HORAN CAPITAL ADVISORS
Investor Letter
Winter 2017
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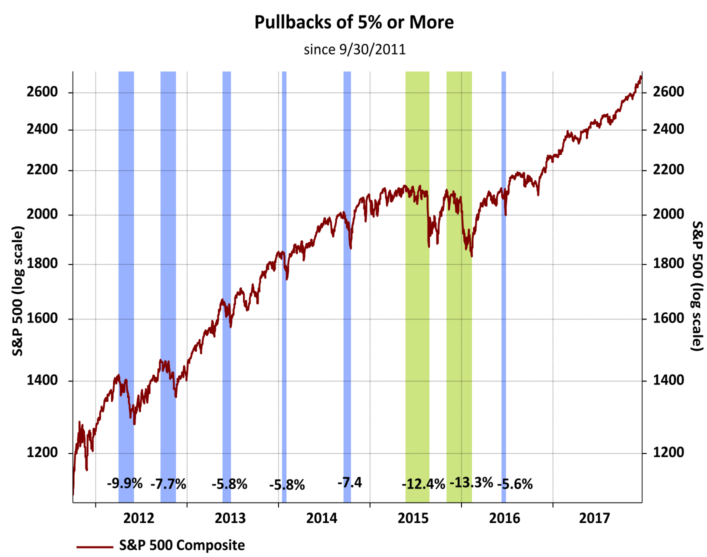
"The dirty little secret of successful, long-term investing is that, 'he who moves less, wins'."
– Mike Williams; Alan Steel Asset Management

An Uninterrupted Climb

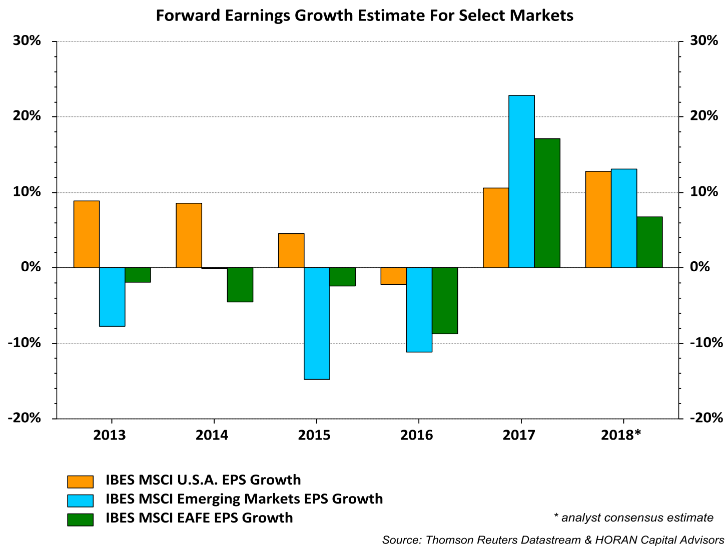
The first week of January has just ended and the S&P 500 Index punched through the 25,000 level like Muhammad Ali in his prime. The four day return of 2.6% is the best start for the S&P 500 Index since 2006. The S&P finished 2017 up nearly 22% while the Dow Jones Industrial Average Index returned 25%. Many investors may worry that strong preceding years may predicate a market decline. However, going back to 1928, the market returned greater than 20% in 30 calendar years. In 21 of those 30 years, or 70% of the time, the S&P 500 Index generated an average return of nearly 16% in the following year.

The S&P 500 has not experienced a double digit decline since February 2016. The last 5% decline came in June of 2016. Since then, the S&P has achieved a 35% price return. For further perspective, the S&P 500's maximum decline in 2017 was a mere 2.8%. Since 1980, the average intra-year decline for the S&P 500 is 14.1% (peak to trough) but average calendar year gains were 11.5%. Notably, 2017 was the first calendar year in the market's history to have 12 consecutive months of positive returns. Not a bad year.



Source: Thomson Reuters Datastream & HORAN Capital Advisors

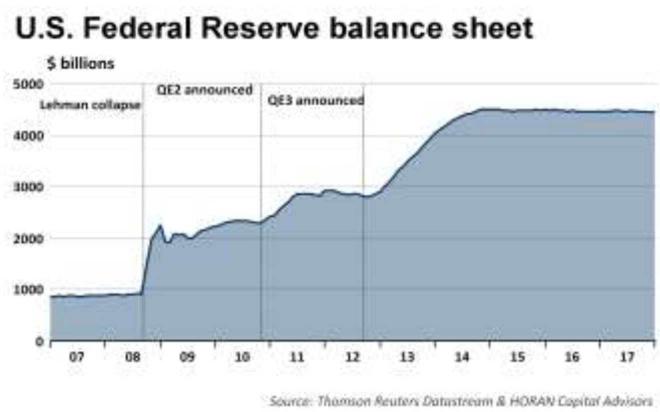
As clients ask us how to prepare for the inevitable pullback, the answer is maintain balance. An investor's asset allocation should be designed to weather pullbacks and provide liquidity without recognizing portfolio losses. Proper balance is based on an individual's specific circumstance and risk tolerance. Fixed income allocations, and to a lesser extent alternative investments, are designed to support the portfolio during equity market pullbacks. We do not expect fixed income and alternative investments to outperform equities over long time horizons, but we do expect bonds to serve as a reliable source of cash/liquidity in the event of a reasonable drawdown. These more protected investments allow investors to avoid selling stocks at unattractive prices following a market decline to fund living expenses.



The U.S. was not the only market to experience solid gains in 2017. International markets were even stronger as global indexes climbed significantly higher: MSCI EAFE index, 25.6%; MSCI ACWI ex-U.S. Small/Mid Cap Index, 30.8%; and MSCI Emerging Equities Index, 37.8%. As the chart at left shows, this strong rebound in international equity performance is supported by stronger and accelerating earnings. With continued Quantitative Easing by both the European Central Bank and the Bank of Japan, analysts are predicting positive earnings growth for developed international markets in 2018. Emerging markets should benefit from the increasing rate of global growth with the IMF predicting 3.7% global GDP growth in 2018. As most of our clients are aware we have been incrementally adding to international equity markets since 2016. Investments made to emerging market equity in Q1 2017 provided sharp gains within a short time frame. We remain committed to investing in less expensive markets with a catalyst for fundamental improvement.

Liquidity vs. Fundamentals

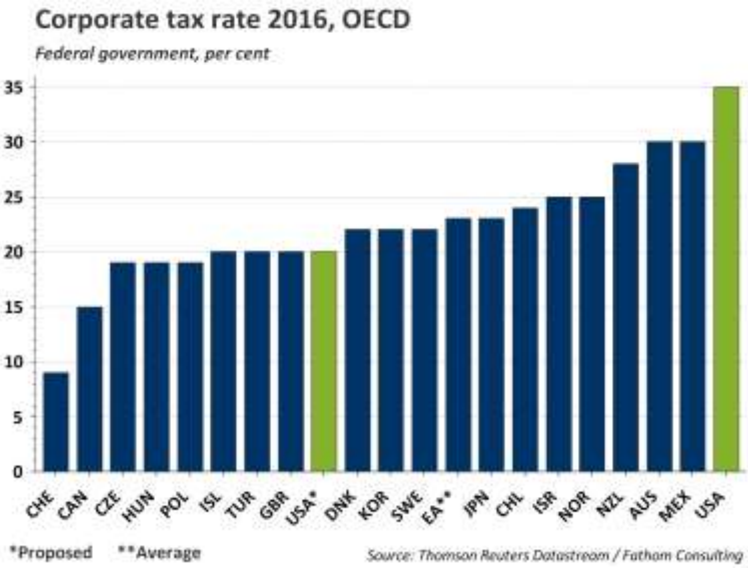
A popular financial debate since the end of the financial crisis in 2009 has been, “What is making the market move higher: ample liquidity or fundamental improvement?” The liquidity argument is that asset purchases by Central Banks (Quantitative Easing) have artificially inflated the supply of money, and this money has been funneled into the stock market thus driving stocks higher. The chart to the right demonstrates the enormous scale of these QE programs by showing the growth in the balance sheet of the Fed. In the wake of the crisis, the balance sheet expanded from less than $1 trillion to nearly $4.5 trillion. The numbers are similar for the European Central Bank and far more extreme for the Bank of Japan. Decreased liquidity, without strong supporting fundamentals, could serve as a headwind for equity markets.



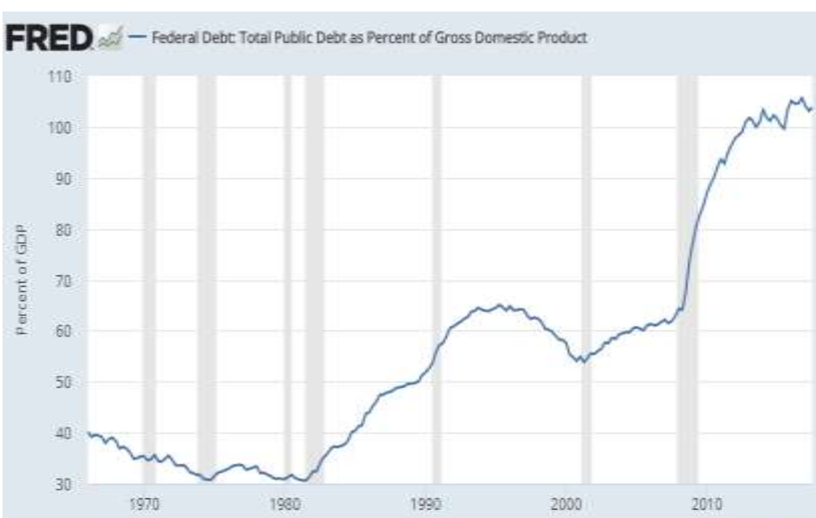
While we believe liquidity played a role in the early years of the recovery from the crisis, the fundamentals appear to be playing a larger role now. As mentioned in previous letters, the P/E, or price to earnings ratio for the S&P 500, is near the historical average when considering today’s low level of inflation. Small business optimism, consumer optimism, and household net worth are all at or near all-time highs. Debt payments, as a percentage of disposable net income for households, are below 10% versus a pre-crisis peak of 13.2%. This business and consumer strength is reflected in company revenues. After growing 5.8% in 2017, S&P 500 revenue is expected to increase another 5.6% in 2018. With profit margins hovering around all-time highs, consistent revenue growth becomes an important driving force behind earnings growth.

The Tax Bill

One of the most important aspects of the new tax bill was a reduction in the corporate income tax rate. Though debated at length, most economists and policy makers widely agreed that the high domestic corporate tax rate was counterproductive and encouraged gamesmanship by U.S. corporations to maintain global competitiveness. The chart at right illustrates the dramatic change from 35% to 21%. The lower corporate tax rate puts the U.S. closer to its developed country peers and should encourage companies to repatriate a larger percentage of their international profits. These repatriated profits can then be used for a range of investments from domestic reinvestment to share buybacks and dividends. Domestic companies, with already high effective tax rates, will also see a significant benefit as their after-tax profits increase in conjunction with the tax rate decrease. Several companies have already announced wage increases for employees and increased returns to shareholders in the form of either buybacks or dividends. Goldman Sachs has estimated that the new corporate tax rate, as well as other aspects of the tax bill, will result in a 5% increase to previous 2018 estimates for corporate earnings.



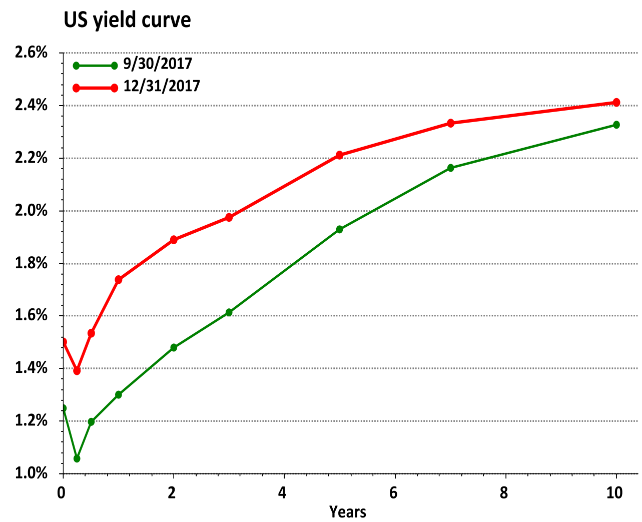
For many individuals, tax deductions were greatly simplified as the standard deduction nearly doubled for 2018. Other key features included a $10,000 limit on state, local and property tax deductions, a lower cap on mortgage values eligible for the deduction of mortgage interest (from $1 million to $750k), a reduction in income tax rates based on income brackets, and the repeal of the individual mandate from the Affordable Care Act. Effects of the tax bill on individuals will vary on a case-by-case basis and we encourage dialogue with an accountant. In the short-term, the tax bill should be a tailwind to both the economy and the markets due to the reduced tax burden on corporations. In the medium to long-term, however, the impact is unclear. Even the most optimistic of forecasts indicate the new tax bill will increase the annual deficit for the foreseeable future.



The effects of high government debt levels are not completely understood by economists, however, several studies indicate an inverse relationship between government debt and economic growth. These studies specifically identify the 90% Debt to GDP Ratio as a key level. Countries above these debt levels are likely to grow at a 1.2 to 1.3 percentage point slower rate than less indebted countries. With the total U.S. Debt to GDP equal to 118% as of Q3 2017, the tax bill will likely continue to move the U.S. further from this 90% level. It is important to note however, the correlation of higher debt to slower GDP growth does not necessarily equal causation.

Conclusion

We continue to make incremental portfolio changes, but as our opening quote suggests, we remain committed and invested in our core portfolios. We are optimistic about the global economy in 2018. Investor sentiment has shifted from skeptical to more optimistic for the first time in a while. U.S. investors worried about the challenges resulting from an aging bull market and a long economic expansion cycle, now have the passage of Tax Cuts and the Jobs Act to consider. Accelerating after-tax earnings growth, on top of an already improving fundamental backdrop, provides a reasonable foundation for continued strength in the equity market. Liquidity should remain strong as central banks around the world (ex-U.S.) plan to continue to support their Quantitative Easing programs.



Source: Thomson Reuters Datastream & HORAN Capital Advisors

We recognize there are risks associated with additional stimulus (corporate tax cuts) provided to markets already experiencing growth. The Federal Reserve will surely be monitoring the U.S. economy for signs of overheating. The Fed is slowly tightening monetary policy in an effort to 'normalize' interest rates via increases in short-term interest rates and reducing the size of its balance sheet.

Lastly, one should expect a higher and more normal level of volatility as 2018 unfolds. While we see no sign of a recession on the horizon, we are overdue for a market correction, which may be unwelcomed but healthy for the markets long-term.

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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