will likely have the most effect on investments. We shall continue to examine the markets every day for you and hopefully make good decisions for your long term investment success. You and your financial advisor have made a good decision to use the investment management services of Hanlon Investment Management. Our specific investment strategies give us the ability to navigate these choppy waters and seek calmer waters when the seas get rough. The seas are rough right now, so in calmer waters we are anchored and shall wait out the current storms.

Thank you for the opportunity to be of service.

Thank you,



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

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