HORAN CAPITAL ADVISORS
Investor Letter
THIRD QUARTER 2010
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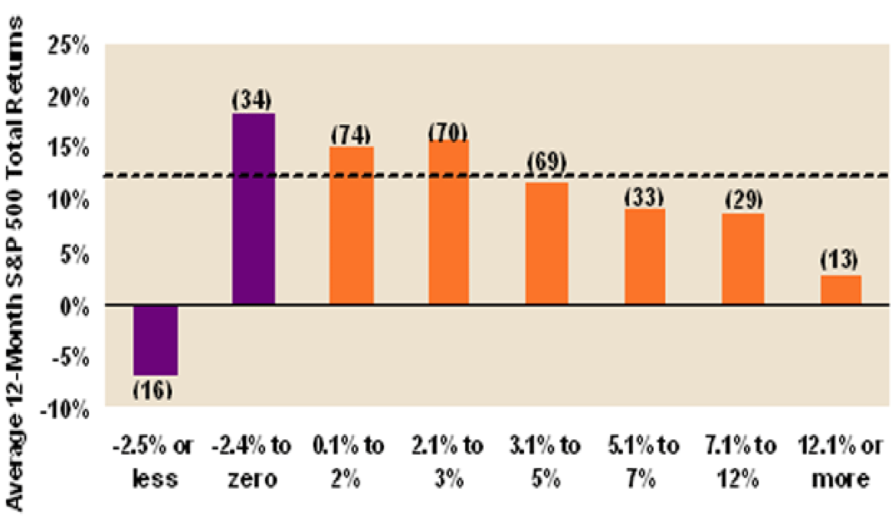
The Quarter

The S&P 500 Index ended up 8.9% for September and 11.3% for the third quarter. It was the market's best September since 1939. Ironically, this strong quarter was achieved in the face of mixed fundamental data. The Philadelphia Fed reported in August that 36 forecasters now see the economy looking less favorable than they thought just three months prior. Third quarter GDP has been revised down to 2.3% from 3.3% (the second quarter was also revised down from 2.4% to 1.6%) and most economists agree the labor market shows little to no signs of improvement. One might assume historically low mortgage rates would stimulate the housing market but, in fact, housing inventories continue to rise and consumers continue to save and reduce debt. As an important aside, consumer spending accounts for 2/3 of the economy. However, we suspect economic data has presented just enough hope that a double dip recession is unlikely, hence, the bullish quarter.

Equities

This past quarter's news flow seemed dominated by the debate between inflation versus deflation and the markets hot new buzz acronym – QE2, which stands for the second round of quantitative easing. Quantitative easing (QE) is a means by which central banks can influence money supply.

In a recent report by The Leuthold Group, they cross-referenced consumer prices with stock market performance going back to 1926. Leuthold (chart below) calculated the rolling 12-month returns evaluated each quarter during that time period. The dotted line shows the average total return and the x-axis displays ranges for deflation and inflation. During the 34 periods with mild deflation, the average gain on the S&P 500 Index was 18.2%. The equity markets appear to find favor within mild deflationary environments.



Persistent deflationary periods can prove problematic for the markets and the economy. Just ask Japan. The Japanese Nikkei Index hit an all-time high of 38,957 in 1989. Shortly thereafter, deflation began to cripple Japan's economy and lasted the duration of the 1990's and 2000's while pushing the Nikkei down 75% to 9500 where it stands today. Deflation is identified by a decline in prices, wages, and asset values. Consumers become paralyzed and become reluctant to purchase goods or services which may be readily discounted in the near future. It's a wicked downward spiral. To combat deflation and provide economic stimulus, the Fed has generated excess reserves through its quantitative easing program.

It seems inflation is not anyone's concern in the near term. U.S. core inflation has fallen to its lowest year over year rate since the early 1960s. As banks rebuild their balance sheets, they have over $1 trillion on deposit at the Fed and consequently, the velocity of money supply is quite low. Although Fed policy continues to push economic stimulus, near term inflation seems unlikely as wage growth, rents, and housing all remain depressed.

	Price Change	Dividend Return	Total Return
1950's	13.2%	5.4%	19.3%
1960's	4.4%	3.3%	7.8%
1970's	1.6%	4.3%	5.8%
1980's	12.6%	4.6%	17.3%
1990's	15.3%	2.7%	18.1%
2000's	-2.7%	1.8%	-1.0%
1950-2009	7.2%	3.6%	11.0%

- In 2000 the high S&P 500 operating P/E equalled ~31
- Current S&P 500 operating P/E equals ~15.7
- Projected 2011 S&P 500 operating P/E equals 12.4

The first round of QE placed massive amounts of liquidity within the banking system to limited or no avail. Depending on whom you ask its ineffectiveness can be associated to either weak loan demand or the unwillingness of banks to lend. There have been many calls to continue the easing program and further economic stimulus but data depicts a consumer who seeks to deleverage and not continue the past 20 years of excessive borrowing. Forcefully expanding the Fed's balance sheet further may be unwarranted and unnecessary as it appears we may be at the forefront of a long-term shift in consumer psychology.

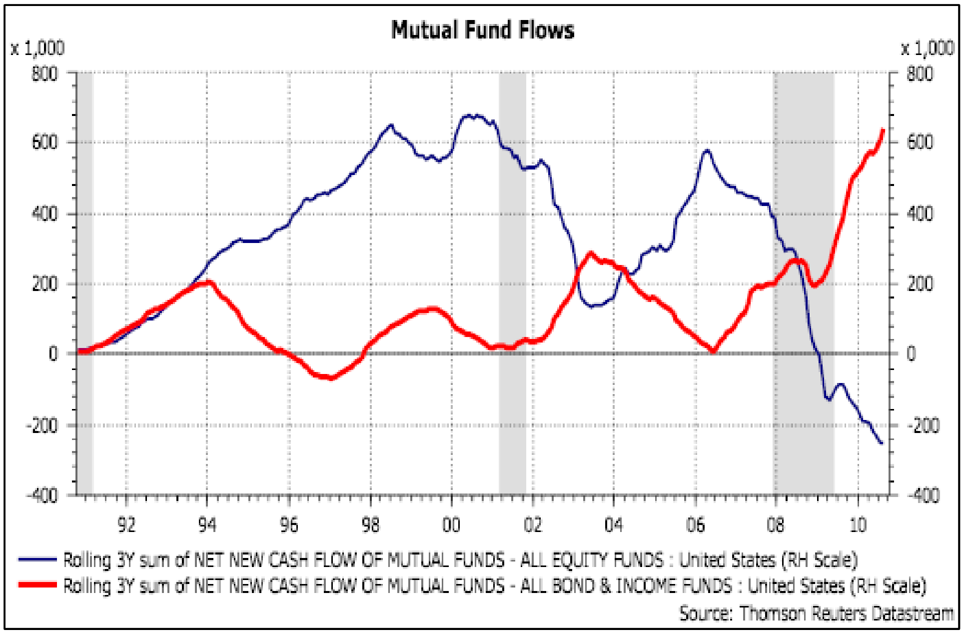
Clearly, quantitative easing is a means to stimulate growth, jobs and, indirectly, the market. The table above demonstrates the effect economic growth can have on equity markets. The 80's and 90's exhibit strong growth and equity returns in the high teens. The 2000's were very difficult as annualized returns were negative 1%. We shudder to think the next decade could be so poor and would argue a reversion to the mean is far more likely. From 1950 to 2009, annualized returns were 11%. We are optimistic and anticipate high single digit annualized returns in the coming decade.

Fixed Income

The 10-Year Treasury Note began the third quarter yielding 2.95% and ended at 2.52% with most of the treasury rally coming in August. These are consecutively strong treasury quarters. HORAN Capital Advisors doesn't wish to be so bold and pronounce treasuries a bubble nor other fixed income for that matter; however, we have a significant bias in continuing to shorten our maturities in fixed income. In our opinion, reaching for extra yield via longer dated purchases seems risky. In fact, we prefer to trade selective credit risk for duration risk. Most recently, HCA has added positions in a floating rate loan fund to its client accounts. Floating rate funds have far less sensitivity to interest rate fluctuations versus traditional fixed income funds. Generally, these funds have higher amounts of lower rated debt but as the Fed continues to push stimulus, bond default risks continue to drop in anticipation of an improving economy.

Active Management & Alternatives

At HCA, we believe higher market volatility is a part of the "new normal." The resulting increased correlations across asset classes are making money managers and investors less reliant on modern portfolio theory. Modern portfolio theory was introduced by Harry Markowitz in 1952 and is a concept based on achieving better risk-adjusted returns by adding the diversifying properties of differentiating asset classes. Unfortunately, as asset class correlations tighten due to greater market volatility, their ability to offset risk is greatly diminished. As a result of excessive market volatility and increased correlation, investors have flocked to fixed income for perceived safety. Fund flows within fixed income



have increased nearly $600 billion in the past two and a half years at the expense of equity mutual funds (see chart left).

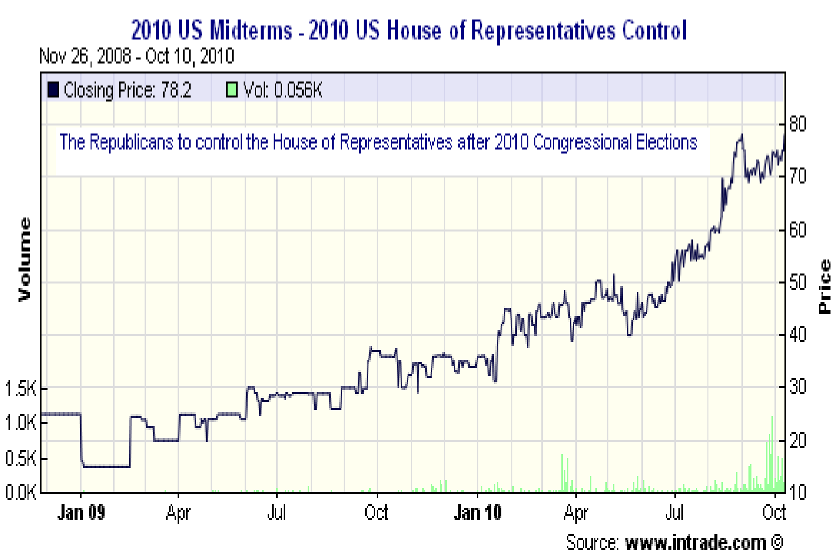
Recent discussions about bubbles forming in the fixed income market may begin to spook investors; yet many are hesitant to move to equities, as investors are still frustrated and disenchanted with the lack of equity returns over the past ten years.

Investors have challenged their investment managers to uncover strategies that allow them to move more freely between equity and fixed income. Many investors would add equity exposure if controls were in place to limit losses. Other investors would add fixed income exposure if the prospects of higher return were available. Alternative investment vehicles designed to meet these demands have become attractive solutions. For example, long/short equity funds have mostly long equity properties, but execute short sales to hedge the portfolio and profit from out of favor equity positions. Fixed income arbitrage and equity market neutral strategies should gain from market dislocations and converging trades while exhibiting lower market volatility.

Markets, trading strategies, and investors are becoming more sophisticated, which is why we seek solutions geared for better risk-adjusted returns. The highest quality advisor firms invest considerable time and resources in researching alternative investment products and strategies that can provide consistent and more favorable return results.

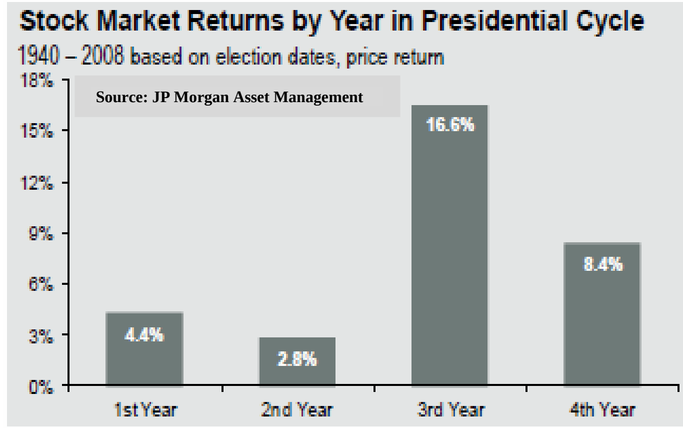
Conclusion

Historically, the results in midterm elections have an impact on the economy and investment markets. The current market seems to be predicting significant gains in Congress by the Republican Party. At the beginning of 2009, the odds of the Republican Party gaining control of the House were below 20%.



As of early October the odds increased to just below 80% as noted in the accompanying chart. The odds of the Democratic Party retaining control of the Senate recently fell below 50%. Democrats are on the defense, as Republicans focus on fiscal deficit spending and the poor employment numbers. Democrats claim to have structured policy to avert crisis and place the country on the right path. Nevertheless, the days leading up to November 2nd will likely add to market volatility, as investors try to digest and predict election sentiment.

The chart at right reveals stock market returns during the years of a Presidential cycle. We believe this chart reveals investor sentiment rather than specific fundamental data points, although, investor sentiment can have a significant impact on economic and market direction. Year three seems to be an interesting data point, as market returns have doubled any other one year period in the Presidential cycle.



It is possible that market gains achieved in the third quarter were pricing in a big Congressional change. What impact, or lack thereof, will a Congressional change have in the fourth quarter? What actions, if any, will occur in the lame duck session of Congress in December? What weight will the expiring Bush tax cuts carry? This is the “to be continued” part of our letter.

We would like to thank our investors and business partners for the confidence placed in HORAN Capital Advisors. As always, please do not hesitate to contact us with questions or comments. Our blog frequently posts updated commentary and may be found at www.horancapitaladvisors.com or http://disciplinedinvesting.blogspot.com/.

Warmest regards,

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