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Financial Planning and Wealth Management

SHOULD I PREPARE MY PORTFOLIO FOR A POST-ELECTION DROP?

September 2012

Beginning in late summer of every election year, the media begins to predict how the markets may behave for the two major political parties and give airtime to the campaigns that are actively trying to get us worked up. As financial advisors, we are now fielding questions like, "They say that if "Mr. X" wins this election, the economy will be devastated. How can I position my portfolio to avoid getting wiped out if X wins?"

We use Mr. X because we get the question, or a variation of it, with both President Obama and Governor Romney as Mr. X. We have heard passionate and reasonable arguments about the approaches of both candidates and their parties as to our country's economic issues. We suspect concern will grow as we approach Election Day. With that in mind, let's take a closer look at the question.

Historical data is often used to imply that one party is "better" for the markets. All candidates want you to believe that their election will ensure your prosperity. But what does the data show? Not much. If you see a headline or story that purports that market history implies a specific election outcome will result in a specific market outcome, or that in certain years of an administration certain results will ensue, ignore the article. The data and common sense do not support the article's suggestion.

Markets have done well for both Democratic and Republican presidents, on average. Since the S&P 500 index was created in 1927, the average result is higher for Democratic presidents. However, the data shows that whenever the Republicans control either the House, the Senate, or both, the average result is better than when Democrats control both chambers of the legislature.

During the 2004 campaign, financial media made note of a statistic from Standard and Poor's that showed since 1945, the S&P 500 index of stocks returned an average of 12.9% in the year after the party that occupies the White House stayed in the White House. However, when a change of party occurred, the average was a *loss* of 3.2%. That's a big enough gap that many would think it compelling. It isn't. Those averages come from only 12 data points and the variance around the averages cited is large.

Mark Twain once said about averages: "A man with one foot in hot coals and the other in a bucket of ice is quite comfortable, on average."

It is easy to read too much into statistics. This is a common flaw of how the human brain functions. We seek patterns and cause and effect relationships to make sense of the world. The media thrives on placing too much emphasis on, or surmising a pattern, based on a very small sample size. There is simply no statistically significant difference between the various combinations of Presidential and Congressional parties (Riepe 2004). If you acted on the switching party statistic by loading up on stocks when President George Bush was reelected, you were probably disappointed as the S&P 500 earned just 4.9% in 2005, well below the average cited. If you continued to believe the cause and effect implication of the statistic and bailed out of stocks when the Democrats took over expecting a loss, you would have missed out on the index's 26.46% gain in 2009.

That is the data. On the common sense front, consider the following:

- All of the House of Representatives and one-third of the Senate seats are up for grabs every two years. All campaigns for high office generally go the same way. Politicians seek to take credit for anything you like and place blame on anything you do not like. We don't know who will win the election or how the markets will react. Whether you like how this one comes out or not, the same credit taking and blame placing is just around the corner. The call for change is a constant.

- We have survived, even thrived, despite some pretty bad presidents and ineffective Congresses.

- The market is far more complicated than these simplistic views imply. While there is no doubt the President is highly influential, he alone does not control economic policy and cannot pass laws without Congress. Just a few of the variables are Fed policy, geopolitical turmoil, globalization of trade, private sector competition, and consumer demand in various parts of the world.

- The market always creates both winners and losers. The policies of some politicians will inevitably benefit some businesses and hurt others. The market will rise and fall in anticipation of what policies will be instituted, which will be continued, and which will end. By the time the fate of these policies is clear, the market will look beyond these policies to other factors that may affect a company's future and adjust prices based on those anticipations.

- Political labels are imprecise. Democratic President John F. Kennedy was regarded by many as a defense hawk and a tax cutter—positions more typically associated with today's Republicans.

From an investment perspective, we caution you about making big moves in anticipation of market reactions. You should *always expect* the market to gyrate significantly because that is its normal behavior.

Going back to President Hoover in 1928, we looked at the calendar quarters in which the elections took place and the first two quarters of the following year. Of those 63 quarters, 32% (20) were negative. If you consider all 323 quarters of the S&P 500's existence through June 2012, 108 were down. That's 33%.

In all time periods, you can find stories that place blame or take credit. The market may very well go down and some will want to place blame on the election results. Has there been an election in which the candidates did not suggest trouble if their opponents were elected? We couldn't find one, but the record is clear bad markets around elections do not happen any more frequently than any other time frame.

If this happens, remember these numbers and the simple fact that in all cases of a down market around an election, markets recovered in plenty of time for prudent investors. Rather than interpreting a market drop as a long term disaster, diversified, disciplined, and patient investors view drops as possible short term opportunities due to the lower prices. Whenever markets are down, our rebalancing approach makes us lean toward buying a little at the lower prices.

The more you focus on playing short term events, the more likely you are to lose sight of your goals and the closer you are to being a speculator and not an investor. A well-structured portfolio would be one that is not dependent upon an accurate prediction of who wins the election or the market's reaction to that result. A good portfolio won't take more risk than is necessary to reach your goals in the first place. It would be broadly diversified enough that the need to make big bets is avoided and any tactical changes would be done in context of your family's best interests.

You may have felt a similar anxiety in past elections. Go ahead and formulate your opinions of the candidates and argue on their behalf with all the passion you wish to display but be careful not to go too far. Getting people fired up is a big part of politics but heightened emotions are not conducive to sound financial decision-making.

This is not to imply that who wins doesn't matter. Without a doubt, the next president will have an effect on the markets, but speculating on what that effect will be is not a sound strategy for investors. We certainly agree that a candidate's economic positions are relevant to deciding your vote. However, we want to encourage our clients to look at the candidates' positions on the broader spectrum of issues and not place too much emphasis on meaningless and conflicting data. Mark your calendar – Election Day is Tuesday, November 6th. Please vote, but don't let the hysteria of the race distract you from your family's goals.

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