

Presidential Elections and Market Returns

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EVERY FOUR YEARS OR SO, WE ARE ASKED ABOUT THE EFFECTS of a presidential election on stock and bond returns. The Fama/French factor returns provide good data for reviewing election history. Fama and French calculate the following five time series of returns as proxies for risk dimensions of stock and bond returns:

- Market factor: Stock market return above Treasury bills, $R_m - R_f$;
- Size factor: Small cap minus large cap stock returns, SMB;
- Price factor: Low-priced minus high-priced stock returns HML, where price is scaled by book value;
- Term premium: Treasury bond minus Treasury bill return, TERM; and
- Credit premium: Corporate bond minus Treasury bond return, DEFAULT.

Table 1 displays the average factor returns from 1927 to 2003, both in total and by month of the year. The pattern of returns across calendar months is pretty random, except for January. Both SMB and HML have unusually large average returns in January.

When presidential election years are considered separately, the pattern of returns is still fairly random. Table 2 displays results for the five months preceding an election and for the five months after an election. The entire month of November is treated as a post-election month. The market premium appears to be unusually high for July and August. However, it is not more than two standard deviations above the average premium for all months 1927-2003. The unusually large average return is attributable to the July-August return of over 100% in 1932.

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The post-election results show strong returns for the first three months after an election, but the twelve-month results are strikingly similar to the overall averages displayed in Table 1.

An incumbent President is running for reelection this year. In 13 of the last 19 presidential elections, an incumbent stood for reelection. Of those, the incumbent won 9 times and lost 4. Table 3 displays the behavior of the Fama/French factor returns in the months around the election for those incumbents who won since 1928. It appears that the incumbent in those cases benefits from a strong stock and bond market, with large cap stocks outperforming small cap stocks. In the year after the election, the factor returns are about normal.

Table 4 displays the results for the 10 elections since 1928 when the incumbent was not reelected. The factor returns are all negative for the month of October. Once again, though, the factor returns for the twelve months after the election are all about normal.

In summary, historical data suggests that the presidential election year results do not produce any significant findings that would suggest a change in an asset allocation strategy. Not surprisingly, factor returns are strong in the months before an election when an incumbent is reelected and weak when an incumbent is not reelected. Win or lose, the post-election factor returns are close to historical norms in the months after the election.

Even though election results don't seem to predict factor returns, factor returns in the months before an election may help predict the election winner. Table 5 displays the success of predicting election results from a derived stock variable. The derived variable, the "E" factor in Table 5, is the difference in returns between the Fama/French Large Cap Value Index and the Fama/French Small Cap Growth Index for the month of October in the election year. The "E" factor correctly predicts all 9 of the reelection victories for the incumbents and all 4 of the reelection defeats!

The "E" factor was developed through a process of egregious data mining, and there is no claim that it can successfully predict winners in the future. Nevertheless, the performance of the stock market between now and the election will probably influence election results, and I, for one, will be curious to see how well the "E" factor performs out of sample.

Table 1

Fama/French Factors
Average Monthly Returns (%)
 November 1927-October 2003

	$R_m - R_f$	SMB	HML	TERM	DEFAULT
All months	0.64	0.26	0.36	0.15	0.03
November	1.30	0.26	-0.36	0.45	-0.10
December	1.40	-0.11	-0.56	0.16	0.20
January	1.50	2.59	2.55	-0.01	0.60
February	0.30	0.69	0.29	0.02	-0.18
March	0.30	0.13	0.20	-0.12	-0.09
April	0.94	-0.08	0.98	0.01	-0.15
May	0.16	0.48	0.02	0.08	0.17
June	0.86	-0.24	0.06	0.56	-0.30
July	1.12	-0.19	1.04	-0.01	0.04
August	1.06	0.08	0.48	0.01	0.13
September	-1.33	0.42	-0.34	0.09	0.15
October	0.10	-0.87	-0.08	0.57	-0.08

Data courtesy of Fama/French.

Equity Factors

$R_m - R_f$	Market factor	Stock market return above Treasury bills
SMB	Size effect	Small cap minus large cap stock returns
HML	Price effect	Low-priced minus high-priced stock returns

Fixed Income Factors

TERM	Term premium	Treasury bond minus Treasury bill return
DEFAULT	Credit premium	Corporate bond minus Treasury bond return

Table 2

Fama/French Factors
Average Monthly Returns (%)
All 19 Presidential Election Years
1928-2000

Pre-Election Months	$R_m - R_f$	SMB	HML	TERM	DEFAULT
June	1.72	-0.40	0.01	1.19	-0.42
July	1.85	-0.95	2.89	0.62	-0.10
August	3.48	1.28	1.29	-0.12	0.42
September	-0.00	0.30	-0.40	0.16	0.29
October	0.20	-1.06	0.36	0.47	-0.11
Post-Election Months	$R_m - R_f$	SMB	HML	TERM	DEFAULT
November	1.48	0.32	-0.36	0.45	-0.13
December	1.36	-0.16	0.17	0.17	0.22
January	1.21	1.71	2.64	-0.28	0.89
February	-1.68	-0.25	1.68	-0.60	-0.02
March	-0.12	0.11	1.41	-0.17	-0.08
Pre-Election Periods	$R_m - R_f$	SMB	HML	TERM	DEFAULT
Last 5 months: Jun-Oct	1.45	-0.16	0.83	0.46	0.01
Last 4 months: Jul-Oct	1.38	-0.11	1.04	0.28	0.12
Last 3 months: Aug-Oct	1.23	0.17	0.42	0.17	0.20
Last 2 months: Sep-Oct	0.10	-0.38	-0.02	0.31	0.09
Post-Election Periods	$R_m - R_f$	SMB	HML	TERM	DEFAULT
Next 2 months: Nov-Dec	1.42	0.08	-0.09	0.31	0.04
Next 3 months: Nov-Jan	1.35	0.62	0.82	0.11	0.32
Next 4 months: Nov-Feb	0.59	0.40	1.03	-0.07	0.24
Next 5 months: Nov-Mar	0.45	0.35	1.11	-0.09	0.17
Next year: Nov-Oct	0.42	0.26	0.53	0.19	0.01

Data courtesy of Fama/French.

Table 3

Fama/French Factors
Average Monthly Returns (%)
All 9 Presidential Election Years When Incumbent Is Reelected
1928-2000

Pre-Election Months	$R_m - R_f$	SMB	HML	TERM	DEFAULT
June	2.01	-0.85	0.55	0.43	-0.25
July	0.03	-0.99	0.77	0.69	-0.01
August	1.89	0.30	0.33	-0.06	-0.01
September	0.13	0.36	-0.03	0.61	0.08
October	2.01	-1.34	1.56	1.12	-0.02
Post-Election Months	$R_m - R_f$	SMB	HML	TERM	DEFAULT
November	0.46	0.56	0.58	1.06	-0.37
December	1.30	-0.01	0.30	-0.61	0.52
January	1.22	1.72	0.82	0.14	0.30
February	-0.30	-0.66	1.81	-0.45	0.10
March	-0.63	-0.52	2.35	-0.31	0.08
Pre-Election Periods	$R_m - R_f$	SMB	HML	TERM	DEFAULT
Last 5 months: Jun-Oct	1.21	-0.51	0.64	0.56	-0.04
Last 4 months: Jul-Oct	1.01	-0.42	0.66	0.59	0.01
Last 3 months: Aug-Oct	1.34	-0.23	0.62	0.55	0.02
Last 2 months: Sep-Oct	1.07	-0.49	0.76	0.86	0.03
Post-Election Periods	$R_m - R_f$	SMB	HML	TERM	DEFAULT
Next 2 months: Nov-Dec	0.88	0.28	0.44	0.23	0.08
Next 3 months: Nov-Jan	0.99	0.76	0.57	0.20	0.15
Next 4 months: Nov-Feb	0.67	0.41	0.88	0.03	0.14
Next 5 months: Nov-Mar	0.41	0.22	1.17	-0.03	0.13
Next year: Nov-Oct	0.36	0.07	0.47	0.23	0.00

Data courtesy of Fama/French.

Table 4

Fama/French Factors
Average Monthly Returns (%)
All 10 Presidential Election Years When Incumbent Is Not Reelected
1928-2000

Pre-Election Months	$R_m - R_f$	SMB	HML	TERM	DEFAULT
June	1.46	0.02	-0.47	1.88	-0.58
July	3.50	-0.91	4.80	0.56	-0.19
August	4.92	2.17	2.16	-0.18	0.80
September	-0.12	0.26	-0.72	-0.25	0.48
October	-1.44	-0.81	-0.71	-0.11	-0.18
Post-Election Months	$R_m - R_f$	SMB	HML	TERM	DEFAULT
November	2.40	0.10	-1.21	-0.11	0.07
December	1.41	-0.29	0.07	0.87	-0.06
January	1.21	1.70	4.28	-0.65	1.41
February	-2.93	0.11	1.56	-0.74	-0.13
March	0.33	0.68	0.56	-0.04	-0.23
Pre-Election Periods	$R_m - R_f$	SMB	HML	TERM	DEFAULT
Last 5 months: Jun-Oct	1.66	0.14	1.01	0.46	-0.03
Last 4 months: Jul-Oct	1.71	0.17	1.38	0.00	0.23
Last 3 months: Aug-Oct	1.12	0.54	0.24	-0.18	0.37
Last 2 months: Sep-Oct	-0.78	-0.28	-0.72	-0.18	0.15
Post-Election Periods	$R_m - R_f$	SMB	HML	TERM	DEFAULT
Next 2 months: Nov-Dec	1.91	-0.10	-0.57	0.38	0.01
Next 3 months: Nov-Jan	1.67	0.50	1.04	0.04	0.48
Next 4 months: Nov-Feb	0.52	0.40	1.17	-0.16	0.33
Next 5 months: Nov-Mar	0.49	0.46	1.05	-0.13	0.22
Next year: Nov-Oct	0.47	0.39	0.47	0.18	0.02

Data courtesy of Fama/French.

Table 5

Presidential Election Years Using "E" Scores to Forecast Election Winners

"E" = Fama/French Large Cap Value Index return (%) minus Fama/French Small Cap Growth Index return (%) for the month of October in the election year.

YEAR	RESULT	"E"
1928	DNP	-4.20
1932	LOST	-20.02
1936	WON	3.28
1940	WON	5.25
1944	WON	1.55
1948	WON	2.10
1952	DNP	0.69
1956	WON	0.22
1960	DNP	6.45
1964	WON	0.22
1968	DNP	3.34
1972	WON	4.39
1976	LOST	-0.56
1980	LOST	-7.61
1984	WON	2.80
1988	DNP	5.39
1992	LOST	-3.99
1996	WON	7.62
2000	DNP	9.75

Data courtesy of Fama/French.

Average "E" Score by Election Outcome

Victory by Incumbent (9)	Won	3.05
Incumbent Does Not Participate (6)	DNP	3.57
Incumbent Loses (4)	Lost	-8.04

If an incumbent runs and "E" score is negative, then incumbent loses 4 times out of 4.

If an incumbent runs and "E" score is positive, then incumbent wins 9 times out of 9.

Editor's Note: Addendum to Table 5

<u>YEAR</u>	<u>RESULT</u>	<u>"E"</u>
2004	WON	1.00

Data courtesy of Fama/French.

Average "E" Score by Election Outcome

Victory by Incumbent (10)	Won	2.84
Incumbent Does Not Participate (6)	DNP	3.57
Incumbent Loses (4)	Lost	-8.04

If an incumbent runs and "E" score is negative, then incumbent loses 4 times out of 4.

If an incumbent runs and "E" score is positive, then incumbent wins 10 times out of 10.