Morris Capital Advisors, LLC

Investment Commentary
December 31, 2013

Climbing to the Top

During the Christmas week we were able to travel to Phoenix, Arizona as a family to visit my daughter Elizabeth and her husband Darren. Since Liz and Darren were at work for several of the days, Anne, Kathryn and I spent some time hiking through the mountain preserves that surround the city. The terrain is rocky and desolate, with hardscrabble vegetation, making the hiking somewhat difficult, despite the moderate weather. I can't imagine what it must have been like for early settlers traversing that terrain without the luxury of bottled water and sturdy hiking boots. Our reward, however, was reaching the top of those climbs and seeing the expanse of the Phoenix area stretched out to the surrounding mountains.

Just a few years ago, the financial markets seemed to be struggling with the market equivalent of some desolate terrain. The cumulative effect of aggressive borrowing, lax lending standards, opaque structured securities, and leveraged financial institutions contributed to a credit bubble that affected the entire global financial marketplace when it burst. It took several years for the financial bailouts and unprecedented Fed liquidity injections to help get the markets surpass the levels of 2007, and after 30+% returns of this past year, it must feel as if we have climbed back to the top of that mountain.

But, as is so often the case, the extreme measures that have brought us to this point bring with them a cost that may not be readily apparent. The tremendous expansion of the Fed balance sheet has created a financial commitment that may take years to unwind. The Fed used its ability to create money to fund its liquidity injections, and at some point this will need to be reversed. The Fed already started to "taper" its security purchases, but that is only the beginning of the process necessary unwind its portfolio. If the Fed's actions over the past several years helped the financial system, then the reversal of those policies should, by definition, have the opposite effect.

The impressive run in the stock market was also fueled somewhat by a collapse in the cost of borrowing as a result of low interest rates and continued demand for bond investments. These lower costs, and ready financing, helped companies lower the cost of capital used to finance dividend hikes and stock buybacks. That lower cost of capital has also enabled companies to focus on productivity enhancing investments, rather than raising hiring. This tendency to focus on inexpensive capital rather than labor has been compounded further by the relatively higher costs for labor as a result of looming regulatory and health-care requirements.

As the year came to an end we started to see some improvement in aggregate economic activity. Weekly unemployment claims moderated, some of the surveys measuring management expectations for business and employment also improved, and revisions to GDP growth for the previous quarter were positive. Corporate earnings announcements during the quarter also seemed to include fewer reductions in forward guidance. Some of these "forward looking" measures have raised expectations for continued economic improvement, but it is too early to know if the rebound will create the self-sustaining economic momentum needed to enable a return to more "normal" economic policies.

For many investors the return of the stock market to new highs is an exhilarating experience. Investor sentiment has improved as the markets rose and the value of 401(k) accounts rebounded, but it is important to remember how difficult the journey has been and that the recovery from excesses of just a few years ago is not complete. The "Great Recession" has been followed by a "Rocky Recovery" in the economy that may not be fully discounted by the market. If the recovery continues to be uncertain future market returns could be much more moderate.

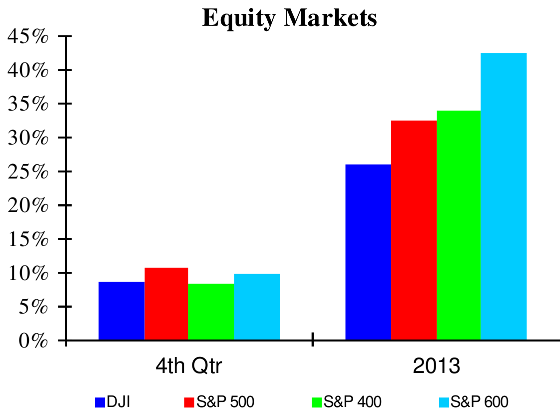
As we look forward to the coming year we remain focused on the process that has guided us successfully through both good and bad times over the better part of two decades. We believe that successful companies are managed in accordance with some basic business principles. These include a focus on growing top line revenue by developing new products or services, and expanding existing markets, the generation of strong earnings growth by optimizing operating margins and controlling expenses, and the conversion of earnings into solid cash flow by the prudent use of capital resources. We also believe that successful companies build their operations on solid balance sheets that focus on high-quality assets and avoid the accumulation of excessive debt. As we approach this coming year we will continue to be guided by our investment process that is designed to help us identify companies trading at attractive valuations relative to these income and balance sheet characteristics. While we are certainly enjoying our view from the top, we refuse to become complacent because we know that the trail could turn rocky and difficult at any time.

Sincerely,
Daniel A. Morris

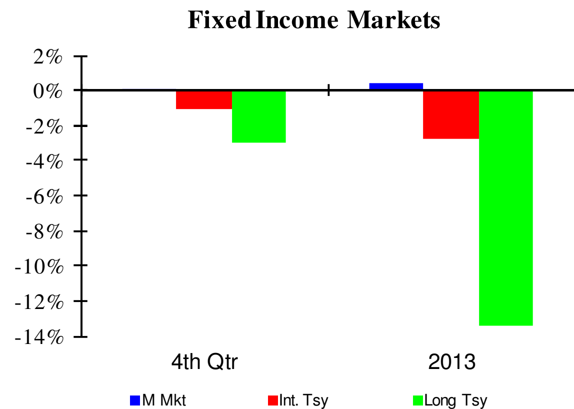
Market summaries on reverse page

Morris Capital Advisors, LLC

Market Summary
December 31, 2013



Equity markets enjoyed a solid uptrend throughout the quarter. Investors took encouragement from a number of developments. Most importantly, officials at the Federal Reserve took great pains to reassure investors that their efforts to gradually taper their policy of massive liquidity injections would be carefully monitored to ensure minimal economic and market disruption. In addition, Congress managed to avoid brinksmanship and enacted budget resolutions that seemed to ease slightly the negative drag on the economy. Private sector activity continued in a slow growth mode. These developments all conspired to allow investors to bid up equity valuations, especially for more economically sensitive names.



Treasury prices were weak again during the quarter, following a brief period of respite as Fed officials recalibrated their messaging regarding the timing of their efforts to begin tapering liquidity injections. As the quarter progressed, various central bankers made clear that economic indicators supported initiating the taper before year-end. As a result, yields on longer maturity paper ended the year at their highest levels since the middle of 2011.
However, policymakers extended their commitment to keep short-term rates at very low levels, resulting in a pronounced steepening of the yield curve.