Do U.S. Politics Influence Investment Decisions?
Evidence from Global Mutual Funds

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Abstract

We examined the investment behavior of U.S.-based global mutual fund managers to ascertain whether the apparent relations between stock market returns and the U.S. presidential elections are indeed taken into consideration by money managers when making investment decisions and, if so, whether those decisions had any impact on investment returns. Our results suggest that global fund managers invest more domestically during the years when a Republican president is in office and favor international markets when Democratic presidents are in power. This behavior, however, does not appear to be beneficial for the shareholders of these global funds, since their risk-adjusted performance is higher, albeit weakly, during Democratic administrations. Regarding the four-year presidential election cycle, it appears that global fund managers do not take it into consideration, or this cycle may have disappeared.

***Keywords*:** global mutual funds; regional exposure; performance; stock returns; stock prices; market efficiency; presidential-election cycle; U.S. politics

***JEL Classifications*:** G11, G12, G15, E60, E65

1. Introduction

Researchers have studied for quite some time the relationship between politics and the behavior of investors. For instance, there is an extensive body of evidence in the literature demonstrating that, at least in the United States, the returns of common stocks tend to follow a four-year cycle that seems to correlate with the presidential elections. Allvine and O'Neill (1980), Huang and Schlarbaum (1982), Herbst and Slinkman (1984), Colón De Armas (1984), Huang (1985), Hensel and Ziemba (1995), Gärtner and Wellershoff (1995), Johnson, Chittenden, and Jensen (1999), and Booth and Booth (2003) all found evidence suggesting that, at least since 1961, common stocks have provided, on average, higher returns during the last two years of a U.S. president's term in office than in the first two years.

Foerster and Schmitz (1997), although analyzing its international aspects, also provided evidence supporting the existence of this four-year U.S. cycle.

This evidence notwithstanding, the literature has not been able to establish categorically whether this four-year cycle regularity in common stock returns, that closely follows the terms in office of U.S. presidents, is actually caused by factors that can be attributed to presidential elections. To further complicate matters, Colón De Armas (2011) found evidence indicating that this cycle disappeared after 1980.

A related body of research examined the performance of the U.S. stock market under the administration of presidents of the two major political parties. For instance, Niederhoffer, Gibbs, and Bullock (1970), and Riley and Luksetich (1980) found that prices in the U.S. stock market have increased more often the day after a Republican presidential candidate won an election than when a Democrat prevailed. Niederhoffer, *et al*, however, found no significant differences between stock market returns during Republican and Democratic administrations, although they noted that during the third year of a president's term, stock prices tend to increase more when a Democratic president is in office than when a Republican occupies the presidency. Hensel and Ziemba (1995) and Johnson, Chittenden, and Jensen (1999) found that small firms had significantly higher returns under Democratic presidencies, but that the returns for large firms were not statistically different across the administrations of both major parties. Santa-Clara and Valkanov (2003) found higher returns under Democratic than Republican presidencies, but more strongly for small firms. After accounting for volatility, however, Campbell and Li (2004), and Powell, Shi, Smith, and Whaley (2007) did not find significant differences in risk and returns across the presidential cycle. Sy and Zaman (2011), on the other hand, found higher returns under Democrats than Republicans and attributed these differentials to risk.

Still another approach was taken by Bialkowski, Gottschalk, and Wisniewski (2008), and Boutchkova, Doshi, Durnev, and Molchanov (2012), who examined whether elections alter the risk of stock market investments.

Despite the efforts of these researchers, and many others, the relation between the U.S. stock market and presidential politics, if any, is an issue not yet settled in the literature. Not only has causality not been established, but the true existence of these return regularities is still an open research issue. Therefore, much is left for investigators to address.

An avenue of research which may provide new insight within this literature is to examine the behavior of investment managers. In particular, it is important to ascertain whether the apparent relations between stock market returns and the U.S. presidential elections are indeed taken into consideration by money managers when making investment decisions. In that regard, the decisions made by U.S.-based global mutual fund managers when selecting the location of the investments in their portfolios have the potential to shed some light on these issues.

U.S.-based global open-end mutual funds fall within the international mutual funds umbrella that also includes foreign, country, and regional mutual funds. For U.S. investors, global funds present an exceptional opportunity to access both the U.S. and the foreign markets at a sensible price. The Investment Company Institute reports that, as of 2011, assets in international mutual funds represented 13% of the $11.8 trillion U.S. mutual fund industry[1].

As defined by Morningstar[2], global fund managers have considerable investment flexibility and differ from the other types of international mutual funds because they hold a

[1] Investment Company Institute: www.ici.org.
[2] Morningstar: www.morningstar.com.

significant portion (between 25%-50% or even higher) of their portfolios invested in domestic securities. They can hold an evenly distributed portfolio between domestic and foreign securities or they may decide to overweigh any of these two markets. This investment freedom allows them to search for good investment opportunities at home or abroad. Thus, we hypothesized that in the investment process of these fund managers the political stability in, both, the U.S. and abroad is an important issue. If the party in power in the U.S. has an impact on that decision, it may be indicative that the relation between stock market returns and presidential elections may be on solid footing. If not, we may conclude that the regularities found by previous research may be more spurious than real.

Although the examination of mutual funds' portfolios and their risk-adjusted performance is not an unexplored topic, very few studies are solely devoted to international mutual funds. Cumby and Glen (1990) conducted one of the few studies that have examined the performance of international mutual funds. Goetzmann, Ivlovic, and Rouwnhourstv (2001), and Chua, Lai, and Wu (2008) also studied international mutual funds, but they focused on the fair pricing of international mutual funds due to the time differences between the U.S. and foreign markets. To the best of our knowledge, our study is the first to explore the relation between global funds' portfolios, their performance, and U.S. presidential administrations.

In this study we focused our attention on the distribution of assets of U.S.-based global fund portfolios during the nine most recent presidential administrations for which data are available for the entire four-year term. In particular, we examined whether the managers of these global funds used the political affiliation of incumbent presidents in making their investment decisions regarding how their assets would be allocated between the domestic and foreign markets and, if so, whether those decisions had any impact on the investment returns of these global funds. In addition, we examined whether the four-year presidential election cycle documented by some researchers in the literature played any part in their investment decisions as well, and whether fund returns were influenced in any way by taking into consideration that cycle.

Our results suggest that global fund managers invest more domestically during the years when a Republican president is in office and favor international markets when Democratic presidents are in power. This behavior, however, does not appear to be beneficial for the shareholders of these global funds, since their risk-adjusted performance is higher, albeit weakly, during Democratic administrations.

Finally, it appears that global fund managers, when making investment decisions, do not take into consideration the four-year presidential election cycle. Alternatively, given that seven out of the nine administrations examined occurred after 1980, these results may serve to corroborate the findings of Colón De Armas (2011) who found that this cycle disappeared after that year.

The rest of the paper consists of four additional sections. Section 2 describes the sample of funds used to conduct this study. Section 3 presents our methodology. Section 4 discusses the empirical results. Finally, Section 5 offers some concluding remarks.

2. Fund samples

We examined global fund managers during the nine most recent presidential administrations for which data are available for the entire four-year term. Accordingly, we start our analyses with the 1972 election of Richard M. Nixon (Republican) and end in the year 2008, after the re-election, in 2004, of George W. Bush (Republican). In all, we examined six

Republican administrations and three Democratic administrations. The elections included, and their corresponding results in terms of the president elected, are presented in Table 1.

In December of each election year, we identified all global mutual funds as classified in the Center for Research and Security Prices (CRSP) Survivorship-Bias-Free Database. For funds with multiple classes we chose the class with the longest return history, since the portfolio underlying each class of the same mutual fund is identical[3]. Table 2 provides a description of the sample including the number of funds and the median value of three of their most common characteristics: total net assets, expense ratio, and turnover ratio. We examined a total of 357 U.S.-based global mutual funds. In Panel A of Table 2, we break down the number of funds by election year. For the first two presidential administrations, we identified only two distinct mutual funds. In later years, however, we were able to include more funds with the 1996 election having the largest number with 97. The median of total net assets ranged from a low of $400,000 for the election of 1972 to a high in 1980 of $221 million. Median expense ratio remained below 2 percent, with a high of 1.8 percent for the election of 1976. The median portfolio turnover increased steadily from 5.3 percent from 1980 to 71.5 percent for the election of 2000[4].

In Panel B of Table 2, the funds in the sample are categorized by the party affiliation of the incumbent president. During the three Democratic administrations, we examined a total of 147 global funds with median total net assets of $80 million, median expense ratio of 1.74 percent and median turnover ratio of 59.78 percent. During Republican administrations, we considered a total of 210 funds with median total net assets, expense ratio, and turnover ratio of $93 million, 1.42 percent, and 57 percent, respectively. Although not reported in Table 2, we

[3] For further details see O'Neal (1999).
[4] Portfolio turnover data were not available in CRSP for the 1972 and 1976 samples of funds.

found statistically significant differences between average total net assets and average expense ratio between parties. The average total net assets were \$630 million under Democratic administrations and \$1,275 million under Republican administrations, and the difference between the averages is statistically significant at the 0.10 level. The average expense ratio under Democratic administrations was 1.73 percent, while under Republican administrations it was 1.38 percent. The difference between the average expense ratios was statistically significant at the 0.01 level.

3. Methodology

3.1 Portfolio exposures

The analysis starts by examining the distribution of assets between the domestic and international markets of U.S.-based global mutual funds during the nine U.S. elections cycles from 1973 through 2008. The purpose of this analysis is to determine whether global fund managers consider the party affiliation of the incumbent president in their investment decisions.

Since we do not have direct access to the portfolio holdings of mutual funds, we employed Sharpe's (1992) quadratic programming technique, also known as style analysis, to estimate the domestic/international portfolio mix of each global fund in the sample. Style analysis allows for the estimation of each fund's portfolio exposure to each market index from the publicly available daily fund returns. Comer, Larrymore and Rodríguez (2009) and Comer and Rodríguez (2011), among others, used style analysis in their respective examinations of hybrid funds and fixed income mutual funds.

To implement this methodology, it is assumed that fund returns can be expressed as:

$$r_i = \sum_{j=1}^{n} w_{i,j} r_j + e_i \tag{1}$$

where, r_i is the total return of fund *i*, $w_{i,j}$ is the exposure of fund *i* to index *j*, r_j is the total return of index *j*, and e_i is the unexplained component of fund return.

Three indexes or factors were included in equation (1): The S&P 500 index, representing the domestic market, the MSCI World ex US, representing the foreign market, and the Lehman Brothers Short Treasury index is used as a proxy for the cash portion of the fund's portfolio. Then, the portfolio weights represent factor loadings on an index strategy that does the best job of explaining the fund's return and are generated as the solutions of a quadratic programming problem that is expressed as follows:

$$\text{Min}\left[\text{var}\left(\text{r}_\text{i} - \sum_{j=1}^{n} w_{i,j} r_j\right)\right] \tag{2}$$

subject to

$$1 \le w_{i,j} \le 0 \quad \forall j$$

$$\sum_{j=1}^{n} w_{i,j} = 1$$

We estimated equation 2 using monthly returns during each of the four-year periods corresponding to each presidential administration under consideration. By analyzing these results, we were able to obtain a better understanding of the investment preferences of global fund managers during the different presidential cycles. Accordingly, we were able to assess whether the political climate in the U.S. had any influence on the domestic and international portfolio exposure of these funds. Special consideration was given to the differences between the exposures to the domestic or international markets according to the party affiliation of the incumbent president. Also, we were able to break down each cycle to focus on whether these global funds were overweighing the U.S. market during the last two years of a president's term in office as would be suggested by some of the evidence provided in the literature supporting the existence of a four-year presidential election cycle whereby higher common stock returns are obtained precisely during those years.

To complete the analysis, however, and to properly evaluate their performance during each presidential administration, we needed to calculate risk-adjusted returns.

3.2 Risk-adjusted performance

To measure the risk adjusted performance of the funds, we turned to the traditional Jensen's alpha and examined the sign and significance of the intercept estimated from the following single index model:

$$r_i - r_f = \alpha_i + \beta_i\left(r_j - r_f\right) + e_i \tag{3}$$

We examined the risk adjusted performance of global fund managers during each of the nine four-year periods. Together with the results from the portfolio exposures above, these performances allowed us to get a clear picture, not only of the portfolio composition of these global funds, but also to assess the performance of each individual global fund during each Republican and Democratic administration. These results allowed us to answer some interesting questions: Do U.S.-based global funds prefer the domestic market during a particular party administration? If so, does that preference have an impact on fund returns? Do global funds perform better during Republican or Democratic administrations? More, importantly, do these fund managers recognize the existence of a presidential election cycle? Are they able to profit from it?

With these questions in mind, let us now turn to the empirical results.

4. Empirical results

4.1 Portfolio exposures

Table 3 presents the results of our three-factor model estimated by using equation 2 and the monthly returns of an equally-weighted portfolio composed of all the funds in existence during each administration. These results appear to validate the three-factor model and its ability to explain global fund returns, since the adjusted R-squared of the model ranges from a low of 74 percent for the 1993-1996 Democratic administration of President William J. Clinton, to a high of 99 percent for the 2005-2008 second term of Republican President George W. Bush. It is also important to notice that most of the factor loadings for the domestic and foreign indexes are significant at the 0.01 level. The notable exceptions are the 1972 and 1976 elections, which is not surprising given the fact that only two global funds existed during these two election cycles.

The results in Table 3 also demonstrate that the estimated values for the exposure to the domestic market vary considerably. For the 1973-1975 Republican administration of Presidents Richard M. Nixon and Gerald R. Ford, this factor loading is 1, meaning that, on average, these funds were fully invested in domestic securities in spite of the fact that these are global funds. The domestic factor loading reaches its minimum during the 1997-2000 second term in office of Democratic President William J. Clinton, with an estimated value of 33 percent. The factor loadings for the foreign portion of the portfolios also vary from one election to the next. Corresponding to the 1973-1976 administration, this factor loading reaches the lowest possible value of zero. However, foreign exposure rises monotonically after 1972 reaching its highest value, 66 percent, during the 1997-2000 administration, declining thereafter. Next, we consider whether these variations in exposures to the domestic and foreign markets are in any way related to the party affiliation of the incumbent president.

Table 4 shows the exposures of our sample of global mutual funds according to the president's political party. During Democratic administrations, global funds had an average exposure to the U.S. market of 35.24 percent, which is lower than the 42.58 percent exposure during Republican administrations. Accordingly, the average exposure to foreign markets during Democratic administrations is higher, 55.79 percent, than during Republican administrations, 48.92 percent. For both exposures, domestic and foreign, the differences between portfolio exposures during Democratic versus Republican administrations are statistically significant at the 0.01 level.

The results in Table 4 suggest that global fund managers invest more domestically during the years when a Republican president is in office and favor international markets when Democratic presidents are in power. These results raise the issue of whether this behavior by fund managers pays off for fund shareholders.

4.2 Risk-adjusted performance

Table 5 presents data on risk-adjusted performance for the global funds in our sample using the classical Jensen's alpha calculated according to equation 3. The MSCI World Index was used as the benchmark.

Panel A of Table 5 shows the average alpha for all the funds in the sample according to the party affiliation of the incumbent president. As a group, global fund managers successfully beat the benchmark during Democratic administrations with an average monthly alpha of 0.0011, which is equivalent to approximately 1.32 percent per year, and is statistically significant at the 0.05 level. When a Republican president is in office, the average monthly alpha is positive, and greater than the alpha obtained during Democratic administrations, but it is not statistically significant. Also, there is no significant difference between the performances of global funds during the administrations of both parties.

Panel B of Table 5 demonstrates that, when considered individually, global fund managers obtain more positive, and significantly positive, alphas during Republican administrations, but they also obtain more negative, and significantly negative, alphas as well.

These results tend to imply that the decisions by global fund managers to favor the domestic market during Republican administrations and the foreign markets during Democratic presidencies are not beneficial for fund shareholders since their risk-adjusted performance is higher, albeit weakly, during Democratic administrations.

4.3 Presidential Election Cycle

Finally, the data in our sample allowed us to consider whether U.S. global fund managers, when making investment decisions, use and profitably exploit the four-year presidential election cycle. According to some authors, that cycle results from the tendency of common stocks to provide, on average, higher returns during the last two years of a U.S. president's term in office than in the first two years. Thus, if that cycle were to be taken into consideration by fund managers when making investment decisions, one would expect global funds to have higher exposures to the U.S. market during the last two years of a president's term in office. To determine if that was indeed the case, we examined the estimated portfolio exposures discussed in Section 4.1 and verified how many funds do have a higher exposure to the U.S. market during the last two years of each administration. The results appear in Table 6.

These results show that 130 funds, or 36 percent of the sample, across the nine administrations examined, have higher exposures to the domestic market during the last two years of the four-year presidential election cycle. Consistent with the results in Table 4, the majority (103/130) of the global funds that invest more heavily at home than abroad during the last two years of a president's term in office do so during Republican administrations.

In terms of performance, however, having a higher exposure to the U.S. market during the last two years of any presidential administration did not appear to be beneficial. For instance, the results presented in Table 6 demonstrate that, on the aggregate, that is, regardless of the party of the incumbent president, average performance is lower (0.00018 versus 0.0051) for global funds with higher exposure to the domestic market during the last part of each administration. The difference between the average alphas, however, is not significant. During Democratic administrations the results are more robust because the average alpha for funds with higher exposure to the domestic market during the last two years of a president's term in office is not only lower (-0.0013 versus 0.0016), but the difference is statistically significant. For Republican administrations, the results are qualitatively similar, with lower performance (0.0006 versus 0.0089), although not statistically significant, for funds with higher exposure to the domestic market.

Since only 36 percent of the global funds in the sample have higher exposures to the domestic market during the last two years of a U.S. president's term in office, these results may suggest that global fund managers, when making investment decisions, do not take into consideration the four-year presidential election cycle. Alternatively, given that seven out of the nine administrations examined occurred after 1980, these results may serve to corroborate the findings of Colón De Armas (2011) who found that this cycle disappeared after that year. The likelihood of this alternative conclusion is strengthened by the fact that return performance was lower for funds with higher exposure to the U.S. market during the last two years of a president's term in office.

5. Conclusion

The relation between the U.S. stock market and presidential politics, if any, is an issue not yet settled in the literature. Although many researchers have found evidence suggesting the existence of some stock return regularities that may be related to presidential elections, causality has not been established. More importantly, the true existence of these return regularities is still an open research issue. Therefore, much is left for investigators to address.

An avenue of research which may provide new insight within this literature is to examine the behavior of investment managers. In particular, it is important to ascertain whether the apparent relations between stock market returns and the U.S. presidential elections are indeed taken into consideration by money managers when making investment decisions. In that regard, the decisions made by U.S.-based global mutual fund managers when selecting the location of the investments in their portfolios have the potential to shed some light on these issues.

Global fund managers have great investment flexibility since they can hold an evenly distributed portfolio between domestic and foreign securities or they may decide to overweigh any of these two markets. This investment freedom allows them to search for good investment opportunities at home or abroad. Thus, we hypothesized that in the investment process of these fund managers the political stability in, both, the U.S. and abroad is an important issue. If the party in power in the U.S. has an impact on that decision, it may be indicative that the relation between stock market returns and presidential elections may be on solid footing. If not, we may conclude that the regularities found by previous research may be more spurious than real.

In this study we focused our attention on the distribution of assets of U.S.-based global fund portfolios during the nine most recent presidential administrations for which data are available for the entire four-year term. In particular, we examined whether the managers of these global funds used the political affiliation of incumbent presidents in making their investment decisions regarding how their assets would be allocated between the domestic and foreign markets and, if so, whether those decisions had any impact on the investment returns of these global funds. In addition, we examined whether the four-year presidential election cycle documented by some researchers in the literature played any part in their investment decisions as well, and whether fund returns were influenced in any way by taking into consideration that cycle.

Our results suggest that global fund managers invest more domestically during the years when a Republican president is in office and favor international markets when Democratic presidents are in power. This behavior, however, does not appear to be beneficial for the shareholders of these global funds, since their returns are higher, albeit weakly, during Democratic administrations.

Finally, it appears that global fund managers, when making investment decisions, do not take into consideration the four-year presidential election cycle. Alternatively, given that seven out of the nine administrations examined occurred after 1980, these results may serve to corroborate the findings of Colón De Armas (2011) who found that this cycle disappeared after that year.

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Table 1

Results of U.S. Presidential Elections

Election year	President	Party Affiliation
1972	Richard M. Nixon[1]	Republican
1976	James E. Carter	Democrat
1980	Ronald W. Reagan	Republican
1984	Ronald W. Reagan	Republican
1988	George H. W. Bush	Republican
1992	William J. Clinton	Democrat
1996	William J. Clinton	Democrat
2000	George W. Bush	Republican
2004	George W. Bush	Republican

[1]Replaced by Gerald R. Ford in 1974.

Table 2

Sample Description

Panel A: Election year

Election year	Number of funds	Total net assets[1]	Expense ratio[2]	Turnover ratio[2]
1972	2	0.40	0.0100	---------
1976	2	0.75	0.0180	---------
1980	3	221.00	0.0123	0.0530
1984	10	99.00	0.0106	0.2190
1988	31	41.00	0.0163	0.4650
1992	48	52.00	0.0165	0.5750
1996	97	96.00	0.0175	0.6025
2000	74	125.00	0.0133	0.7150
2004	90	99.00	0.0149	0.4900

Panel B: Party affiliation

Party	Number of funds	Total net assets[1]	Expense ratio[2]	Turnover ratio[2]
Democrats	147	80.00	0.0174	0.5978
Republicans	210	93.00	0.0142	0.5700

[1]Median value, in millions of dollars.

[2]Median value.

Table 3

Portfolio exposures

Election year	Number of funds	US	Foreign	Cash	Adj. R squared
1972	2	1.0000	0.0000	0.0000	0.9148
1976	2	0.8883	0.0722	0.0395	0.9189
1980	3	0.8311***	0.1156***	0.0532	0.9008
1984	10	0.6435***	0.2425***	0.1138*	0.8688
1988	31	0.4610***	0.3641***	0.1747***	0.9155
1992	48	0.4835***	0.4201***	0.0962	0.7496
1996	97	0.3317***	0.6682***	0.0000	0.8146
2000	74	0.4288***	0.5551***	0.0159	0.9846
2004	90	0.4540***	0.5459***	0.0000	0.9916

*** Statistically significant at the 0.01 level.
** Statistically significant at the 0.05 level.
* Statistically significant at the 0.10 level.

Table 4

Portfolio exposures by party affiliation of incumbent president

Party	US	Foreign	Cash
Democratic	0.3524	0.5579	0.0693
Republican	0.4258	0.4892	0.0835
Difference	-0.0734***	0.0687***	-0.0143

*** Statistically significant at the 0.01 level.
** Statistically significant at the 0.05 level.
* Statistically significant at the 0.10 level.

Table 5

Risk adjusted performance according to party affiliation of incumbent president

Panel A: Aggregate results

Party	**N**	**Alpha** Mean
Democratic	147	0.0011**
Republican	210	0.0048
Difference		-0.0037

Panel B: Individual Results

Party	**Positive alphas (sig.)**	**Negative alphas (sig.)**
Democratic	87 (6)	60 (10)
Republican	113 (36)	97 (27)

*** Statistically significant at the 0.01 level.
** Statistically significant at the 0.05 level.
* Statistically significant at the 0.10 level.

Table 6

Global funds and the presidential election cycle

Panel A: Aggregate results

Exposure to the U.S.	**N**	**Alpha** Mean
Lower	227	0.0051
Higher	130	0.00018
Difference		0.0049

Panel B: Democratic administrations

Exposure to the U.S.	**N**	**Alpha** Mean
Lower	120	0.0016
Higher	27	-0.0013
Difference		0.0029**

Panel C: Republican administrations

Exposure to the U.S.	**N**	**Alpha** Mean
Lower	107	0.0089
Higher	103	0.0006
Difference		0.0084

*** Statistically significant at the 0.01 level.
** Statistically significant at the 0.05 level.
* Statistically significant at the 0.10 level.