HORAN CAPITAL ADVISORS
Investor Letter
SECOND QUARTER 2012
www.horancapitaladvisors.com

Revisiting Recent Past

The market's pattern in 2012 resembles the market's action in 2011 while a number of key issues continue to hang over the financial markets. In our second quarter 2011 Investor Letter, we discussed the debt ceiling debate in Washington and Standard & Poor's subsequent negative outlook and downgrade of U.S. government debt. We also wrote about serious weather related issues that greatly influenced the commodity markets. As was the case last summer, the Euro Zone crisis endures as many of the southern European countries attempt to get their fiscal houses in order. As Yankee great, Yogi Berra, once said, "It's déjà vu all over again."

The most pressing current policy issue is the need for Congress to take action on raising the U.S. debt ceiling. Similar to last year, the debt ceiling is expected to be reached in early September. It's not surprising that investor confidence is fragile and waning with multiple unresolved issues.

Potential Headwinds

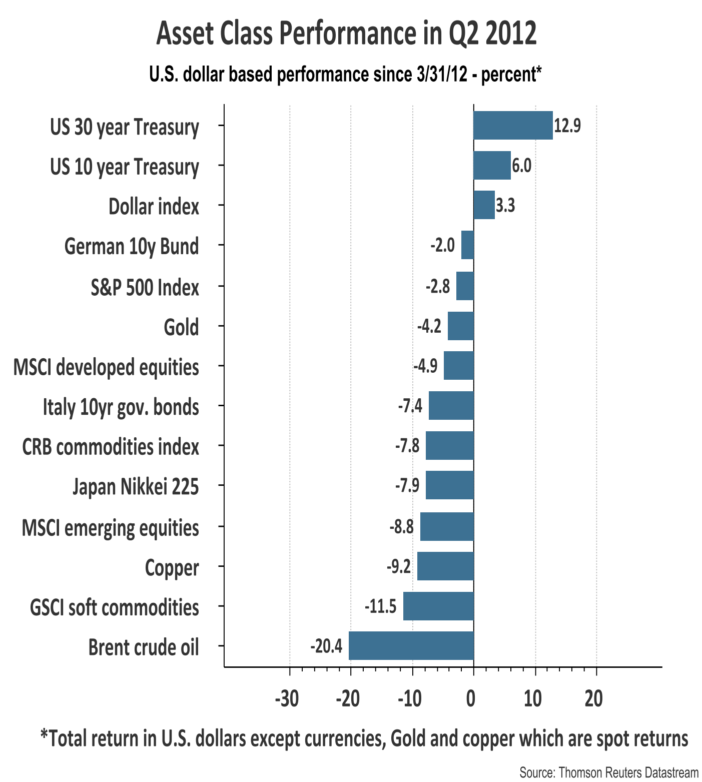
<u>September 2012, Debt Ceiling Debate:</u> The market's response to the debt ceiling debate last year started with a six week decline following S&P's downgrade of U.S. government credit. This year, President Obama has targeted July as the deadline for Congress to form an agreement which would increase the debt ceiling by $2 trillion.

<u>November 2012, U.S. Elections</u>: New to the fray this year is a polarizing presidential election. The political rhetoric will undoubtedly be raised as the November election quickly approaches. Historically, equity markets have been stronger in the second half of a presidential election year; however, given the many issues that still need to be addressed, it remains to be seen whether the market can move higher in the face of these hurdles.

December 2012, Fiscal Cliff: The “fiscal cliff” is a reference to the expiration of the Bush era tax policy which would result in broad tax increases, expiration of the payroll tax cut, the implementation of automatic spending cuts and the initiation of additional taxes to support the new healthcare law. This “fiscal cliff” is as much as 3.9% of GDP and is likely to have a negative impact on economic growth in an already suspect economy.

December 2012, The End of Operation Twist: The Fed recently stated they will maintain Operation Twist, the monetary action taken to sell short-term Treasury bonds and purchase long-term Treasury bonds, through the end of this year. Past Federal Reserve actions such as Quantitative Easing (QE) and Operation Twist (OT) have supported higher equity market returns. Interestingly, each subsequent liquidity action by the Fed had a smaller positive impact on equity market returns. The end of prior QE programs have been met with a weakening equity market.

Ongoing, Euro Zone Issues: For investors, a chronic and exhausting issue is the European Union’s debt crisis. The European Central Bank (ECB) and International Monetary Fund (IMF) have provided multiple bailouts with strict provisions that call for budget cuts and higher taxes. Broader monetary easing has been implemented but nonetheless, recovery will be long and painful as a deeper recession and higher short-term unemployment is likely.



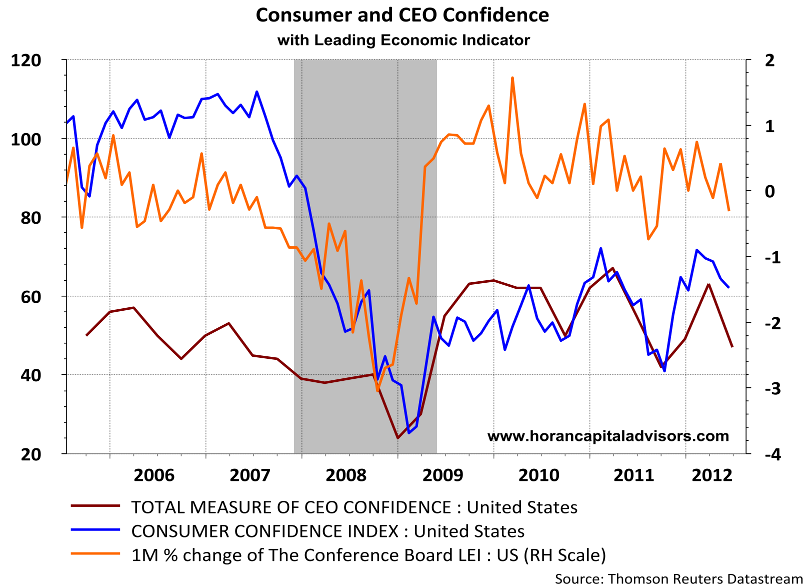
Second Quarter Returns

Virtually all markets – equity, bond, commodity, currency, etc. – remain sensitive to media sound-bites surrounding the issues listed above. Investors continue to allocate investment dollars into asset classes they believe are more conservative.

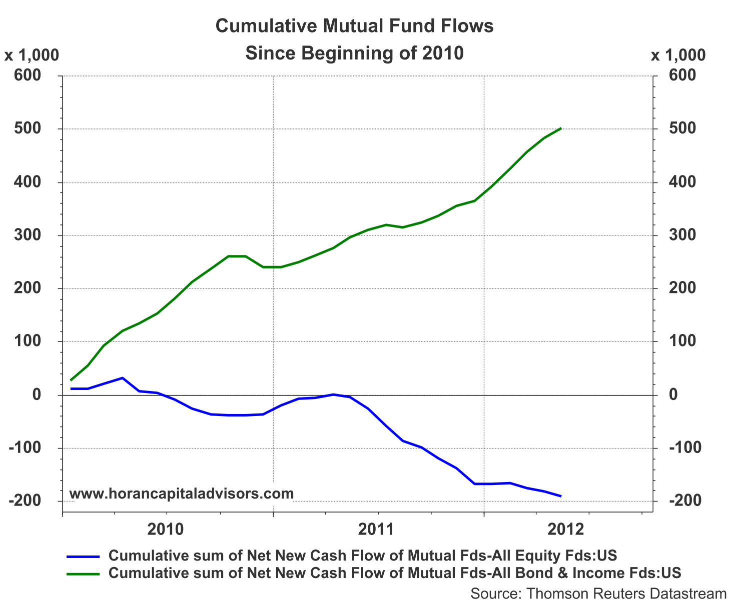
In the second quarter, the S&P 500 Index declined 2.8% giving back some of the 12.6% gain achieved in Q1. Additionally, after the 30-year treasury fell 7.57% in Q1, it was higher by 12.6% in Q2. These significant fluctuations from risk on/risk off (equity/treasuries) continue to negatively impact investor confidence.

Notably, for the quarter, commodities such as oil and copper declined on weaker global growth concerns.

Living Beyond Our Means



Governments around the globe continue to neglect their respective fiscal deficit issues in a meaningful way. In large part, this continues to negatively impact business and consumer confidence. As shown in the chart to the right, The Conference Board's Leading Economic Indicator fell 0.31% in June. This was the second decline in the last three months. The correlation between Leading Economic Indicators and confidence is clearly high. We believe that serious and perhaps unpopular reform measures including broad tax reform and spending/entitlement reforms are needed. These measures may be contractionary to economic growth; however, we believe quantifiable and positive policy actions could lead to increased corporate spending. This increase in private sector spending could offset the contractionary effects of reduced government spending as businesses maintain nearly $2 trillion in cash on their balance sheets. There will be a day when cash deployment for hiring, capital spending, and acquisitions will lift economic output.



The Federal Reserve continues to pursue a policy that makes it easier for investors to borrow cheaply in an effort to encourage higher allocations in risk based assets. Available credit is outstripping demand. As Ben Inker of GMO states, "The Fed is trying to entice investors into buying risky assets. The question we [GMO] are grappling with today is whether we should take the bait." Cheap money provides the incentive to borrow and deploy capital into riskier asset classes such as equities and yet mutual fund flow data does not support this case. The data shows the exact opposite is occurring with investors allocating investment cash to fixed investments as seen in the chart to the left.

When Headwinds Ease

Standard & Poor's recently described the current investment climate as similar to sailing. They noted that novice sailors often fear strong winds as the sailboat tips or heels in fear that the boat will tip over and dump them into the confused and rough waters. In actuality, as the boat heels, less of the sail is exposed to the wind and the boat rights itself. We believe the current market climate will eventually find calmer waters. Equity valuations for the S&P 500 Index certainly appear attractive with the market trading at a forward PE of 12.9 times 2013 earnings.

We continue to find compelling value in various markets but remain biased towards investing in higher quality companies with strong cash-flows and lower debt levels than the broader market. Howard Marks of Oaktree expresses that "active management has to be seen as the search for mistakes." Howard is generally referring to the ability to recognize opportunities where investors have not been participating. As advisors, we believe a part of our role is to assist clients in navigating the emotional aspects of investing during these somewhat volatile times.

Our blog frequently posts updated commentary and a link may be found at our website at the following link: www.horancapitaladvisors.com or a direct link can be found at: http://www.horanassoc.com/horan-capital-advisors/blog.aspx. As always, please don't hesitate to contact us with questions, concerns or general commentary.

Best Regards,

HORAN Capital Advisors

Corporate Headquarters
4990 East Galbraith Road
Cincinnati, Ohio 45236

513.745.0707 I 800.544.8306

Regional Office
2500 Kettering Tower
40 North Main Street
Dayton, Ohio 45423
937.610.3700 I 800.544.8306

www.horancapitaladvisors.com