HORAN CAPITAL ADVISORS
Investor Letter
Fourth Quarter 2013
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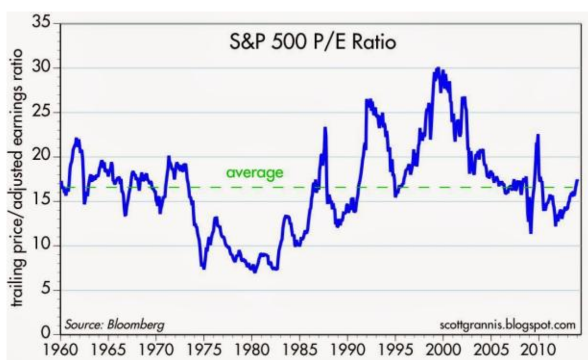
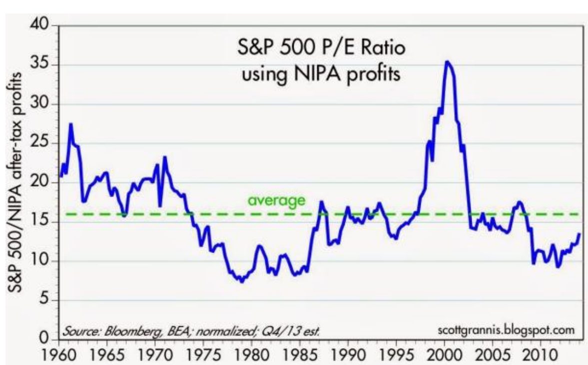
Equity Market Bubble?

A recent publication from Charles Schwab highlighted that the previous five year **cumulative** return of the S&P 500 Index at the end of 2012 was 9%. Just one year later, the previous five year cumulative return is a whopping 126%. Given the recent strong U.S. equity market returns, some investors are assessing whether the market has entered “bubble” territory. Historically, equity market bubbles have exhibited some common characteristics. In a report by Richard Bernstein of Richard Bernstein Advisors, he notes five common factors in past equity market bubbles.

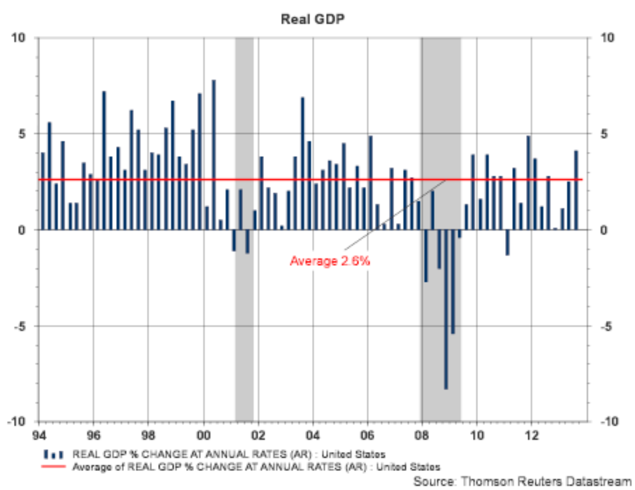
1. Available liquidity
2. Increased use of leverage
3. Broad based ownership of equities by individuals
4. Increased turnover
5. Record new issues





Given the above five factors, Bernstein commented, “One could certainly argue that the Fed’s extraordinary efforts to stimulate the U.S. economy have provided tremendous liquidity to the financial markets. However, we find scant evidence that the other four characteristics currently apply to the U.S. equity market. For example, many have noted that volume was weak during 2013, new issues were not rampant, and [downside] protection was more important to most investors than using leverage to accentuate performance.” We have seen evidence that margin debt (leverage) is near all-time highs, but when viewed as a percentage of total market capitalization, it’s not as elevated as one may think.

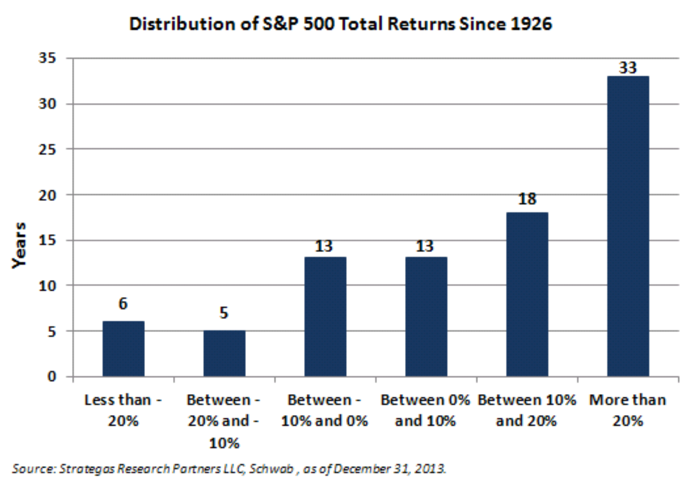
Importantly, investors should not look at historical returns alone to assess the market’s future direction. What seems obvious is to research the valuation of asset classes, sectors and/or specific companies with respect to expected future returns. We discussed this in our last newsletter as we highlighted PE multiple expansion (i.e., increasing market valuation or PE) occurring from 2009 until today. The top chart at right shows the S&P 500 P/E ratio is roughly equal to its long term average. However, a wider valuation measure takes the economic profit figure used in the calculation of GDP. This profit figure is an actual data point taken from company profits reported to the IRS. By using this valuation measure, the P/E is below its long term average (see second chart previous page).



From an earnings perspective, Thomson Reuters reported third quarter 2013 S&P 500 company earnings growth at 6%. Earnings growth in the fourth quarter of 2013 is expected to come in around 7.5%. Some of this earnings growth, however, has come by way of company stock repurchasing programs. This has the effect of inflating earnings per share growth since reported income is divided by fewer shares outstanding. The expected earnings growth rate for all of 2014 is estimated to be 10%. Top-line revenue growth is forecast to increase 5.7%. We believe companies will need to generate better top-line growth in order to achieve the expected earnings growth rate for 2014. We are optimistic that acceleration in the economy will meet these expectations.

Real GDP in the third quarter of 2013 was revised higher to 4.1%. This is certainly a respectable rate of economic growth; however, the GDP growth rate since the end of the recent recession is below the expected growth rate following prior recessions. The most recent data suggests the U.S. economy will continue to improve. As we continuously evaluate economic data points to appropriately implement our client investment strategies, the improving economic environment should continue to be positive for stocks.

Examining historical market returns indicates that double-digit market returns tend to occur much more than one would expect. As reported by Liz Ann Sonders, Chief Investment Strategist at Charles Schwab, and denoted by the chart at right, the S&P 500 Index achieves a greater than 10% return 51 times out of 88 years, or 58% of the time since 1926. In 73% of the calendar years (64 years), positive returns have occurred. Notably, single-digit returns are far less common than double-digit returns. Therefore, “bubbles” should not be judged solely by strong consecutive years of performance.



2013 Returns

Three themes have guided our investment allocation recommendations for the past several years:

1) Maintain a bias to U.S. large cap equity
2) Invest in credit sensitive bonds as opposed to interest rate sensitive bonds
3) Incorporate exposure to alternative investments in lieu of fixed income

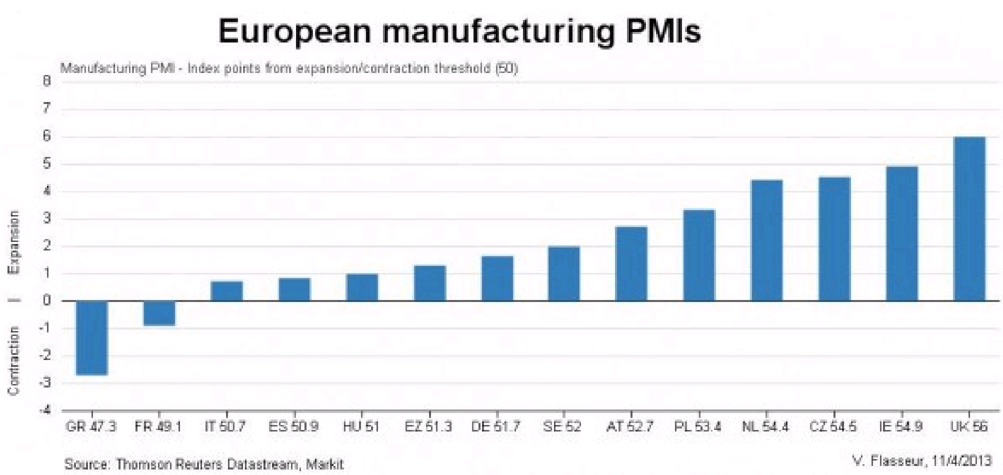
This strategy bias rewarded investors in 2013. Broadly, our overall equity exposure generated returns in the high 20% to low 30% range led by our U.S. Large Cap Growth & Income Strategy which produced returns in the mid to high 30% range. Further adding to our returns was the alternative investment category which produced returns in the 20% range. A growth-oriented portfolio, fully invested in our strategy for 2013, returned 16-20% net of fees.

Fixed income was a challenging asset class for investors last year. Many fixed income categories produced negative total returns as the trend in interest rates was higher (bond prices move inversely to the direction of interest rates.) Most of our clients' fixed income returns were flat to marginally up in 2013. Not exciting, but we feel this was a win in a challenging environment for fixed income. High-yield bonds and floating rate bank loan investments were virtually the lone outliers generating positive fixed income returns in the low to mid-single digits. We continue to maintain allocations to both of these strategies for our clients.

For the third consecutive year, U.S. stocks outperformed their foreign counterparts. The S&P 500 Index produced a total return of 32.39% in 2013. The developed international markets and emerging international markets produced returns of 22.78% and -2.60%, respectively. Looking back over the prior three years, the S&P 500 Index has outperformed developed international equities by an average of 8% per year and emerging market equities by 18% per year. Our U.S. focus has certainly enhanced our clients' portfolio returns.

Outlook

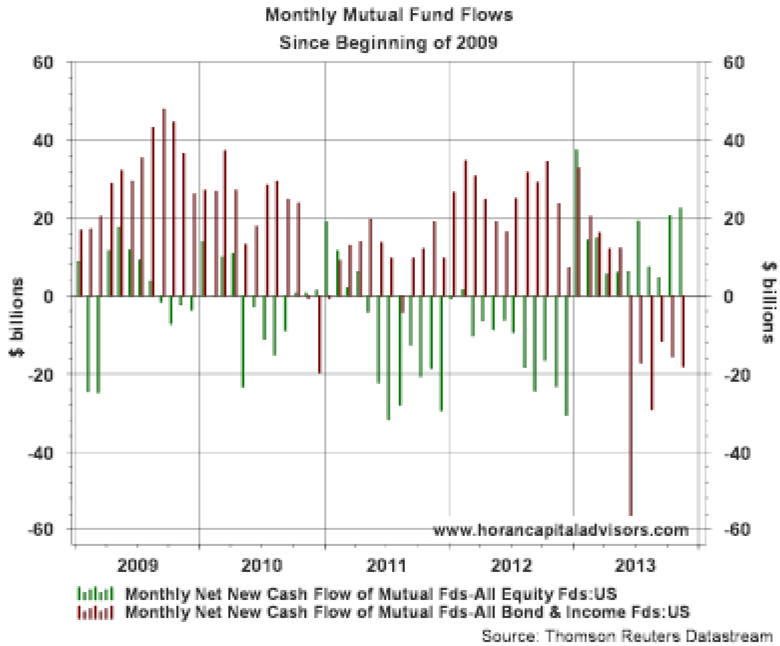
Sam Stovall of S&P Capital IQ believes good years typically follow great ones. He states, "Since 1945, there have been 21 times that the S&P 500 gained more than 20%. In the following year, the S&P 500 recorded an average increase of 10%." We believe the markets will experience more volatility in 2014 than what occurred in 2013. The market exhibited a very low level of volatility in 2013 as there were only two mild pullbacks of about 5%. It would not surprise us to see a pullback of 10-15% in 2014. All else being equal, we would view a pullback as a likely buying opportunity and, like Mr. Stovall suggests, the market could close 2014 at another new high.



Our research suggests investors will place a greater emphasis on valuations in the coming year. In 2013, a rising tide seemed to lift most stocks. Less than 10% (40 stocks) of the S&P 500 Index saw their stock prices decline. We do not believe 2014 will be a year where this type of broad based equity market increase reoccurs. However, we continue to have a favorable view of equities and believe the market will distinguish between those companies that can not only deliver bottom line growth, but top line revenue growth as well.

As we noted in the second half of 2013 we have a cautious, but favorable, view of developed international equity markets. We do not anticipate robust economic growth internationally, but current valuations in some foreign markets seem to be discounting the slowly improving economic environment outside the U.S. The chart above emphasizes this point as European Manufacturing PMIs continue to point toward expansion. It is likely we will add to foreign market exposures in 2014.

Recent mutual fund flow data would suggest the rotation from fixed income investments into equity investments has only just begun as noted in the chart on the next page. Not until 2013 did investors begin to rotate capital into equities as noted by the green bars in the chart (right). A recent article on the Minyanville website cites ICI data, noting "investors responded to 2013's climate by putting $160 billion of new money into equity mutual funds, a dramatic shift in a market that saw five straight years of equity outflows totaling $536 billion." One concern is the equity markets have had strong returns over the last five years and investors are just now rotating into equity investments.



Conclusion

As noted earlier, from a fundamental perspective, the economy does seem to be strengthening. The expected earnings growth rate for all of 2014 is currently estimated at 10%.

One of the dominant stories of 2014 will likely be the U.S. Federal Reserve's plans to reduce quantitative easing/stimulus. Many economists and market observers now believe the economy has reached a level of self-sustaining activity. Many economists have referred to the self-sustaining economy as having achieved "escape velocity." The Fed's hope is that reducing stimulus will not negatively impact economic growth. Reaction to recent Fed policy has had a significant influence on market returns. Another factor likely to garner much attention in 2014 is the ultimate cost and effect of the Affordable Care Act (ACA). The cost of the ACA may negatively impact the American people's discretionary spending habits through various tax hikes and higher deductibles and premium payments.

The federal budget deficit as a percentage of GDP has narrowed in the short-term, consumers have continued to reduce their debt as well as improve household balance sheets, and the U.S. housing market has continued to improve along with the stabilization of world economies. In this light, we remain constructive on the markets and the economy in the coming year.

We thank our clients for their continued confidence. We wish all of our clients and friends a healthy and prosperous 2014. Please visit us at www.horancapitaladvisors.com .

Warm regards,

HORAN Capital Advisors