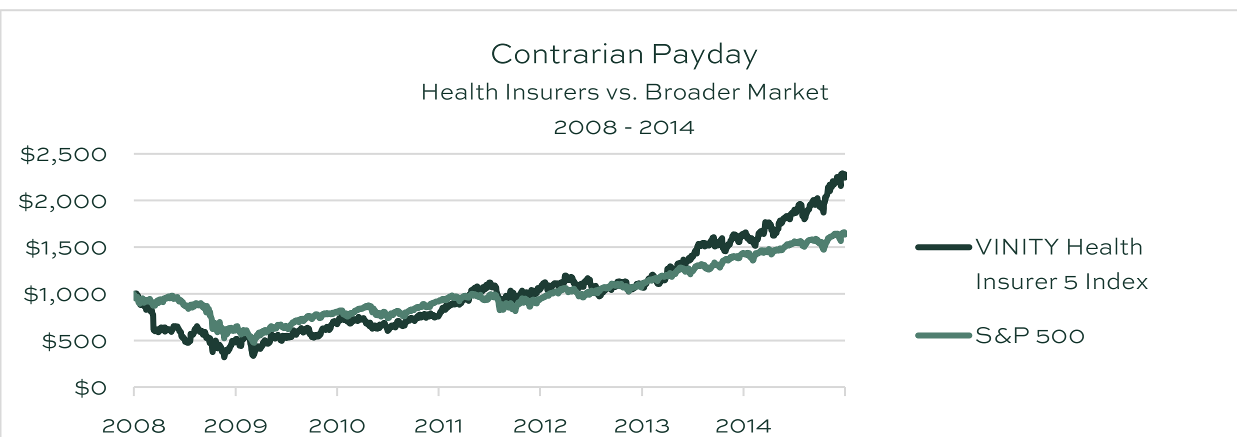
Michael Friedman, CFA | Chief Investment Officer

Elections and the Stock Market

The media coverage and discussion at home tend to focus on the race for the White House, but we find the composition of Congress to be just as important in terms of the stock market impact. Presidents can propose bold policies, but the members of Congress vote to make any legislation into law, often a cumbersome process at best with less than 10% of prospective bills becoming law. The process is also dependent on the political landscape; a party will have more leverage with a majority in the Senate, the House, and control of the presidency.

Considerable policy change can have varying outcomes depending on individual circumstances and may cause concern, especially when the impact is on your wallet. Although this can cause jitters for individuals, it is a much different story when examining the impact on S&P 500 companies. Those are the largest corporations in the U.S. by market capitalization, with more resources than individuals, and are not about to let a bright-eyed bushy-tailed politician derail their success.

A good example is the 2008 election. The key initiative for President Barack Obama was to bring extensive reform to the health insurance industry. This policy caused concern that expanding and mandating certain levels of coverage would impact health insurer profitability and result in higher premiums for individuals. Subsequently, health insurer stocks sold off through 2008 at a pace faster than the overall market. To assess the impact, we created the VINITY Health Insurer 5 Index (VHI 5), which tracks the performance of the top five publicly traded health insurers and is weighted by market capitalization. The VHI 5 hit a low in 2008 on November 20, down -68% for the year, while the S&P 500 was down -48%. It would have taken some guts, but as you can see in the below graph, buying while others were fearful would have paid off. The VHI 5 returned an annualized 38.4% from the November low in 2008 through the end of 2014, while the S&P 500 delivered 20.9%. The selected period captures performance during the Affordable Care Act implementation, which began in 2010 with the last phase put into effect in 2014.



We have heard plenty of rhetoric lately from both sides explaining the stock market is doomed if their candidate does not win the election. Considering there is a 25% chance of a correct prediction (president and direction of stock market), we are not placing too much weight on this. Unfortunately, we do not have a crystal ball, nor do we claim to possess a particular ability to determine what will happen over the next four years predicated on the outcome of an event just under three months from now. But, this has piqued our interest, so we reviewed stock market performance based on which party is in control to see what we could learn from history. Utilizing data from the past 120 years, we determined the median and average annual return when each party was in control of the presidency and each legislative branch. The median and average are both included because we want to present the full story impartially. As you can see in the below tables, any narrative can be created based on the measure used.

Why does looking at one measure versus the other produce a different outcome? The reason is that stock returns generally follow a normal distribution with fat tails. Meaning the return distribution includes extreme positive or negative values that are uncommon (more than two standard deviations) and skew the average in one direction or the other. For example, if we have annual returns of -24%, 4%, 8%, 10%, and 12%, the average return over the five years is 2%, although, in four out of the five years, the annual return was above the average. In our example, the median was 8%, so the performance in half the years was above and half the years was below the median value. As demonstrated, it only took one bad year to skew the average annual return lower, meaning it was more common for the annual return to be higher than the average, rather than below.

We can apply this to explain why the median return for a Republican president was 9.6%, while the average was 5.9%. For a Democratic president, the median and average were 8.8% and 8.4%, respectively. Meaning, it was more common for higher returns during a Republican president, although also more common to have extreme negative annual returns, lowering the overall average, as compared to during a Democratic president.

Median Annual Return
January 1900 - July 2020

Party in Control...	President		Senate		House	
	Return	Years	Return	Years	Return	Years
Democratic	8.8%	56	8.8%	66	8.2%	74
Republican	9.6%	64	9.6%	54	13.2%	46

Average Annual Return
January 1900 - July 2020

Party in Control...	President		Senate		House	
	Return	Years	Return	Years	Return	Years
Democratic	8.4%	56	6.7%	66	5.5%	74
Republican	5.9%	64	7.6%	54	9.7%	46

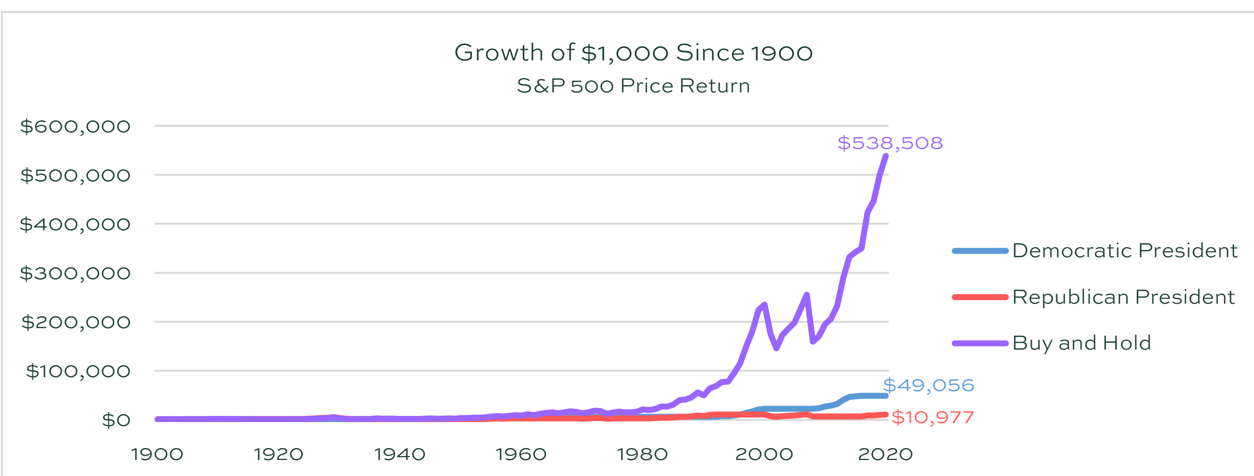
We also wanted to go one step further and determine what historically has been the best combination of party control for the stock market. The returns are sorted by the median to help control for the impact of outlier annual returns in the dataset. Based on our research, the best performance occurred during a Democratic president with a Republican majority in the House, followed by Republicans in control of the presidency and Congress.

Best Combinations of Party Control
January 1900 - July 2020

President	Senate Majority	House Majority	Median Annual Return	Average Annual Return	Number of Years
Democratic	Democratic	Republican	13.8%	14.5%	4
Democratic	Republican	Republican	12.5%	11.8%	12
Republican	Republican	Republican	11.6%	8.1%	30
Republican	Democratic	Democratic	9.2%	5.0%	22
Republican	Republican	Democratic	8.7%	2.1%	12
Democratic	Democratic	Democratic	7.8%	6.8%	40

The biggest takeaway is that you should not invest based on which political party is in control. To be clear, we are not saying the president or congressional leadership does not matter. We do understand at the policy level, specific issues may be more or less meaningful to you, and changes to those policies may have a financial or non-financial impact. We are not discounting the effect that different leadership may have, simply just stating that historically you have been better off voting with your ballet rather than your portfolio.

In the below chart, we examined the growth of three different portfolios, with two attempting to time the market based on the political party of the president. In the Democratic President portfolio, assets were invested in the S&P 500 only when a Democrat was president since 1900. The Republican President portfolio followed the same methodology only remaining in the market during Republican presidents. The Buy and Hold portfolio made no changes over the subsequent 120 years. On average, the Buy and Hold strategy would be worth 30 times more than trying to time the market based on the political party of the president.



Regarding the difference in ending values between the Democratic and Republican portfolios, the gap is the result of unfavorable timing. The portfolio values were within $500 at the end of 1996, and then the market doubled over the following four years fueled by the dot com craze. A Democratic president was in office at this time, so the Republican portfolio was not invested in the market. At the end of 2000, a Republican president was elected in a period now referred to as "the lost decade." The tech bubble hit its peak and began tumbling down in the second half of 2000. From November of 2000 through the bottom in 2002, the market lost almost 40% before rallying 75% over the next five years. Then, the financial crisis wiped off another 40% through the election of 2008, leaving the portfolio value beneath where it started the 21st century. The Democratic portfolio was not invested during that time, locking in the dot com gains, missing the financial crisis fallout, and getting back in the market just about at the bottom. Not bad! Consequently, the Republican portfolio sold at the bottom in 2008 and missed out on the gains from almost eight of the eleven years of the longest-running bull market.

The circumstance described above is not the first time over the analysis period in which the portfolio values experienced a sizable divergence. This example is only the most recent, and the situation has played out both ways. The outperformance of one portfolio may persist for an extended period, but history has shown the trend can only endure for so long before eventually reversing.

In our experience, the political arena can become cluttered with nuance. That is why our seat preference is the 50 yard-line about 25 rows up, as you have a perfect view of both sides. However, this is just the view from our seats; there are many different seats, each offering a unique view of the action leading to various interpretations of the same play. Unfortunately, one seat location is not better than another, only offering a different perspective. From our viewpoint, we do not believe either party has been so destructive warranting a change in investment strategy based on the political party in control.

The VINITY Health Insurer 5 Index (VHI 5) is unmanaged and weights the top five publicly traded health insurers by market capitalization. The constituents include: UnitedHealth Group, Anthem, Cigna, Humana, and Centene.

The median and average annual returns are calculated from November 1 through October 31 to capture the stock market return from the election up until the next election. Although the inauguration is not held until January 20 in the year following the election, we assume the market begins pricing in their views immediately following the election.

S&P 500: Measures the performance of U.S. large-cap equities and is comprised of 500 companies across sectors and covers approximately 80% of available market capitalization.

Sources: YCharts