HORAN CAPITAL ADVISORS
Investor *Letter*
Winter 2015
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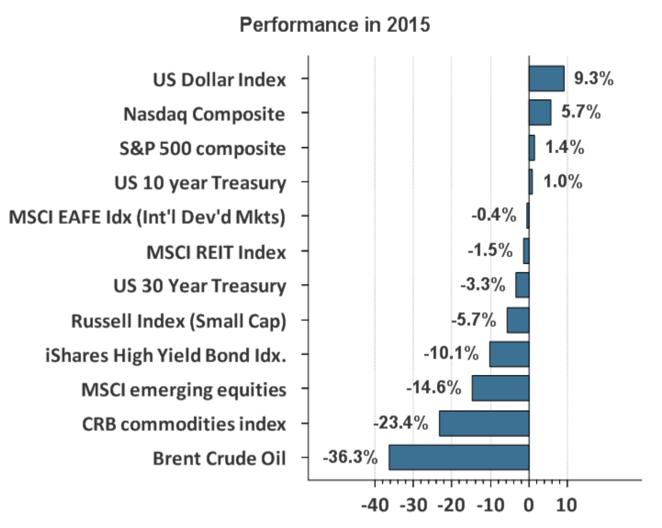
Narrow Leadership

After the equity market moved higher for nearly four years without a 10% correction, 2015 was the year the market succumbed to selling pressure. A challenging 2015 has been followed by a difficult start to 2016. Global stock markets are experiencing volatility driven largely by China growth fears and geopolitical events in North Korea and the Middle East. The markets are also reacting to signals of a potential global economic slowdown.

Although there are certainly issues within the domestic economy, we see positive economic activity related to the consumer and services segments of the economy. Importantly, the U.S. economy rests on a more solid foundation than during 2008-2009 with stronger corporate balance sheets, fewer leveraged consumers and well-capitalized banks.

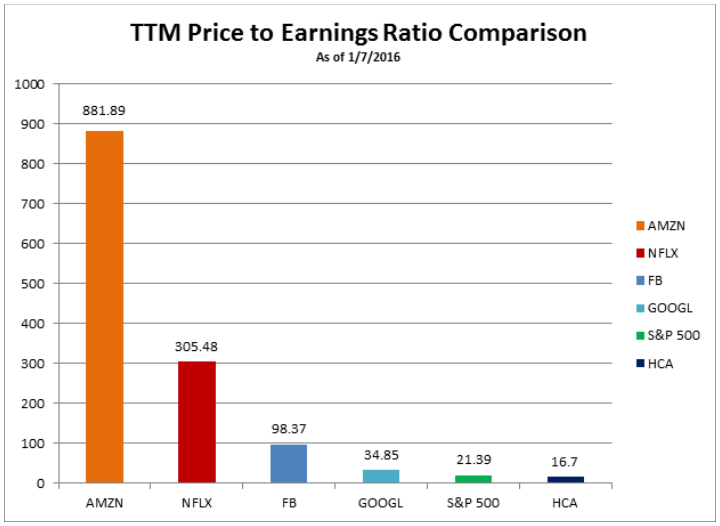
This past year was the first in four years to have a market correction greater than 10%. The market fell 12.4% through August 25 and retested that low towards the end of September before rallying back in the fourth quarter. The S&P 500 Index was at risk of breaking its six-year winning streak by losing 0.74% on a 'price only' basis, but dividends matter and the S&P 500 Index's total return in 2015 was a positive 1.4%. The winning streak survives.

Admittedly, a 1.4% return for the S&P 500 Index is not an exciting one; however, investment returns in many traditional asset classes were negative for 2015. It made for a difficult year for investors diversifying their investments across multiple asset classes. This was quite evident in almost every asset class. As David Snowball of the *Mutual Fund Observer* commented, "Investors saw losses in 8 of 9 domestic equity categories (excluding large growth), 17 of 17 asset allocation categories, 8 of 15 international stock categories and 14 of 15 taxable bond categories." Snowball acknowledged the difficulty for real assets like MLPs and hedge funds that experienced average losses of 4%. Many notable managers (Ackman, Einhorn, Greenblatt and Robbins) in the hedge fund universe were down 10-25%.



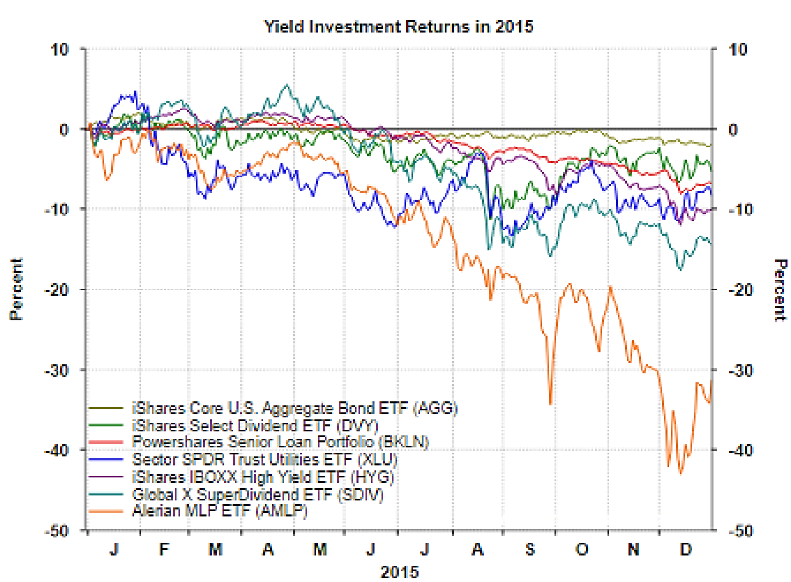
Source: Thomson Reuters Datastream

One positive outlier for index returns was the NASDAQ, which finished the year up 5.7%. The significant contributors to the NASDAQ return were the group of stocks known as the FANGs: Facebook, Amazon, Netflix and Google (now named Alphabet). These stocks, also represented in the S&P 500 Index, led the S&P to a small positive return for 2015. As Charles Schwab recently noted, “The FANG stocks were up over 60% on a cap-weighted basis. Excluding those four stocks, the S&P was down 4.8% last year.” Market leadership was narrow this past year.

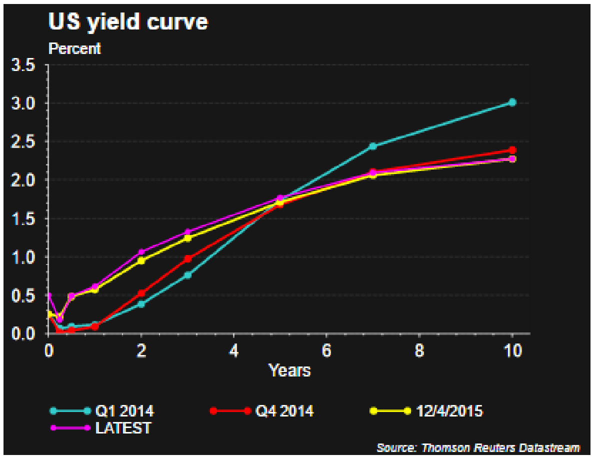


The table to the left shows the trailing 12-month price-to-earnings (P/E) ratios, a measurement of valuation, for the FANG stocks, the S&P 500 Index and our Core Stock portfolio. Notably, our discipline leads us to stocks that typically trade at a discount to the market and certainly a discount to the FANGs (although we do own Google, a more reasonably priced stock). Earnings expectations are high for Amazon, Netflix and Facebook. Should expectations for exceptional earnings growth not come to fruition, these stocks may struggle. It is possible these names will be unable to carry the entire market again and therefore, broader stock participation will be important for better market returns in 2016.

Two phenomena occurring last year were the wide disparity in returns generated by growth stocks versus value stocks and the weakness of higher yielding investments. When comparing the returns of S&P’s Pure Value Index and Pure Growth Index, the Pure Growth Index generated a positive return of 1.48% while the Pure Value Index had a large negative return of -10.48%. This disparity in return is attributable to a number of factors, but two are prominent. The Pure Value Index contains six times as many energy names versus the Pure Growth Index, and the energy sector was the worst performing sector in the S&P 500 Index last year. Additionally, the Pure Value Index holdings have an average dividend yield of 3% while the Pure Growth Index constituents’ average dividend yield is 1%. As Charles Schwab recently highlighted, "the four deciles of stocks with the highest P/Es (i.e., the most expensive stocks) were all at least flat or up on the year." Schwab also noted, "Stocks which pay no dividends at all were up 3.9%, while the decile of stocks which started the year with the highest dividends yields were down 14.6%." Dividend oriented stocks, and in particular, utilities, were down 5% to 15%. Additionally, higher yielding investments were not strong performers in 2015. The performance chart to the right shows many fixed income asset classes struggled in 2015, including leveraged loans, high-yield and core bonds.



The Fed Moves On



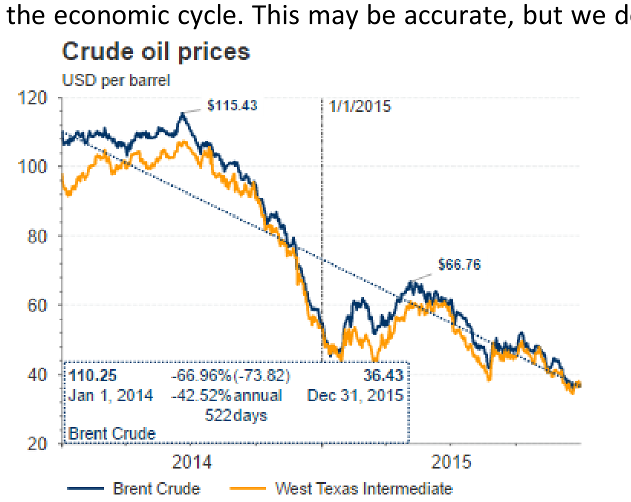
It had been nine and a half years since the Federal Reserve last increased the Fed Funds Rate until this streak ended after the Fed raised rates 0.25% or 25 basis points in December. The Fed's key mandates, and its use of monetary policy, are to support economic growth commensurate with the economy's long-term potential, promote maximum employment and maintain stable prices. Many key analysts and economists believe the Fed may have moved too soon in raising interest rates (although others argue the Fed kept rates too low for too long) as economic growth continues to run below historical trend and inflation seems to be contained. Continued rate hikes are likely in 2016 based on Fed language; and therefore, our clients' bond portfolios remain invested in higher quality fixed income investments with a shorter-term maturity profile.

Short-term rates are moving higher while longer-term rates have declined. The yield curve's pivot point is around the five-year maturity. Historically, a yield curve that is flattening can be a signal of an impending recession, though we do not believe a recession is likely for several reasons. There has been strong buying of our debt both domestically and abroad. Quantitative Easing was intended to bring down long-term rates and even though QE has ended, the Fed is reinvesting bond proceeds as they mature. Foreign investors have been buyers of U.S. government debt, as yields remain higher than most other "safe-haven" countries.

Outlook For 2016

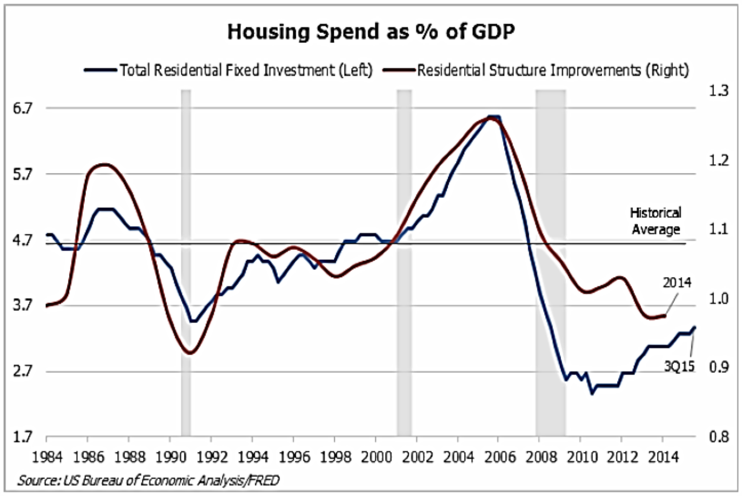
The consensus view for 2016 is one of low expectations and higher volatility. We believe the economy will continue to grow slowly. We have positioned client accounts in a manner to minimize volatility by limiting or eliminating exposure to high yield bonds, emerging market equities and small cap stocks, which are more prone to volatility. We are maintaining a higher level of cash in client accounts and hedged equity allocations are generally in excess of 10%. The hedged equity managers did well in 2015 - matching or outperforming the S&P 500 Index returns while taking significantly less market risk.

Many analysts believe we are in the late stages of the economic cycle. This may be accurate, but we do not believe we are at the end of the current expansion or at a point where the economy is heading for an imminent recession. The manufacturing/commodity producing sectors are weak while the consumer/service sectors are doing reasonably well. We continue to monitor consumer spending. Consumers account for 70% of economic activity and the benefit they receive from the significant decline in energy prices should contribute to reasonable spending growth this year.



One area that could see further strength is the housing market. With inventories low and

Millennials slowly moving into the homebuyer market, housing should remain a bright spot. Home construction is an important measure of economic growth. The construction industry touches many facets of the economy including labor, service businesses, retail, and manufacturing. As a percentage of GDP, consumer spending on housing is much lower than the historical average, although higher interest rates may potentially limit housing's upside.



From a fundamental perspective, U.S. corporate balance sheets are strong with companies holding near record levels of cash, consumer balance sheets are strong and the employment level in the economy continues to improve. In the first ADP Employment report in January, 'unusual' strength was anticipated for the subsequent Employment Situation Report. The ADP report noted a 257,000 increase in payrolls versus expectations of a 190,000 increase. The ADP report did accurately forecast the strong Employment Situation Report that followed.

As we look at corporate earnings expectations, we believe some of the headwinds from last year; specifically the headwinds from the sharp drop in oil prices and the strength in the U.S. dollar, will not be as large of a detractor on company earnings in 2016. Expectations for U.S. corporate earnings in 2016 are a mid-teens increase versus 2015. Important to note, strong earnings growth will be predicated on an improving or flat energy environment. We believe earnings growth expectations may be on the high side; however, the U.S. stock market should be able to produce reasonable returns this year with more moderate earnings growth.

We do not believe the long-running bull market is ready to die just yet. As legendary investor John Templeton noted, "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria." US equity markets seem a long way from euphoria, and much closer to skepticism. On a positive note, when the market return is flat (-3% to +3%) in any given year, the subsequent year's return tends to be strong. Going back to 1960, there have been six flat equity market years for the S&P 500 Index. The average return in the following year is nearly 19%, and in each case the subsequent year return was a positive double-digit one. We would clearly welcome that.

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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