Investment Commentary
December 31, 2016

(Bad)Behavioral Finance

I have been reading the new book by Michael Lewis, "The Undoing Project". It's not his usual page turner, but it may provide some useful perspectives on the markets. The book is based on Daniel Kahneman and Amos Tversky and their studies of human decision making. They observed that people often do not make logical decisions, particularly under stress. Some of the factors that their research identified as distorting the logical decision process include risk aversion, non-linear probability weighting, and the influence of cognitive vs. social biases.

One of the most prevalent and widely acknowledged of these concepts is risk aversion. According to Kahneman and Tversky, the negative impact of a loss is 2.25 times more powerful than the positive impact of an equivalent gain. Investors in the stock market often allow their concern about short-term losses to override the knowledge that stocks generally outperform all other asset classes over longer periods. Investor risk aversion is clearly evident when I am asked if stocks are overvalued and ready for a fall. I have fielded this question with increasing regularity because investors are concerned that an external event could cause valuations to collapse, triggering a market crash. While relative valuation levels are subject to wide interpretation, and it is almost impossible to ascertain the potential impact of an external factor on valuations, the lack of certainty reinforces investor risk aversion.

The researchers also found that non-linear probability weighting is also a powerful influence on decision making. Non-linear probability causes people to over-weight small probabilities and under-weight large probabilities. When a person buys a lottery ticket, for example, they overweight the very small probability of winning a lot of money while underweighting the very high probability that they are wasting their money. Likewise, investors often overweight the possibility that they could lose all their money in a particular investment, often sacrificing attractive returns.

While both of these factors are important, their influence is magnified by cognitive and social biases. Cognitive bias works on an individual level when an investor decides not to invest in a particular stock because they have a negative image of a company or a bad experience with one of its products. While cognitive bias is very powerful on an individual level, it has only a minor influence on markets as a whole because the sum total of investor's positive and negative cognitive biases tend to average out. Social bias is the result of news, analysis, or media influence on investor perceptions, and can create a "herd instinct" when it leverages cognitive bias in a positive or negative direction. In the financial markets, this social bias can create its own momentum, generating a feedback loop that can drive markets further from a "fair price" valuation.

Over the past year I sense that social bias has become much more influential. Media attention has focused on the negative impact of geopolitical events around the world. This drumbeat of negative experts heightens risk aversion and the tendency of investors to overweight the impact of an election or policy change. As social bias overwhelms rational decision making it becomes a recipe for bad behavioral finance.

Kahneman and Tversky observed that risk aversion, non-linear probability, and cognitive or social biases tend to distort the logical decision making process to a greater degree during periods of stress. And if there is one thing that we can all agree upon, it is that stress levels are elevated due to the explosion of social media and the tendency of individuals to self-select sources that support their preferred points of view. Right now, it is probably more important to resist the urge to over-react to external market events, and focus on limiting the impact of those behavioral factors that can so easily distort the important logical decision making process.

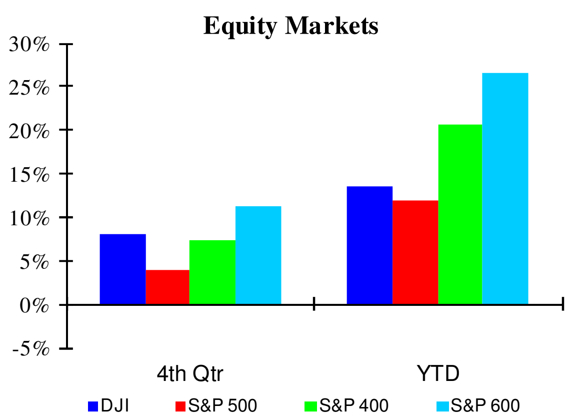
We recognize that we are also subject to the same behavioral factors that impact decision making and believe that the best way to minimize their impact is to employ an analytical discipline that can guide us. Our investment process starts with an objective assessment of corporate earnings, growth, and cash flow to identify companies whose stock is trading at an attractive valuation compared to the market and their peers. Our goal is to build a diversified portfolio managed with a long-term investment horizon. We recognize that there may be times when market stress may not reward our analytical approach, but we know that over time our disciplined process will provide the best opportunity to produce attractive risk-adjusted returns.

Sincerely,
Daniel A. Morris

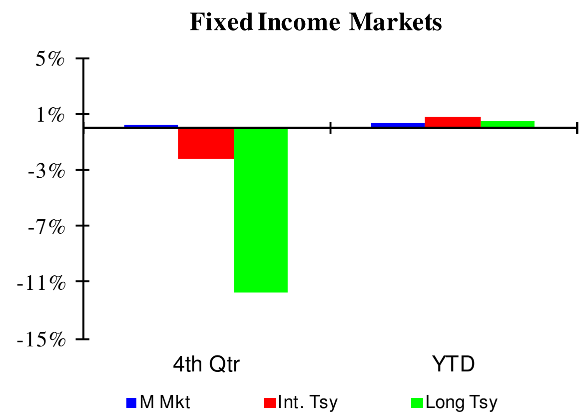
Market summaries on reverse page

Morris Capital Advisors, LLC

Market Summary
December 31, 2016



To say that equity markets were as surprised as everyone else by Donald Trump's victory is an understatement. Most markets had been trending flat-to-down in the weeks before the election, but subsequently not only did the indices bounce, sector rotation was severe as investors attempted to anticipate new policy directions and impact on earnings growth. The market's verdict was that lower taxes, deregulation, infrastructure spending and higher interest rates would be strongly positive for U.S economic activity and domestically sourced earnings. Shares of banks and other financial services companies were the prime beneficiaries, but shares of other cyclically exposed stocks also outperformed. Small-Cap stocks far outperformed their Large-Cap brethren, perhaps because non-US revenues account for a smaller percentage of the total, and the regulatory burden falls disproportionately on smaller companies.



Yields on U.S. Treasury securities trended higher early in the quarter, as it became clear that fears of Brexit's deflationary impact was vastly overblown, and the Federal Reserve made increasingly clear that it was likely to raise interest rates by year's end. The trend was reinforced by the reaction to Trump's election victory, as yields jumped by about 50 basis points in the longer part of the curve. Part of the move reflected a reevaluation of the likely impact of increased fiscal stimulus on the inflation outlook. But the reaction also reflected Trump campaign rhetoric which seemed to indicate that the Fed was keeping rates too low and implied that vacancies and Chair Yellen herself would be replaced with more hawkish members. The Fed itself surprised markets by suggesting that rates in 2017 were likely to rise slightly higher and faster than previously communicated. As a result, fixed income prices declined substantially, with negative total returns in double digit territory on the long end of the curve.