Morris Capital Advisors, LLC

Investment Commentary
December 31, 2022

The News of My Death Has Been Greatly Exaggerated

The quote above has been attributed to Samuel Clemens (more commonly known by his pen name, Mark Twain), when contacted by an English journalist to inquire whether the rumors that he was gravely ill, or dead, were indeed true. Clemens was in good health and wrote back to the journalist using a version of the quote we know so well today. While the quote above may not have been his exact response, it is a good one, nonetheless.

This comes to mind lately as I have been reading the commentary by financial journalists regarding the market action over the past year, specifically in regard to what is referred to as the 60/40 portfolio. The 60/40 portfolio is an investment allocation model investing 60% of the total portfolio in stocks, and 40% of the portfolio in bonds and cash. It is popular among investors and financial advisers because that investment allocation has generated the best return relative to risk over numerous market cycles. The relationship has generally been the case for almost seven decades, until this past year. Through the first nine months of the year, stocks (as measured by the S&P 500 index) were down approximately 23%, while bonds (as measured by the Bloomberg Barclay Intermediate Treasury index) were down approximately 12%. Both asset classes turned higher during the final quarter, but not enough to significantly change the relationship. The results were enough to prompt articles on “the death of the 60/40 portfolio”. But, to paraphrase Clemens, the stories of the demise of the 60/40 portfolio might be greatly exaggerated. I don’t think that a portfolio allocation with seven decades of history should be tossed aside because of one bad year. This also highlights the mistaken tendency to project short term investment results as a guide to long-term decisions. Every investment disclosure reminds us of that fact, but it is frequently forgotten.

Calendar year 2022 was a difficult year for equity and fixed-income investors. The financial markets were primed for a reversal after years of strong performance driven by highly accommodative Fed policy, unprecedented spending bills passed by Congress financed by ever-increasing debt, and a willingness by investors to ignore unreasonable valuations when investing in “innovative” companies or “meme” stocks. Things began to change as inflation pushed higher. When the Fed belatedly admitted that the inflationary spiral was not “transitory”, they were forced to aggressively reverse years of easy money policy. Successive rounds of interest rate hikes pummeled the bond market, resulting in one of the worst calendar year performance for bonds in modern financial history. Stocks declined, at one point crossing into bear market territory (a decline of more than 20%). Many of the mega-tech names led the move lower, suffering from unsustainable growth expectations and extended valuations.

A rebound in both the stock and bond markets during the 4th quarter of the year is a good reminder, however, that every market correction eventually ends, and that there are investment opportunities even amid the downturn. The rebound in stocks rewarded investors that were focused on high quality companies trading at moderate valuations. Economically-sensitive stocks generally outperformed with strength in energy, financial, industrial, and materials sectors. All somewhat counter-intuitive in the face of rising interest rates and recessionary concerns. The bond market rebounded, as well, as yields stabilized at higher levels and credit-sensitive bonds rallied. The markets may be gravely ill, but rumors of their demise might indeed be greatly exaggerated.

As I wrote last quarter, it is hard to feel good in the face of high inflation, rising interest rates, aggressive tightening by the Fed, and conflicting economic policy out of Washington; and it is not surprising that many people feel that our country is heading in the wrong direction. But the financial markets are forward looking, and the 4th quarter rebound could be an indication that the Fed may soon begin to slow the pace of interest rate hikes. There is still much to be done to lower inflation, and the news of substantial layoffs among numerous high-growth companies is a reminder that the risk of a prolonged recession remains real. The Fed will need to tread carefully as it manages the inherent conflict between fighting inflation and supporting the economy. If the Fed raises rates too high as it fights inflation it risks pushing an already weakened economy further into recession. Conversely, if it slows the rate hikes too soon inflation could remain elevated and economic growth could stagnate. The combination of persistent inflation and slow growth, a phenomenon known as stagflation, presents a difficult dilemma for investors and policy makers. High inflation will force interest rates higher as bond investors focus on real rates of return (yields less the rate of inflation), while stocks will struggle as higher interest rates raise costs and weak growth pressures earnings.

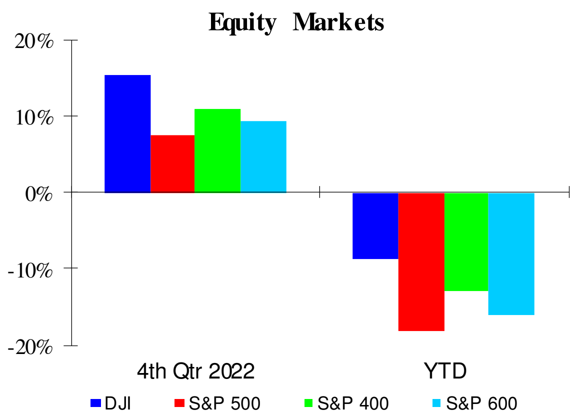
Given the uncertainty, it is not surprising that investors are overly sensitive to events in the financial news cycle. That uncertainty translates into a tendency to over-react on both the upside and downside, leading to sharp reversals in the market, sometimes on an intra-day basis. We recognize the risks of over-trading in this volatile market and believe that it is prudent to look past the market noise and focus on our long-term view. We take a conservative approach in our search for well-managed companies with the potential to grow, a sound financial structure to support that growth, and strong free-cash flow. Our objective is to invest in those types of companies when their share price gives us the opportunity to invest at reasonable valuations. Our investment process is designed to build portfolios that can withstand the bouts of uncertainty, while remaining positioned to participate in the rebounds that inevitably occur. This process has served us well over several market cycles reinforcing the view that the death of conservative investing has been greatly exaggerated.

Sincerely,
Daniel A. Morris

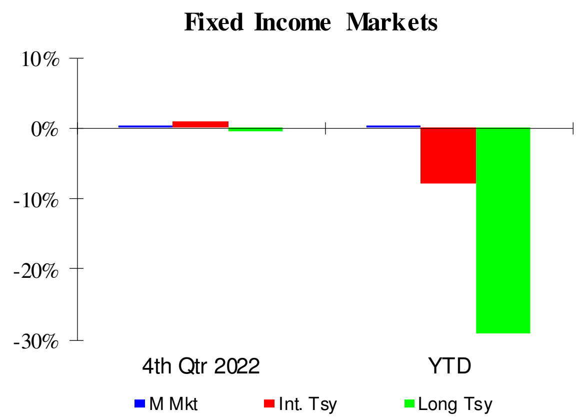
Market summaries on reverse page

Morris Capital Advisors, LLC

Market Summary
December 31, 2022



The stock market rebounded during the 4th quarter of 2022 led by economically sensitive stocks in the energy, financial, industrial, and materials sectors. The relative outperformance of these sectors is somewhat counter-intuitive in the face of rising interest rates and recessionary concerns. Investors balanced ongoing caution from the Federal Reserve with indications that the pace of policy tightening could slow, and signs that the elevated rate of inflation could begin to decline. Large-cap stocks underperformed small-cap name, primarily due to weakness in the mega-cap names that had led the stock market prior to the recent decline. As a result, value stocks outperformed growth stocks with much of the under performance in the tech sector. Value stocks were also helped by more attractive valuations and exposure to business sectors that less sensitive to cyclical fluctuations.



The bond market rebounded during the 4th quarter of 2022. Yields on government bonds edged up slightly during the quarter, causing a decline in bond prices, but the price decline was cushioned by the increasing income from the move higher in yields earlier in the year. The Fed pared back their final rate hike of the year to 50 basis points (bps) after four consecutive hikes of 75 bps. The rate hike was accompanied by a softer tone in the rate announcement which bolstered investor belief that the Fed could continue to pare the rate of interest rate hikes. Credit spreads tightened reflecting investor belief that more moderate rate increases could reduce the likelihood of a deepening recession. The tightening of credit spreads contributed to better returns among high-yields names as compared to government bonds.