# HCM Quarterly Report

Horan Capital Management

Jan 2017

## What's Inside



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*Your HCM Team can also provide you with up-to-date information about your holdings and discuss any changes in your personal financial situation.*


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# Market Review*

By Tim Hai, CFA®, CAIA

- Equity markets generally outperformed fixed-income markets with the S&P 500 climbing 3.82% (including dividends; +11.96% YTD) and the Barclay's Capital U.S. Aggregate Bond index increasing 2.98% (+2.65% YTD).
- Small caps outperformed large cap stocks (S&P 500) as the Russell 2000 small cap stock index returned +8.83% (+21.31% YTD).
- Value outperformed growth during the quarter and YTD (as determined by the S&P 1500 broad market index which includes large, mid, and small capitalization stocks).
- Non-U.S. markets generally underperformed U.S. equity markets in both local currency and US dollar terms (MSCI EAFE**: -0.68% in USD; +7.11% in local currency; +1.51% and +5.88% YTD, respectively).
- Emerging markets outperformed non-U.S. developed markets (MSCI EAFE**) but underperformed U.S. equity markets (in both local currency and USD) as the MSCI Emerging Markets Index fell 4.08% in USD and -1.36% in local currency (+11.60% and +10.11% YTD, respectively).
- Brazil (+2.20%; +66.75% YTD), Canada (+3.43%; +25.49% YTD), and Russia (+18.72%; +55.93% YTD) were notable based on their strong performance during the year. (All quoted in USD).
- Most U.S. market sectors were positive during the quarter. Energy (+7.28%; +27.36% YTD) and Financial (+21.10%; +22.80% YTD) stocks were most distinguishable given their strength. Health Care stocks were noticeably weak (-4.00% and -2.69% YTD).
- High yield bonds fell 0.19% during the quarter (+14.27% YTD). The U.S. corporate bond sector fell 3.11% during the quarter (+4.65% YTD). 10-Year U.S. Treasury yields climbed from 1.61% at the beginning of the quarter to 2.43% currently (2.28% at the beginning of the year).
- The U.S. dollar rose versus the British Pound (+4.88%; +16.16% YTD) and the Euro (+6.14%; +2.90% YTD) during the quarter and full year period. The Yen declined versus the U.S. dollar during the quarter (-15.18%) but rose against the U.S. dollar for the duration of the year (+3.04%).

* Unless otherwise noted, performances stated above reflect data provided by Standard and Poor's, Russell Investments, MSCI, and Barclay's Capital.

** The MSCI EAFE Index is a large capitalization, developed market benchmark that tracks non-U.S. or foreign equity markets.

Past performance is no guarantee of future results. Indexes are not available for direct investment.

# Market Commentary

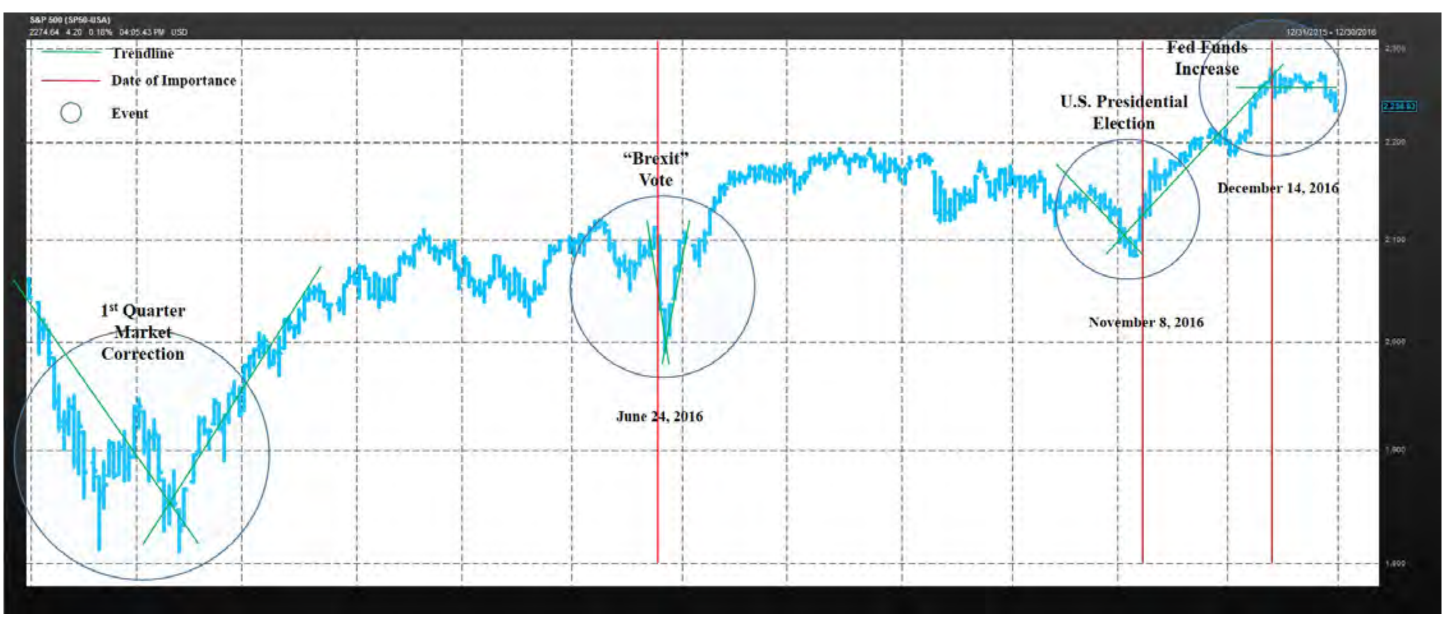
By Tim Hai, CFA®, CAIA

**Tim Hai, CFA®, CAIA**
*Portfolio Manager*

U.S. equity markets opened the final quarter of 2016 with a whimper, falling 3.67% in the days leading up to the Presidential election. And despite a weak opening the morning after (which saw equity market futures fall as much as 5%), U.S. equity markets (as represented by the S&P 500) rebounded strongly, climbing 8.40% off quarterly lows and through their December 14 peak. A strongly telegraphed increase in the Federal Funds rate (i.e. interest rates) by the U.S. Federal Reserve (the "Fed") could only slow down the advance as the S&P 500 would eventually return +3.82% for the quarter (+11.96% for the year) - capping eight straight years of annual performance gains.

The strong end to the year (off early November lows) offered a stark contrast to how the year began. Recall that U.S. equity markets experienced a strong contraction to open the year, falling over 10% and into "correction" territory. Equity markets were spooked by the Fed's December 2015 increase in interest rates (its first change since 2009 and its first increase since 2006) in addition to weakening economic data from China, and falling oil prices (U.S. oil prices fell below $30 per barrel in February 2016). The Fed would eventually assuage the stock market by walking back the potential for further interest rate increases later on in the year.

**2016 Market Chart**



# Market Commentary

**Continued**

Interest rate futures markets were pricing in up to four interest rate increases for 2016 up to that point. Interest rate increases are considered an impediment to economic growth and thus, unfavorable to stock markets (especially if implemented too quickly). U.S. equity markets would bounce back sharply soon after until the fading days of June, when the majority of British citizens voted for the country to exit from the European Union. Equity markets worldwide roiled from the potential repercussions but just as quickly rebounded in a matter of days. U.S. equity markets were generally stable for the remainder of the summer until the period preceding the U.S. Presidential election (see above).

What can we glean or learn from such an eventful year? For one, 2016 was a very volatile year. Our readers may recognize this lesson from past commentaries. We firmly believe that the stock market is volatile and inefficient over short periods of time. But then, volatility driven by exogenous factors outside of company fundamentals is precisely what creates the opportunities we seek as active investors. Even the best and highest quality companies can be affected by non-company specific noise in the short-term. However, the stock market is more efficient over the long-term, allowing company fundamentals to drive the stock prices of these great companies back to intrinsic value. One last lesson is that market timing is a very hard if not impossible endeavor to succeed at continually. One-time success is not easily replicable. The book-end periods of volatility in 2016 (mentioned above) offered only a few weeks of momentum in one direction or another – hardly enough time to perfectly “time” the market. The “Brexit” event was even more difficult to participate in having only lasted one week. More likely than not, market timing results in severe transaction costs, possible tax implications, opportunity costs, and in many cases, real and tangible losses (i.e. a permanent loss of capital).

At Horan Capital Management, we practice long-term, high-quality, value investing in which we have high confidence. We offer our clients strong financial planning that includes a long-term asset allocation suitable to the client’s unique risk/return requirement. We invest our clients’ portfolios in high quality companies that we believe will compound in value and benefit clients for years to come. And furthermore, we buy these companies’ stocks at a substantial discount to our calculations of their intrinsic values. More importantly, we focus less and worry less on/about volatility but seek to reduce the real threat to performance: a permanent loss of capital. We hope that everyone had a wonderful holiday season, and we wish everyone the best in the new year to come. As always, please contact us with any questions or concerns you may have. Stay warm!

**John G. Heinlein**
*Chief Executive Officer and*
*Chief Investment Officer*

*The following discussion mentions stocks that are widely — but not universally — held by clients of Horan Capital Management. Client portfolios are customized, so this commentary may or may not be directly applicable to any given client or account. Our intention is to provide general insight into portfolio holdings and into our overall approach and to highlight situations of interest, both positive and negative. The mention of any stock is neither advice nor a solicitation to buy or sell any particular investment and our opinions regarding securities are subject to change without notice. Investing involves risk of loss. See the legal disclosures at the end of this publication and on our website for more information.*

# Portfolio Activity

By John G. Heinlein

## NEW PURCHASES

### Allergan, Plc (AGN)

Allergan is a specialty pharmaceutical company that develops, manufactures, markets, and distributes medical aesthetics, biosimilar, and over-the-counter pharmaceutical products worldwide. Its product portfolio includes treatments for the central nervous system, gastroenterology, women's health and urology, and plastic surgery (among others). Allergan has a wide economic moat, which is a result of its strong product pipeline and brands (i.e. Botox). Ultimately, we believe that the company is undervalued due to long-term industry impairments and a failed Pfizer merger. That being said, we view Allergan as an opportunity to gain exposure to a high quality company that is priced below its true intrinsic business value.

### Cerner Corporation (CERN)

Cerner Corporation is a premium provider of healthcare IT services, offering value to hospitals and clinical centers through software, hardware, and other IT services. Its offerings are deeply integrated into the operations of almost one-third of all U.S. hospitals. This scale, combined with the high switching costs that stem from deep system integration, creates a very wide economic moat. The company's recent fall in share price does not deter us. Cerner generates strong free cash flow, high returns on capital, and enjoys a strong balance sheet while operating with zero net debt. As always, we view share price volatility as an opportunity, and we believe that we are purchasing shares of Cerner at a discount to the company's true intrinsic value – a discount that, as always, compensates us for any inherent risks.

## ADDITIONS

**(Unless otherwise noted, all positions listed in this section were added to selected accounts due to our belief that they had attractive valuations during the quarter.)**

### Apple, Inc. (AAPL)

Apple designs, develops, and distributes consumer electronics, online services, and computer software. Its products include the iPhone, Mac, iPad, Apple Watch, the iTunes Store, and the Mac personal computer. Its customers include consumers, small and mid-sized businesses, education customers, and enterprise and government customers worldwide.

### BorgWarner, Inc. (BWA)

BorgWarner develops, manufactures, and sells highly engineered automotive systems and components for automotive powertrain applications. Its products include: four-wheel and all-wheel drive transfer cases, clutches, torque converters, and manual and automatic transmissions.

# Portfolio Activity

**Continued**

**Fossil Group, Inc. (FOSL)**

Fossil Group is a premier designer, marketer, and distributor of watches. In addition to creating and selling watches under its own Fossil brand, it also does so under high-end licensed brands like Emporio Armani, Burberry, and DKNY.

**Polaris Industries, Inc. (PII)**

Polaris Industries manufactures and sells ATVs, snowmobiles, and motorcycles.

**Gilead Sciences, Inc. (GILD)**

Gilead Sciences, Inc. is a biopharmaceutical (bio-tech) company that discovers, develops, and commercializes medicines in areas of unmet medical needs in North America, South America, Europe, and the Asia-Pacific. The company's main products offer treatment for HIV and Hepatitis-C.

## POSITIONS ELIMINATED

**(Unless otherwise noted, all positions listed in this section were sold in selected non-taxable accounts as we believe they reached full valuation during the quarter and proceeds were used to fund other portfolio purchases.)**

**C.H. Robinson Worldwide (CHRW)**

C.H. Robinson Worldwide is a non-asset based third party logistics provider mostly focused on domestic truck brokerage.

**Fastenal (FAST)**

Fastenal is an industrial supply company that distributes several types of industrial equipment. Its offerings include fasteners, plumbing, electrical and welding equipment, inventory management, and tool repair (among others).

**Express Scripts Holding Co. (ESRX)**

Express Scripts is the largest pharmaceutical benefit manager (PBM) in North America. As a PBM, it acts as a liaison between drug companies, pharmacies, and insurance companies – negotiating rebates for insurance companies, driving down costs for pharmacies, and granting exposure to drug companies. Shares of Express Scripts were sold after reassessment of the company's business model in light of heightened regulatory scrutiny and greater political risk surrounding industry drug pricing practices.

# Portfolio Activity

**Continued**

## REDUCTIONS OF EXISTING POSITIONS

**(Unless otherwise noted, all positions listed in this section were trimmed in selected accounts based on price performance and an over-weighted position during the quarter.)**

**Alphabet, Inc. (GOOG)**

Alphabet is a multinational conglomerate and the parent company of Google, which generates more than 99% of its revenues. Other subsidiaries include Calico, GV, Google Capital, Verify, and X.

**Bank of America (BAC)**

Bank of America is the largest consumer and commerical bank in the US. It offers a wide range of financial services including credit cards, asset management, mortgage banking, retail banking, commercial banking, securities trading, and investment banking.

**Berkshire Hathaway (BRK/B)**

Berkshire Hathaway is a holding company primarily focused on property and casualty insurance. Other business activities range from electric utilities, railroads, building products, and newspapers to ice cream and candy manufacturing.

**Coach (COH)**

Coach markets handbags and accessories for men and women. It sells its merchandise through Coach Stores, factory outlets, department and specialty stores, duty free locations (airports), and ecommerce. Coach markets its products as “affordable luxury.” Its strategy is to target higher and upper-middle income shoppers. This differentiates Coach from its luxury merchandise competitors, who focus on the very wealthy. We sold shares of Coach in select accounts for tax purposes.

**Cummins, Inc. (CMI)**

Cummins designs, manufactures, sells, and services diesel and natural gas engines, electric power generation systems, and engine-related component products.

**Fossil Group, Inc. (FOSL)**

Fossil Group is a premier designer, marketer, and distributor of watches. In addition to creating and selling watches under its own Fossil brand, it also does so under high-end licensed brands like Emporio Armani, Burberry, and DKNY. We sold shares of Fossil in select accounts for tax purposes.

**International Business Machines Corp. (IBM)**

IBM is one of the largest IT companies in the world, with an array of offerings in hardware, software, and services. The firm has operations in more than 170 countries and generates about 65% of revenue internationally. We sold shares of IBM in select accounts for tax purposes.

**U.S. Bancorp (USB)**

U.S. Bancorp is the seventh largest bank, by assets, in the United States. It generates a substantial portion of its revenue through asset management and custody.

**Visa (V)**

Visa is the largest retail electronic payments network in the world. It provides processing services and payment product platforms that include credit, debit, and prepaid cards.

# HCM Privacy Policy

We hold all personal information provided to our firm in the strictest confidence. This includes all personal information that we collect from you in connection with any of the services provided by HCM, including—but not limited to—asset management, tax preparation and planning, and any financial planning services.

We do not disclose information to nonaffiliated third parties, except as permitted by law, and we do not anticipate doing so in the future. If we were to anticipate such a change in firm policy, we would be prohibited under the law from doing so without advising you first.

As you know, we may use health and financial information that you provide to us to help you meet your personal financial goals while guarding against any real or perceived infringements of your rights of privacy.

We limit employee and agent access to information only to those who have a business or professional reason for knowing, and only to nonaffiliated parties as permitted by law. (For example, federal regulations permit us to share a limited amount of information about you with a brokerage firm in order to execute securities transactions on your behalf, or so that our firm can discuss your financial situation with your accountant or lawyer.)

Additionally, brokerage firm custodians have their own client privacy policies, which they administer separately from HCM.

We maintain a secure office, filing system, and computer network to ensure that your information is not placed at unreasonable risk.

The categories of nonpublic personal information that we collect from each client depend on the scope of the client's engagement. These include information about your personal finances, health (to the extent that it is needed for the planning process), and transactions between you and third parties, and it may include information from consumer reporting agencies.

For unaffiliated third parties that require access to your personal information (including financial service companies, consultants, and auditors) we also require strict confidentiality in our agreements with them, mandating that they also keep your personal information private.

We do not release any personal information to third-party providers unless the client specifically authorizes us to do so.

Personally identifiable information about you will be maintained during the time you are a client and for the time thereafter that such records are mandated to be maintained by federal and state securities laws and also consistent with the CFP Code of Ethics and Professional Responsibility. After this required period of record retention, all such information will be destroyed.

Federal and state regulators also may review firm records as permitted under law.

Should you have any questions, comments, or concerns you may contact John Heinlein, CEO at: 20 Wight Avenue, Suite 155, Hunt Valley, MD 21030; 410-494-4387 or 800-592-7534.

We take your right to privacy seriously and will do all that we can to ensure it. As always, we appreciate your trust and confidence and the opportunity to provide you with our services.

**Annual ADV Notice** All investment advisors are required by the Securities and Exchange (SEC) to register and file information regarding their business. The resulting documents, which includes ADV Part 2, detail important information about the services we offer, our fee schedule, employee biographies and other various disclosures. All clients receive these documents when they first sign up with HCM for investment management services, but the information contained in the documents may have been changed since you received your copy. Please contact us if you would like to receive the most up-to-date version and we will immediately send you a copy via email or USPS.

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