Morris Capital Advisors, LLC

Investment Commentary
June 30, 2017

Innovation and Adaptation

In the early 60's a young student at Yale University wrote a paper for his economics class on a new concept for a delivery service. Legend has it that he barely earned a C for the paper (much like another famous Yale University graduate) from a dismissive professor who told him that the idea wasn't feasible. The young man was Frederick Smith, and the paper became the basis for the company he founded, Federal Express. His company transformed the mail and package shipping industry, using overnight delivery to create a multi-billion dollar company and turning FedEx into a highly respected global brand.

There are several lessons from the experience of Fred Smith and his company that may be instructive for our economy and the financial markets today. His business idea was truly innovative, targeting a low-tech industry with entrenched participants. He took tremendous risks in the early years and went to great lengths to keep the company afloat. His focus on long-term goals ultimately created millions of jobs, but also created many winners and losers among those who tried to emulate him or those who resisted.

We can see the similar innovators in our economy today as companies like Apple, Amazon, Facebook, and Uber transformed industries and created global brands and businesses. It is interesting to note that this "second wave" of innovation has really been an adaptation of the technology infrastructure created during the first wave of innovation in the late 1990's. It has taken much more than a decade, and there have been more than a few winners and losers along the way, but it is clear that major economic sectors are changing.

Some have argued that the Fed has been an innovator over the past decade. Coordinated interest rate policy that pushed short term rates to zero, and the outright purchase of government securities (quantitative easing) are examples of policy innovations. Those innovations have been extended as the Fed expanded its purchases to mortgage backed securities, as well. The financial markets and investors have been forced to adapt to this new role of Fed policy.

Innovation has occurred in the financial markets, as well. High frequency computer driven trading algorithms ignore valuation metrics, ultra low cost electronic trading encourage more trading, and a plethora of ETF and index offerings mask risk and diversification concerns. As the markets push to new highs it is difficult to determine if the adaptation of these innovations is truly transformative, or if they will disrupt the ability of investors to make sound long-term decisions.

As the financial markets adapt to these innovations it has become more difficult to reconcile traditional valuation measures to their historical norms. Companies mentioned above, and many others like them, have disrupted those metrics replacing plant and equipment assets with intellectual property and outsourced manufacturing, and traditional debt-based financing with venture capital and private equity. The process is further complicated as pro-forma earnings and cash flow have replaced reports based on generally accepted accounting principles.

While the recent push to new highs in the markets has led to elevated valuation measures, it has also prompted concerns about the anemic growth in the economy and the lack of growth in middle class incomes. Innovations in technology and artificial intelligence are making it easier to replace some higher skilled workers without a major loss of productivity, constraining income growth despite a tight labor market. Employers will have a greater incentive to accelerate the adaptation of these technologies as well-meaning but miss-guided policy efforts increase the cost of labor above its productive value. If this trend persists we may continue to experience anemic growth in both the economy and middle class incomes accompanied by elevated market valuations.

Over the past several months we have begun to observe a shift in the drivers of market performance. Initial interest rate hikes by the Fed, and the discussion of steps to reduce the Fed balance sheet, have been a reminder that Fed liquidity driven support for the financial markets is starting to unwind. As a result, investors have begun to focus on more of the fundamental, company specific factors that drive our investment process. We believe that trend will continue and think that this is an excellent opportunity to invest in those innovative companies that are priced attractively relative to those fundamental factors.

Sincerely,
Daniel A. Morris

Market summaries on reverse page

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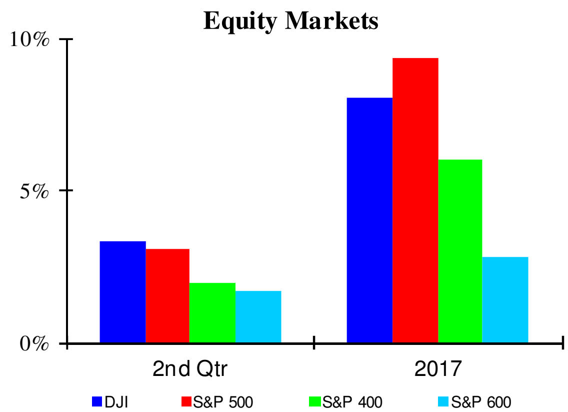
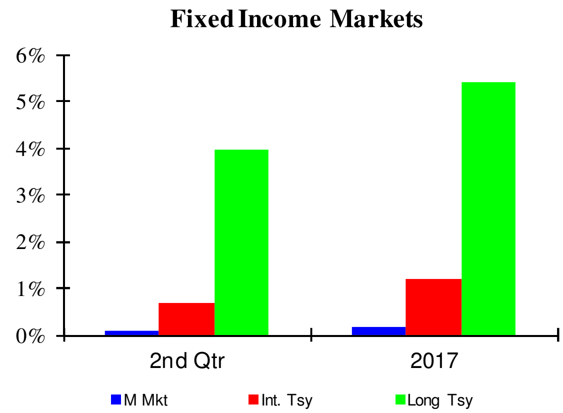
Market Summary
June 30, 2017



In the 2nd quarter of 2017 the stock markets continued to move higher despite some troubling signs. The equity markets seemed to look past general dysfunction in Washington, stalled tax reform and healthcare reform, and indications that the Federal Reserve is on the verge of reducing the enormous flow of liquidity that has done so much to support markets over the past eight years. Perhaps these potential negatives here at home were offset when the European central bank surprised markets by indicating that it too would soon follow suit on reducing the quantity of stimulus, leading to a significant strengthening of the Euro versus the dollar. The currency adjustment should improve earnings prospects for US companies with significant overseas revenue sources. The weakening dollar, declining long-term interest rates, and slow but steady growth translated into a steady upward trend in stock market indices. Growth stocks outperformed value stocks, and large cap issues outpaced their smaller brethren.



Yields on longer-term treasury securities declined modestly in the quarter, while shorter term rates held steady. The Federal Reserve spent much of the quarter attempting to communicate its intention to raise short-term rates and unwind its massive balance sheet. To make a long story short, investors seemed to conclude that the Fed is likely to raise short-term interest rates by less than previously feared, and that the liquidation of the Fed balance sheet will be very slow and measured, with priority given to minimizing market disruption. Given the relatively placid backdrop of subdued inflation and anemic economic growth, the yield curve flattened a bit.