HORAN CAPITAL ADVISORS
Investor Letter

SECOND QUARTER 2010 www.horancapitaladvisors.com

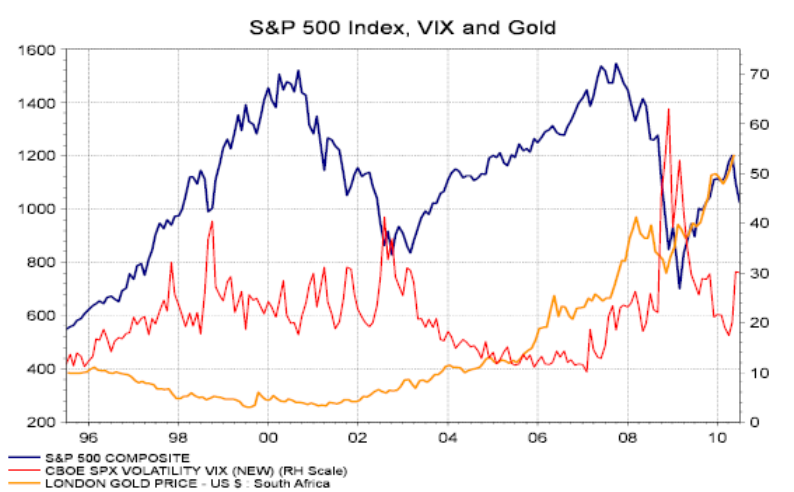
The Quarter

The second quarter of this year certainly presented noteworthy headlines, most of which led to market pressure. The S&P 500 Index ended down 11.43% and the 10-Year Treasury note rallied sharply as yields fell from 3.83% and settled below 3%, demonstrating a desire for less risky assets. Looking forward, if earnings expectations are met in Q3 and Q4, this market has strong upside potential. Our letter this month will review Q2 and discuss market positioning and thoughts for the remainder of this year.

The Greek debt crisis that threatens to break up the European Union has sent the Euro and the European debt and equity markets into a free fall. Currently, the European Central Bank and stronger European countries like Germany (who retire at an average age of 67 and not Greece's 60) are making fiscal promises to support Greece and potentially others such as Spain. Despite targeted assistance, European economies are slowing and face 10% + unemployment (Spain at 19%). European banks are clamping down on providing liquidity to one another and European sovereign credit spreads have widened dramatically. More recent data regarding stress testing of European banks has come back better than anticipated as the ECB has injected liquidity to the market. As this has unfolded, the US has seen dramatic appreciation in the dollar and its treasury market, viewed as the global safe haven.

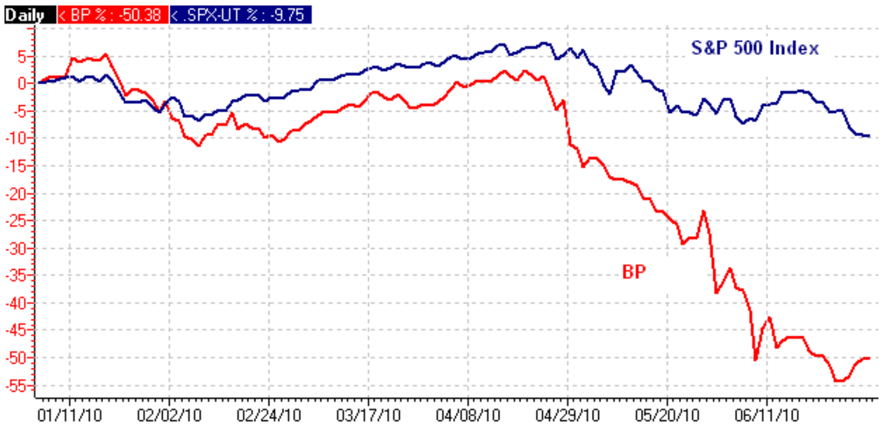
The efficiency of equity trading was greatly tested May 6th by the infamous "flash crash" which resulted in a 1000-point intraday drop in the Dow Industrial Average. There was much finger pointing regarding automated programs that can dramatically exacerbate market moves. The lack of designated market makers supporting and providing ample liquidity likely contributed to the higher volatility. Market volatility returned in early May and continued as markets headed lower in Q2.

In the quarter, volatility as measured by the VIX Index, rose significantly from around 15 to as high as 45, closing the quarter at 35. The VIX Index has been described as the investor "fear gauge," and gold may soon be named the same, as it ended the quarter just below its all time highs. Confident and stable markets are marked by less variability and we hope to see the VIX and Gold retreat in Q3.



The BP oil spill, which began April 20th due to an oil rig explosion about 40 miles off the coast of Louisiana, was an unexpected and tragic event. Eleven rig workers lost their lives. It will likely be deemed the greatest ecological disaster in history. Outside of ecology, this spill means a great deal to the financial markets. It is likely the loss of oil inventories will generate higher oil prices in an already fragile consumer market. The Department of Energy anticipates the spill will cost 26,000 barrels a day in the fourth quarter and

70,000 barrels a day in 2011. Some predict that unless consumption declines, oil may top $140 a barrel, similar to the height in 2008. A number of energy stocks were dragged down by the spill but certainly none more affected than BP, which has lost over 50% of its market capitalization. Commodity prices have traded with high correlation to equities over recent years and we anticipate this correlation will remain high in the near future.

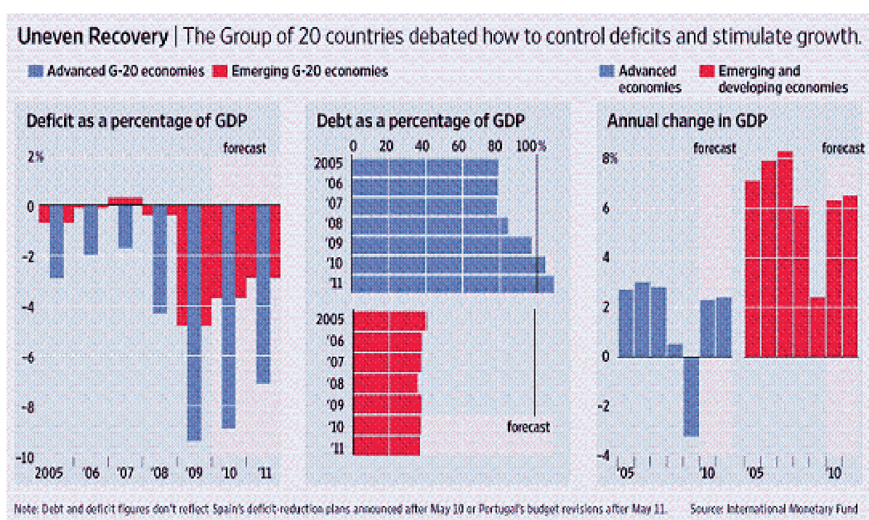


The quarter brought great debate as to where we go from here. Bulls argue that a steep yield curve, little to no inflation, earnings expectations, and piles of corporate cash should lead to a stronger 3rd and 4th quarter in 2010. Bears rest their arguments on sovereign debt concerns, the scarred consumer, weaker GDP and earnings expectations, and continued housing weakness. Many pundits feel the road to broader economic recovery will be predicated on job growth and the housing recovery but both are quite unclear and treading in lonely waters. Those who predicted the square root shaped recovery may be rightfully awaiting vindication. Recent data would suggest that the economy is slowing and volatility will remain.

<u>Equities</u>

We remain cautiously optimistic for the remainder of 2010. Active management should prove rewarding for those trying to navigate this market's volatility. Investors looking for better risk return scenarios should look to equity strategies that can fend off short-term volatility spikes with stock ownership in companies exhibiting lower beta, lower debt levels, and consistent cash flows. Companies with such metrics have historically distributed dividend income and such income is more than appetizing as a 3% dividend is 270 basis points better than the 1-Year Treasury rate. Equity fund ownership via strategies that offer downside protection is also appealing.

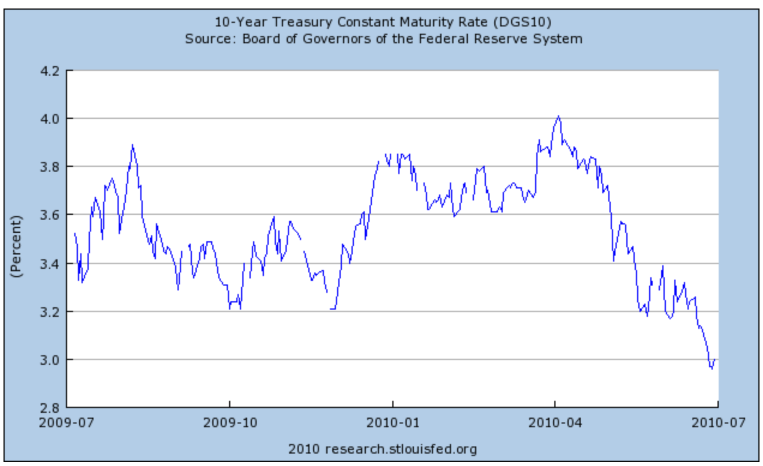
We currently favor large cap multi-national companies and will continue to overweight this segment as these companies tend to weather the storm better during periods of increased market volatility and unpredictability. The International Monetary Fund recently raised forecasts for global growth but quickly hedged their statement with commentary regarding the myriad of growth impediments.



International equities, split between emerging economies and developed ones, offer interesting valuations. We are currently underweighted in developed Europe; however, there will come a time when currency, employment and debt issues will be adequately discounted for the opportunistic investor. The emerging economies have long been considered an understudy on the world stage, while the highly industrialized economies dominated the economic spotlight. Demographics have played a significant role in recent years as the developed world struggles with a declining demographic and the emerging world caters to a rising middle class. We've seen this movie before in the mid to late 19th century as Britain and the US grew exponentially. A profound metamorphosis is occurring globally as indicated by the IMF and the attached chart (bottom page 2) found in a recent Wall Street Journal article. The chart highlights the dramatic bifurcation between the developed world economies and emerging world economies. Note that developed economies are now characterized by significant budget deficits, accumulated debt exceeding their economies and growth roughly one-third of the emerging nations. It is clear that a continuation of these trends will reduce economic flexibility and limit opportunities for the indebted industrialized nations. In the U.S. and indeed the world, the most successful companies are those adapting their business models to the *New World* stage.

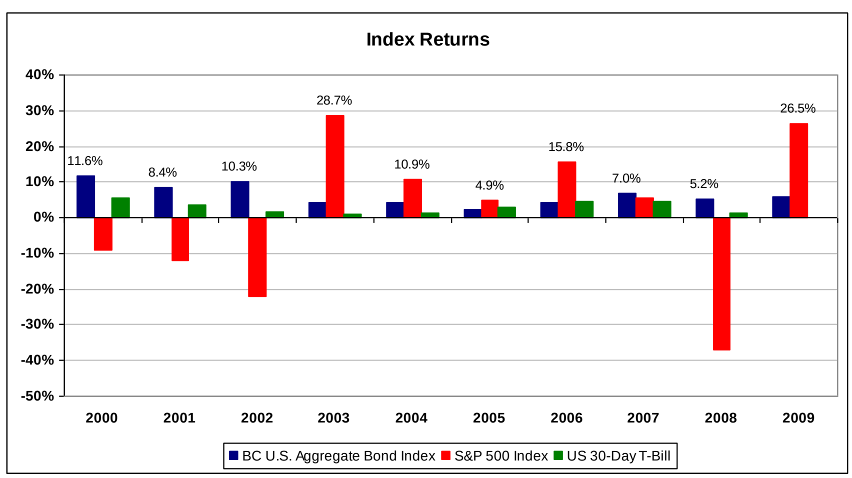
Fixed Income

Recent worries that the U.S. and European economies are headed toward a double dip recession dominated the fixed income markets during the second quarter. Fears of severe credit stress in Greece, Spain, Italy and other highly levered sovereign credits propelled a flight to quality. U.S. Treasury yields dropped dramatically (chart below left) as bond prices were bid higher. The U.S. dollar continued to appreciate but found a short-term bottom in late Q2. Low levels of absolute yields did not deter fixed income buyers as cash yields were virtually nonexistent. With signs of added financial stress, the likelihood of the Federal Reserve raising short-term interest rates in 2010 is very unlikely.



The yield curve remains historically steep which entices those with cash to move out on the curve toward longer-term maturities. Caveat Emptor! Signs of inflation have not materialized but the mere thought of sudden and excessive inflation should caution investors reaching for yield. And, if not inflation, the prospect of credit fears may quickly drive yields higher too. We will primarily remain on the short side of the interest rate curve while participating in some spread product such as high yield, which offers attractive cash flow and total return.

Given the difficult market returns experienced by investors over the past ten years, it would seem holding a significant allocation of one's investments in cash would have been a wise investment choice. However, during this time period, as indicated on the chart on the right, there was not a single year when cash outperformed both stocks (S&P 500 Index) and bonds (Barclay's Capital Aggregate Bond Index).



Further, since 1926, cash has outperformed equities and bonds in only 12% of the calendar years. Cash is certainly necessary when funding short-term needs and is a necessary result of playing short-term market defense. However, we prefer to allocate cash to short duration (1-3 year) credit vehicles currently yielding 3.5% or better.

Conclusion

The “new normal” will likely be defined by slower U.S. growth, lower yields, increased market volatility, changing consumer behavior and challenging public policy. Tax policy, to address runaway public spending, will be a harsh reality to accept. The bull markets of the 1980s and 1990s seem to be in the very distant past, but we believe market participants exhibiting patience and discipline will be rewarded once again with consistent and reasonable portfolio growth. Our core equity philosophy, which is centered on fundamentals and valuations, is uncovering compelling equity values for long-term investors. We mentioned silver linings. The Fed will ultimately keep rates low for an extended period, designated stimulus money remains on the sideline and earnings estimates are currently being met. Patient investors uncover opportunity.

As always, we appreciate your confidence and business. Feel free to share our investor letter with friends, family and colleagues. If any person would like to be added to our quarterly correspondence, please email one of the senior investment team members below or email: info@horancapitaladvisors.com.

Warmest regards,

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