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Presidential Election Cycle

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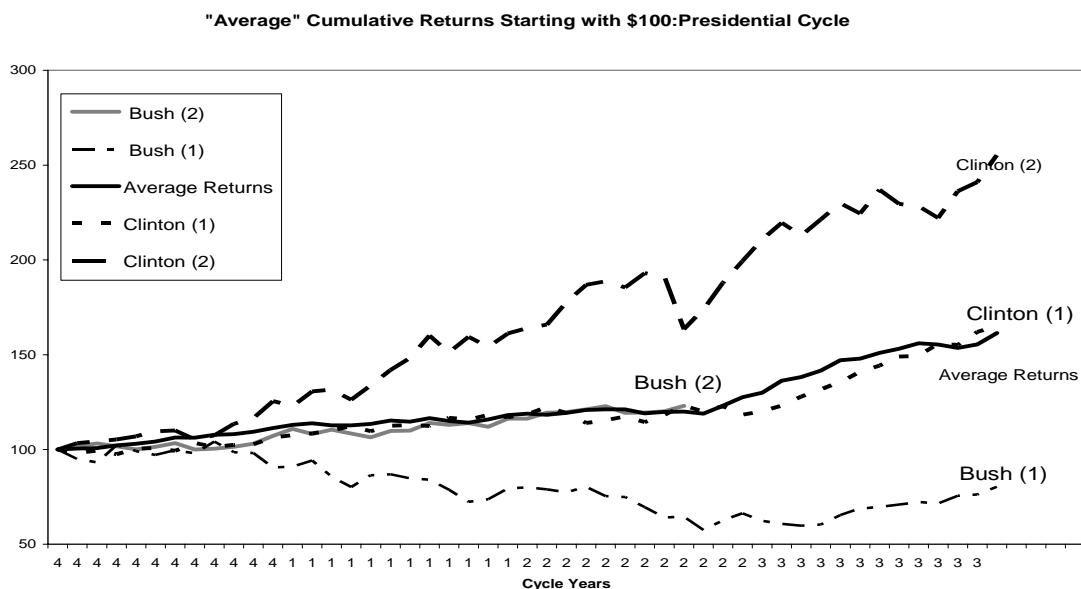
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Introduction

Market watchers use all types of models to predict when stocks will rise and fall, and the Presidential Election Cycle has been a long-time favorite. The indicator uses a simple four-year cycle to predict major market trends. As the theory goes, each year of the Presidential Cycle holds predictable policy changes that affect the economy, and those changes are reflected in stock prices. Despite the model's simple methodology, it has been an uncannily accurate method over the past 100 years. This paper reviews the Presidential Election Cycle and provides you with food for thought.

First, a word of caution: The research we publish on market trends and valuation may be interesting and sometimes entertaining. However, we do not recommend using this paper or any other indicator in an attempt to achieve higher returns from market timing. You can be assured that as soon as you attempt to use this or any other indicator, that methodology will no longer work.

The figure below compares the long-term "Average" cumulative gain starting with \$100 over a four-year cycle with the recent cycles of the Clinton and Bush administrations. As you can see, in all the Presidential terms the least performing period was the first two years of a presidency, and so far the best performing years were the last two.



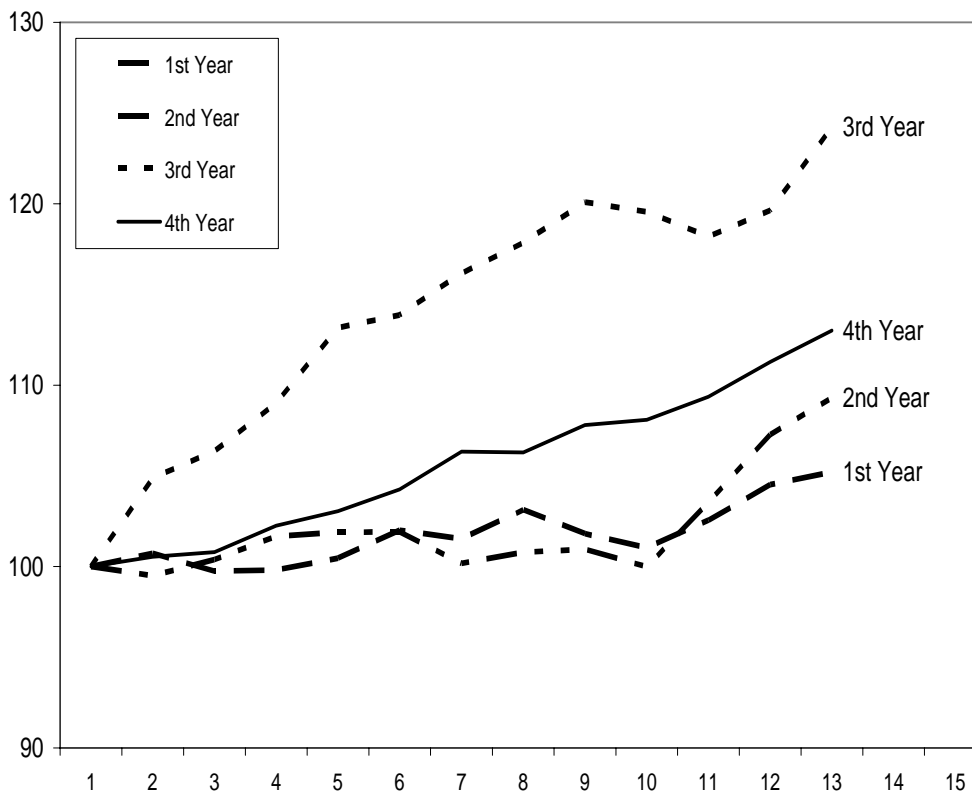
This research report uses data from 1948 to the present. Prior to WWII is eliminated due to the conditions during the Great Depression in the 1930s and WWII in the 1940s. The market data is measured using the S&P 500 index with dividends reinvested.

"Presidential elections every four years have a profound impact on the economy and the stock market."-Yale Hirsch¹

¹ Yale Hirsch and Jeffrey Hirsch, *The Stock Trader's Almanac 2004*, Hoboken, NJ: John Wiley and Sons, (2004): 127.

The presidential election cycles assert that major market changes can be predicted based on the U.S. presidential election cycle. The theory states that the economy declines the first two years after a president is elected because investors are uncertain of a president's real agenda or power. In addition, a first-term president wants the economy to have any bad news and interest rate hikes to happen early so that by re-election time the economy is humming again. It is commonly believed that mid-way through the cycle, the public becomes familiar with the president and the economy begins to pick up. Consequently, stocks rise in anticipation of brighter economic conditions. A strong economy can improve the re-election chances of the incumbent president or improve the conditions for maintaining party leadership. The cycle then repeats itself for a new president or an incumbent president.

"Average" Cumulative Returns Starting with \$100: Election Cycle
Years

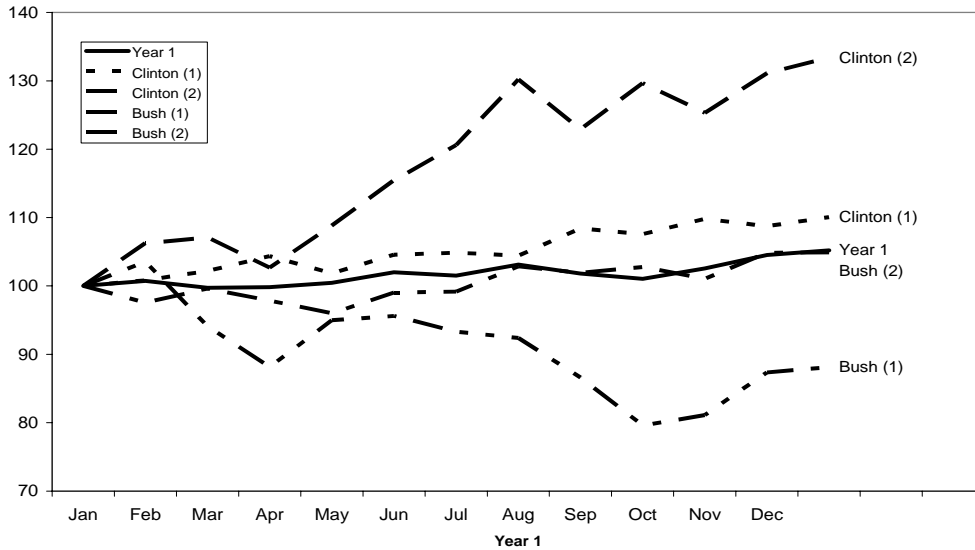


Both Clinton (1) and (2) and G.W. Bush (1) (2) partial have acted in line with presidential cycle expectations. The first two years of the administration were the weakest, and the last two were the strongest. As we enter the second two years of G. W. Bush (2), the cycle indicates stock market prosperity.

1st Year of the Presidential Election Cycle

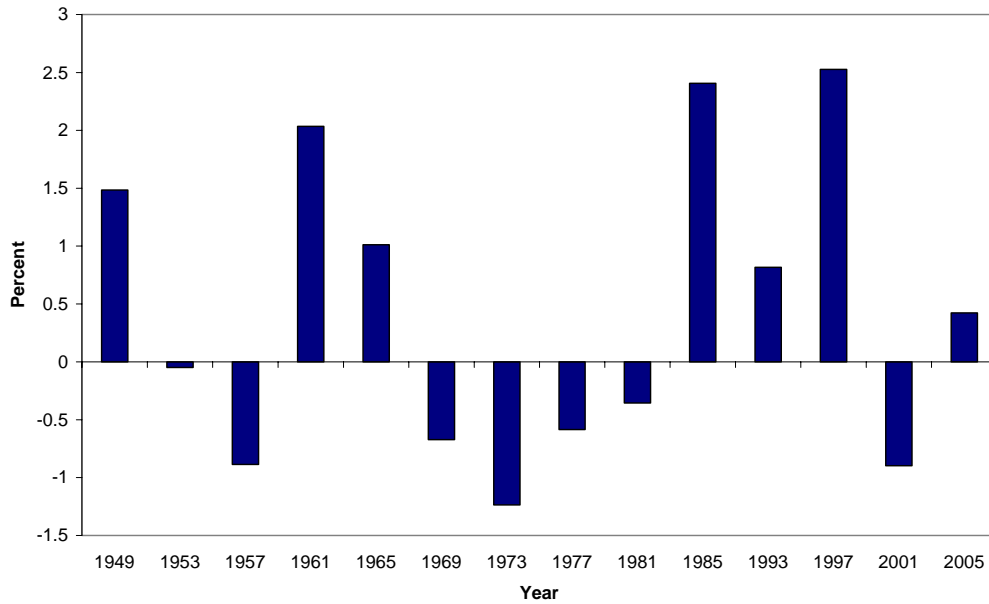
The first year of the election cycle has provided a relative flat to slight positive total return.

Average Returns Starting with \$100: Year 1



Based on the average returns, the first year shows only modest positive returns and both Clinton presidencies outperformed the Bush presidencies. The phenomenon has been more pronounced under the Bush administration recently.

Presidential Election Cycle Returns: Year 1

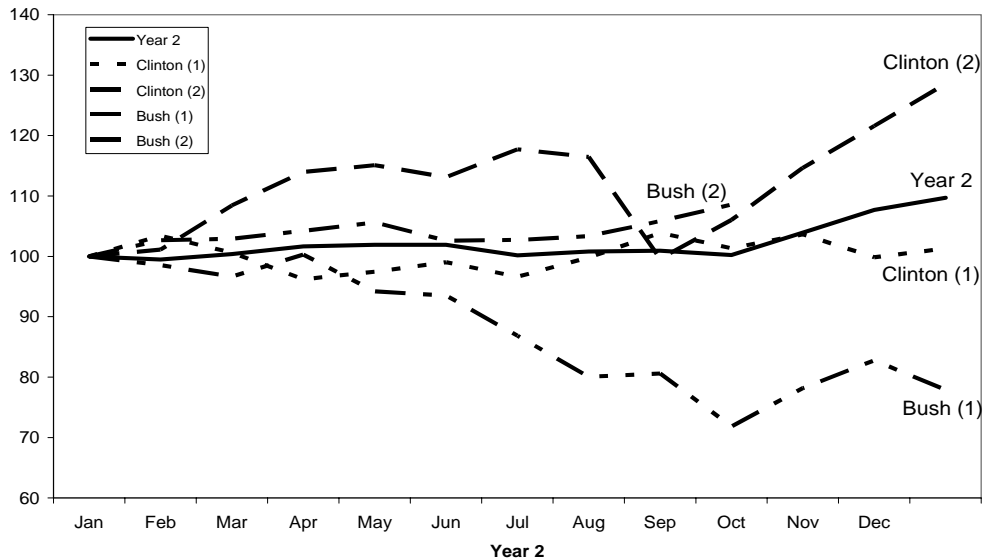


In the figure above, the annual returns are broken down into average monthly returns. The results are erratic. About half the years were positive and half negative.

2nd Year of the Presidential Election Cycle

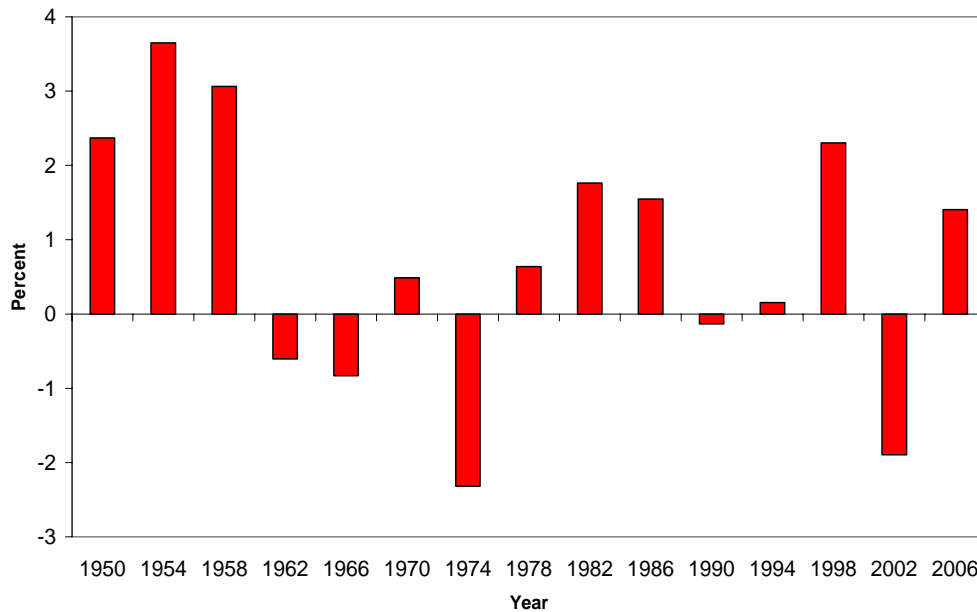
The second year of the presidential cycle is typically the worst performing. However, a rally typically begins in the fall.

Average Returns Starting with \$100: Year 2



The returns for the Clinton (1) and for Bush (2) are very close to the cycle. A fall rally is evident in the past three out of four cycles, including 2006.

Presidential Election Cycle Returns: 2nd Year

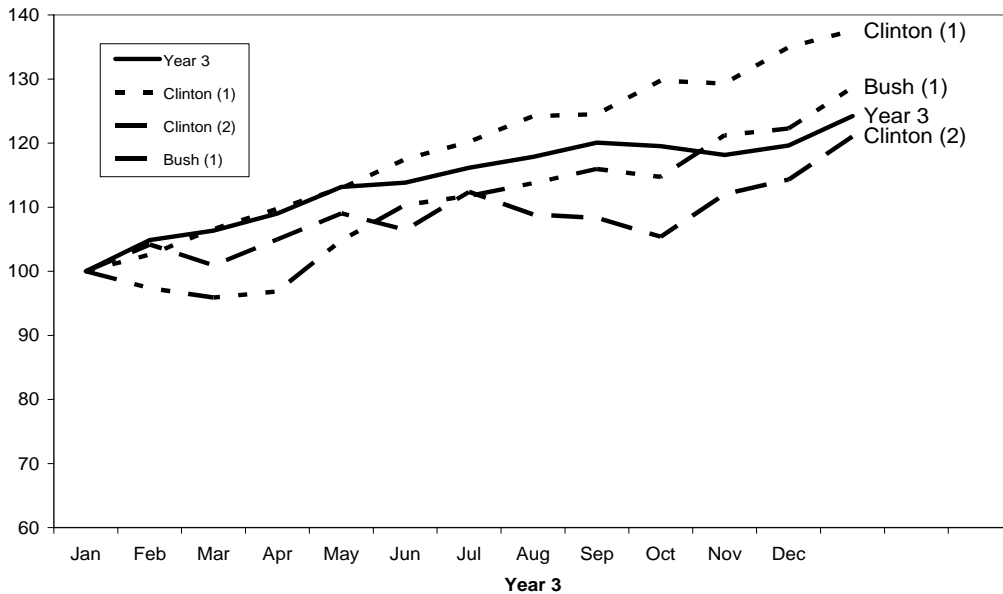


The results for the average monthly returns show inconsistencies; although wider swings. Recently the trend has followed the election cycle closer than during other presidencies.

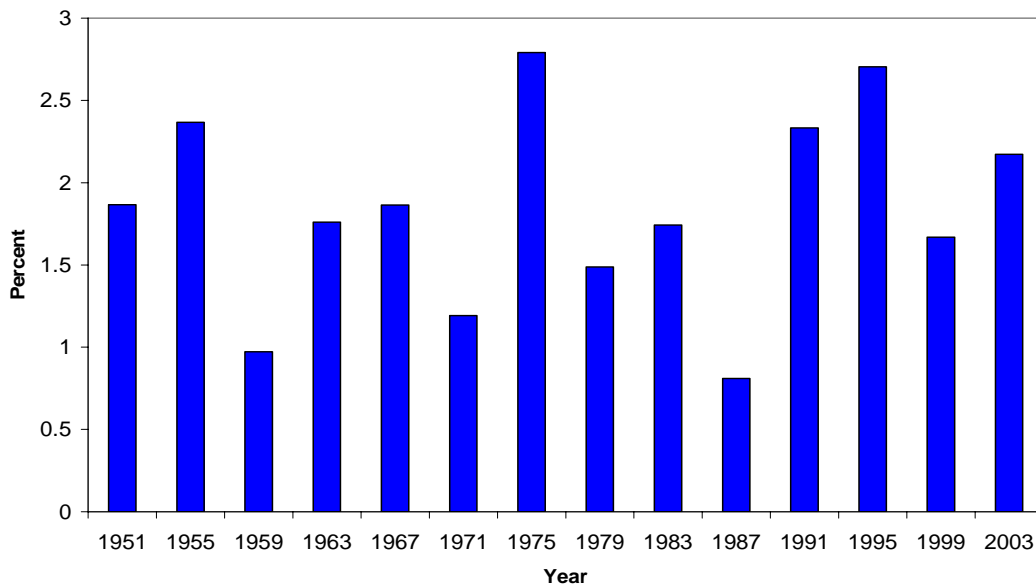
3rd Year of the Presidential Election Cycle

The third year of the cycle has historically been the best performing year. Perhaps we will be lucky and the phenomenon will continue in 2007 during Bush (2).

Average Returns Starting with \$100: Year 3



Presidential Election Cycle Returns: 3rd Year

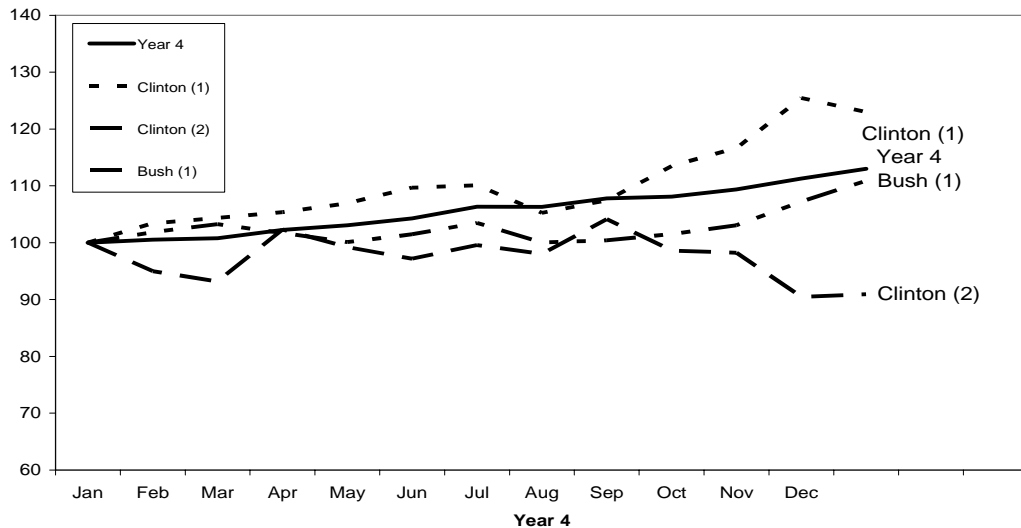


The average monthly returns for the third year are all positive, with average annual gains of 18%. The worst performing third year was during Reagan (2) when the market gained 5%.

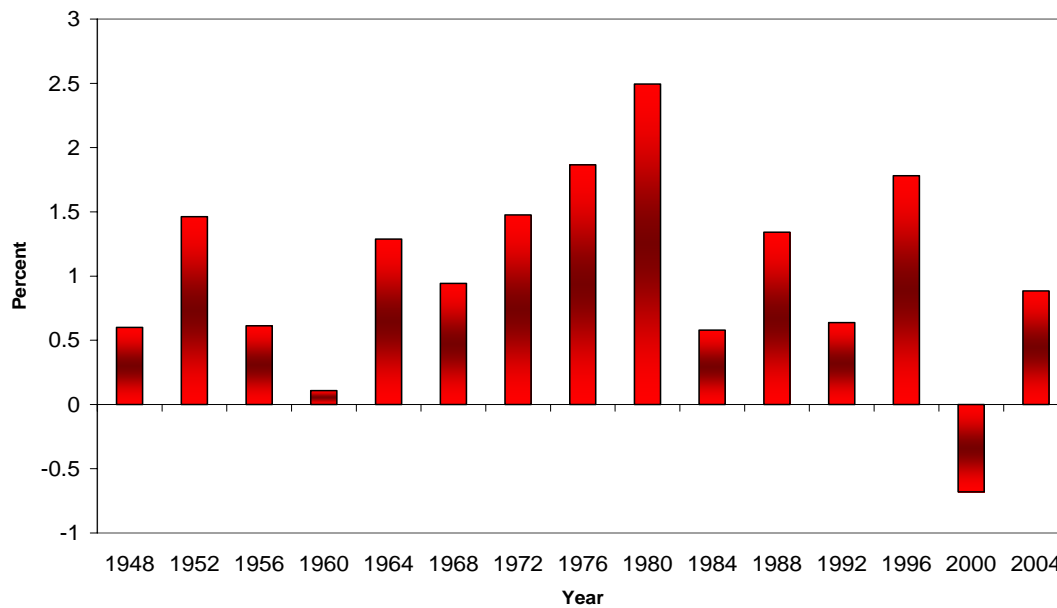
4th Year of the Presidential Election Cycle: The Election Year

The fourth year (election year) is also a good year according to the cycle. The president desires to continue the strong economy started in the second and continued into the third. His (or someday her) reelection may depend on it. There is some indication that the Federal Reserve accommodates the party in power in the fourth year by lowering interest rates, holding rates steady, or delaying interest rate increases.

Average Returns Starting with \$100: Year 4



Presidential Election Cycle Returns: Election Year

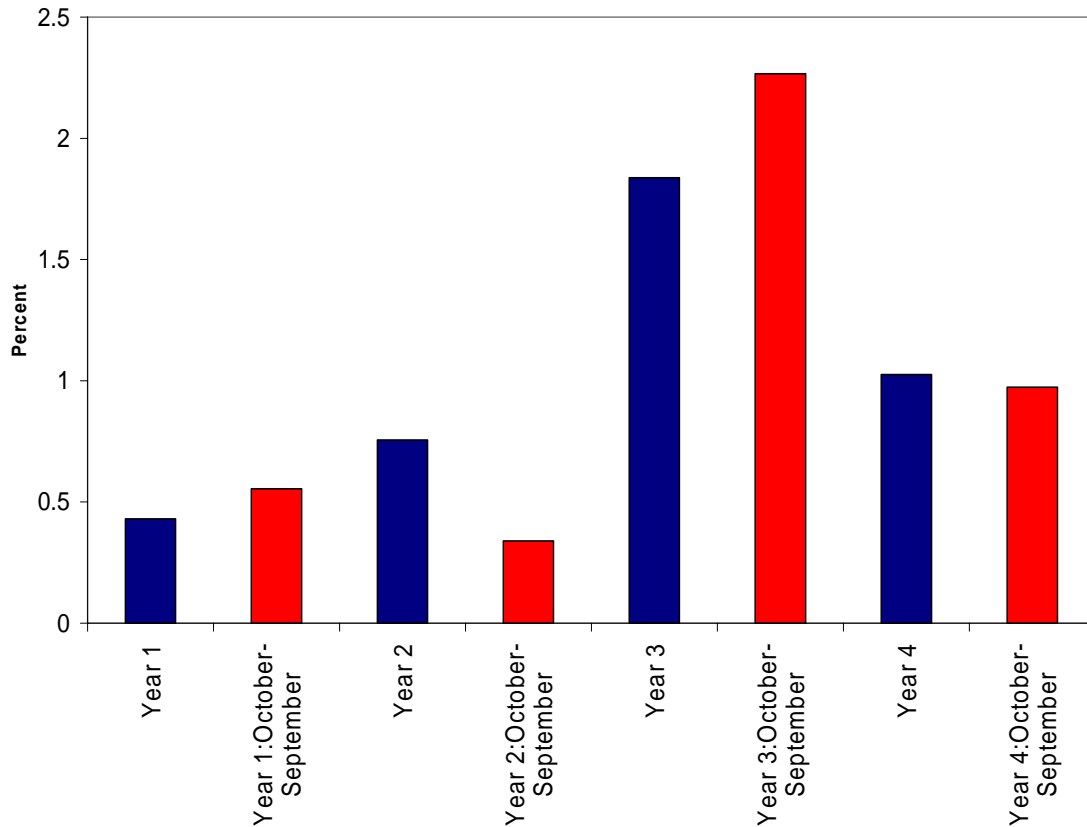


In 2000, the average yearly return was negative. It was the only election year in the post WWII period to feature negative returns, and may have contributed to Al Gore's loss.

October through September Presidential Cycle

The figure below shows the average monthly percent returns of the presidential cycle and the average monthly percent returns of the October through September presidential cycle. The presidential election cycle is more pronounced during this period. If you believe in the cycle, the figures below should make you bullish on stocks through the fall of 2007.

Presidential Election Cycle Returns



The chart shows October through September performance that includes three months of the *previous* calendar years. Therefore, October 2006 is part of the third year rather than the second year of a calendar cycle. Using this method, the third year returns from October through September are higher than other 12-month periods; averaging over 25%. The fourth year from October through September averaged 12%.

Conclusion

Presidential election cycles in stock returns is a theoretical relationship between the political process and the economy. The first two years are mediocre at best, and the last two are robust.

As the theory goes, a new president is untested and unknown. There will be changes in policy, but we do not know what those changes will be. That creates anxiety in the stock market for the first couple of years. In addition, the Federal Reserve may put the breaks on a bubbling pre-election economy by increasing interest rates after a presidential election. Higher interest rates also worry stock investors. By the end of the second year, presidents are predictable, policy is in place, the economy begins to recover from Fed tightening, and the stock market starts a two year rally.

If the time period for the election cycle is shifted forward from the calendar year to October through September, the results become even more pronounced. From October of the first year through September of the second year it has had the lowest returns out of all 12 month periods. The third and fourth years have had the highest average monthly returns.

The presidential election cycle is a theory, and theories do not work on demand in the real day-to-day management of a portfolio. Interesting as the material may be, we do not recommend you use this data to manage your investment portfolio. A buy-hold-rebalance approach to investing will beat any market-timing strategy over your lifetime.

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