HORAN CAPITAL ADVISORS Investor Letter

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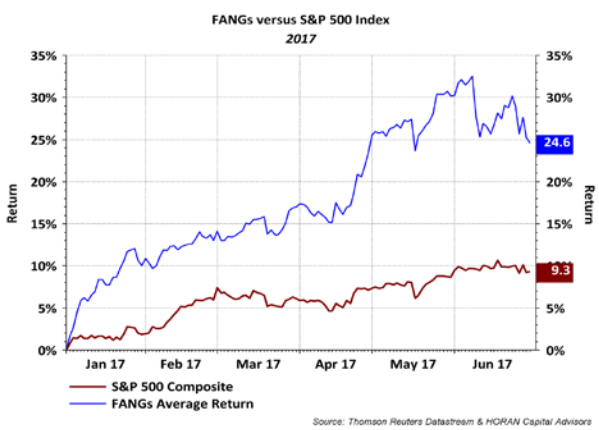
“Far more money has been lost by investors preparing for corrections than has been lost in corrections themselves.” – Peter Lynch

Quarter in Review

The second quarter marked a continuation of the strong global equity market performance of the first quarter. As of quarter end, the S&P 500 is up 9.34%, the Nasdaq is up 14.07%, and the MSCI EAFE Index is up 14.23% year to date. As investors become increasingly worried about the first significant market decline since early 2016, stocks continue to climb the proverbial “wall of worry.”

Return of the FANGs/Growth Outperformance

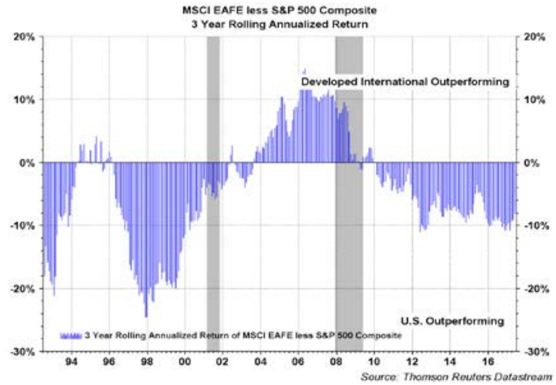


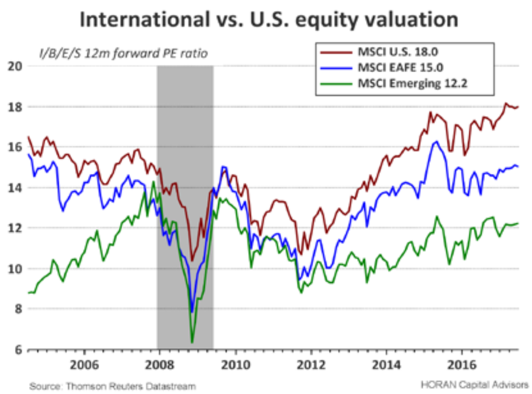
One of the biggest factor discrepancies this year has come from the growth vs. value investment style. The S&P 500 Growth Index has driven total index returns this year by rising 13.33% while its value counterpart has only risen 4.85%. Technology and Health Care have been the two best performing sectors, and the FANG stocks of 2015 fame – Facebook, Amazon, Netflix, and Google – are once again the individual stock leaders. Though this is reminiscent of 2015, the rest of the market in 2017 has been comparatively stronger. As Charles Schwab noted then, “The FANG stocks were up over 60% on a cap-weighted basis. Excluding those four stocks, the S&P 500 was down 4.8% (in 2015).” The chart above shows the average return of these same FANG stocks in 2017 compared to the overall return of the S&P 500.

The appeal of the FANG stocks remains their market beating revenue growth. Facebook (FB) expects to grow revenue almost 40% this year, Amazon (AMZN) 22%, Netflix (NFLX) 28% and Google/Alphabet (GOOGL) 20%. With final Q1 GDP growth coming in at 1.4%, the U.S. remains entrenched in its slow growth environment where it is reasonable to expect that fast growing companies would command a valuation premium. The current forward P/E ratios of 28 for FB, 107 for AMZN, 106 for NFLX, and 26 for GOOGL reflect a high valuation premium relative to the market (S&P 500 P/E is 17.74). While we remain long GOOGL in client accounts, we are mindful of exceedingly high valuations for some of the other high growth stocks. Higher valuations are a lot like raising the height of a high-wire act; raising the height/valuation makes the performer no more likely to fall, but drastically raises the consequences if he/she does indeed fall.

International Strength

International markets continued to show strength in the second quarter with the MSCI EAFE index up 6.37%, MSCI EM up 5.17%, and MSCI ACWI ex US: Small/Mid up 6.07%. After underperforming U.S. equity for the past several years, 2017 is showing signs of a potential turning point. The chart at right reflects the historical tendency for long cycles of outperformance relative to domestic vs. international equities. In light of this, we have been increasing our clients' international equity allocations since mid-2016, and reducing the overweight to U.S. equity that we have maintained and benefited from for several years.





Valuations were one of our key reasons for adding to international equity exposure in 2016 and early 2017. As the chart to the left shows, the gap between U.S. and international P/E ratios has been steadily growing. However, we believe U.S. equities continue to deserve a significant valuation premium based on the resilience of the economy and current earnings trajectory. It appears significant upside remains in international markets even considering their recent outperformance. Foreign central banks maintain exceedingly loose monetary policies and emerging markets continue to stabilize after the commodity routs of the past two years.

Valuing an Asset

The present value of an asset/company/index is simply the value of its future cash flows discounted back to today. There are two obvious components to this type of valuation: the numerator – future earnings for the company, and the denominator – the discount rate.

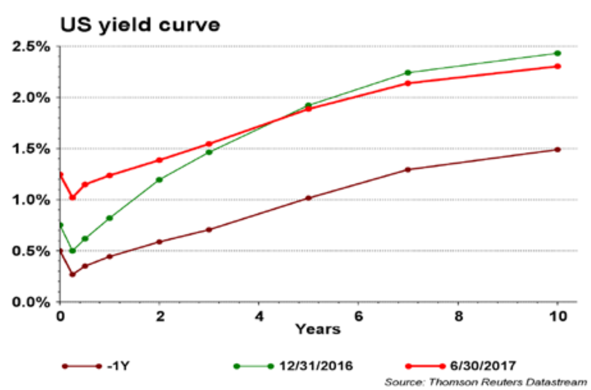
Future Earnings

The earnings forecasts for US equities remain a significant bright spot. After bottoming in Q1 2016 on a trailing twelve-month basis, S&P 500 earnings are rebounding. Current analyst expectations project the continuation of the recovery with S&P 500 earnings growing over 11.4% in 2017 and over 11.7% in 2018. As the chart at right shows, however, much of the recent S&P 500 rally has come from multiple expansion as opposed to earnings growth. The forward-looking market appears to be confident about the current trajectory of earnings. With profit margins near cyclical highs, future earnings growth will rely on revenue growth. Revenue growth should have a relatively high correlation with GDP, so we continue to monitor the strength of the overall economy for indications about the potential for future revenue and earnings growth.

Discount Rate

"*The President has very little effect on the economy. If you want to put blame or credit, the main person who influences the business cycle is the head of the Federal Reserve Bank*." – Robert Fogel

The second component of asset valuation is the discount rate for cash flows. With solid growth in earnings, the discount rate becomes a major point of focus. We calculate the discount rate by taking the yield on a long-term treasury as the risk free rate, and then adding a risk premium to account for the inherent risk in the company's future earnings potential. While risk premiums can change based largely on market sentiment, the risk free rate is a much easier component to monitor.



The Federal Reserve once again increased the Fed Funds rate in June to a target rate between 1% and 1.25%. Continued rate increases have been effective in raising the short end of the yield curve (as shown by the chart to the left), but it has had little effect on the longer end of the yield curve (Treasuries with 10 year maturities or greater). While this has been beneficial for equities (lower long-term risk free rate in denominator), the Fed is wary of allowing the yield curve to invert (long-term yields below short-term yields). An inverted yield curve has been a potential recession indicator in recent history.

In June, the Fed also expressed their intention to begin "normalizing" their $4.5 trillion balance sheet. In order to stimulate the economy from the recession of 2008-2009, the Fed launched a Quantitative Easing (QE) program whereby they bought debt securities with the goal of lowering long-term interest rates while encouraging investment. The Fed continues to reinvest principal payments; thus, maintaining QE. With the recent announcement, the Fed appears set to begin reducing the size of their portfolio by selling assets, or at a minimum, halting reinvestment of certain principal and interest payments. Depending on the strategy employed, the result would be either more supply or less demand on the long end of the yield curve and, all else being equal, would drive prices down and yields up. Unfortunately, unwinding the Fed's balance sheet is unchartered territory, so the outcomes are difficult to predict.

We remain focused on short duration in our client fixed income portfolios and value-tilted in client equity portfolios as the Fed starts to unwind its balance sheet. If the Fed's balance sheet reduction results in higher yields on the long end of the yield curve, then long duration fixed income and high growth equities (because they derive much of their value from future earnings/terminal value) could be the hardest hit. The "great unwind" of the balance sheet may prove ineffective, but as the section's introductory quote notes, we are wary of ignoring the Fed. As the saying goes, "Don't fight the Fed."

Cryptocurrencies

"*It's not greed that drives the world, but envy*." – Warren Buffett (according to Charlie Munger)

Cryptocurrencies such as Bitcoin and Ethereum have been the hot topic of the investing world this past quarter. As the chart on the following page shows, Bitcoin is up almost 300% from last year and has easily been one of the most lucrative investments of the past few years. Though our firm does not currently invest in cryptocurrencies, the recent frenzy is difficult to ignore and potentially offers valuable

insight for investors everywhere. As the latest investment craze, cryptocurrencies have drawn in many investors who do not truly understand the underlying asset. Though Bitcoin and others may continue to trend higher, buying without an underlying rationale is speculation, not investing. The temptation to buy grows each day as people watch others get rich. This envy has caused great losses for investors from Tulip Mania in 17th Century Netherlands to the Tech Bubble in 2000. Cryptocurrencies may have a different ending, but investors must constantly seek to avoid buying an asset due to envy rather than a legitimate analysis.

Politics

With Emmanuel Macron's victory over Marine Le Pen in the French elections and the defeat of Geert Wilders and his Party for Freedom in the Netherlands, it was evident that the populist movement hit a roadblock in Europe. Though these were certainly setbacks, the poor performance of the Conservative Party in the U.K. snap elections, called by Theresa May, was far more surprising. As the U.K. begins its long-term process of exiting the EU, May called for snap elections in order to solidify the strength of her party in the negotiations. Surprisingly, however, the election resulted in just the opposite. The poor performance of the Conservative party has added a new level of uncertainty to the BREXIT process as there no longer remains a clear leader. Continued setbacks for the populist movement could signal the end for protectionist politics. This would benefit global trade and could serve as a catalyst for emerging markets. Domestically, tax reform legislation is looking less likely as time goes on. As we get closer to the 2018 midterm elections, the focus will shift to the likelihood of Republicans' maintaining control of the legislative branch. A lack of tax legislation undermines an important bullish thesis of the post-election market run.

Conclusion

As U.S. markets continue to hit record highs during the first half of 2017, and without much of a correction since early 2016, the introductory quote from Peter Lynch comes to mind. As fear of a market decline becomes more prevalent amongst market participants, long-term investors must adhere to disciplined asset allocation policies to prevent losses caused by overreaction. We continue to look for tactical opportunities to enhance returns in client accounts while maintaining the core asset allocation approach that we believe helps our clients achieve their long-term goals.

Thank you for your continued confidence in HORAN Capital Advisors. Please be sure to visit us at www.horancapitaladvisors.com

Warm regards,

HORAN Capital Advisors

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