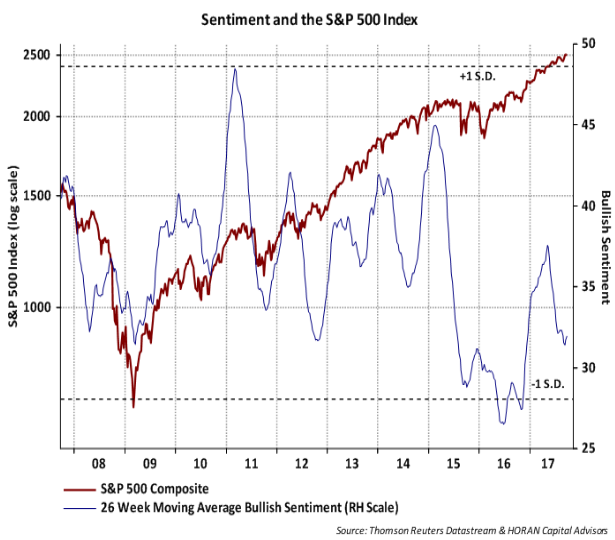
HORAN CAPITAL ADVISORS Investor Letter

Fall 2017 www.horancapitaladvisors.com

“Scared money don’t make money” – Young Jeezy

The Hated Rally Continues

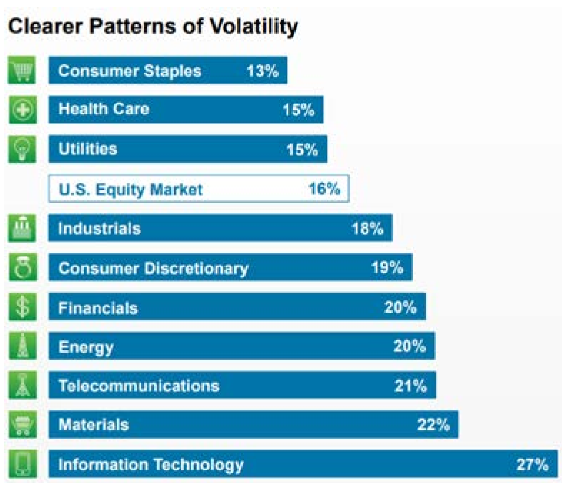


We have an age-diverse team as it relates to the employees of HORAN Capital Advisors and as age goes, so does the taste in music for our colleagues. Young Jeezy, the American rapper, is certainly not viewed as a fount of financial wisdom, but the opening quote appears to fit the times. As the chart at right shows, the 26-week moving average of bullish investor sentiment (blue line) has been very bearish since mid-2015 even as the S&P 500 (red line) has continued to climb to all-time highs. Many market participants have been “scared” for the better part of the past two and a half years and missed substantial gains. The S&P 500 finished the third quarter at 2519.36, a total return gain of 14.24% in 2017, while the Dow Jones Industrial Average was up 15.45% and the Nasdaq 20.67%. Large cap stocks have been the clear winner domestically with the Russell 2000 Small Cap Index up only 9.85%, but international markets have been even stronger. Developed international markets, represented by the MSCI EAFE Index, are up 20.47% through the third quarter while emerging markets (MSCI EM Index) are the overall winner increasing 28.14%. In all of these markets, however, abandoning an established investment process due to fear would have been costly.

“Living is easy with eyes closed, misunderstanding all you see” – The Beatles

Low Volatility and High Beta

Smart-beta funds have become the investment du jour in recent years with their claim to combine the benefits of both active and passive management styles in a cost effective manner. “Smart-beta” is a strategy that uses rules to capture a very specific market in a more efficient manner, i.e., small cap U.S. stocks. This form of quasi-passive investing can have value for investors by offering cheap and diversified exposure to specific factors, such as size, value and volatility, but investors often fail to understand what they are really buying. We believe that investors may misunderstand some of their “smart-beta” investments due to a lack of research into the underlying holdings. As the Beatles quote indicates, ignoring reality can make things easier, but we would caution that ignorance could prove dangerous in investing.



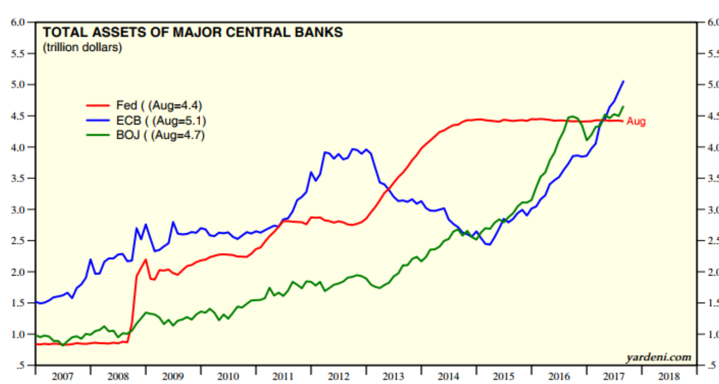
One of the significant factor discrepancies in the equity markets this year has come from low volatility vs. high beta within the smart-beta category. Through quarter end, the S&P Low Volatility Index is up 12.19% while the S&P High Beta Index is up only 9.32%. Low volatility strategies attempt to own the stocks with the lowest standard deviation, and high beta strategies seek to own the stocks that are most sensitive to the movements of the broader market. We believe that much of the demand for low-volatility funds stems from the aforementioned bearish sentiment in the markets. With fear as the prevalent emotion, demand for "safe" assets only grows. Unfortunately, the low volatility funds are not nearly as "safe" as they appear.

The chart from Fidelity (above) shows the historical sector volatility from 1996-2015. Only three sectors (consumer staples, health care, and utilities) were less volatile than the broader U.S. equity market. Interestingly, in the current allocation of the S&P Low Volatility Index, these three sectors make up only 35% of the fund and none are as well represented as financials (~21%). In fact, the weighting to the most volatile sector by Fidelity's measurements (information technology) has doubled in 2017 to over 11% of the fund (by far the largest allocation to tech in past 5 years). S&P's strategy for allocating the fund involves only a 12-month historical volatility review. This method results in typically volatile companies such as Alphabet (Google) being included in the index due to its relatively stable price movement in the second half of 2016.

"This is the end beautiful friend, this is the end my only friend" – The Doors

<u>The Fed's Balance Sheet</u>

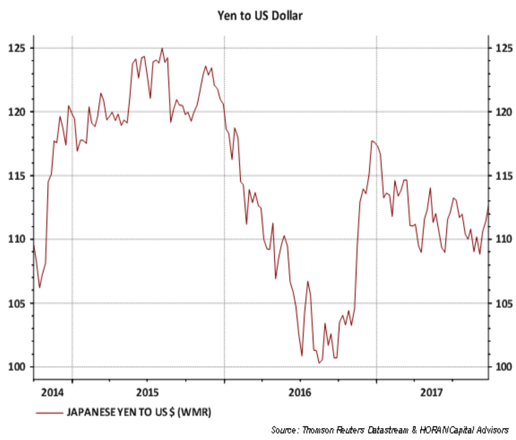
After engaging in Quantitative Easing (QE) to support economic activity in the wake of the Great Recession of 2008-2009, the Fed's balance sheet has ballooned to an enormous $4.5 trillion. Quantitative Easing contributed to the abnormally low interest rates of recent years. These low interest rates have been a key catalyst behind the market as it continues to set all-time highs. This sort of interest rate manipulation is, however, not a sustainable central bank strategy, so at its September meeting, the Fed laid out plans to shrink its balance sheet. Beginning in October, the Fed will reduce its securities portfolio by $10 billion per month by not reinvesting all of the principal payments received from maturing bonds. In each subsequent quarter, the Fed will decrease this reinvestment by an additional $10 billion until it reaches a maximum of $50 billion per month. This plan minimizes some of the uncertainty surrounding the balance sheet reduction, but the consequences remain far from certain. As described in our Summer 2017 Investor Letter, this type of balance sheet reduction has never been attempted, so history gives us little insight. Investors will remain hypervigilant of changes in long-term interest rates, inflation and global capital flows to assess potential outcomes and market ramifications. Investors' greatest fear is that Quantitative Easing truly was the



Source: Haver Analytics.

market's only friend, and that asset prices will fall as the balance sheet shrinks and interest rates rise. At HORAN Capital Advisors we remain flexible in our decision-making, but believe that the Fed's measured approach and the economy's relative strength should be stabilizing factors for the market moving forward.

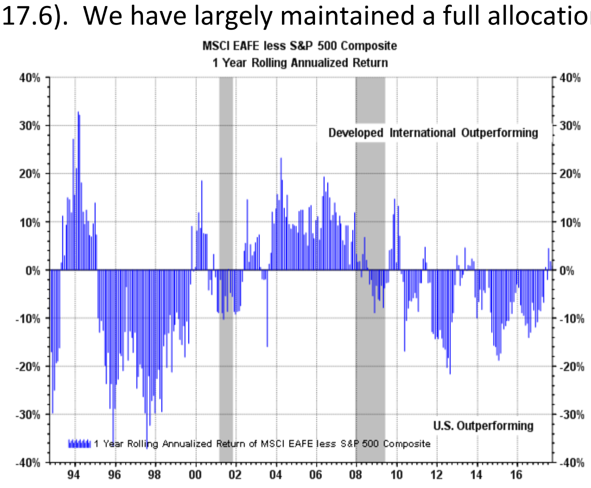
Central banks of other developed nations are continuing unabated with their respective asset purchases (Quantitative Easing) as shown by the chart on the prior page. The asset bases of the European Central Bank (ECB) and the Bank of Japan (BOJ) continue to grow rapidly while the stable asset base of the Fed (red line) will soon begin to shrink. This dichotomous relationship between major central banks has led to unusual cross-border asset pricing. One prime example is that the European High Yield Fixed Income sector is currently yielding around 2.32% while the 10-year Treasury in the U.S. is yielding around 2.33%. This means that the least creditworthy borrowers in Europe can currently borrow at a similar rate to the theoretically risk free rate of the U.S. Treasury. Another example comes from the Yen to Dollar exchange rate. As Japan has continued to expand their QE policy, the Yen/Dollar FX rate has become very volatile. This volatility, however, has resulted in a current exchange rate that is roughly equivalent to the rate prior to Japan's first large QE increase in October 2014.



"It's a brand new morning, it's a brand new day, forget the past now, it's ancient history" – Bob Seger

Client Portfolios

While forgetting the past is imprudent, the historic activity of central banks in recent years has created a truly unparalleled period in market history. This unique situation demands that investors consider new relationships between assets and avoid becoming excessively reliant on historic averages without context. A prime example of this comes in the form of domestic equity market valuations. Although we are currently observing above average historical valuation ratios, domestic equity indices do not appear irrationally priced given interest rates, inflation expectations, and expected earnings growth. In fact, as indicated in our Spring 2017 Investor Letter, the current forward P/E of the S&P 500 of 18.06 is only marginally above the historical average from 1958-2016 when inflation is between 2%-3% (average is 17.6). We have largely maintained a full allocation to domestic equities for clients in light of this view.



Throughout the past two years, we have added to client international equity positions as the global economy strengthened and central banks abroad committed to their QE programs. Though our thesis has taken some time to materialize, it appears that international equity markets have turned an important corner in 2017. As the chart to the left shows, developed international markets have outperformed the S&P 500 over a 1-year time horizon for the first time since 2013. The result has been similar for emerging markets equities, which we re-entered in early 2017.

We continue to observe the wide disparity of returns between U.S. growth and U.S. value stocks this year. We remain wary of overly expensive stocks in specific sectors and continue to analyze various opportunities as many companies continue to go through fundamental changes.

Client fixed income allocations remain positioned towards short-term duration as the Fed changes course on its asset portfolio. We have maintained a shorter duration fixed income portfolio with the goal of adding incremental return through tactical credit risk rather than interest rate risk. Bank loans and real estate fixed income have helped us achieve this objective, while the alternatives allocation has also provided a key source of incremental return with less equity risk.

"Glory days, well they'll pass you by, glory days, in the wink of a young girl's eye"
– Bruce Springsteen

Aiming for Income

Throughout most of the past 100 years, investors could find a reliable stream of income from their portfolios. Today, however, in an era where the 10 Year U.S. Treasury pays 2.33% and the S&P 500 Index is similarly yielding 2.01%, this income is not sufficient for most investors. Fortunately, this is not a problem. Theoretically, investors should be indifferent when comparing capital gains and interest/dividend income, as the tax treatment of each is frequently similar. Many investors have expressed concern about retirement income in a prolonged low rate environment, but capital gains can be a suitable, and sometimes even superior, source of income in retirement.

Conclusion

We expect to see mixed economic numbers throughout the rest of the year and into early 2018 due in large part to the natural disasters that struck the U.S. in the third quarter. We expect an initial hit to GDP and subsequent recovery as residents return to their homes and reconstruction begins. Our thoughts and prayers are with all those affected by these disasters. On a global basis, a synchronized expansion seems to be taking place and is being reflected in asset prices. On a year to date basis through the end of the third quarter, all forty six country ETFs (exchange traded funds) have generated a positive return. Lastly, in a recent Bloomberg report, Torsten Slok, chief international economist at Deutsche Bank AG in New York stated, "The global economy is in better shape than it has been in several years. We just don't see what would be a trigger for a recession." Global growth seems to be occurring without stoking inflation concerns and we believe this is partially due to efficiencies driven by implementation of technology advances.

Thank you for your continued confidence in HORAN Capital Advisors. Please be sure to visit us at www.horancapitaladvisors.com

Warm regards,

HORAN Capital Advisors

* HORAN Capital Advisors, LLC is an SEC Registered Investment Advisor.

Corporate Headquarters
4990 East Galbraith Road
Cincinnati, Ohio 45236
513.745.0707
800.544.8306

Regional Offices
2480 Kettering Tower
40 North Main Street
Dayton, Ohio 45423
937.610.3700

Columbia Executive Center
207 Grandview Drive, Suite 100
Fort Mitchell, Kentucky 41017
859.572.4500

www.horancapitaladvisors.com