Morris Capital Advisors, LLC

Investment Commentary
December 31, 2020

Damn the Torpedoes . . .

I'm sure that all of you can finish that headline above. It is probably the most famous quote in US naval history, attributed to Rear Admiral David Farragut during the Battle of Mobile Bay. Farragut was in command of a naval force comprised of eight heavily armed sloops, six gunboats, and four monitors on the morning of August 4, 1864, with the objective to capture the fort that protected Mobile. He climbed to the top of the mast of his flagship to view the battle and issue orders. As the battle began, a leading monitor struck a mine (torpedo) and quickly sank. As the other ships hesitated Farragut gave his famous order, which ultimately led to victory.

Like Farragut's fleet, investors today are sailing into dangerous investment waters, despite the risks that they know are there, with the belief that they will be rewarded with ever-greater returns. And why wouldn't they? Stocks ended the year 2020 up more than 17%, as measured by the S&P 500 index, after that same index rose more than 31% in 2019. It was an impressive performance. The move was fueled by massive government stimulus measures that flooded the financial markets with liquidity while the Fed indicated that they expected to keep interest rates close to zero while injecting $120 billion a month into the markets. New investors flocked to "free" online trading sites like Robinhood, while David Portnoy, internet blogger and founder of Barstool Sports, enticed the fledgling investors to play the stock market, popularizing the acronym "TINA", There Is No Alternative (to equities).

In their exuberance, these investors may be underestimating the dangers that lurk below the surface. By the 3rd Quarter of 2020, Federal debt held by the public hit $21 trillion, 25% higher than the year before. The Fed balance sheet rose to $7.3 trillion, a shocking 78% increase over the prior year. Total Federal debt at $27 trillion represents 108% of GDP, a level that many economists believe will negatively impact economic growth. Central banks around the world pushed real yields (yields minus inflation) into negative territory, as real yields in the US Treasury market fell to -1%, while real yields in Germany and the UK declined to –1.5% and –3.0%, respectively.

In addition to rising debt levels and negative real yields, the stock market faces three notable challenges; concentration risk, extended valuations, and optimistic industry expectations. By the end of 2020 the five largest stocks comprised 25% of the S&P 500 index. Those five stocks (Facebook, Apple, Amazon, Microsoft, and Google) rose more than 47% during 2020 while the remaining 495 stocks rose just 6%. Valuations, as measured by the PE ratio (stock price divided by earnings) are at extended levels. The trailing 12 month PE ratio of the S&P 500 index was 40 at year-end (compared to an average of 17), while the PE based on earnings averaged over ten years was 34, compared to an average of 17. Finally, market commentary at year-end seems overwhelmingly positive. The consensus is that widespread Covid vaccination will eliminate the virus risk, lead to a rapid reopening of the economy, a strong economic rebound, higher spending, higher employment and higher corporate earnings. That scenario, however, leaves little room for error.

I am always concerned when market analysis is uniform and pervasive. If investors uncritically embrace that "group think" the risk is that anything unexpected could trigger a market correction. The concentration of mega-cap names has been known for some time, but the elevated valuation measures concern me. It is true that the market can be overvalued for extended periods, but it will return to more normal levels by a market (price) correction or significant earnings growth. Based on a reading of year-end commentary it seems that most analysts are counting on a strong rebound in economic activity and rising earnings. If that rebound does not materialize these extended valuations will be corrected by a market decline. The new Biden administration has already embraced another massive stimulus package, so we will see more of the deficit spending and Fed bond buying that the market has come to enjoy so much. But investors may be overlooking the fact that the Democratic administration will substantially increase regulatory burdens, and increase taxes, both of which will negatively impact the economic rebound.

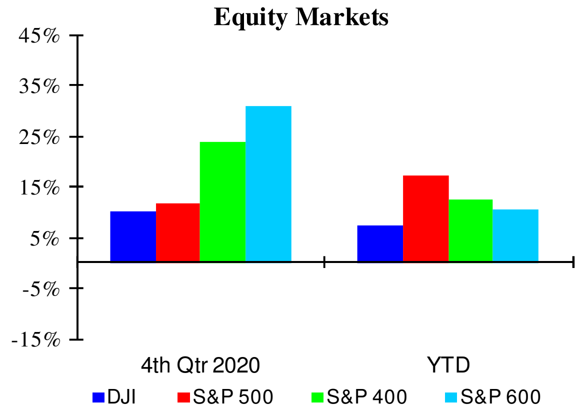
We certainly cannot predict what the market might do, so we need to push ahead while taking careful consideration of the risks we face. We will continue to invest with a diversified portfolio of companies with valuation metrics that are attractive relative to the market. We may not be Farragut's "Full Speed Ahead", but we believe that this careful approach provides the opportunity for long-term success.

Sincerely,
Daniel A. Morris

Market summaries on reverse page

Morris Capital Advisors, LLC

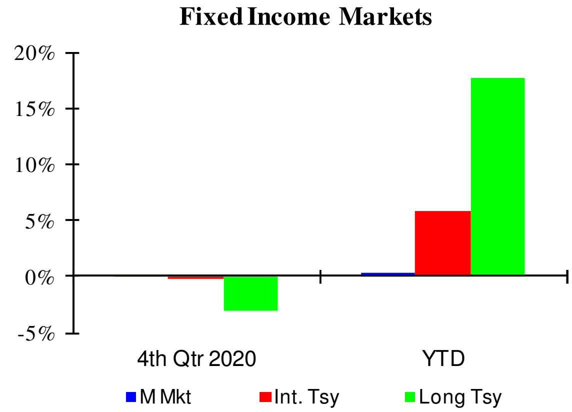
Market Summary
December 31, 2020



The equity markets began 2020's fourth quarter locked in the same volatile trading range that dominated the month of September. Investors were increasingly concerned that rising COVID-19 infection rates and the reimposition of government shutdowns would threaten the economic recovery and damage near-term earnings prospects. Meanwhile, as election season began in earnest, D.C. lawmakers failed to make much progress on another round of economic stimulus.

Beginning in early November, the markets traded sharply higher on news of surprisingly strong efficacy results from COVID vaccine trials. As the quarter went on, news of expedited FDA approval of two vaccines served to reinforce momentum, as did expectations of a bipartisan compromise on a new round of Federal stimulus.

The renewed upswing in stock markets was driven by increased investor certainty that the economic recovery would gain momentum during the course of 2021. Economically sensitive stocks outperformed growth issues, and small cap securities sharply outperformed large cap stocks. Most market indices posted very healthy double digit returns for the quarter.



Bond yields in the US Treasury markets trended higher throughout 2020's fourth quarter. Very positive news on COVID vaccine efficacy boosted investor confidence that any negative impact of rising infection rates on economic growth would likely be short-lived. The benchmark 10-year Treasury bond yield flirted with the 1% level for the first time since the market dislocations of mid-March 2020. Rising yields put pressure on the prices of fixed income securities, resulting in modest negative total returns across the yield curve.

Nevertheless, yields closed the 2020 at levels far lower than prevailed at end-of-year 2019, generating total returns for longer-dated bonds that were competitive with equity markets.