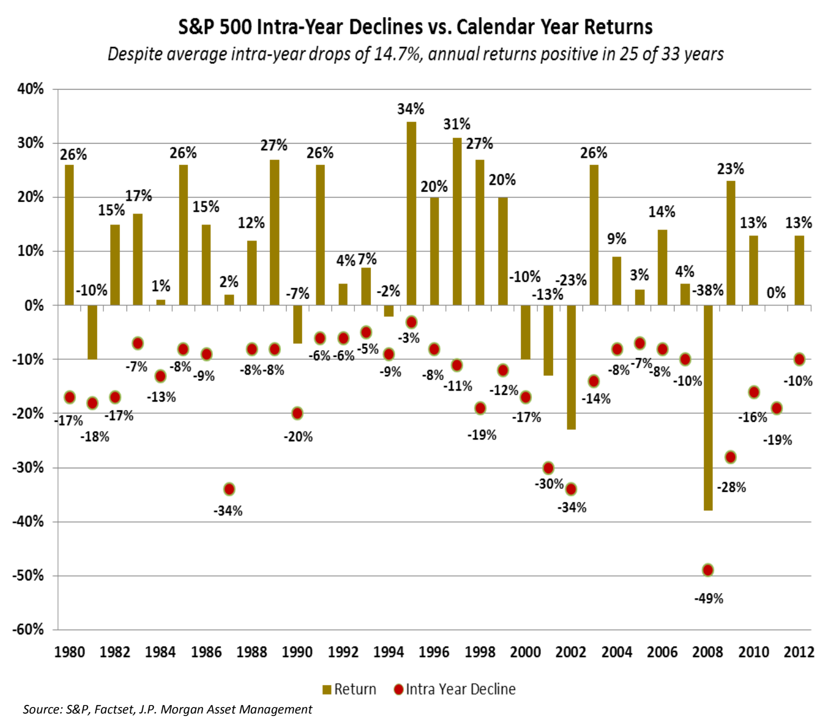
HORAN CAPITAL ADVISORS
Investor Letter
First Quarter 2013
www.horancapitaladvisors.com

"Bull-markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."
-- Sir John Templeton

Defensive Sectors Win First Quarter

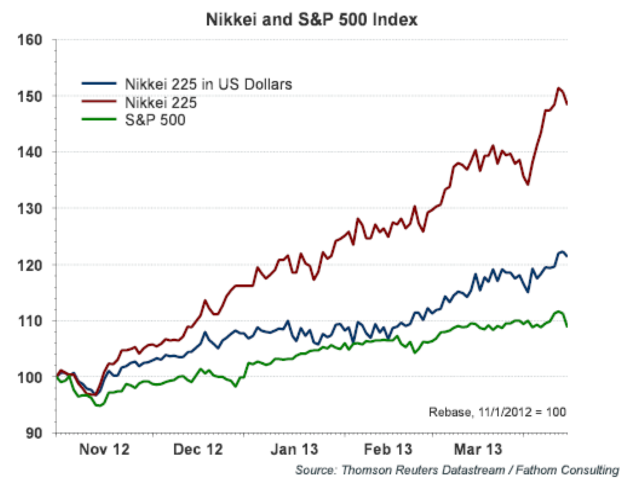
The stock market continued its steady, multi-year rise through the first quarter with the Standard and Poor's 500 Index up 10.6%. The gains were strongest in the more traditional defensive sectors, such as health care (+15.2%), consumer staples (+13.8%) and utilities (+11.8%), while the more growth oriented and economically sensitive sectors such as materials (+4.2%) and technology (+4.2%) lagged, as global growth remained muted. Another strong area for the first quarter was the master limited partnership exposure (oil and gas pipelines) up 21%. Our equity strategy has been positioned to take advantage of those areas that lead the market in the first quarter.



We believe a short-term market pullback is certainly possible, but individual investors appear underinvested in equities. When the market declines, investors are buying these market dips. Additionally, some investors attempting to reinvest proceeds from bond maturities are gravitating to dividend paying stocks within the defensive sectors of the stock market in a search for yield. History does suggest there is a high probability of an intra-year pullback. The market has gone over 100 sessions without a pullback of 5% or more, the third longest streak since 2002. As the chart (left) displays, since 1980, the average intra-year pullback is 14.7%, while 25 of the 33 years remained positive on a calendar year basis.

There were two interesting non-U.S. story lines in the first quarter of 2013. The first involved a small island in the Mediterranean Sea, Cyprus, and the second, a sizeable island nation in the Pacific Ocean, Japan. Cyprus would seem inconsequential from an economic perspective, but actions taken to save local banks resulted in meaningful losses for local depositors. Although the debt issues of other countries in the Eurozone continue to make headlines, the Cyprus issues raised eyebrows as depositors experienced significant losses on their deposits. Importantly, the promise of insured deposits was broken and the capital structure hierarchy was completely ignored. We continue to believe the path for economic healing will be long and arduous for the euro zone.

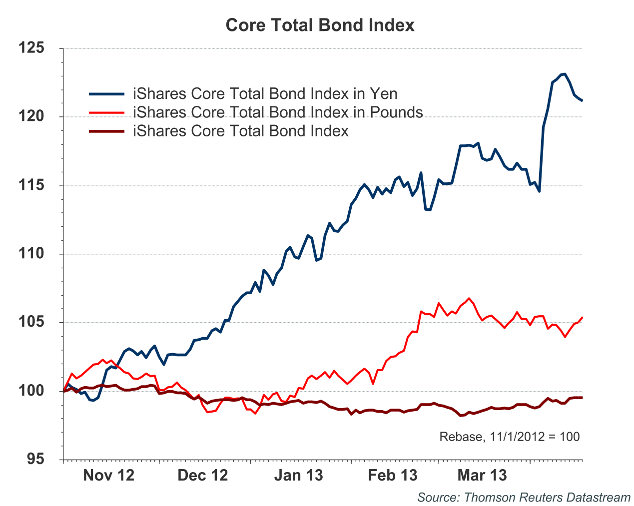
Japan had a major change in power this past December as the Liberal Democratic Party won the lower house majority in the Japanese Parliament. Japan's subsequent actions surrounding economic stimulus (quantitative easing) have been aggressive and resulted in Japanese markets moving considerably higher while devaluing the Yen substantially.



Note the chart to the left. The Nikkei 225 Index is up nearly 50% since last November; however, the devaluation of the Yen versus the dollar has provided most U.S. investors with approximately a 20% return in U.S. dollar terms. A similar effect has occurred with the Core Total Bond Index (AGG). Foreign investors in the U.S. market are enjoying substantially better returns as a result of weaker currencies outside the U.S. These currency wars are helping to keep U.S. interest rates lower as foreign investors allocate investment funds to U.S. assets, specifically stocks and bonds.

As we evaluate central bank actions around the world, in particular those of developed nations, we continue to see a "race to the bottom" in the currency wars. Developed world economies have adopted the strategy of massive liquidity injections resulting in the devaluation of the respective country's currency. This appears to be a last ditch effort to address years of overspending and ever-growing structural deficits. The race is on to repay the debts accumulated from financing the deficits with cheaper currency.

<u>Future Expectations</u>



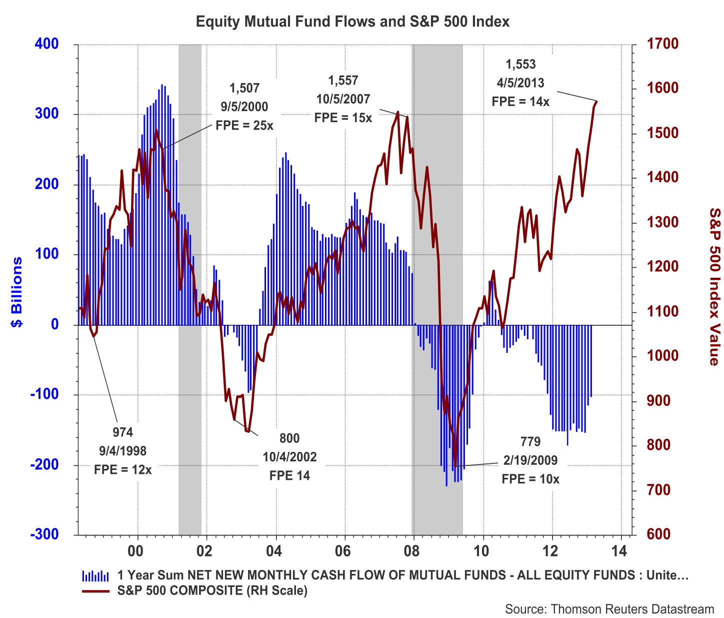
We frequently assess whether the bond bull market is nearing the end of an era. Quantitative easing programs, resulting in exceptionally low interest rates, could result in poor future returns for bond holders. There is an inverse relationship between interest rates and bond prices. As interest rates increase, bond prices decline. Meanwhile, the news is littered with stories about private and public pension plans that are significantly underfunded due to the current low interest rate environment, overpromised pension benefits and mediocre investment returns. Most of these underfunded plans are projecting future return assumptions that require significantly higher returns than what may be attainable. The social and economic consequences resulting from pension plan providers addressing the underfunded nature of their respective plans could be quite significant.

Many retirees and those nearing retirement believe their saving needs are far greater than what they are able to save. Add in the prospect of lower benefits from underfunded pension plans, and you have a nervous group of retirees. In a recently released March survey by the Employee Benefit Research Institute, they note, "A sizeable percentage of workers have virtually no money in savings and investments. Among workers providing this type of information for the Survey, 57 percent report that the total value of their households' savings and investments, excluding the value of their primary homes and any defined benefit plans, is less than $25,000. This includes 28 percent who say they have less than $1,000 in savings."

We continually analyze and evaluate future return expectations for the various asset classes. We allocate funds to the asset classes we believe offer our clients the best balance between risk and long-term capital appreciation. If an investment manager promised 7% to 8% returns in the mid-1990s, most investors would have scoffed as they enjoyed an extended period of mid-teens equity returns. The world has certainly changed as we deal with very different economic and market-related issues and the days of credit expansion and reduced tax rates experienced in the 1980s, 1990s, and 2000s appear behind us. Unfortunately, many institutional portfolios, such as endowments, foundations and pensions, with significant long-term liabilities, are still utilizing the expected annual returns of 8% or 9%. We have compiled a table incorporating future return assumptions from several major investment firms to provide an indication of consensus long-term return expectations. These returns are reported in nominal terms and do not reflect the impact of future inflation. Both institutional and individual investors may observe that a growth-oriented portfolio of 70% equities and 30% bonds is expected to return nearly 7% on an annualized basis before the effects of inflation. Depending on need, this may or may not meet an investor's expectations. Pensions or endowments requiring 8-9% returns may struggle to meet their liabilities. The trade-off may be to assume more risk to achieve higher returns.

10 Year Asset Class Return Assumptions	Nominal Return	Allocation Weight	Portfolio Contribution
Equity 70%			
U.S. Large Cap	7.25%	40%	2.900%
U.S. Mid Cap	8.00%	5%	0.400%
U.S. Small Cap	7.75%	5%	0.388%
Developed International	7.00%	10%	0.700%
Emerging Markets	9.75%	10%	0.975%
Fixed Income 30%			0.000%
U.S. Investment Grade Corporate	4.25%	20%	0.850%
U.S. High Yield	6.50%	5%	0.325%
Foreign Sovereign Debt	5.00%	5%	0.25%
		Total Portfolio Return	6.788%

While a higher interest rate environment would help reduce the underfunding of retirement plans and improve the returns for retiree savings, higher interest rates will simultaneously place more stress on the U.S. federal budget. The cost to service U.S. government debt would rise substantially. The Federal Reserve is truly between a rock and a hard place and is teetering ever so carefully on a monetary tightrope. As economist David Rosenberg has noted, "If recent decades have taught investors anything, it is that every time the Federal Reserve drives interest rates to negative levels after inflation, it creates a bubble that subsequently bursts." We have captured strong bond returns for our clients by allocating bond investments in high yield and global bonds, but increasingly remain on guard to the risk/reward characteristics of the various fixed income alternatives. In this near zero interest rate environment, fixed income will be one of the more challenging areas of the market looking forward.



Peak Comparison

The above chart emphasizes two points. The first makes a comparison between the three market peaks of

2000, 2007 and highs of 2013. Today the market is slightly less expensive than at the peak of 2007 but markedly less expensive as compared to the 2000 forward price-to-earnings multiple (FPE) of the S&P 500 Index. This data suggests the market appears reasonably valued from a historical perspective. The second point denotes the divergence over the past 3 years between the positive performance within the S&P 500 Index and the negative money flow into equity mutual funds. Monthly equity flows have just turned positive for January and February. This implies many investors have not enjoyed the market's strong returns since 2009.

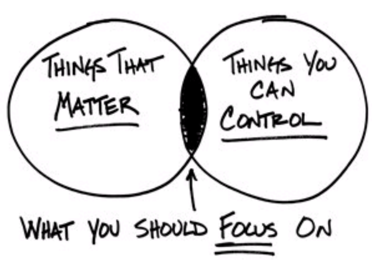
Positive Fundamentals

A frequently debated market topic relates to the effects of the Fed's quantitative easing program. Many believe liquidity injected into the monetary and financial system is inflating the value of equity assets, thus creating an artificial, not fundamental, rise in asset prices. This may be true to a degree, but as the table (right) depicts, there are many fundamental factors that have created a positive influence on recent market performance relative to where we were at our last market high in 2007. The market is less expensive, generates higher operating earnings and pays out more in dividend income. The market seems more appealing on a relative basis to the 10-Year Treasury as Treasury rates are significantly lower. Inflation is down since 2007 and collective American household debt is down.

	October 9, 2007	April 1, 2013
S&P 500 Index	1,565	1,562
S&P 500 Operating Earnings	$89	$98
S&P 500 P/E (trailing)	17.5	16
S&P Dividends Per Share	$28	$32
AAII Sentiment Survey - Bullish	55%	38%
10-Year Treasury Yield	4.7	1.9
10-Year minus 2-Year Treasury Yield Spread (basis points)	52	163
NYSE 52-Week New Highs	14%	19%
% of S&P 500 Above 200-Day Moving Average	60%	87%
% of S&P 500 with 50-Day Moving Average Above 200-Day Moving Ave	43%	86%
NYSE Advance/Decline Line	Positive	Positive
Core CPI (y/y % change)	2.20%	2.00%
Household Debt	$13,555b	$12,831b

Source: Bloomberg, FactSet, Federal Reserve, Ned Davis Research (NDR), Inc., Standard & Poor's

As already mentioned, a near-term equity market pullback would not be surprising. However, a protracted U.S. or global economic recession seems unlikely barring an unforeseen shock, like an outbreak of war precipitated by North Korea. Several sectors which have not participated in the first quarter rally look attractive from a valuation perspective, but are tied to growth in the economy, such as technology, energy, industrials and materials. We believe there are variables we can control, such as risk mitigation and the avoidance of euphoric markets, but there are things we cannot control, such as the Fed and North Korea. Our clients ask us to focus on the things we can control and the things that matter most to them. If we execute on that basis, we've formed a valued partnership.



Source: BehaviorGap.com and AAII

We thank you for your business and confidence. As always, do not hesitate to contact us with any questions or comments.

Respectfully,

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