HORAN CAPITAL ADVISORS

Investor *Letter*

FOURTH QUARTER 2012 www.horancapitaladvisors.com

We own several businesses that have strong unit growth characteristics, very favorable industry structures that drive pricing power, and management teams that understand the proper allocation of free cash flow to maximize equity returns. In a low or no growth economic environment, these companies should command significant valuation premiums to the overall market, yet they continue to trade today at P/E ratios that are undemanding.

– Alan Fournier of Hedge Fund Giant Common Sense

Quarter and Year-End Commentary

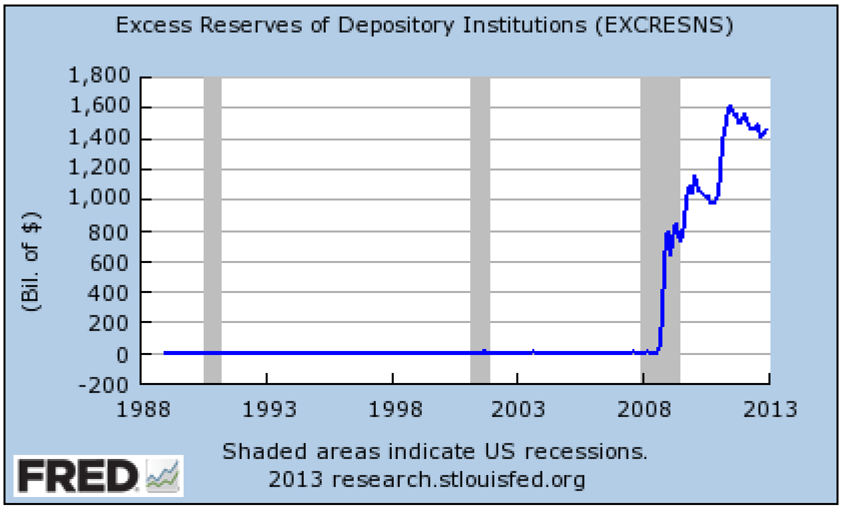
In 2012, diversification was a strategy which rewarded investors as most asset classes generated strong returns. Positive returns were achieved on a broad basis across the investment landscape with equities, fixed income and alternative investments generating mid-teen returns. The total return for the S&P 500 Index was 16%. U.S. large cap equities were relatively flat for the fourth quarter with most of the 2012 gains registered in the first quarter. Lower quality stocks performed better than high quality stocks. The broad asset class exposures we choose for our clients enabled them to participate in the positive returns achieved globally.

	Category as of 12/31/2012	Q4 2012	Calendar 2012
	Equity		
Large Cap	S&P 500 Index	-0.38%	16.00%
Small Cap	S&P 600 Index	2.22%	16.33%
International	MSCI EAFE Index	6.57%	17.32%
Emerging Markets	MSCI EM Index	5.58%	18.22%
	Fixed Income		
Broad Market	Barclays Aggregate Bond Index	0.21%	4.21%
Credit	Barclays High Yield Index	3.29%	15.81%

As we analyze the capital markets and project expected long-term returns and risks, we believe we are in an environment that favors equities and alternative investments over bonds. Two components of risk, inflation risk and interest rate risk, give us concern about the prospect of positive *real returns* in diversified fixed income portfolios. Potential short-term shocks like the debt ceiling debate and sequestration in Washington could be catalysts for an equity market pullback. In the following pages, we make an effort to detail our case that supports equities over the longer term.

Inflation

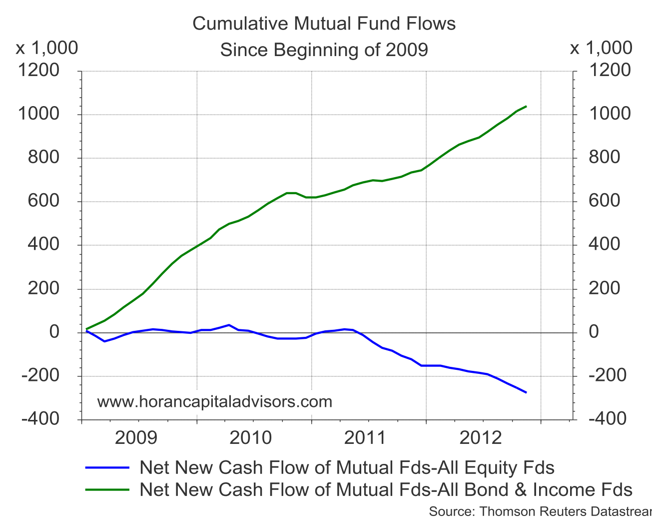
The debate surrounding deflation versus inflation is gaining in popularity largely because of the Federal Reserve Bank's seemingly unlimited Quantitative Easing (QE) programs. Currently, several of the factors keeping inflation in check may actually be more deflationary than inflationary. Current deflationary influences include global deleveraging, low capacity utilization rates, high persistent unemployment and slowing demand for goods, services and credit. Bond market yields imply deflation is more likely than inflation, and although housing may be bottoming, an elevated level of foreclosures reduces public sentiment around home purchasing. Deflation can be characterized as an economic environment where a lack of demand exists. Inflation, by contrast, measures the general level by which goods and services rise in cost. Those who argue inflation is at levels far greater than reported point to the rise in the cost of a number of commodity goods: oil, corn, cattle, etc. Those not in the inflation camp cite the fact a number of commodity price increases are a result of supply disruptions or speculation rather than secular trends. Weaker housing numbers (seeing strength recently) and stagnant consumer wages, large components of overall cost inputs, have helped curb inflation data. The bond market certainly does not imply an expectation for future inflation; however, the Fed's effort to keep interest rates low is temporarily capping the market's normalized level of interest rates. The Federal Reserve is currently spending $85 billion per month for asset purchases which closely matches the U.S. government's annual budget deficit. How long will/can the Federal Reserve keep up this pace?



So, which camp are we in? We believe two forces are likely to lead to higher inflation. The first is the increased supply of U.S. dollars. In order to relieve the U.S. of its debt burden, the U.S. government will continue to aggressively monetize the U.S. debt. We believe the Fed's attempt to stimulate the economy through an increase in money supply has not been effective due to the lack of current demand. This is evident by the growth of "excess reserves" held at banks which eventually will be deployed into the economy. In 2011 and throughout 2012, bank lending has actually started to pick up. The second factor to contribute to higher inflation is the growing consumer base in the emerging markets. The emerging market consumers have an appetite for an improved standard of living which leads to broader consumption.

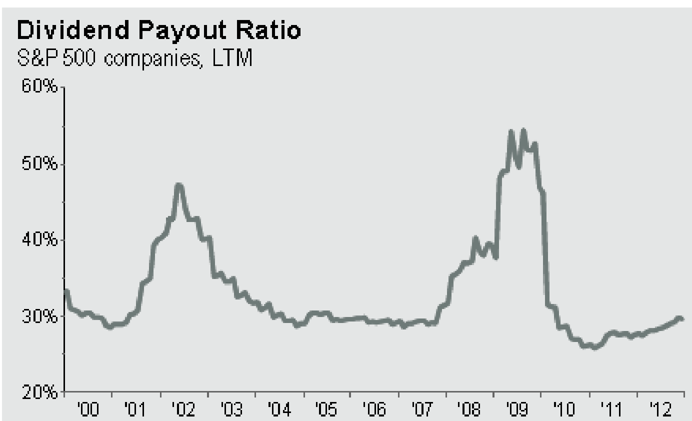
<u>Momentum Favors Equities: Investors Underweight</u>

Since the financial crisis that saw the S&P 500 Index bottom in March of 2009, investors have allocated more of their investment dollars to bonds versus stocks. Since 2009 the absolute difference has been in excess of $1 trillion. This allocation decision has resulted in investors missing out on the much stronger returns generated by equities. Out of the last four years, only 2011 saw bonds beat stocks in the U.S. investment market. Influencing investor asset allocation decisions is the decline in interest rates. This secular decline in interest rates since the early 1980's has led investors to forget the consequences a rising interest rate environment can have on the value of one's bond portfolio. Also, many investors have been conditioned to the nice returns bonds have been able to provide within the context of a "safer" alternative to equities. Higher interest rates will result in a decline in bond prices. The rotation from fixed income investments to equity mutual investments could be significant and create a tail wind for a broad equity market rally.



We continue to believe equities trade at attractive valuations. Over the past few years, we have been attracted to equities and believe they are broadly undervalued, particularly relative to fixed income. For example, it has been common for high-quality U.S. companies to issue 20-year debt yielding in the neighborhood of 2.75%. Many of these same companies have stocks with dividend yields in excess of 3.30%. Given this disparity in income percentages, investors should evaluate the long-term growth and income potential for each type of investment. Although it's highly likely that the stock's volatility will be higher than the bond's, the growth prospect for the stock will certainly be higher. And, the stock will have far greater prospects to keep pace with inflation through price and dividend growth. In this example, a $100,000 investment in the bond will provide a compound future return of $172,042 in 20 years, while the stock, assuming no price fluctuation, will return $191,428. Assuming, over the long run, that the company's stock price remains flat and initiates regular dividend increases, the stock would need to decline by $19,386 or nearly 20% to be a worse investment than buying the bond. We believe most high quality companies will return a much higher level of income vis-à-vis the dividend in this scenario, but also provide for growth of income and growth of principal.

Equity Buybacks and Dividends



Source: Standard & Poor's, FRB, Bloomberg, FactSet, J.P. Morgan Securities, J.P. Morgan Asset Management.

It's no secret that U.S. companies are holding record levels of cash. Corporate stock buybacks are very strong and dividend growth rates are the highest in six decades as reported by JP Morgan. Companies have a high propensity to distribute more of their cash or future cash-flow in the form of dividends. U.S. payout ratios are near all-time lows and are significantly lower than their foreign market counterparts. Howard Silverblatt, senior index analyst at S&P Dow Jones Indices recently noted, "Payout ratios — the percentages of profits corporations hand back to shareholders as dividends — are only about 36%, well below their historical average of about 52%. They've got significant cash-flow." Standard and Poor's recently reported dividend data for S&P 500 companies through the third quarter of 2012. Year over year dividend growth was reported at 17.4%. Also, the recent favorable extension of the dividend tax rate will likely encourage future increases to company dividends. We believe companies will continue to reward investors through higher dividend payments.

2012 Looking Back

The following few paragraphs highlight some of our strategy and the recommended fund manager selections that benefited clients in 2012. Importantly, our Core Equity (individual stocks) portfolio has posted strong results over the last few years and performance is ahead of the S&P 500 Index since inception, while assuming less risk and generating higher dividend cash-flow. As we reviewed our recommended fund managers for 2012, 10 of the 15 managers on our current recommended list finished in the top third of all funds within their respective categories. 4 of those 10 finished in the top 10th percentile and 2 of the 10 were named the top manager in their category by Morningstar. The average category outperformance of our top 4 funds was 8.68% relative to the stated benchmark.

High-yield was a top performer in 2012 as the Barclays High-Yield Index was up nearly 16%. Global bonds were another top performer as our allocation to the Templeton Global Bond Fund returned more than 19%. Consequently, the fund was ranked in the top 1% in 2012.

Our alternative investment manager selection was strong in 2012, particularly in the long/short equity space. TFS, one of our recommended mutual fund managers, was named the top alternative investment manager by Morningstar for 2012. The fund has been closed for new investment for some time and consequently, for clients without this holding, our replacement fund, Robeco Boston Partners Long/Short Research Fund, was in the top 7% of long/short managers. The fund took less than half the equity market risk while capturing 84% of the S&P 500 Index's return.[1] Overall, we are extremely pleased with returns achieved across the board.

2013 Looking Ahead

As we look forward in 2013 and beyond, we see specific themes forming which are influencing our investment strategy.

- Interest rates cannot be capped forever and fixed income *real* returns could present challenges
- Natural resource exploration and discovery could lead to both U.S. energy independence and job growth, as well as a resurgence in competitive manufacturing in the U.S. due to low cost energy supplies
- Tax revenues will very likely go up and government/entitlement expenses down, leading to contractionary pressure for economic growth
- Technology and labor productivity will continue to dampen the employment market

We do anticipate positive returns for equities in the coming year while fixed income could be pressured. Alternative investments could once again be an attractive source of return for investors. As always, we appreciate the confidence our clients place in us in managing their financial assets. Please don't hesitate to contact us with any questions or comments.

Respectfully,

HORAN Capital Advisors

[1] This data was provided by the fund companies and by Morningstar as of December 31, 2012.