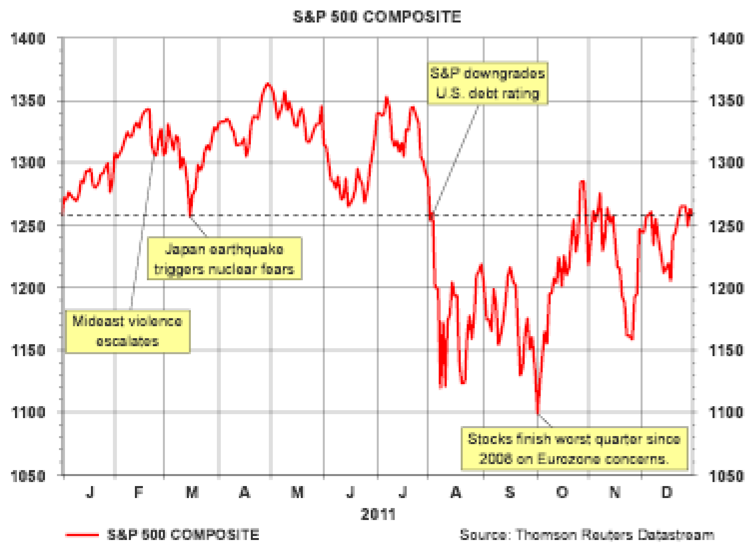
HORAN CAPITAL ADVISORS

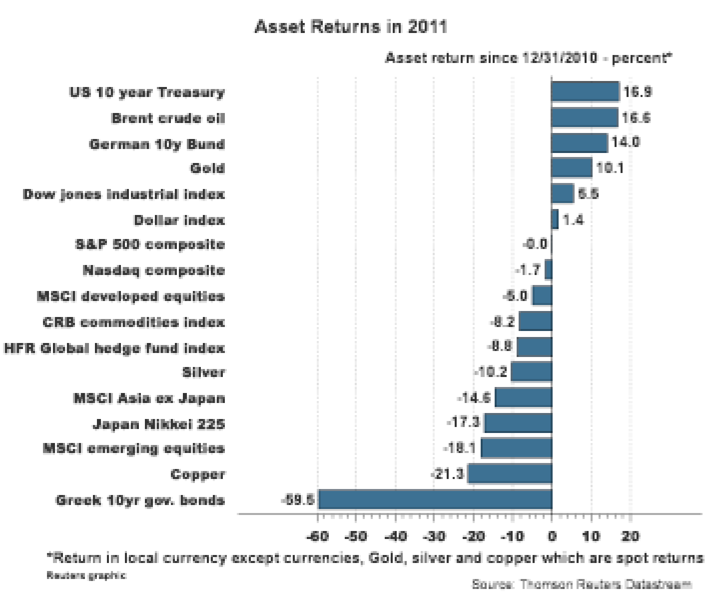
Investor *Letter*

FOURTH QUARTER 2011 www.horancapitaladvisors.com

A Rare Occurrence

The frequencies at which we see markets begin and end at the same level in any given year are quite rare. The S&P began 2011 at 1,257.64 and ended the year at 1,257.60. This narrow decline was the slimmest since 1947. However, it was anything but a smooth ride in 2011. The trading range was considerably wide. The new phrase repeated throughout the year was “risk on/risk off,” simply defined as buying riskier investments during positive momentum and selling riskier investments during negative momentum. “Risk on” assets include stocks, commodities and high-yield bonds; whereas “risk off” assets include cash, U.S. treasuries and gold.

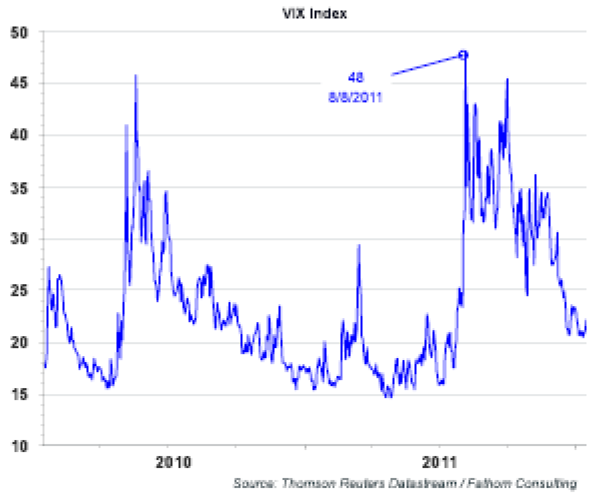




Global equity markets and commodities were challenged in 2011. Long maturity U.S. treasuries became the preferred asset class. The U.S. equity market was the *cleanest dirty shirt*, as Mohamed El-Erian of Pimco likes to say, relative to world equity indexes. The international equity markets struggled mightily. A global slowdown coupled with European debt market issues attributed to lackluster equity returns across the board. As equities suffered, bonds and the U.S. dollar rallied. In the face of U.S. debt ceiling issues and global credit issues, the world’s most liquid and resilient economy saw significant inflows into treasuries. This flight to safety, the “risk-off” trade, pushed yields down and resulted in long-term treasuries having a banner year.

Questions persist as to whether regions of the world can isolate themselves from the negative implications of sovereign debt issues in Europe. It appears that U.S. equity markets were able to disconnect from those issues in 2011. The U.S. markets were highly correlated to foreign markets with respect to general market direction; however, they weathered the storm far better as to degree of negative downside. The U.S. was able to accomplish this as consumers increased their spending, productivity improved and banks solidified their capital position.

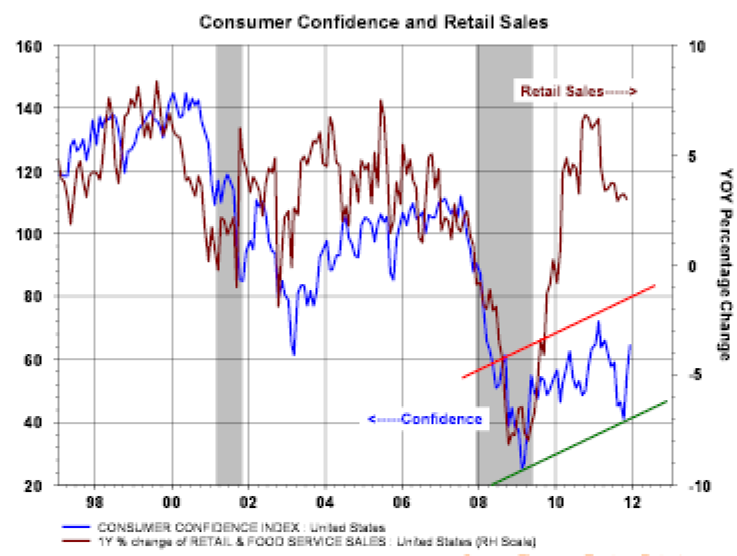
Market sentiment has been mixed of late. The common fear measure, the VIX Index, has declined to 18 this month. Readings below 20 are generally associated with investors being less fearful of the market ahead. During the market sell-off in the third quarter of 2011, the VIX Index spiked as high as 48 indicating investors were in a "risk off" mode.



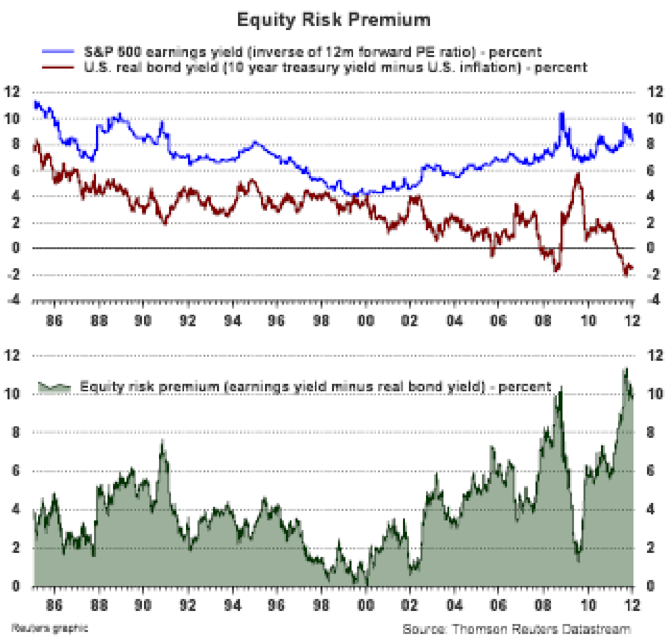
A number of notable perma-bear strategists, John Hussman, David Rosenberg, and Jim Chanos, to name a few, continue to predict negative outcomes related to world growth and equity returns. Conversely, there are certainly those who feel overwhelmingly positive about world growth and equity returns. It is interesting and amazing that the smartest of the smart can have such dissention. While measuring the temperature of various market strategists is important, we feel assessing the consumer to be an integral part of market forecasting. Consumers continue to account for 70% of economic activity. As the chart below details, consumer confidence has improved but remains far below the confidence numbers reported prior to the onset of the recession in 2007 when the consumer confidence index was significantly higher than today. On the other hand, the retail sales line (in red) is at a level last seen prior to the recession in 2007. Should we be giving more weight to what consumers do or what they say? The growth in consumer spending in the U.S. almost certainly will be constrained compared to the past several decades when borrowing from home equity for consumption was ubiquitous. Indeed, the Federal Reserve and others estimate consumers have experienced some $7 trillion in lost home equity value over the last several years.

The Valuation Gap

We have our reservations about world economic output, but stand by our past comments about slow U.S. growth without a recession. We do believe equities offer attractive return opportunities for the foreseeable future in the context of historical valuation and relative valuation. We acknowledge the structural issues prevalent in developed economies and the risk that comes with debt hurdles, demographic challenges and potential deflation, but there are many data points that make us optimistic about equity returns in 2012 and for long-term strategic investment allocations of capital.



The chart on the top of the next page presents the equity risk premium (ERP) which measures the relative attractiveness of stocks versus the risk free rate (bonds). In other words, the ERP measures what investors demand in return over and above the risk free rate. The ERP has averaged about 4% dating back to the 1920s and is tracking near a 20-year high. The higher risk premium level suggests equities are attractive relative to bonds or quite possibly that bonds are quite expensive. In either instance, we would move to favor equities relative to bond allocations. Note the future expected return for equities nearly equals 10%.



A key driver for higher expected returns is corporate earnings and the ability of earnings to continue to make new record highs in 2012. Earnings growth for 2012 is expected to continue, albeit at a slower rate than achieved in 2011. Many companies today are participating in aggressive stock buyback programs and more importantly, raising company dividends. It seems these companies have confidence in future earnings; however, today, companies are paying out a lower percentage of their earnings in the form of dividends. On an absolute basis, companies are maintaining record cash levels on their balance sheet. In this low interest rate environment, these high cash levels could be construed as companies being fearful about future earnings. This may be due to uncertainty about government policies or the future direction of the broader economy. We believe investors will pressure companies for higher dividends and consistent dividend growth as interest rates remain depressed.

Cautious investors with a "risk off" focus will continue to gravitate towards bonds; however, as the risk premium chart above indicates, the real yield on the 10-year Treasury is now negative. That is to say the Consumer Price Index (inflation) is running at a higher rate than the 10-year Treasury yield. Nominal yields will have to increase nearly 100% to mitigate losing ground relative to inflation. This is a significant consideration for portfolio construction while investment managers seek to preserve and grow capital and maintain an investor's purchasing power.

Yield alone is not the benchmark for return. Clearly, expected growth of principal is an important component. As we have written and commented on frequently, ownership in a 10-year bond yielding 2% with very little margin for principal growth, pales in comparison to a high quality equity position yielding 3% with excellent growth potential over the same 10-year horizon. This has not gone unnoticed within the investor community. Investors have gravitated to blue chip dividend payers, pushing many of their price to earnings multiples higher. We certainly continue to focus on high quality equities but are always mindful of their respective valuations. A case in point is our recent sale of McDonalds (MCD) as the valuation was getting stretched in our view. Earnings are expected to grow 9% next year and the stock trades at a 12-month forward P/E of 19 times earnings. McDonalds is a great company, but the stock valuation seems high at this time. The proceeds from our sale of MCD were used to begin a position in Staples (SPLS). Staples' earnings are expected to grow 9% this year with the dividend growing around 10% a year. It trades at a forward P/E of 11 times earnings.

Questions to Answer

Here we stand with some uncertainty for the markets. The most astute economists and market strategists are prognosticating as to the outcome for equity, fixed income, commodity, real estate, and currency investments. We similarly analyze the data in order to position our clients for the best possible investment outcome. We make investments in areas we feel present the highest likelihood for positive and meaningful returns.

As we look forward to 2012, we recognize that developed economies are in the cross hairs of deflation and emerging markets are in a sustained growth mode – cheap labor, cheap capital, and cheap commodity goods. But nonetheless, both offer different reasons for investment. While the labor cost gap has narrowed between developed and emerging markets, rising incomes in the developing world will likely present great opportunities for those companies positioned appropriately. Coca-Cola projects that one billion new people in the developing markets will move into the middle class over the next eight years. The investment firm, Franklin Templeton, estimates 59% of middle class spending will come from Asia by 2030. We worry about equity implications should austerity in developed economies become very real and constraining, although it is far more likely (and palatable) for politicians to implement austerity in an incremental fashion. It is likely policy makers will be forced to make big decisions in 2012 before the markets force the change. It's a very meaningful election year. So we ask, what could derail positive equity performance? European sovereign or bank default? Israel attacks Iran? U.S. politicians find no bi-partisan support to address structural deficits? Demand weakens and corporate profit margins contract causing higher unemployment? We also ask, what drives us higher this year? Quantitative Easing part III? Corporate cash implementation for acquisitions, dividends, hiring and capital expenditures? Presidential change? The return of manufacturing jobs or technological innovation?

S&P 500 P/E Entry Level	Subsequent Average Annualized S&P 500 Price Return 1 YR	2 YR	3 YR	5 YR	10 YR
<8	13.6%	10.6%	8.5%	10.2%	11.1%
8-10	8.3%	10.9%	12.3%	12.0%	9.0%
10-12	12.3%	12.9%	11.5%	8.0%	8.3%
12-14	8.9%	8.8%	6.7%	6.2%	7.4%
14-16	11.4%	7.3%	6.5%	6.8%	6.5%
16-18	3.3%	1.8%	2.3%	3.1%	2.6%
18-20	3.5%	3.4%	3.5%	4.0%	3.1%
20-22	2.4%	5.8%	7.4%	8.2%	6.2%
22-24	-4.8%	4.2%	7.2%	2.4%	2.0%
>24	-3.3%	-2.5%	-2.9%	-0.7%	-1.2%

P/E = Price-Earnings Ratio. Data from 1913 to September 2011. Data as of September 30, 2011. Source: Bloomberg, Factset, S&P, Stock Market Data Used in "Irrational Exuberance" by Robert Shiller, and JP Morgan.

Though questions persist, global equity market valuations are quite compelling. Emerging markets are trading at 9x 2012 expected earnings; Europe, 10x; U.S., 12x. Historically, this is cheap and the years following such favorable valuations prove rewarding. Relative to many other asset classes, equities look inexpensive especially, when compared to long-term bonds which look very expensive. Let's not also forget investor fund flows for the past 12 months. According to EPFR Global, all U.S. equity stock funds saw inflows of just $4 billion in 2011. Comparatively, fixed income managers experienced inflows of $86 billion. This overwhelming discrepancy paints the picture of investors positioned for "risk off" and raises concern for a dramatic reversal, one that would greatly benefit equities. Frequently individual investors make decisions after meaningful market moves and help define buy high, sell low. We continue to focus on the fundamentals in order to position our clients appropriately in advance.

As always, we thank you for the confidence you place in us. 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,

HORAN Capital Advisors

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