Investment Commentary
June 30, 2013

The 18th at Merion Golf Club

I had the opportunity to attend a practice round for the US Open at Merion Golf Club this year. It was interesting watching the pros as they studied the fairways and greens in preparation for the tournament. They played solo or in small groups, and spent a lot of time surveying the greens and testing various pin placements. Some of them even had a small level that they used to measure the break of the greens at various spots.

I also learned about a piece of US Open golf history on the 18th fairway at Merion. It is the spot, marked by a brass plaque today, where Ben Hogan used a 1 iron to reach the green 218 yards away in the final round of the 1950 Open Championship. That shot enabled him to record a par on the hole, forcing a playoff which he ultimately won. But today's pro golfers employ advanced club and golf ball technology, along with better training and conditioning, to reach the green from that same spot with a four iron.

The investment markets also seem to be dominated by new technology these days. It started with electronic order routing and decimalization, and progressed to high speed automatic trading algorithms using co-located servers and intelligent networks to support high frequency trading strategies designed to exploit minute differences in security prices. That technology extends to hedge funds using expert networks to gain an information edge so they can take concentrated positions with high leverage to amplify returns.

The Fed has contributed to this type of short-term investing by pushing interest rates to historical lows with its zero interest rate policy (ZIRP), the outright purchase of US Treasury securities, and then the outright purchase of mortgage-backed securities. These policies have generated a flow of liquidity that ultimately found its way to risk assets, especially stocks.

The combination of high frequency trading, hedge fund investment strategies, and Fed policies have created an odd circular valuation process in the market. The historically low interest rates and liquidity injections meant to stimulate economic growth have achieved only marginal results as the rebound in GDP and employment have been anemic compared to the other post-war recoveries. Corporate earnings however, have been growing, helped by reduced financing costs, a focus on expense containment, higher productivity and less hiring. As a result, the stock market has been rising while earnings valuation measures remain moderate. The pressures on earnings valuations probably reflect investor concerns about the over reliance of economic growth and corporate earnings on low interest rates and Fed liquidity.

Those concerns were clearly evident when Ben Bernanke began to talk about "tapering" the Fed's liquidity injections. The reaction was swift in both the stock and bond markets and the Fed chairman was forced to quickly reassure the markets that the accommodative policies of the Fed would remain in place. Bernanke's comments temporarily settled market jitters, but investors remain concerned about the ability of the economy to generate self-sustaining growth, and market vulnerability to potential changes in Fed policy.

It is interesting to note that the scores this year at Merion were not that much different from the scores in Ben Hogan's day. The latest in technology is helpful, but it ultimately comes down to executing the fundamentals of the shot correctly. We believe that approach is still the case in successful investing today. High speed execution and proprietary information access might help generate short-term returns, but a coherent strategy based on company fundamentals and attractive valuations will be successful over the long-term market cycles.

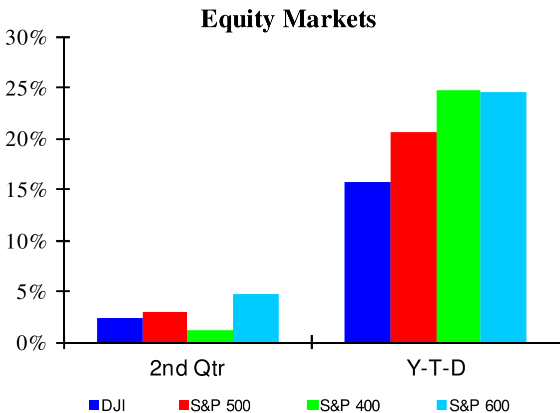
Recent market action after Mr. Bernanke's comments certainly seems to underscore just how much market participants have shifted away from company fundamentals. While we recognize that Fed policy wields great influence, we believe that over the long-term well managed companies will adapt to the complete mix of economic and policy factors to chart a course with the best chance of success. We will continue to search for companies that generate long-term revenue and earnings growth, possess solid balance sheets, and produce significant cash flow. That cash flow can then be reinvested in the business, used to pay dividends or buy back stock, and/or finance new opportunities through strategic acquisitions. Our investment strategy is designed to identify companies with those characteristics and invest when their share price is attractive relative to their near-term and longer-term potential. It is our belief, a belief that has been supported by results over two difficult market cycles, that this approach will continue to be successful.

Sincerely,
Daniel A. Morris

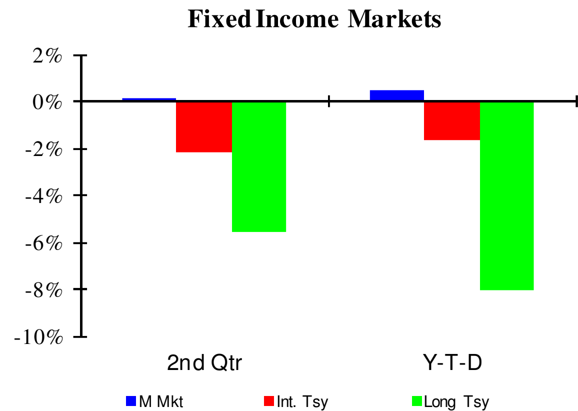
Market summaries on reverse page

Morris Capital Advisors, LLC

Market Summary
June 30, 2013



Stock market action during the quarter was determined almost entirely by investor concerns over the near-term course of monetary policy. Policymaker comments early in the quarter focused on the possibility of reducing liquidity provisioning earlier than expected, but following adverse market reaction the tone of the Fed became more soothing. However, investors remain concerned about the ability of the economy to generate self-sustaining growth and market vulnerability to potential changes in Fed policy. Stock market indices fell swiftly from all-time highs established in mid-May, but still managed to generate low single-digit returns for the quarter. Investment vehicles that sport high current income tended to do the worst, while more growth oriented sectors tended to outperform.



Treasury securities across the yield curve experienced significant price weakness during the quarter. Chairman Bernanke's commentary after the most recent meeting of the Federal Open Market Committee suggested to investors that a reduction in the amount of outright purchases of Treasury Securities could happen sooner than most observers expected. Market participants have very little visibility on how well, or poorly, the central bank will manage the transition to a less expansive monetary policy, and were inclined to expect the worst. As a result, yields rose substantially, and longer duration fixed income instruments performed quite poorly.