HANLON
INVESTMENT MANAGEMENT, INC.

Quarterly Report – December 31, 2010

The fourth quarter was generally a positive one for Hanlon client portfolios. What seems to have propelled the equity markets higher in the last quarter of the year was partly the result of the Democrats losing control of the House and numerous Senate seats, coupled with the Federal Reserve launching QE2 - quantitative easing version 2. The results of the mid-term election forced the President to work more with the Republican controlled Congress and they were able to iron out a compromise that extended Bush-era personal income tax rates, provided a payroll tax break and extended unemployment insurance. Collectively, this may result in more stimulus than expected in 2011 and was viewed as positive by the equity markets.

The Federal Reserve's announced QE2 program is geared toward purchasing US Treasury securities in the open market for the period November 2010 through June 2011, with the expected result to keep interest rates low and create liquidity. We won't know for some time how successful it will be at stimulating the economy. However, it seems that the Fed's willingness to do whatever is necessary to keep the recovery on track has been received very positively by the equity markets.

Oddly enough, after the Fed announced QE2, the bond market fell and interest rates rose. Especially hurt was the high quality sector of the bond market. Remember, if interest rates suddenly rise, there is an associated sudden drop in the value of bonds and bond funds. In the US, the 5-year Treasury yield nearly doubled from 1.17% on October 29th to 2.06% on December 30th, the 10-year Treasury yield jumped from 2.63% to 3.38% and the 30-year Treasury yield increased from 3.99% to 4.43%! The Barclays 20+ Year Treasury Index lost 11.7% in the quarter while the Barclays 7-10 Year Treasury Index declined 5.8%. High quality corporate bonds were slightly affected as the average corporate bond fund lost 1.4% in the quarter.

The good news for Hanlon clients is that we avoided having large investments in the high quality sector of the bond market and instead were invested in the lower quality sector, through domestic high yield bond funds. Our client portfolios have benefited from the continued consistent returns generated from domestic high yield corporate bond funds. Not only have they continued to appreciate in value, they also continue to pay a handsome dividend rate, with most currently in excess of 7% per year. Many of the domestic high yield bond funds that we own pay their dividend's monthly, which provide a nice cash flow stream each month.

Here are some of the reasons why domestic high yield corporate bond funds continued to be a good investment;

- ✓ Interest rates increased during the fourth quarter, but as we have been projecting, the increase in rates had no perceptible negative effect on domestic high yield corporate bond funds.

- ✓ The world economies continued to recover from the 2008-2009 Great Recession. The International Monetary Fund (IMF) projects that overall global growth for 2011 should be in excess of 4%. That includes both mature and emerging market economies. That growth should help companies improve profits and make interest payments on their debt, which is good for domestic high yield corporate bond funds.

- ✓ The default rate on domestic high yield corporate bond funds has declined considerably in the past 18 months and is projected to go below 3% in the coming year. This is a very positive factor for high yield bonds. Remember, high yield corporate bonds pay a higher rate because the investing public demands more return from companies that can have challenges if the economy slows considerably, amongst other things. That slowdown is not in the forecast now; instead economic expansion is the expectation.

- ✓ Corporate balance sheets continued to improve. It was reported at mid-year that corporate earnings reached an all-time high, recovering to a previous peak faster than most indicators of the economy, such as unemployment. Strong cash flows helped propel corporate cash positions to their highest levels in 50 years, leaving nearly $2 trillion of available funds on their balance sheets.

- ✓ The Economic Cycle Research Institute – go here http://www.businesscycle.com/ if you are having trouble sleeping – continues to report that the recovery is expanding and rather robust, projecting a good economy ahead.

So the economic conditions continue to be good for domestic high yield corporate bond funds and we maintain exposure to that asset class. Of course, as always, we shall navigate the markets and those investments in the coming months.

With respect to the equity markets, through early September of this past year most equity indices were breakeven at best. This was primarily due to market participants' inability to make up their mind as to what was going on. Markets rebounded from their March 2009 lows, but were far from fully recovered back to their October 2007 highs. There were fears of a double dip recession, unemployment was not improving, the consumer was not spending and the first round of fiscal stimulus did not seem to be producing the desired results. Plus, the healthcare package enacted by the administration put additional pressure on the markets as everyone attempted to figure out how it was all going to be paid for and what it meant for the average American. By midyear, it seemed that the major developed economies were losing momentum early in the recovery and that much of the economic news being reported was gloom and doom. Portions of the European economy were in and out of the emergency room.

For the first nine months of 2010 downside volatility existed in the equity markets, but was less prevalent in the final three months. In the first nine months, the S&P 500 Index and the MSCI Emerging Markets Index experienced four draw-downs in excess of 7%. Even more volatile was the Russell 2000 Index, which had four draw-downs of in excess of 9.7%. The alternating ups and downs of the markets made it very challenging to identify investable trends, which is our primary investment technique. Below is a chart of the peaks and troughs that the S&P 500 Index experienced during the first nine months of 2010.

<u>Chart 1 - S&P 500 Index December 31, 2009 through September 30, 2010</u>

Our methodology attempts to identify investable, profitable trends in various asset classes, primarily bonds and equities. As mentioned, the difficulty with equity markets for the first nine months of this year was the considerable counter-trend activity in short periods of time. This is known as "whipsawing" (defined as abrupt increases and decreases in prices). For all that volatility in the first nine months the S&P 500 Index was up less than 2% at September 30! Fortunately, during the April 23rd to July 2nd period, our clients did not experience anything close to the experience of the S&P 500 Index, when it fell 16% peak-to-trough. As mentioned in our prior quarterly commentary, our trend-following techniques created buys after the July gains in the markets; we did experience a whipsaw when we added and then sold those partial equity allocations in August.

For those allocations that permit equity exposure (Growth, Growth and Income and Balanced Allocations) our research held off on investing in equities until later in the fourth quarter. This was because even though October saw continued equity appreciation, November saw some downside in equities, most likely the result of the increase in interest rates. In the fourth quarter, the largest draw-downs for the S&P 500 Index and Russell 2000 Index were about 4% and the MSCI Emerging Markets Index had only one decline greater than 2.5%. That is a nice investing environment. With that in mind, our research indicated that a potentially profitable equity trend was in place near late November / early December and that prompted us to make portfolio moves and invest in equities.

What will occur in this coming year? I am sure you have already read too many lists of predictions, expectations and the like. At Hanlon, we avoid making long-term predictions; it is not a part of our investing style. We are leery of most predictions and do not incorporate them into our investment technique. Who really knows what the future will bring? Our approach is the one-day-at-a-time approach. We do our best to manage against large downside volatility, with no guarantees of course, and then attempt to achieve gains when we are comfortable with the market conditions and invest accordingly.

The New Year brings opportunity and challenge. Please know that we will continue to attempt to manage the volatility in the markets and to make 2011 a profitable one for the portfolio you have entrusted us to manage. We very much respect this responsibility you have called on us for and approach it with great attention and care. We really, truly care a great deal about the results that we achieve for you.

Thank you for the opportunity to be of service.

Thank you,

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

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