ISSUE 3 | VOLUME 5 | SEPTEMBER 2016

Cadence clips

FOCUSED ON WHAT MATTERS MOST.

The Futility of Election Cycle Investing

We have fielded questions recently on if we think it necessary to make investment changes ahead of this year's election. We can understand the feeling that there is some amount of science behind the election cycle affecting the stock market. Even a cursory search of the Internet on the subject of election cycle investing, whether it relates to historical expectations of returns in election years or to the potential impact of either of the current candidates winning, can reveal such juicy "research" as:

- "Since 1928, the Standard & Poor's 500—a widely watched benchmark of U.S. large-cap companies—has dropped an average of -2.8% in presidential election years that don't include an incumbent seeking reelection", notes Stephen Suttmeier, technical research analyst at BofA Merrill Lynch Global Research.
- "In fact, the U.S. stock market usually performs very poorly in the eighth year of a President's term with five of the six occurrences this century being negative and averaging a loss of -13.9%." (Mark Yusko, Morgan Creek Capital Management)
- "Given that the past three years are so out of sync with the normal cycle, we're not certain what 2016 will bring," says Jim Stack, a market historian and publisher of the newsletter InvesTech Research.

Man, those sound really official, don't they? It makes it seem like the Presidential election cycle is somehow RESPONSIBLE for those returns. Even that last one, though a little vague, hints at a "normal cycle", which would lead one to believe that investment returns are somewhat predictable when viewed through the lens of the election cycle.

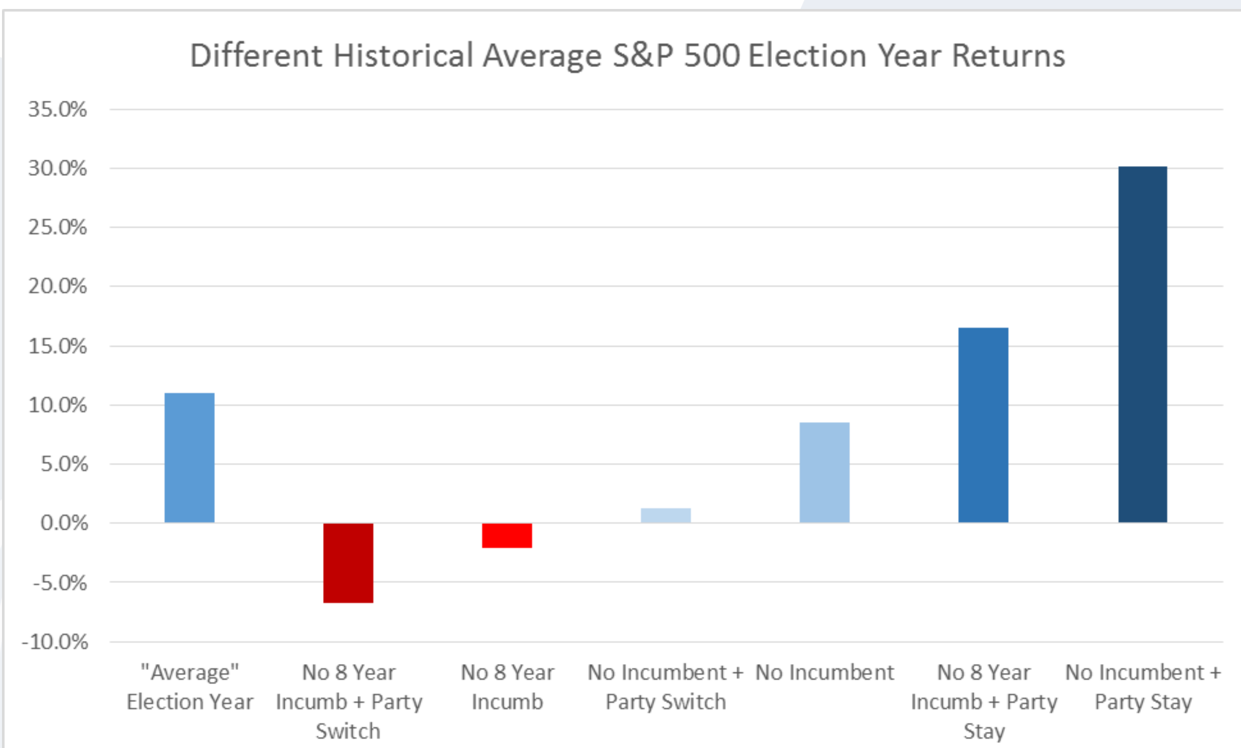
Speaking of THIS particular election cycle, searching on how to "Trump-proof" or "Hillary-proof" your portfolio will yield wisdom from such well-known sources as the Financial Times, Forbes, CNBC, and TheStreet. Not to be outdone, lesser-known websites interested in increasing their traffic have also gotten in on the action, some of them republishing the information from the better-known sources, and some, like joebusiness.com and esawdilis.com, taking their own crack at it to attract those eyeballs desperate to get in on the game of election cycle investing.

But is there any truth to this?

Well, consider this: the average election year return since and including the election of 1928 is 11%, and the average inauguration year return since then is 9%. If it were that simple, we can feel good about how this year should end and how next year should continue. Pundits seem to really enjoy focusing on what supposedly happens to the markets in years where the sitting President is not running for re-election. There isn't an incumbent in this election and since 1928 that's not a terrible thing, with the average return in an election year without an incumbent being 8.5%. That's worse than our 11% for ALL election years, but still not a bad return.

But hang on for a moment. Election year returns with no incumbent after a full 8 year presidency have averaged -2.1%. Yikes! That means we can expect the S&P 500 to drop into the red before the end of the year, right? Wait; it gets even worse. Election year returns with no incumbent after an 8 year presidency when the election is won by the party not in the White House have averaged -6.8%. That MUST mean if Donald Trump wins we're in for a rough ride the rest of the year. There is hope for our poor portfolios, though, as election years with no incumbent after a full 8 year presidency when the election is won by the party currently in the White House have had a really nice average return of 16.5%. That's a pretty profound swing of 23% solely based on whether or not Trump or Clinton wins, or so the "research" would lead you to believe.

When charting different average S&P 500 returns for election years that have similarities to this year, you have a veritable cornucopia of supposed possible returns for 2016:



Wow. That is a lot to consider, all those possible outcomes, and we haven't even looked at all the possible returns for the average inauguration year, and the average inauguration year after an 8 year presidency, and the average inauguration year after an 8 year presidency when the Democrats or Republicans retain or lose power, OR EVEN the average inauguration year after an 8 year presidency when the Democrats or Republicans retain or lose power and it snows during the inauguration! There's no end to the possibilities.

We believe this tendency to ascribe different average returns to different election year factors is known as the "Clustering Illusion", which is defined as "the tendency to overestimate the importance of small runs, streaks, or clusters in large samples of random data (that is, seeing phantom patterns)."* When you look at all the S&P 500's annual returns, not just election years, from 1928 through 2015, you get an average annual return of 11.4%. When you consider how much the individual annual returns have fluctuated around that 11.4% average, you find that 2 out of every 3 years you would expect the returns to fall between 31.1% and – 8.3% based on a statistical measure called standard deviation. When you fit the returns from the chart above into that range, what you find is that ALL of them fall between the normally expected high of 31.1% and normally expected low of -8.3%.

This essentially means that all these patterns the pundits are seeing for election year returns are actually just NORMAL returns, not "special election year returns", and not predictive at all. All the different possible returns we looked at are close enough to the average election year return to be fully explained by the amount of deviation you'd expect to find in all years, not just election years. You can play around with different election year returns, analyzing just those that have a certain characteristic, and you'll get a different standard deviation and therefore a different set of "normal" returns, but that's just it, isn't it? You can play around with this data all you want and draw any amount of conclusions to sound like you've discovered a meaningful pattern, but our own analysis tells us that there's no need to adjust portfolios just because it's an election year because there's nothing magical about election years.

This is not to argue that elections, candidates and presidencies don't affect financial markets, both over the short and long term, because they do. We also believe that the opposite is true: what the markets do can influence who wins elections, as evidenced by John McCain's statement that "the fundamentals of the economy are strong" in the face of a plunging stock market and dire economic news. Admittedly, the party out of power frequently gets a bump in votes when the economy is doing poorly because it's more the economy than the stock market which seems to have influenced some elections, but a late year plunge in the stock market certainly helped remind Americans the economy was doing poorly back in 2008 and McCain's campaign would not recover from that (though of course there were other factors). To predict how a particular candidate getting elected will move the markets up or down over the short or long term, even with candidates as polarizing as our current ones seem to be, is impossible. You can guess and get it right, but there's no way to predict it consistently. There are just too many other variables influencing the markets at the same time.

How far returns go in either direction during any year, elections years included, is determined more by how much they have grown or shrunk PRIOR to that year. For example, since February of 2009, the S&P 500 has increased nearly 250% and even relatively conservative corporate bonds have increased nearly 80%; that's a rate of return on domestic large cap stocks of ~18% per year and high grade corporate bonds of ~8% per year. You can look at the current value of most financial assets as kindling, and given the high asset prices for both stocks and bonds, the kindling is piled high.

This election could be the match that lights that kindling, as might the Zika virus spreading in more of Florida, or a major hurricane, or any other major event. We pay attention to the amount of kindling, because we know the match can come from anywhere. Despite what some industry insiders seem to indicate, whatever happens this election, financial market returns will still more than likely be normal by historical standards. However, should this election spark a financial market downturn, we have been protecting against as much of that as possible while also still providing growth opportunities for months. So to answer our clients' questions of if we think it necessary to change portfolios based on this current election, our answer is we do not. Your portfolio positioning should be based on how much you can or cannot afford to lose at this point in your life, and any tactical repositioning should be based on whether or not assets are expensive or cheap relative to historical norms, not because by late January there will be a President Trump or a President Clinton.

* Iverson, Grant; Brooks, Brian; Holdnack, James (2008). "Misdiagnosis of Cognitive Impairment in Forensic Neuropsychology". In Heilbronner, Robert L. Neuropsychology in the Courtroom: Expert Analysis of Reports and Testimony. New York: Guilford Press. p. 248. ISBN 9781593856342.

Key Takeaways:

- According to our research, there is no pattern to stock market returns in election years. All the historical election year returns can be explained by the normal variability for ALL years.
- There is no way to predict how the stock market will react to either major party candidate winning this election, nor if the election will move the markets up or down a certain amount over a certain time frame more than any other variable that could impact the stock market.
- The amount the financial markets can move up or down in reaction to an event is to a large degree dependent on how expensive or cheap asset prices are relative to historical norms. The more expensive, the more room to move downward; the more cheap, the more room to move upward.
- Because stock market prices are so high above their long-term averages, we have already adopted a more protective posture with client portfolios and therefore we do not believe we need to adjust investments for this election.

Stocks as a Last Resort?

Over the months we've heard countless experts and market participants make the argument that one should buy stocks because there simply isn't a better alternative. In fact, this thesis led to the acronym "TINA" – "there is no alternative". While a convenient argument because of its simplicity, we all know that things are never quite so simple. In fact, if you look at history, investing in stocks based on this TINA principal seems quite reckless. Realizing there are many investment choices out there, for simplicity, we'll work through the numbers for stocks and bonds to see if this "TINA" argument holds water.

Bonds are the investment that most are referencing when they suggest there's no alternative to stocks. With interest rates so low, you're simply better off investing in stocks that pay dividends – especially if those dividends are higher than the interest you'd be earning on the bond. In addition, you'd also get growth potential with the stocks, or so the argument goes. This is absolutely true, but there's a huge assumption being made here - the potential for growth. We would argue, based on history and math, that based on where stock prices are currently, the potential for market losses over the next few years is much better than the potential for gain. That little assumption alone tips the TINA argument on its head. More on that in a minute…

When evaluating bonds as a long-term investment, it's important to not just look at the interest rate or yield on the bond, but the yield to maturity. The reason for this is that although you may be getting a seemingly attractive yield on your bond investment, when the bond matures, you may get back less than what you initially paid, hurting your overall return. This is possible since you may have paid more for your bond than it was originally issued at because of the higher rate of interest that it pays. Assume for example that ten years ago you paid $10,000 for a bond paying 6%. If someone wanted to buy that bond from you today, they'd be willing to pay much more than $10,000 for it (and you'd demand more to give it up), given the lower rates offered on bonds currently. That fair price takes into account all of the income the bond would pay between now and maturity as compared to what a new bond would pay over the same period of time. An example can be seen in the chart below. So, when you take into account a potential capital loss when a bond matures, the total return on the investment could be quite a bit less than the yield or interest rate alone would imply. **Yield to maturity reflects this and should always be used when evaluating bonds.**

This yield to maturity concept is just as important for stocks as it is for bonds. Evaluating the dividend alone does not take into consideration the amount of your initial investment you're likely to get back at some point down the road. Much like a bond's price can fluctuate over time given current rates of interest versus that of the bond, stock prices can also fluctuate based on a host of factors. If prices are higher than normal, the possibility of a price decline down the road could negatively affect your overall return. When taking this into account, the long-term return prospects even for stocks paying healthy dividends don't look quite so good. The table below takes these factors into account.

	Stocks	Bonds
Face Value	N/A	$ 10,000
Market Price	$ 2,184.00	$ 14,940
Coupon	N/A	6.63%
Yield	2.0%	4.43%
Months to Maturity	120	120
Dividend/Interest Frequency		2
Current Price/Earnings	25	
Average Price/Earnings	16	
Current Margin	10.0%	
Average Margin	8.0%	
Assumed Trough Margin	6.5%	
Forward GDP Growth	4.0%	
Total Div/Int Income	$ 436.80	$ 6,625.00
Total Capital Gain	$ (528.78)	$(4,940.00)
Net Gain/Loss	$ (91.98)	$ 1,685.00
Net Gain/Loss %	-4.2%	11.3%
Annualized Gain/Loss % or **Yield to Maturity**	**-0.42%**	**1.33%**
<u>Stock Market Drop Scenario</u>		
Mean Reversion Level	908.54	
Gain/Loss %	-58.4%	

The important points are as follows:

- The bond investment represents a 30 year U.S. Government Treasury Bond that initially was paying a 6.63% coupon (interest rate) when issued approximately 10 years ago. Because that is attractive given today's low rates, investors are willing to pay $14,940 for a bond that initially sold for $10,000, resulting in a current yield on the $14,940 of 4.43%. However, after considering the fact that the buyer of this bond will only get back $10,000 at maturity in 120 months (not the $14,940 paid), the yield to maturity (YTM) is 1.33%.

- The stock investment represents the recent level of the S&P 500 at 2,184 and a current yield of 2%. On the surface, this 2% looks attractive relative to the 1.33% YTM on the bond. However, when we take into account the current valuation multiple of the market of 25 (this is how many times corporate earnings on the S&P 500 investors are willing to pay) relative to its long-term average of closer to 16 and the current profit margin of 10% relative to a more average 8%, we see the potential for a large downward price adjustment. We have to also factor in an economic growth rate that would lead to an increase in corporate earnings over time – here we're assuming 4% annually. **In the end, if the valuation multiple and profit margins on the S&P 500 were to revert back to their long term averages, we would actually see a negative return on investment even after factoring in the 2% dividends every year.** What's more is that under a scenario where a market and economic downturn takes profit margins below its average of 8% to a level of 6.5% in a hurry, we'd be looking at a 58% loss on the S&P 500. This type of downward move in the market would make it very difficult for the average investor to stay the course and even realize that -.42% effective yield to maturity over time. By selling early after incurring such dramatic losses, one would be significantly behind where they would have been with that measly 1.33% YTM on the bond investment.

- So as pathetic as interest rates on bonds and more traditionally stable investments are at the moment, it may be wise to think twice before investing in stocks thinking there's no alternative. Low interest rates are both a function of central bank manipulation AND long-term economic growth and stock market assumptions. It's very possible that demand for bonds has been so high (and thus rates so low), because bond investors feel that stocks are not an alternative. Maybe they've done the math on the stock market just as we have.

Key Takeaways:

- Investing in stocks because bonds and cash offer such low rates of interest is a very dangerous proposition. Even if dividend yields look attractive on stocks, the current price of stocks is extremely high by historical standards and could lead to poor long-term returns even with those attractive dividends.

- The justification for investing in bonds for the long-term is that interest rates will stay low, thus keeping prices high. For stocks to make sense over the longer-term, one has to believe that valuations can and will remain historically high for a long period of time and not revert back to more normal levels. We feel it's fair to say that neither offer great return potential over the next few years - portfolio composition should reflect this. We're taking all these factors into account for our clients.