Maycrest Capital – Outperforming the Market with Discipline and Patience

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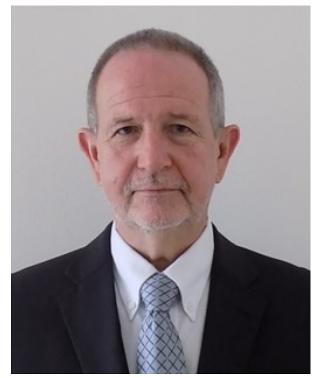
by Robert Huebscher



Richard Davis is the CEO and chief investment officer at Maycrest Capital, a Florida-based asset manager. Richard holds a bachelor's degree in mathematics and physics from the University of North Carolina. His unique strength comes from combining his expertise in the development of financial instruments software with his experience in managing complex financial instruments at global European banks.

Richard is the portfolio manager of the Maycrest Balanced Fund Strategy. Since its in inception on January 1, 2007 to August 31, 2018, the Maycrest Balanced Fund Strategy had an annualized return of 11.46% versus 8.36% for its benchmark, the S&P 500 Total Return Index, for an outperformance of 310 basis points. The Maycrest Balanced Fund Strategy is available to investors through separately managed accounts.

I interviewed Richard last week.

Please give us the firm's history in a nutshell

Maycrest Capital is a boutique money manager. The firm was founded in 2002, so we are currently celebrating our 16th year in business. Over the first five years, we focused on developing an investment strategy for U.S. equities. Since 2007, we have implemented our strategy, the Maycrest Balanced Fund Strategy, while continuing to refine our model. Our sole focus is investing in the U.S. stock market using our strategy.

Describe Maycrest Capital's investment approach. What makes it unique?

We employ an active risk management approach. Our tactical strategy aims to capture the broad swings in the market that come with the business cycle. The market tends to overshoot at the end of an expansion. Then, when the economy turns south, fear sets in and the market underprices equities. Stocks get cheap. Our strategy pares back the stock market exposure before an impending recession and reinvests funds after the market has declined. Over a business cycle our strategy is designed to generate alpha, to outperform the market by escaping some of the losses of a stock market downturn.

We invest in broad-based, liquid ETFs, rather than individual stocks.

What makes us unique? We have developed a mathematical model, the "BearCasting Model," to help us determine points in the business cycle when the risk of investing in stocks outweighs the returns. The BearCasting Model is a mathematical model, implemented in software, which uses indicators and trading rules to generate signals. It takes into consideration market, technical and sentiment indicators.

We use our BearCasting model to guide our investment decisions. The strategy and model have worked well over the last business cycle. We have booked a handsome return, exceeding the return of a buy-and-hold investor in an S&P 500 ETF by more than 3% per year, after fees. That adds up when you look at the ending equity of an investor.

What are your thoughts on the U.S equity market right now? Are we overdue for a major correction?

The S&P 500 Index trades at approximately 17-times forward earnings. While that is somewhat high as compared to historical P/E levels, we are still in a low interest rate environment. If we compare the current valuation with fixed income investments, the valuation of stocks seems acceptable.

Also, let's think about the business cycle. The U.S. economy has had a good run in recent quarters, as far as GDP numbers are concerned. Unemployment is at historical lows and inflation is not out of control yet. That should bode well for a continued stable economy, at least in the next one to three months, which is the time frame we are focused on.

There are a few clouds on the horizon. Take, for example, the effect of trade negotiations with different countries or the Fed's commitment to tighten monetary policy. But we don't see these clouds triggering a downturn in the immediate future.

Despite the resurgence of growth of the U.S. economy, wage growth has not kept pace. What is the reason for that and how does that affect your longer-term view of the prospects for inflation?

Yes, wage growth has been quite low. Why is that? Two factors that have contributed to that development are productivity gains through new technology and globalization. The world has changed quite a bit since the 1970s. Computers were just up and coming, email did not exist and the internet was not invented. Email and the internet alone have drastically changed the way we communicate with each other, the way we shop, the way we educate ourselves. And email and the internet were also instrumental in employing labor from other countries and integrating operations internationally.

Companies now can use employees throughout the world, not just to produce clothing and furniture, but also for a lot of other jobs, be it for design services, software programming or call centers, for example.

People in other countries, like India, are well-versed in English and they are educated. American workers have to compete with that labor force from abroad, and the hourly wages in many countries are a lot cheaper. That puts a brake on wage growth in the U.S. Also, being able to tap into a pool of labor from other countries means that open positions may be filled by employing labor from other countries, again resulting in less pressure on wage growth.

Wages have a direct impact on inflation, as they are part of the cost of goods and services. Higher wages thus directionally act as an inflationary force.

The threat of an all-out trade war has escalated recently. How do you expect that to unfold and what will be its impact on the economy?

It is not clear whether there will be a trade war or whether the situation will be resolved after a period of negotiations between the U.S. and other countries. Of course, the ongoing discussions cause uncertainty in the markets, which is bad for companies and acts as a brake on the stock market. The market has priced that in. If the trade war could be resolved in a year or two, that could be a boost for the economy.

If the situation cannot be resolved and if we are entering a protracted period of protectionism, I expect the impact on growth to be negative and it will lead to inflationary pressures.

What are your concerns about rising interest rates and how they might affect companies and the market?

Well, since the 1950s, all recessions were preceded by the Fed raising interest rates, so rising interest rates are a concern. The stock market has accepted the Fed's policy of monetary tightening so far without a tantrum. How the market will react when the Fed tightens further – either by raising interest rates or by reducing the size of the Fed's balance sheet – will remain to be seen. It is a tough line to walk between keeping inflation in check and driving the economy into a recession by having too tight a policy.

And of course, recessions often trigger huge market sell-offs.

U.S. equity investors have been well-served for most of the post-crisis period by owning a low-cost, market-capitalization weighted index fund as opposed to an actively managed fund such as yours. Will an index fund continue to prevail over active management?

Whether investors choose low-cost index funds or work with an asset manager is a personal choice. Active management does add a layer of cost, there is no doubt, so investors have to weigh the management fees against the benefits they receive. Investors should certainly be critical when they select an asset manager. They should understand and like the manager's strategy, look at the research the manager has performed and ask for evidence of past results (that is, the manager's track record).

For example, our strategy is invested in the U.S. equity market most of the time. We focus on protection of asset values in bear markets and reduce the stock market exposure in our portfolio as the economy softens. Our strategy's design is to reinvest before a business cycle expansion starts again, when stocks are relatively cheap. There are long periods where our portfolio positions are not adjusted.

The portfolio remains invested in broad-based liquid ETFs and captures much of the returns of the stock market. It takes discipline and patience to follow that investment approach.

You mentioned that the fund is tactical. Most advisors associate tactical investing with market timing and have a dim view of the likelihood that it will generate risk-adjusted outperformance. How do you respond to that concern?

We take a long-term view and adjust our position based on what is happening in the business cycle. Often, when advisors refer to market timing, they refer to short-term market timing, rather than a strategy that seeks to adjust the position as the underlying economy undergoes changes. We have a disciplined investment process in place, using our BearCasting Model when we make investment decisions.

Also, not everyone can do everything. Some are good at selecting stocks for their portfolios – take Warren Buffett – others are talented bond traders. We have had good results in what we are doing for more than 11 years now, and we will continue doing what we have been doing well.

Many investors and asset managers are what I call ”stock pickers.” But you can view the collection of the companies that make up the S&P 500 Index as one stock. You have earnings and earnings forecasts for the S&P 500 Index, you have a P/E ratio, and you can judge the whether the S&P 500 Index is at a level that is attractive, just as you can with other stocks. So, by looking at the S&P 500 Index through this lens, why do advisors believe that one can be successful buying and selling individual stocks, but one cannot be successful buying and selling the S&P 500 Index?

You may find this interesting. I recently browsed through Graham and Dodd’s classic *Security Analysis*. In that book, Graham and Dodd talked about adjusting portfolio positions using a disciplined approach as a means to exploit cyclical swings in prices. They thought that such a strategy could be helpful for investors. So, the idea has been around a while, we just have developed it further and put more sophisticated parameters around it.

Some doubt that it is possible to forecast recessions. They also point out that the stock market precedes recessions. How do you respond to that concern?

Our indicators tell us what is going on in the economy at the present point in time, rather than predict what will happen over the next couple of years. Our system is focused on the present and the immediate future, looking out one to three months.

Our BearCasting Model does not give us a recession signal; it gives us a warning sign when it is time to adjust the portfolio, before a recession.

Think of our approach like a hurricane-warning system. The system picks up on cues, considers the wind, the time of year and cloud formations. The warning system gives people and officials time to prepare. Similarly, with our system, we take steps to protect our portfolio when we see a recession approaching. As we invest in highly liquid ETFs, we are able to adjust our positions in a relatively short time frame.

You currently have a track record of 11-plus years. Have you tested how this strategy would have worked historically and how robust is that test?

We have tested our strategy from 1967. Some of the indicators we are using for our model are not available before then, so that's as early as we could back test our strategy.

There were seven recessions from 1967 to 2001. Using the BearCasting Model over that time horizon would have resulted in a return that exceeded the returns of a buy-and-hold investor by about 3% annually with lower drawdowns, which is similar to what we have achieved since implementing it in 2007.

How does your tactical strategy fit in client portfolios?

Our investment style lends itself well to wealth accumulation. It is designed for investors who seek capital appreciation. We do not aspire to outperform the market during expansions, as this would entail greater risk.

Our strategy is well-suited for investors' core U.S. equity position. The strategy is particularly beneficial for pre-retirees or retirees who may not want to live through the roller-coaster of the stock market, because they may feel they don't have time to wait for a market recovery, but still want a high exposure to equities.

