



The Presidential Election Cycle

by

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“It’s the economy, stupid!”

Bill Clinton

Imagine a world in which the stock market goes up almost 100% of the time with an average annual return above 20%. Sounds pretty good, doesn’t it?

There is such a world. You’re living in it.

Welcome to the Presidential Election Cycle, a four-year period with some amazing investment regularities. Take year three – the pre-election year – it’s been up 100% of the time since 1939 (when it was down about 5%), averaging a return of 22.3%.* To put this in perspective, the historical appreciation of the market in year three of the election cycle is about three times the average appreciation of the market over all years.

In sharp contrast, the second year of the president’s term – the mid-term election year – has been a toss-up – up about half the time, with a negative bias over the past 50 years. It tends to be the year when multi-year bear markets come to a conclusion (as in 2002) or when sharp, but painful corrections occur (as in 1998). Since 1902, the Dow Jones Industrial Average has produced a net loss of 4,000 points in the second and third quarters of year two.

The Presidential Election Cycle 1963 - 2006						
Year	AVERAGE RETURN BY INDEX*			PERCENTAGE OF YEARS UP		
	DJIA	S&P 500	NASDAQ			
1	3.26%	3.70%	4.77%	DJIA 45%	S&P 500 55%	NASDAQ 64%
2	-0.55%	0.91%	-2.57%	DJIA 45%	S&P 500 55%	NASDAQ 40%
3	18.88%	19.93%	38.65%	DJIA 100%	S&P 500 100%	NASDAQ 90%
4	9.22%	10.79%	12.02%	DJIA 82%	S&P 500 90%	NASDAQ 82%

*Returns are appreciation only, dividends not included.

*S&P 500, appreciation only. When dividends are included, the S&P 500 hasn’t been down in year three since 1932.

Election cycle theory states that these regularities are caused by the persistent self-serving behavior of the political class backed up by the power of the presidency and the policy decisions of the Federal Reserve.

The basic theory states that the elected president and his party use the first year of his term (the “honeymoon”) to get the “dirty work” done. This is typically when taxes are raised, anti-business legislation is passed, foreign adventures begin, and new spending programs are introduced. The investment fall-out from these initiatives hits the market in years one and two.

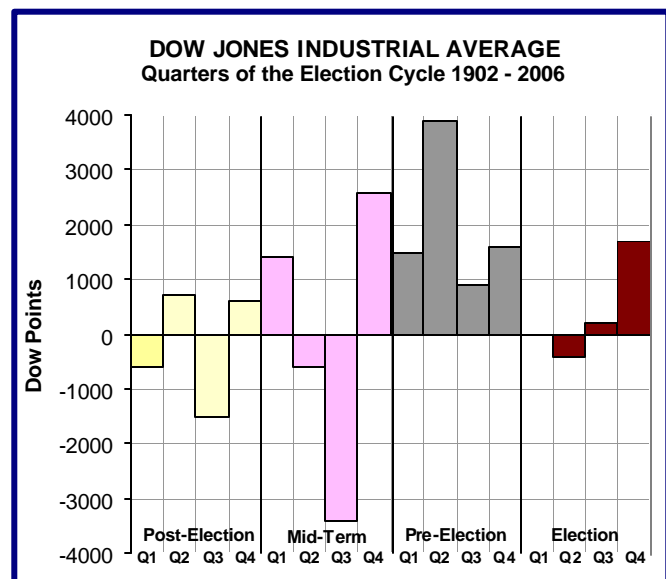
In the third year, the political class begins to prepare for the next presidential election and starts the process for pro-business, pro-investment initiatives which will appear in year four. This is also when “pork barrel” legislation and “special interest” spending programs move into high gear, greasing the wheels of the re-election process for incumbents. The Federal Reserve usually adopts a more expansive monetary policy – increasing the money supply, lowering interest rates – in order to produce a vibrant economy by the next election.

Incumbents of both parties know that voters are far more likely to “turn the rascals out” when the economic news is bad and voter concerns are centered on jobs and unemployment. The dominant party has a deep appreciation for the potential of negative economic news to eject them from the seats of power and therefore use their influence to insure that they are re-elected. George W. Bush, FDR, and Theodore Roosevelt are the only presidents to be re-elected after a market decline over their terms.

Once the party is over, the cycle begins again. The economic stimulus of years three and four, which raise the specter of inflation, is followed by a more restrictive monetary policy by the Federal Reserve, which dampens returns in the market.

This recurrent self-serving behavior causes a four-year market cycle which has been very consistent over the past 100 years. Sometimes the cycle is muted over long time periods. Throughout the mid-eighties and the nineties, for example, declining periods were short and below average, while recoveries were powerful and erased losses fairly quickly. Other times, the cycle is pronounced, as it was from the early 1960’s to the early 1980’s, a period of about twenty years. Yet throughout the entire period from World War II, (with the exception of the crash of 1987), the market has bottomed in year one or year two of the election cycle. This cyclical regularity has produced lower returns in the first two years and much higher returns in years three and four.

If we dig deeper into this cycle, another remarkable pattern emerges. Because bear markets often end in year two, the fourth quarter tends to be consistently powerful. The end of the previous bear market is also the beginning of a new bull market and is partially responsible for the large gains early on in the pre-election year. As you can see in the table, the last quarter of year two (mid-term) and the first two quarters of year three (pre-election) are particularly powerful. This effect is largely due



to the behavior of investors during the final stages of a bear market. Bear markets tend to end in a frenzy, as investors, en masse, throw in the towel at the very bottom. Once the final cadre of sellers is out of the way, the overhead pressure on the market is lifted and the results can be very explosive as buyers find no more eager sellers at recent price levels.

The Presidential Election Cycle

Two Strategies

Strategy 1: Own the S&P 500 from October 1 of the second year of the presidential term through December 31 of the election year.
Total: 27 months

Strategy 2: Own the S&P 500 from January 1 of the inaugural year through September 30 of the second year of the presidential term.
Total: 21 months

Presidential Election Dates	Strategy 1 % of change*	Strategy 2 % of change*	Strategy 1 Dollar results	Strategy 2 Dollar results
1952	+35%	+22%	\$1,350	\$1,220
1956	+45%	+8%	\$1,956	\$1,318
1960	+16%	-2%	\$2,271	\$1,291
1964	+52%	-9%	\$3,451	\$1,175
1968	+39%	-19%	\$4,798	\$952
1972	+40%	-47%	\$6,717	\$505
1976	+70%	-4%	\$11,418	\$483
1980	+32%	-12%	\$15,072	\$425
1984	+37%	+40%	\$20,649	\$595
1988	+19%	+11%	\$24,571	\$660
1992	+38%	+7%	\$33,909	\$707
1996	+60%	+42%	\$54,254	\$1,004
2000	+34%	-36%	\$72,701	\$643
% Up	100%	46%		
Avg Return	39.6%	0.0%		

*Changes are appreciation only. Dividends not included. No cost factors are considered. Past performance is not a guarantee of future performance. The S&P 500 index is an index of 500 of the largest U.S. companies weighted by capitalization. Data from Pepperdine University, Graziadio Business Reports. 2004 Vol 7, Issue 3.

To see the compounding power of these election cycle regularities, let's imagine two investment strategies. The first strategy is to buy the S&P 500 on September 30 of year two and hold for nine quarters (27 months). The second strategy is to buy the S&P 500 on the last day of December of year four and hold until October 1 of year two (21 months). Beginning in 1952, there have been 13 complete cycles (we're in the 14th).

Strategy 1 has produced gains 13 times, averaging a return (appreciation only) of 39.6%, or about 17% annualized. A \$1,000 investment grew to \$72,701 at the end of 2004.

Strategy 2, on the other hand, was down seven times, averaging a return of 0%. A \$1,000 investment in Strategy 2 shrank to \$643 over five decades.

In essence, Strategy 1 captured all of the appreciation of the market since 1952 with none of the downside.

Portfolio Strategy

The Alpha Election Cycle Portfolio is constructed to exploit the most consistent, statistically meaningful regularities of the presidential election cycle. The principle objective is to avoid large losses.

Losses, in the order of 30% - 50% or more, are the product of recession-related bear markets which normally begin in the first year of the presidential term. The 2000-2002 bear market was exceptional, having begun in March of 2000, an election year. Most of the losses, however, were experienced in years one and two, with the second and third quarters of 2002 containing more than half of the final loss for the S&P 500.

Losses of this magnitude are the number one risk to pre-retirement and retirement portfolios. Not only do such losses require years of recovery (which rob portfolios of the compounding effect), but the consequences for income-producing portfolios are disastrous. A retiree, withdrawing 5% or more of an equity portfolio annually, could find the portfolio down 60% or more, virtually insuring the rapid depletion of the asset in order to maintain the original income requirement.

Therefore, our portfolio adopts a conservative stance, maintaining a 25% equity commitment, during the most dangerous period of the election cycle – the second and third quarters of the mid-term year.

Why not forego equities entirely in the period? Because it is rare that both quarters are down in the same year. Some market bottoms occur as early as April (1978), others in mid-summer (1982), and others later in the third quarter (1974, 1994, 1998, 2002). By maintaining a 25% exposure, we insure that the damage caused by the rare event is minimal, while also capturing a portion of the upside during the more normal mid-term years.

As we have seen, the period containing the fourth quarter of year two and all of year three is especially robust and consistently profitable. Our portfolio will be fully invested throughout this period. Since 1933 this period has been up 100% of the time.

The next best bet during the election cycle is the fourth quarter of any year. Since 1952, covering 55 years, fourth quarters have been up 90% of the time, averaging an appreciation rate of 4.2% in the S&P 500. This appreciation has been boosted by dividends of about 0.75% on average, bringing the total return to almost 5%.

In the mid-term and election years, the fourth quarter has been up 93% of the time. The remaining years average 86% positive returns.

This boils down to an annual bet each fourth quarter with 9:1 odds in our favor. Alpha's portfolio is always fully invested in the fourth quarter.

We have now determined the fate of nine quarters – Q2, Q3 of year two (25%), Q4 of all years (100%) and Q1, Q2, Q3 of the pre-election year (100%). What about the remaining quarters?

Valuations Matter

In addition to the four-year cycle, the market goes through a much longer 15-20 year cycle which market observers have dubbed “the secular cycle”. This cycle takes stocks from undervalued status (low price to earnings) to overvalued status (high price to earnings) over multiple four-year cycles. The cycle then repeats in the other direction.

The period from World War II to the early nineteen sixties was a 20 year “secular” bull market, with a total return of 774% (S&P 500). The period from 1965 to 1982 was a “secular” bear market, with a total return of -10%. More recently, the period from 1982 to 2000 was a “secular” bull market with a total return of 1214%. Many observers believe that the U.S. has now entered a “secular” bear market and that returns for the next 10 to 15 years will be sub-normal with high market volatility. If this is true, the presidential election cycle could become extremely significant. During the last secular bear market (1965-1983), there were five four-year

cycles and each one contained a bear market lasting more than a year. Each of these occurred during years one and two of the election cycle (see attachment: Valuations and Real Returns).

Since the current stock market is valued in the top quintile historically, and since ten-year returns associated with this level of valuation have been virtually zero, we have adopted a very conservative position regarding the remaining quarters in the cycle. This may cost the portfolio some return opportunities but, most importantly, it offers protection against downside volatility during the cycle's more vulnerable periods.

When not fully invested in stocks, the portfolio will hold the balance in intermediate bonds, with average maturities of 3-5 years. During periods of declining rates, these maturities can add significantly to total returns. During periods of rising rates, they tend to be competitive with money market funds, especially over periods of three to four quarters.

Alpha Election Cycle Portfolio					
Market Exposure 2008 - 2011					
2008	Q1	25%	2010	Q1	50%
	Q2	25%		Q2	25%
	Q3	50%		Q3	25%
	Q4	100%		Q4	100%
2009	Q1	25%	2011	Q1	100%
	Q2	50%		Q2	100%
	Q3	25%		Q3	100%
	Q4	100%		Q4	100%

Conclusion

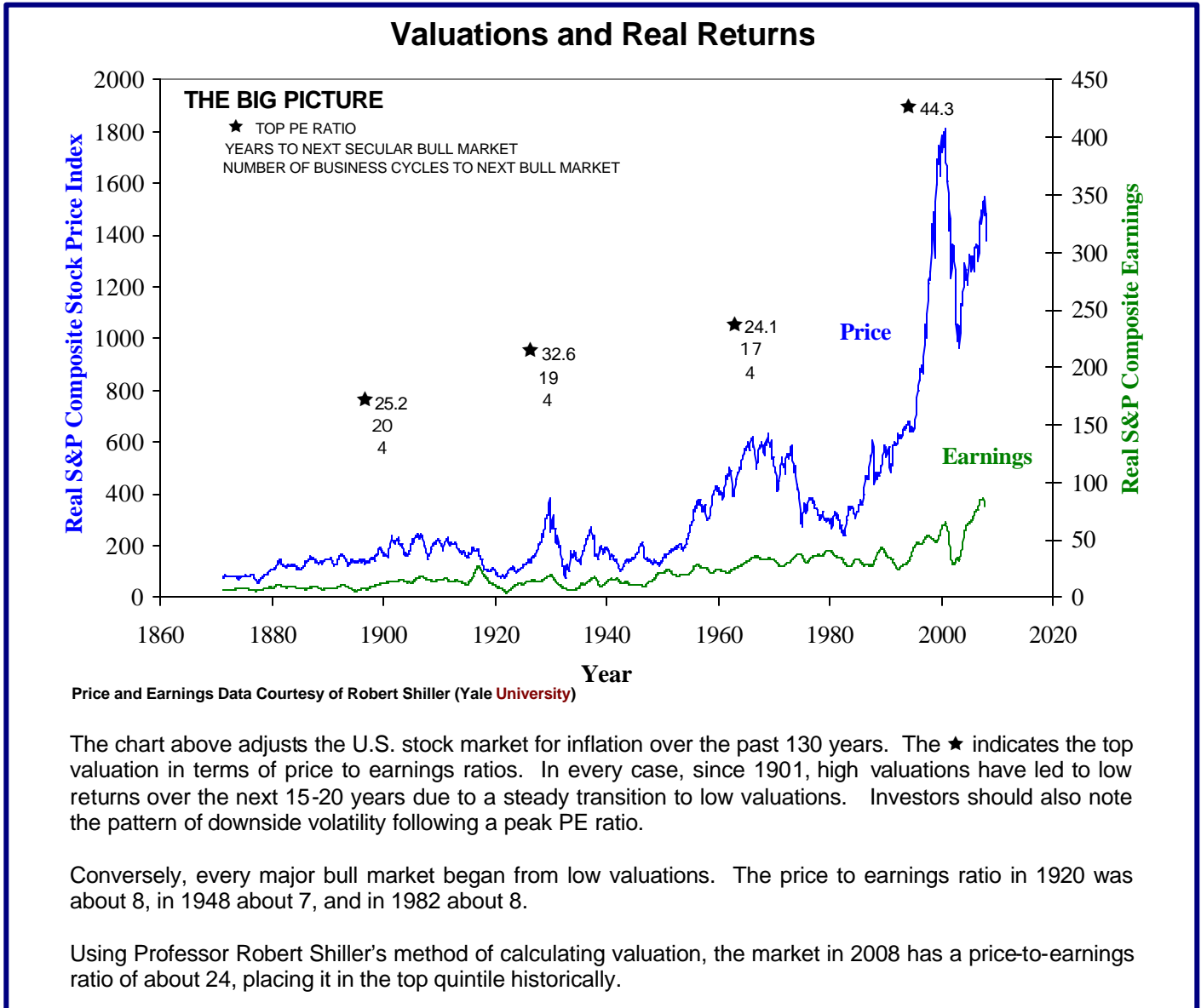
Investors nearing retirement or in retirement do not have the luxury of waiting out a deep bear market and the subsequent recovery period. The most important factors for this class of investors are consistently positive annual returns and long-term returns significantly above the inflation rate.

The Alpha Election Cycle Portfolio seeks to address this necessity by accepting full market risk only during periods which have produced robust returns with a statistical probability of 90% or more. The portfolio's underlying assumption is that the political forces at work historically have not changed and, if anything, have become a more powerful causal factor in stock market returns.

The stock market is intrinsically cyclical. Investors who hold on to a market-like portfolio through thick and thin should realize that they are accepting the probability of large losses at some point in time as a matter of course. This risk is multiplied many-fold in today's market, which has one of the highest valuations in history – a valuation normally found at secular market tops and never found at the beginning of secular bull markets. For investors who recognize this risk and who are unwilling to take it, the Election Cycle Portfolio offers a lower-risk, long-term alternative.

Attachments

The Presidential Election Cycle



"SWEET SPOT" STRATEGY
5 QUARTERS: YEAR 2, Q4; YEAR 3, ALL
S&P 500, with dividends reinvested
1953 - 2008

1954 Q4: 11.4%	1982 Q4: 18.2%
1955 All: <u>26.4%</u>	1983 All: <u>22.6%</u>
TOTAL: 40.8%	TOTAL: 44.9%
1958 Q4: 10.3%	1986 Q4: 5.6%
1959 All: <u>8.5%</u>	1987 All: <u>5.2%</u>
TOTAL: 19.7%	TOTAL: 11.1%
1962 Q4: 12.1%	1990 Q4: 9.0%
1963 All: <u>18.9%</u>	1991 All: <u>30.5%</u>
Total: 33.3%	TOTAL: 42.2%
1966 Q4: 4.9%	1994 Q4: 0.0%
1967 All: <u>20.1%</u>	1995 All: <u>37.6%</u>
TOTAL: 26.0%	TOTAL: 37.6%
1970 Q4: 9.4%	1998 Q4: 21.3%
1971 All: <u>10.8%</u>	1999 All: <u>21.0%</u>
TOTAL: 21.2%	TOTAL: 46.8%
1974 Q4: 9.4%	2002 Q4: 8.4%
1975 All: <u>37.2%</u>	2003 All: <u>28.7%</u>
TOTAL: 50.1%	TOTAL: 39.5%
1978 Q4: -4.9%	2006 Q4: 6.7%
1979 All: <u>18.6%</u>	2007 All: <u>5.5%</u>
TOTAL: 12.8%	TOTAL: 12.6%

\$1,000,000 invested grows to \$42,192,000

Total Time Invested	17.5 Yrs
Compound Annual Return	24%
Down Years	0

THE "SWEET SPOT"
YEAR TWO Q4 & YEAR THREE

AVERAGE RETURNS*

	NASDAQ 1963-2008	S&P 500 1953-2008	MID-CAP 400 1991-2008
Y2 Q4	8.4%	8.1%	9.2%
Y3	34.3%	18.4%	24.0%
TOTAL	45.6%	28.0%	35.4%

RECENT RETURNS*

	NASDAQ	S&P 500	MID-CAP
2002 Q4	13.9%	7.9%	5.5%
2003 ALL	50.0%	26.4%	34.0%
TOTAL	70.9%	36.3%	41.4%
2006 Q4	6.9%	6.4%	6.6%
2007 ALL	9.8%	3.5%	6.7%
TOTAL	17.4%	10.1%	13.7%

"THE HOLE"
YEAR TWO Q2, Q3

AVERAGE RETURNS*

	NASDAQ 1963-2008	S&P 500 1953-2008	MID-CAP 400 1991-2008
Y2 Q2	-4.6%	-2.5%	-5.7%
Y2 Q3	-5.6%	-1.4%	-5.8%
TOTAL	-10.5%	-3.9%	-11.8%

RECENT RETURNS*

	NASDAQ	S&P 500	MID-CAP 400
2002 Q2	-20.7%	-13.7%	-9.5%
Q3	-19.9%	-17.7%	-16.8%
TOTAL	-44.7%	-33.8%	-27.9%
2006 Q2	-7.2%	-1.9%	-6.7%
Q3	4.0%	5.2%	2.0%
TOTAL	-2.9%	3.2%	-4.8%

*Appreciation only, dividends not included.

S&P 500
Large-Cap Index
Total Returns
27 Months, Y2 Q4 - Y4 Q1

1974 Q4 - 1977 Q1	+85.8%
1978 Q4 - 1981 Q1	+49.2%
1982 Q4 - 1985 Q1	+54.2%
1986 Q4 - 1989 Q1	+29.4%
1990 Q4 - 1993 Q1	+52.7%
1994 Q4 - 1997 Q1	+68.8%
1998 Q4 - 2001 Q1	+33.4%
2002 Q4 - 2005 Q1	+54.6%
Average	53.5%
Average/Qtr	5.9%

S&P 400
Mid-Cap Index
Total Returns
27 months, Y2 Q4 - Y4 Q1

1982 Q4 - 1985 Q1	+53.0%
1986 Q4 - 1989 Q1	+21.7%
1990 Q4 - 1993 Q1	+81.4%
1994 Q4 - 1997 Q1	+51.7%
1998 Q4 - 2001 Q1	+73.4%
2002 Q4 - 2005 Q1	+67.8%
Average	58.2%
Average/Qtr	6.5%

Pre-Election Year Returns

1915	Wilson (D)	Dow	+81.7%				
1919	Wilson (D)	Dow	+30.5%				
1923	Harding/Coolidge (R)	Dow	-3.3%	(Teapot Dome Scandal)			
1927	Coolidge (R)	Dow	+28.8%				
1931	Hoover (R)	Dow	-52.7%	S&P	-47.1% (Depression)		
1935	Roosevelt (D)	Dow	+38.5%	S&P	+41.2%		
1939	Roosevelt (D)	Dow	-2.9%	S&P	-5.5% (Dow up 24% April-Dec)		
1943	Roosevelt (D)	Dow	+13.8%	S&P	+19.4%		
1947	Truman (D)	Dow	+2.2%	S&P	0.0%		
1951	Truman (D)	Dow	+14.4%	S&P	+16.5%		
1955	Eisenhower (R)	Dow	+20.8%	S&P	+26.4%		
1959	Eisenhower (R)	Dow	+16.4%	S&P	+8.5%		
1963	Kennedy/Johnson (D)	Dow	+17.0%	S&P	+18.9%		
1967	Johnson (D)	Dow	+15.2%	S&P	+20.1%	NASDAQ	+54.0%
1971	Nixon (R)	Dow	+6.1%	S&P	+10.8%	NASDAQ	+27.4%
1975	Ford (R)	Dow	+44.8%	S&P	+37.2%	NASDAQ	+29.8%
1979	Carter (D)	Dow	+10.5%	S&P	+18.6%	NASDAQ	+32.4%
1983	Reagan (R)	Dow	+26.0%	S&P	+22.6%	NASDAQ	+22.0%
1987	Reagan (R)	Dow	+5.4%	S&P	+5.3%	NASDAQ	-3.9%
(October 1987 market crash)							
1991	Bush (R)	Dow	+24.3%	S&P	+30.5%	NASDAQ	+59.4%
1995	Clinton (D)	Dow	+36.8%	S&P	+37.6%	NASDAQ	+41.2%
1999	Clinton (D)	Dow	+27.1%	S&P	+21.0%	NASDAQ	+86.1%
2003	Bush (R)	Dow	+28.2%	S&P	+28.7%	NASDAQ	+50.8%
2007	Bush (R)	Dow	+8.9%	S&P	+5.5%	NASDAQ	+10.7%

*Prior to 1975 returns are appreciation only. On a total return basis, the only down year for the DOW was 1931. The S&P 500 with dividends was flat in 1939.

STOCK MARKET ACTION SINCE 1933 Annual % Change in Dow Jones Industrial Average

4-Year Cycle Beginning	Elected President	Post-Election Year	Mid-Term Year	Pre-Election Year	Election Year
1933*	F. Roosevelt (D)	66.7	4.1	38.5	24.8
1937	F. Roosevelt (D)	-32.8	28.1	-2.9	-12.7
1941	F. Roosevelt (D)	-15.4	7.6	13.8	12.1
1945	F. Roosevelt (D)	26.6	-8.1	2.2	-2.1
1949*	Truman (D)	12.9	17.6	14.4	8.4
1953*	Eisenhower (R)	-3.8	44.0	20.8	2.3
1957	Eisenhower (R)	-12.8	34.0	16.4	-9.3
1961*	Kennedy (D)	18.7	-10.8	17.0	14.6
1965	Johnson (D)	10.9	-18.9	15.2	4.3
1969*	Nixon (R)	-15.2	4.8	6.1	14.6
1973	Nixon (R)	-16.6	-27.6	38.3	17.9
1977*	Carter (D)	-17.3	-3.1	4.2	14.9
1981*	Reagan (R)	-9.2	19.6	20.3	-3.7
1985	Reagan (R)	27.7	22.6	2.3	11.8
1989	G. H. W. Bush (R)	27.0	-4.3	20.3	4.2
1993*	Clinton (D)	13.7	2.1	33.5	26.0
1997	Clinton (D)	22.6	16.1	25.2	-6.2
2001*	G. W. Bush (R)	-7.1	-16.8	25.3	3.1
2005	G. W. Bush (R)	-0.6	16.3	6.4	
Total % Gain		96.0%	126.0%	325.0%	125.0%
Average % Gain		5.0%	6.7%	17.1%	6.9%
# Up		9	12	18	13
# Down		10	7	1	5

*Party in power ousted
Data from Stock Traders Almanac 2008