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The Power of Compounding - You Need Solid Sequential Returns

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After the wild ride in the equity markets over the past three calendar years (2008-2010), I thought this was a good time to write a short commentary about the power of compounding.

There's no doubt that the past two years (2009 and 2010) have been very good for the equity markets. As measured by the S&P 500 Index, returns have been 26.5% and 14.8%, respectively, for 2009 and 2010, including dividends. That result is a compounded return of 45.1% for the two years combined. Excellent! We haven't seen returns this strong in back-to-back calendar years since 2003 and 2004 when the S&P 500 Index returned 28.7% and 10.8%, for a total two-year compounded return of 42.6%.

There is also another similarity between those two time periods. They both came on the heels of huge corrections in the equity markets. During the 2000-2002 "dot-com technology burst", the S&P 500 Index lost a total of 37.7% of its value, with maximum draw-downs of -49%. In the 2008-2009 "debt induced great recession", the S&P 500 Index lost 37.0% in 2008 alone and ultimately experienced a maximum draw-down of -57% in early 2009. While the causes of these two bear markets were different, the result had similar negative effects on long-term, sequential returns.

Many investors believe that a return of negative 40%, followed by cumulative returns of 50% easily recover from the losses and produce gains. Not even close. Why? Because the power of compounding is diminished due to the large losses reducing considerably the amount of capital that is working and compounding. Therefore it requires a GREATER positive return, relative to the negative return that reduced the portfolio value, to get the portfolio back to even.

See the table below for the gains needed to recover after losses of varying sizes.

Investment Loss	Gain Required to Get Back to Even
-10%	11%
-20%	25%
-30%	43%
-40%	67%
-50%	100%
-60%	150%

How does this relate to Hanlon? If you've been with Hanlon for the past three years - or longer - you may know the answer. Hanlon's primary objective in managing client portfolios is to attempt to avoid large portfolio draw-down / losses. If successful we should mitigate the maximum draw-down and therefore render the negative effects of compounding less harmful. For the past three years, we've been successful at this. How so? See the table below, which is for illustrative purposes only and not meant to depict any particular Hanlon portfolio or account.

Portfolio	A	B
Starting Value	\$100,000	\$100,000
Year 1 Return	-35%	-2%
Year 2 Return	+25%	+25%
Year 3 Return	+15%	+2%
Ending Value	\$93,437	\$124,950

In portfolio A, even though the simple addition of the three separate year returns equals a positive number, the portfolio ending value is still below its starting value. In portfolio B, the lack of significant draw-down during year 1 more than compensates for a lower investment return in year 3. Many investors and even advisors get focused on the short-term results, often forgetting about the long-term historical impact of the returns from all years. A lifetime of successful investing experience, year-in and year-out is the goal for each investor. Avoiding the "cliffs" is an important objective each investor needs to experience that lifetime of successful investing.

Thank you for the opportunity to be of service.

Thank you,



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