INVESTMENT INSIGHTS

Analysis, Insights and a Different Perspective

September 2020

DON'T MAKE YOUR PORTFOLIO PARTISAN

KEY POINTS

- Politics often influences investors' emotions, and investors tend to alter their investment strategies based on their emotions rather than facts.
- Politics is one of the many factors that impact the market. The economy and corporate earnings are more important determinants than who is in the White House.
- It is dangerous to make important investment decisions based on political developments. Bias may cost you opportunities to meet your financial goals.
- The economy has withstood various political issues. The optimism about the nation's long-term prosperity should not fluctuate with short-term political noises.

As the election approaches, investors become increasingly sensitive to news from D.C. In this issue of Investment Insights, we discuss the reasons why we believe it does not make sense to play politics with your portfolio.

ELECTION EMOTIONS

Investors tend to be hypersensitive to news from D.C. during an election year because political topics dominate headlines. The political climate can play with investors' emotions, which may undermine their investment decisions. The political development through the year can cause excitement or despair, depending on your side of the aisle. However, if you invest with a long-term approach, neither presidential candidate is likely to have a dramatic effect on your investments.

A study[1] published by the National Bureau of Economic Research shows that when people choose the side of their political stand, they also tend to make their portfolio partisan. For example, after the 2016 election, Republicans became more optimistic about the market and increased their holdings of risky assets such as stocks, while Democrats exhibited a "flight toward safety" and turned to assets like bonds and cash.

Neither a red nor blue strategy is a good investment idea for the recent decade. By implementing such a strategy, a conservative would have missed 195% (based on S&P 500 1/1/2009 – 12/31/2016 return) from the stock market during the Obama presidency, and a liberal would have missed over 68% (based on S&P 500 1/1/2017– 8/28/2020 return) since Mr. Trump took office.

1 Maarten Meeuwis & Jonathan A. Parker & Antoinette Schoar & Duncan I. Simester, 2018. "Belief Disagreement and Portfolio Choice," NBER Working Papers 25108, National Bureau of Economic Research, Inc.

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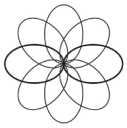

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WEALTH MANAGEMENT

THE PRESIDENTIAL PUZZLE

How has a politicized strategy played out over history? Below we present the track record of the financial markets and the economy under different combinations of political parties in power.

The table exhibits a striking pattern: stock returns and the economy in the United States perform better under Democratic presidents than Republican ones. Santa-Clara and Valkanov (2003) carefully documented this phenomenon and dubbed it as the "Presidential Puzzle." It seems that over the long term, a Democrat had higher returns because they would have enjoyed higher stock returns during a Democratic presidency and also higher bond returns during a Republican presidency. But is the pattern repeatable? Our answer is no. An example would be, again, the fact that a Democrat following this strategy would have missed the recent stock rally during the Trump administration.

PERFORMANCE OF STOCKS, INFLATION AND BONDS BY PARTY OF PRESIDENT AND MAJORITY PARTY* IN CONGRESS (1/1/1926 – 6/30/2020)

	Stocks**	Inflation (CPI)	Real Stock Returns	Long-Term Govt Bonds***
Democratic President	14.62%	3.61%	10.63%	3.87%
Republican President	6.26%	2.06%	4.12%	7.55%
Democratic Congress	11.18%	4.01%	6.89%	5.08%
Republican Congress	12.35%	1.36%	10.85%	5.55%
Democratic Pres, Democratic Congress	14.43%	4.01%	10.03%	2.50%
Democratic Pres, Republican Congress	13.90%	2.85%	10.75%	8.02%
Republican Pres, Republican Congress	4.89%	-1.28%	6.26%	4.96%
Republican Pres, Democratic Congress	7.44%	4.36%	2.96%	9.51%
All Periods Buy/Hold	10.10%	2.86%	7.04%	5.71%

* Majority Party = Party with an average of % control in House and % control in Senate greater than 50%
** IA SBBI US Lrg Cap Index is represented by the S&P 500 Composite Index (S&P 500) from 1957 to present, and the S&P 90 from 1926 to 1956.
*** Long-term government bonds are represented by the IA SBBI US LT Govt TR index.
Data Source: Morningstar Direct

SMALL SAMPLE SIZE

A simple reason for the invalidity of a partisan portfolio is the small size of the sample. Since the great depression, the U.S. had only six Republican administrations and seven Democratic administrations. From a statistics standpoint, it is commonly believed that one needs a minimum sample size of 30. When you flip a coin 10 times, you may not be able to tell from the results how likely you will get tails, but when you flip it 100 times, you will get a much better idea of the likelihood. Likewise, presidential history is a sample too small to draw meaningful conclusions.

PRESIDENTS' CONTROL OVER THE ECONOMY

Moreover, a deep dive into academic research leads us to think about the causality between the presidency and economic growth. A recently published paper, "Political Cycles and Stock Returns,"[2] provides a possible answer to the presidential puzzle: "the return gap is not explained by what presidents do, but rather by when they get elected." A Democratic president is more likely to be elected when risk aversion is high, and people demand more social insurance, while a Republican president is more likely when risk aversion is low, and people tend to take more business risk. Therefore, it has been the economy that has determined presidents' partisanship, not the other way round. In other words, Democratic presidents happened to be elected when the stock market and economy happened to perform better, rather than the illusion that Democratic presidents' policies determined economic growth.

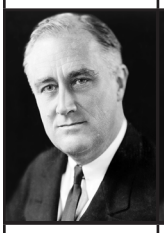
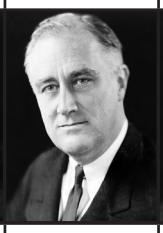
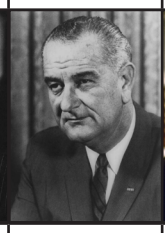
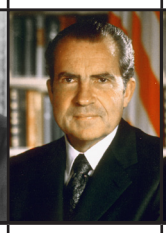
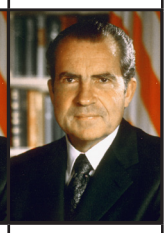
2 Pastor, Lubos and Veronesi, Pietro, Political Cycles and Stock Returns (May 26, 2019). Chicago Booth Research Paper No. 17-01; FamaMiller Working Paper.

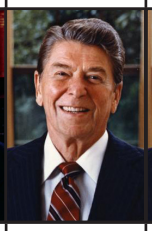
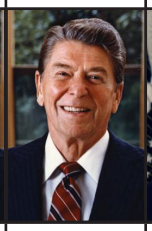
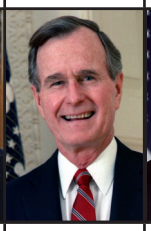
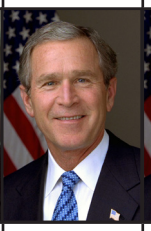
Furthermore, each president has a specific economic backdrop at the time they were elected: Most of Roosevelt's presidency was in the shadow of World War II. Eisenhower was inaugurated right at the beginning of the global post-World War II economic expansion. The Jimmy Carter administration encountered the global energy crisis and rampant inflation in the late 1970s. President Clinton certainly deserves the credit for his economic policies, but the economy was also largely driven by the rapid technological changes and the Fed's accommodative monetary policy. George W. Bush took office almost at the same time when the dot-com bubble burst. Obama started to preside as the financial crisis was looming.

The reality is that presidents have less control over the economy than the mass public would imagine. Firstly, the timing of the Inauguration Day relative to the business cycle maters. For example, President Obama achieved a cumulative job growth of 8.7% over eight years of service. That number would drop to 3.5% if he had taken office one year earlier in January 2008 and would rise to 13.8% if the inauguration had happened in January 2010 (assuming 8 years of service for all scenarios, source: FRED).

Secondly, the demographics are not under any politician's control but are an essential part of the economy. Demographics influence the labor force, which is one of the key determinants for the economy's long-run growth rate. After World War II, women and the Baby Boomer generation began entering the workforce in higher numbers and acted as a huge tailwind for the economy. That demographic trend is a result of broader social force rather than one president's policies. Thirdly, the president does not set monetary policy. The Federal Reserve, designed to maintain independence from the president, is the effective steward of the monetary policy. In other words, it is the Fed, not the president, that raises and lowers interest rates to keep the employment and price level stable.

Economic forces are more significant than political forces. Forces from the business cycle, labor supplies, innovations, and productivity improvements have had a more powerful impact on the economy and financial markets than politics. The following table shows that we have never been free of political issues. The United States has weathered through assassination, impeachment, scandals, deficits, and a variety of wars. The economy, thanks to the American people's hard work, withstood all of these issues. And the financial market, as nurtured by the strong economy, has been breaking record highs. New policies from Washington, D.C., may impact our lives in many ways. But they should never change our optimism of the nation's long-term prosperity, regardless of the policy implications.

1936	1940	1944	1948	1952	1956	1960	1964	1968	1972
Dow: 177	Dow: 135	Dow: 148	Dow: 190	Dow: 270	Dow: 495	Dow: 598	Dow: 876	Dow: 946	Dow: 985
									
Franklin D. Roosevelt v. Alf Landon	Franklin D. Roosevelt v. Wendell Willkie	Franklin D. Roosevelt v. Thomas Dewey	Harry Truman v. Thomas Dewey	Dwight Eisenhower v. Adlai Stevenson	Dwight Eisenhower v. Adlai Stevenson	John F. Kennedy v. Richard Nixon	Lyndon Johnson v. Barry Goldwater	Richard Nixon v. Hubert Humphrey	Richard Nixon v. George McGovern
Great Depression, rise of Nazi Party	Isolationism v. engagement, World War II	FDR's health, post-war impact	Civil rights tension, Cold War	Hydrogen bomb, Korean War	Middle East troubles, Soviets invade Hungary	Cuban Missile Crisis	Civil Rights Act, Gulf of Tonkin	Vietnam, civil rights, assassinations	Watergate Scandal, Vietnam War

1976	1980	1984	1988	1992	1996	2000	2004	2008	2012	2016
Dow: 966	Dow: 937	Dow: 1229	Dow: 2125	Dow: 3262	Dow: 6042	Dow: 10977	Dow: 10054	Dow: 9320	Dow: 13112	Dow: 18332
										
Jimmy Carter v. Gerald Ford	Ronald Reagan v. Jimmy Carter	Ronald Reagan v. Walter Mondale	George H.W. Bush v. Michael Dukakis	Bill Clinton v. George H.W. Bush	Bill Clinton v. Bob Dole	George W. Bush v. Al Gore	George W. Bush v. John Kerry	Barack Obama v. John McCain	Barack Obama v. Mitt Romney	Donald Trump v. Hillary Clinton
NYC threatens bankruptcy, recession	Iran Hostage, Cold War	Budget deficits, stock market	Savings and loan crisis, Iran-Contra Affair	LA riots, NAFTA ratification	Saudi Arabia, Iraq	Tech bubble, USS Cole	Oil prices, Iraq and Afghanistan	Subprime crisis, Lehman Brothers	Fiscal cliff, Greek debt crisis	Trade tensions

FOCUS ON WHAT YOU CAN CONTROL

Undeniably, the president may have a significant influence on economic growth and stability by changing the tax rates, government spending, and regulatory rules. However, even if he or she had complete control over the economy, an investor still faces a lot of questions before making an investment decision. How long does it take for the government to pass the policies? How long does it take to implement them? At what time and to what extent the policies will start to have a meaningful impact on the economy? And importantly, how the market will react to the policies?

Unfortunately, most of the time, the answers are unknown and unpredictable to the investor. Paying too much attention to politics that are out of your control will only grow your anxiety and add to emotional responses. Investors should focus on what they can control to make wise investment decisions to pursue their long-term financial goals. For example, keep your portfolio diversified and maintain a long-term perspective. Before you head to the polls, research the candidates' policies and make informed decisions, but do not let your political decisions drastically impact your investment portfolio.

If you have any questions about your investments or would like to know more about Cornerstone's Model Wealth Program, please contact your advisor.

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