HORAN® CAPITAL ADVISORS

Investor Letter

THIRD QUARTER 2012 www.horancapitaladvisors.com

"If the fiscal cliff isn't addressed, as I've said, I don't think our tools are strong enough to offset the effects of a major fiscal shock, so we'd have to think about what to do in that contingency."

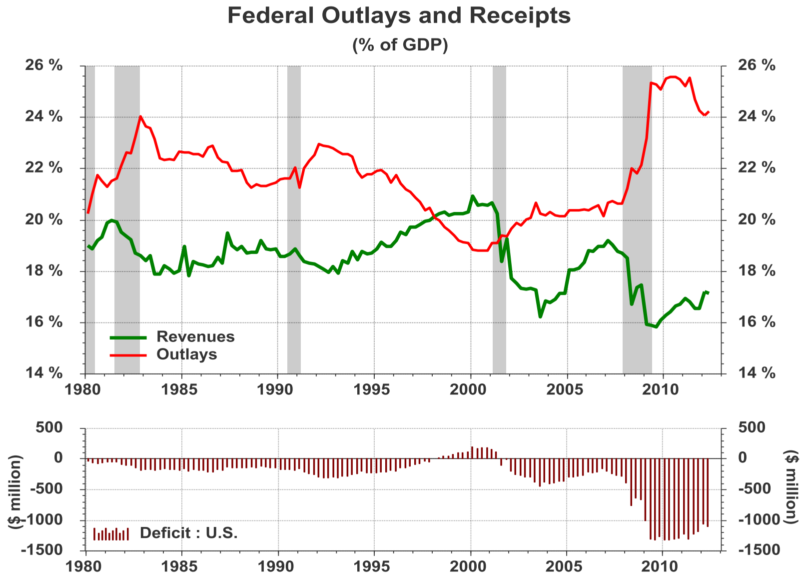
— Ben S. Bernanke, Federal Reserve Chairman

At the beginning of the third quarter, investors following the "sell in May" strategy felt vindicated as the S&P 500 Index declined over 9.0% from May 1st to June 4th. The June 4th date turned out to be the intra-year market low and the equity rally was almost uninhibited throughout the remainder of the third quarter. The rising tide seemed to lift all markets during the quarter: S&P 500 Index +6.4%, S&P Small Cap Index +5.4% and the MSCI Emerging Markets Index +7.7%. The investment grade bond indices were mostly flat to slightly higher (lower rates) during the quarter. High yield bonds were a standout category as the Barclays High Yield Bond Index returned 4.5% for the quarter and is up more than 12% year to date. The market strength in the third quarter caught some strategists by surprise. Goldman Sachs recommended investors short the S&P 500 Index in late June. Shorting the market means investors would profit if the market actually declined. The S&P rallied over 8.0% between Goldman's recommendation and the end of the third quarter.

We have been experiencing mixed global economic data over the past several months and in response, the Federal Reserve announced a third round of quantitative easing (QE3). Bernanke commented that in addition to boosting economic growth and thus employment, it's the Fed's intention to help savers by pushing asset values higher. The asset values in which he refers are riskier assets such as real estate and equities. While the market initially responded favorably, it ultimately declined through the end of the quarter.

The Fed and Corporate America

Quantitative easing is an alternative fed policy response used to spur economic growth by anchoring interest rates. Unfortunately, pushing interest rates lower has not significantly improved economic growth or employee hiring. Both of these facts were noted in the Fed's QE3 statement. "We expect the economy to continue to grow. Our concern is not really a recession. Our concern is that growth will continue but at a pace that's insufficient to put people back to work." Interestingly, the Fed's open ended statements regarding the timing and degree of bond purchases implies QE3 could very easily become "QE-perpetuity." Lasting quantitative easing could likely lead to inflationary pressures and we suspect the Fed wants this desperately, but if the Fed thinks they can temper future inflation, just note, inflation is the most regressive tax of all. A cheaper dollar, by way of inflation, is one alternative to tackling our deficit issues. Our current rate of economic growth has not been sufficient to put much of a dent in the deficit faced in Washington. As the chart on the following next page shows, the gap between government revenues and outlays continues to run at record dollar levels and as a percentage of GDP. This is a path that is unsustainable and must be addressed in the near term.



Source: Thomson Reuters Datastream

Maintaining loose monetary policy has not been as effective as the Fed would hope during this household and corporate deleveraging cycle. Companies have been vocal in regard to their greater concern about the future of tax and regulatory policies. On October 4th, The Conference Board released its CEO Confidence Survey results and noted the measure declined to 42 from 47 in the previous quarter. The Conference Board noted, "This latest report reflects ongoing concern about the strength of the economy. CEO assessment of current conditions remains weak and they have grown increasingly pessimistic about the short-term outlook. Sluggish growth and a persistent cloud of uncertainty have played a role in CEOs curtailing spending plans this year….Nearly one-third of chief executives report scaling back on their company's capital spending plans since January of this year, while less than 10 percent have increased spending based on a supplementary question asked each year in the third quarter. Last year, 22 percent of respondents had increased their capital spending plans and 23 percent had made cuts. A decline in sales volume is a major reason for cutting back on spending plans."

In Search of Income

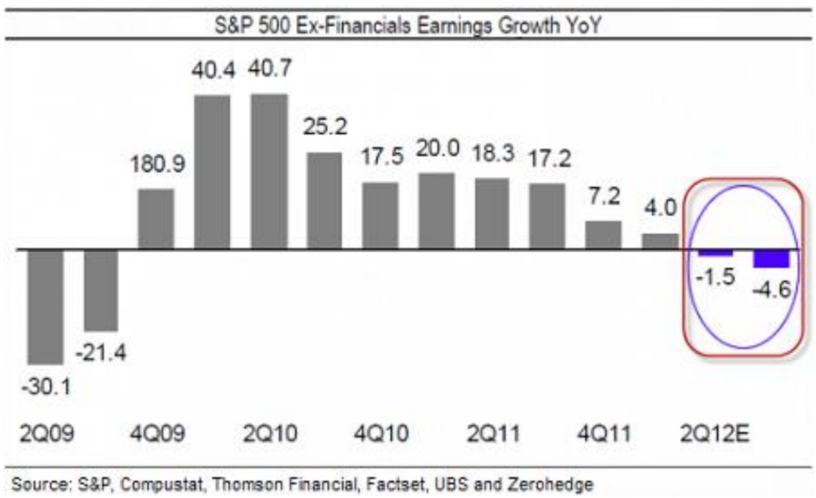
In the face of sluggish growth, the markets continue to rise. Many investors are focusing on income producing assets to support lifestyle needs. The Fed has not been a friend to those seeking reasonable interest from fixed income investments. For example, if an investor bought a two year treasury note seven years ago (October 2005), with the intent to generate $100,000 in annual income, the investor would have invested $2,375,000 in that note. Fast-forward seven years to today and that same investor would need to invest $40,000,000 to generate the same $100,000 in annual income. You didn't misread that statistic. The best "yield" opportunities are coming from riskier asset classes such as high yield bonds, REITs, MLPs and dividend-paying equities; however, as the table above details, tax rates on dividends and capital gains are set to increase significantly starting January 1, 2013. This level of tax increase would eat into an investor's after-tax income.

Top Federal Tax Rate on . . .	2012 Rate	2013 Rate	Net Investment Income Surtax*	Medicare Surtax*	Total 2013 Maximum Rate
Ordinary Income *	35.0%	39.6%	3.8%	.9%	44.3%
Capital Gains *	15.0%	20.0%	3.8%	-	23.8%
Dividends *	15.0%	39.6%	3.8%	-	43.4%
Estate Tax **	35.0%	55.0%	-	-	55%

* Includes a 3.8% surtax on net investment income with AGI over $200,000 for individuals and $250,000 for joint filers

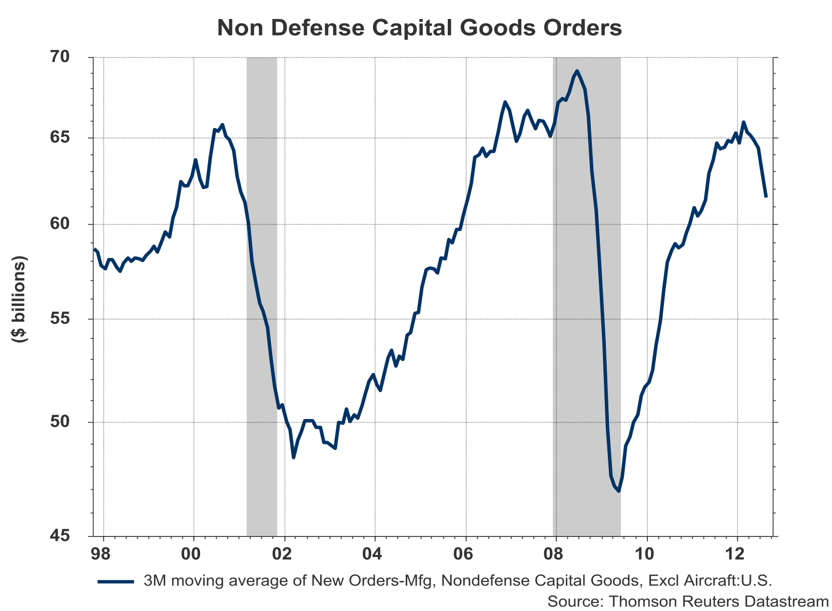
Earnings Recession?

The S&P 500 Index has more than doubled since the equity market low in March of 2009, rising 116% in spite of numerous uncertainties. However, as of late, companies seem to be signaling a cautious operating environment. This negative outlook by businesses can be a leading indicator of weaker equity market returns.



As of the end of September, Thomson Reuters reported there have been 91 negative earnings per share (EPS) preannouncements issued by S&P 500 companies compared to 21 positive EPS preannouncements for third quarter 2012. By dividing 91 by 21, one arrives at an N/P (negative to positive) ratio of 4.3 for the S&P 500 Index. This 4.3 ratio is the weakest showing since the third quarter of 2001. S&P 500 Index earnings (ex-financials) were down 1.5% on a year over year basis in the second quarter and are expected to be down 4.6% in the third quarter as illustrated in the chart above. This earnings pace is the weakest showing since the third quarter of 2009. Additionally, the Fed recently lowered GDP expectations from 2.15% to 1.85% for 2012 while second quarter GDP numbers were revised down from 1.7% to 1.3%. This slowing in economic growth is contributing to the weaker earnings expectations for companies. We very well may be entering an "earnings recession."

Although investors are showing signs of rising confidence, data indicates investors continue to favor fixed income investment over equity investment. It begs the question, "how does this market continue to climb?"



Based on a Federal Reserve quarterly report, corporations had a negative net equity issuance of $218 billion in 2011. Currently, net equity issuance is running at an annual rate of negative $259.5 billion through the second quarter of this year. In other words, one reason the equity market continues to move higher is the fact companies are reducing the supply of available equity in the market place. This has been accomplished via stock repurchases. Another factor contributing to negative equity issuance is the increase in the number of corporate acquisitions by publicly traded companies and private equity firms. That being said, if demand for equities stays the same and available equity supply continues to decline, equity prices will trend higher. In 2006 and 2007, net equity issuance was nearly negative $1 trillion which preceded the peak of the market in 2008. Corporations seem to be more confident in buying their own shares than investing in future growth. Note the recent downturn in capital goods orders (chart above).

Thinking Long-Term

Although short-term equity volatility can cause investors to question the benefit of owning equities over the long run, equities have been a rewarding asset class over time. Nick Murray, author of eleven books for financial services professionals recently wrote, “I believe I see a clearly discernible trend. The S&P stock index was earning about a dollar at the beginning of 1946; this year it'll be over $100. The dividend then was around $0.70 and this year it looks to be about $29. The index itself was 18 and right now it's around 1,400. The cost of living over this period is up about 12.5x, so you can get a real sense of how effective quality equities have been at preserving and enhancing purchasing power.”

Our client accounts have been broadly allocated to participate in the economic recovery over the past two and a half years. While the financial markets have experienced periods of significant volatility during this time period, the returns for investors have been quite good. A bias to U.S. equity has served us well. The three-year return for the S&P 500 Index now stands at 13.2% annually with the latest one-year returning 30.2% from the bottom of the 2011 market correction. These numbers compare quite favorably to foreign developed and emerging market equity returns over this time period. Our allocations to high-yield bonds and global bonds have added value over the Barclays U.S. Aggregate Bond Index during this period as well.

As we look forward, we are mindful of near term potential risks, i.e., the U.S. fiscal cliff, Europe struggling with sovereign debt and growth issues, heightened Middle East tension and a more muted outlook for third quarter corporate earnings. We are positioned for a slower economic growth environment. We see some signs for long-term optimism as housing seems to have regained some footing, energy independence is increasingly possible and the repatriation of U.S. jobs is gaining traction. Longer term we continue to believe equities will be a strong performing asset class supported by compelling long term valuations. We also continue to believe the marginal return from owning longer term bonds is becoming an ever riskier proposition.

HORAN Capital Advisors has redesigned its website. Please visit us at www.horancapitaladvisors.com. We deeply value our clients’ opinions and thoughts so please, don’t hesitate to contact us with your comments.

Best Regards,

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