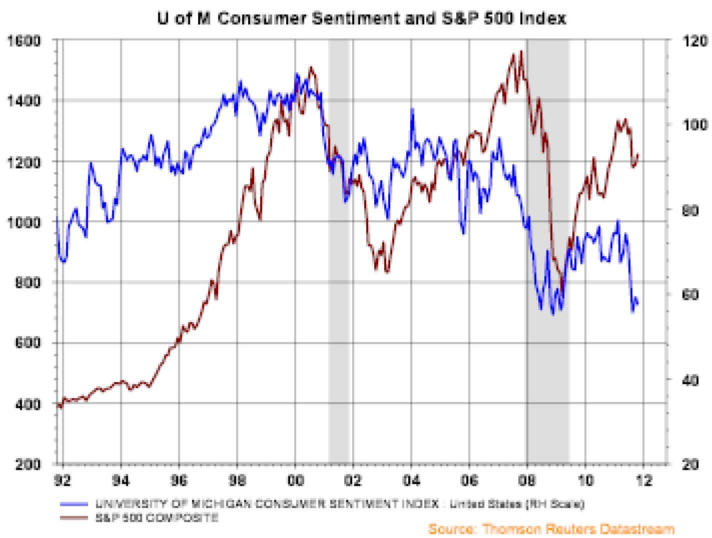
HORAN CAPITAL ADVISORS

Investor Letter

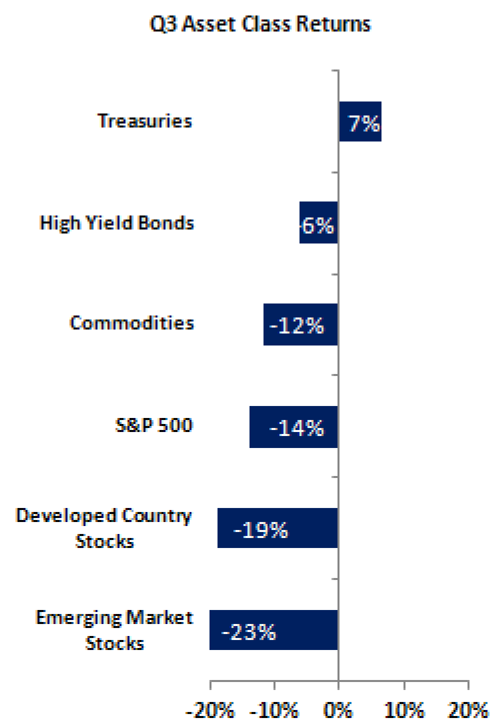
THIRD QUARTER 2011 www.horancapitaladvisors.com

A Difficult Quarter

The market contraction experienced in the third quarter of 2011 was precipitated by Congress' protracted debt ceiling debate as well as the European Union's inability to provide a solution to the sovereign credit risks affecting a number of its member countries. Congress and our administration also appear unable to develop a reasonable plan to reduce the U.S.'s budget deficit. The inability of our politicians to set aside bipartisan politics in an effort to deal with structural issues has caused Americans to lose confidence in our leaders and their ability to solve very serious structural problems. The percentage of polled respondents who believe the government is doing a poor job rose to record highs while The University of Michigan Consumer Sentiment Index is nearing recession level lows. Consumer and business attitudes are important as they influence equity market action.



Equity market returns for the third quarter were comparable to the crash quarter of 2008. Emerging markets were hit hardest by the worldwide sell-off as an anticipated global slowdown weighed heavily on these markets and their export economies. Asian markets contracted significantly as concerns about a Chinese economic slowdown took foot. The Chinese manufacturing sector contracted throughout the third quarter along with subdued industrial output. In Latin America, the three markets of Argentina, Brazil and Chile had the region's worst performances.



Emerging markets are not without risks as Mark Mobius, Executive Chairman of Franklin Templeton's Emerging Markets Group notes, "special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets." Risks are certainly prevalent, but on a long term basis, emerging markets offer higher growth opportunities than the more mature developed markets. Emerging markets have favorable demographics and far less structural debt issues that negatively impact the developed markets. At the moment, these economies have considerable fiscal policy flexibility to tackle economic hurdles and more favorable valuations based off the recent decline.

Correlations Pose Problems for Diversification

As the return chart on the previous page detailed, all markets listed declined except for the U.S. Treasury market. In fact, outside of U.S. Treasuries and pockets of small individual sectors or individual commodities (gold), all markets moved down for the third quarter. This high positive correlation among asset classes is not surprising in the context of globalization, but presents diversification challenges.

A recent *The Economist* magazine article *All in the Same Boat* notes, "the volume of world trade has risen in every year bar one (2009) over the past decade and now represents 29.7% of GDP, up from 23.8% in 2001. Many developed countries are counting on a surge in exports to boost their own sluggish domestic economies."

Past conventional wisdom told investors seeking broad market participation that markets are efficient. Nobel Prize winner Harry Markowitz introduced Modern Portfolio Theory (MPT) in the 1950s and proposed that investors may minimize market risk for an expected level of return by constructing a diversified portfolio. Modern Portfolio Theory emphasizes portfolio diversification. An efficient portfolio is one that has the lowest risk for a given level of expected return. To construct a portfolio consistent with MPT, investors add various asset classes to smooth the risk characteristics of the portfolio while increasing the expectation for higher returns.

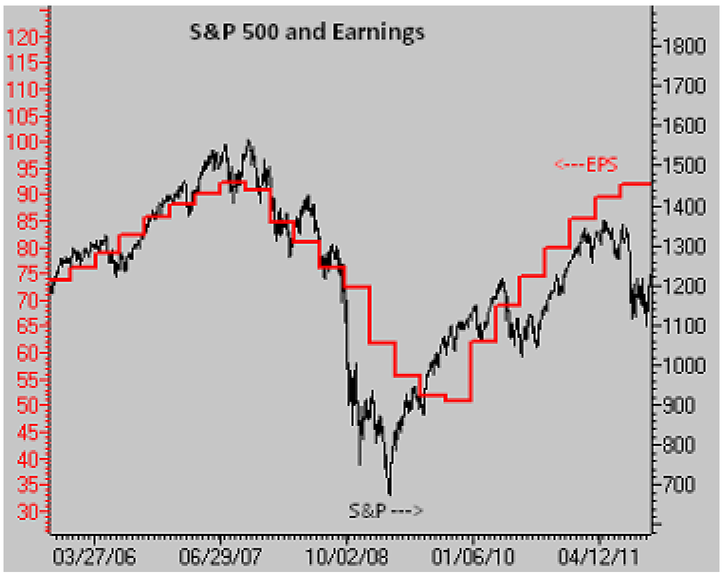
The problems with Modern Portfolio Theory run deep and are exposed by various flawed assumptions that have proven the theory ill-fated over the past 10 years. Markowitz's work assumed that markets can be measured by historical return patterns, are normally distributed, and exhibit no extremes. Clearly, past performance is not indicative of future results and we contend that extreme conditions have been prevalent far too often in the last 10 years and likely will remain. A key point related to MPT was that diversification reduced collective portfolio volatility. Modern Portfolio Theory did not suggest that diversification would provide for a higher level of return. In fact, the more risk an investor is willing to assume, the higher expected return.

We believe an investment portfolio that is constructed in a manner that leaves the asset allocation static or fixed exposes an investor to undue potential risk. The ability to add to investment returns can be achieved by active management, valuation analysis, and strategy specific alternative investments. This is not to say we don't diversify our equity or fixed income allocation, however, certainly not under the guise of unmanaged static allocations.

The active management component for investors is multi-faceted but can be summarized by taking advantage of displaced markets. Markets tend to be mean reverting. Under this premise we look to allocate our investments to markets and specific investments that have underperformed the most during a prolonged market sell-off.

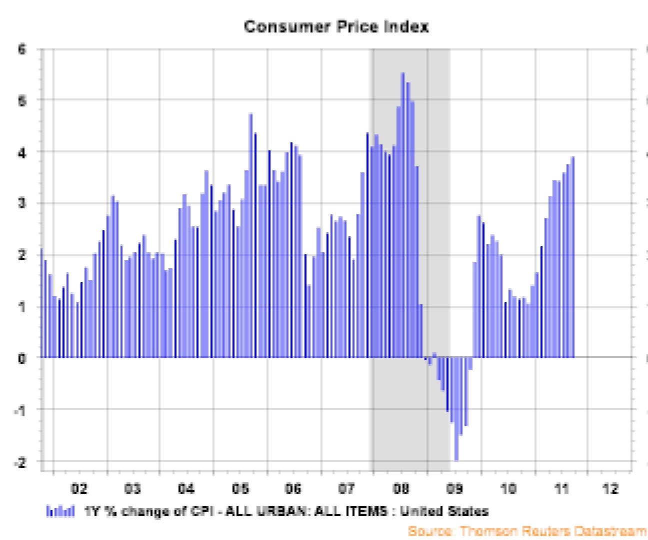
Valuation Analysis

A positive aspect related to the current market is that valuations and fundamentals for companies continue to become more attractive. For the S&P 500 Index, earnings continue to mostly meet or exceed expectations. Estimated operating earnings for the S&P 500 Index for 2011 are expected to reach a record level of $96.57 or 11% higher than earnings reported in 2010. Additionally, for 2012 S&P operating earnings are anticipated to reach $103.42. As the chart to the left shows, the market has a history of tracking earnings. From a valuation perspective, the estimated market price- to-earnings ratio, or P/E ratio, for 2011 is 12.6 and for 2012 the projected P/E is 11.7.



One aspect investors will note in the chart is the red operating earnings line continues to reach record levels, while the S&P has trended lower since about April of this year. A consequence of this is the P/E ratio has contracted. This is commonly referred to as multiple compression. The compression may be influenced by future expectations regarding inflation.

The recognition of higher inflation could play out to be positive or negative for future equity returns dependant on many variables, however, bond returns will most certainly be negatively impacted by higher inflation. One of the Federal Reserve's mandates is to maintain some sort of price stability. In order to do this, the Fed attempts to minimize the rate of inflation in the economy by raising the Fed Funds Rate to slow economic activity. The year over year inflation rate in September was reported at nearly 4%. If inflation continues to increase as it has this year, the Fed may need to raise interest rates. This event would have a negative impact on bond returns. We believe inflation and higher interest rates are highly probable longer term, therefore, we have maintained a shorter duration and average maturity of our client's bond portfolios. We have favored more credit sensitive bond investments, such as high yield, as an alternative to purchasing longer term bonds.



Mitigating Volatility

A means for broader diversification can be achieved through strategy specific allocations in addition to asset class diversification. Our alternative investments' category allocates a portion of client capital to investments that hedge risk in declining markets. The table attached outlines manager investment returns we have utilized for our clients. Year-to-date and third quarter price performance is provided as well as respective benchmarks returns.

This past quarter we implemented an alternative strategy delivered in a fixed income format but tied to equity market performance. The investment is referred to as a structured note. Structured notes are unique investment vehicles that allow stewards of capital to think creatively and execute a specific thesis timely and effectively. Structured notes are actually bonds that provide the ability to customize market access and instead of paying interest, they pay returns based upon the designated market. In our particular effort, we chose to approach the European markets with a "seatbelt." Our thesis was to maintain our allocation but to do so with some downside protection. The ensuing 18 month Barclays Bank issued note, protects our investors on the first 15% decline in the Dow Jones Eurostoxx 50 Index and FTSE 100 Index. Over the same period, investors participate 1 for 1 on the upside to a maximum return of 47%. This equates to a 31% annualized return should the cap be met – a rewarding trade-off in which exploiting the high European volatility provided us with more upside.

	Price Return Q3 2011	Price Return YTD (10.12.11)
Multi-Cap Long Short Manager	**-9.89%**	**-0.84%**
Benchmark: Wilshire 5000 Index	-15.72%	-6.40%
Equity Collar Manager	**-5.20%**	**-1.26%**
Benchmark: S&P 500 Index	-14.33%	-5.70%
Small-Cap Long Short Manager	**-10.18%**	**-3.66%**
Benchmark: S&P Small Cap 600 Index	-20.08%	-8.78%

Final Thoughts

The flight to quality experienced during the third quarter left U.S. interest rates at levels unimaginable and not seen in 50 years. The U.S. Federal Reserve has espoused a commitment to maintaining an accommodative monetary policy, thereby holding down short term interest rates through 2013. This unprecedented action has driven already historically low U.S. Treasury rates even lower to a paltry .10% on 1 year bills, .26% on 2 year notes and 1% on 5 year notes. In addition, the FED has further announced "operation twist" primarily designed to force longer term rates down as well. As investors fled to higher ground and poured money into U.S. Treasuries, credit sensitive fixed income lost ground as credit spreads widened.

Despite mounting worries about the U.S. and Europe entering into a double dip recession, more recent economic data indicates a slow growth trajectory that will likely avert contraction. We feel third quarter corporate earnings could provide a positive catalyst for equity markets given the depressed level of equity valuations. Also, positive developments out of Washington or Europe could provide additional momentum. S&P 500 companies are projected to grow revenues and earnings in the 10%- 15% range for the remainder of the year. Financial companies are expected to contribute more meaningfully as a result of better year-over-year comparisons and commodity cost pressures should subside providing a tailwind for corporate profits.

We thank you for your trust and confidence. Our blog frequently posts updated commentary and may be found at www.horancapitaladvisors.com or http://www.horanassoc.com/horan-capital-advisors/blog.aspx. Please do not hesitate to contact us with questions or comments.

Warmest regards,

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