U.S. Presidential Politics and the Asset Allocation Decisions of Individual Investors

Abstract

During the six presidential administrations between 1989 and 2012, individual investors allocate more of their investment portfolios to stocks when a Democrat presides than when a Republican is in office. Also, they allocate more of their portfolios to stocks during the last two years of a president's term in office than during the first two years. These findings are consistent with previous studies suggesting that stock returns are higher during a Democrat president's term in office than during a Republican presidential administration. In addition, these results support the idea that investors acknowledge the existence of a four-year presidential election cycle and try to profit from it.

Keywords: individual investors; investments; investment portfolios; U.S. politics

Carlos A. Colón-De-Armas
Professor
Graduate School of Business Administration
University of Puerto Rico
PO Box 23332
San Juan, PR 00931-3332
Tel. 787.398.2913
cacolondearmas@yahoo.com

Javier Rodríguez
Professor
Graduate School of Business Administration
University of Puerto Rico
PO Box 23332
San Juan, PR 00931-3332
Tel. 787.764.000, Ext. 87118, 87129
javier.rodriguez19@upr.edu

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I. Introduction

Market lore is replete with stories of how politics influence economics. The stock market in particular is full of tales in that regard. Naturally, researchers have converted most of this lore into testable hypotheses studying aspects such as the political party preferences of investors, including an analysis of the party under which the stock market performs better [Niederhoffer *et al*. (1970), Riley and Luksetich (1980), Hensel and Ziemba (1995), Johnson *et al*. (1999), Santa-Clara and Valkanov (2003), Campbell and Li (2004), Bohl and Gottschalk (2006), Powell *et al*. (2007), Stangl and Jacobsen (2007), and Sy and Zaman (2011)], the existence of a four-year cycle in the stock market related to 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), Foerster and Schmitz (1997), Johnson *et al*. (1999), Booth and Booth (2003), Beyer *et al*. (2008), Colón De Armas (2013)], elections as a factor that may alter the risk of the stock market [Bialkowski *et al*. (2008) and Boutchkova *et al*. (2012)], the relation between political cycles and government spending [Belo *et al*. (2011)], the influence of the U.S. Congress on the stock market [Ferguson and Witte (2006)], and whether the sentiment of investors drives the aforementioned results [(Colón De Armas, Rodríguez, and Romero (2014)], among others.

All these research efforts notwithstanding, the relation between politics and the stock market is still an unsettled issue in the literature. For instance, the form of these return regularities, and their very existence, is still an open issue. Not only that, but even when the data appear to suggest some kind of relation between politics and economics, the literature has not been able to determine if the results simply correlate with the politics or whether they are actually caused by it. Therefore, there is much more research work to be done in this area.

A line of research that could shed some light on these issues is to examine whether investment managers and investors actually use the return regularities that may be implied if political influences indeed are at the bottom of their existence. After all, if statistical analyses imply the existence of return regularities tied to political events, but investors do not use them, that would seem to suggest that the statistical results may be more spurious than real.

Accordingly, Colón De Armas and Rodríguez (2015) examine the investment behavior of U.S.-based global mutual fund managers and find that they 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, appears to be detrimental to the funds' shareholders, since their risk-adjusted performance is lower during Republican administrations. Furthermore, they find evidence that either suggests that these global fund managers do not consider the four-year presidential election cycle in their investment decisions, or that this cycle may have disappeared.

Colón and Rodríguez (2015), however, did not have direct access to the portfolio holdings of global mutual funds. Therefore, they use Sharpe style methodology to estimate the domestic/international portfolio mix of these global funds.

A logical expansion of this line of inquiry is to examine the behavior of individual investors to consider whether they actually use the return regularities related to political events documented in the literature when making investment decisions regarding the asset allocation in their portfolios. Not only would that be beneficial in understanding these issues, but the data to directly examine this behavior are actually available.

With this objective in mind, this study examines, specifically, the influence of the presidential administrations on the asset allocation decisions of U.S. investors. The purpose of conducting this study is to ascertain whether the apparent relations between stock market returns and the U.S. presidential elections documented in the literature are indeed taken into consideration by individual investors when making investment decisions and, if so, whether those decisions have any impact on investment returns. As such, this study will be a significant addition to the literature that has documented the apparent existence of stock market return regularities tied to political events.

There is a good amount of work on the asset allocation decisions of individual investors. In fact, Sharpe (1990) argues that the allocation decision of individual investors is the most important step in the investment process. At this time, we want to focus on studies that examine the asset allocation decision of investors by relying on the survey data from the American Association of Individual Investors (AAII). These individuals have long been cataloged in the literature and popular press, as small, well-informed, investors.

Bange (2000) follows the AAII allocation survey responses during the 1987-1994 time period, and finds that shifts in portfolio allocations are consistent with positive feedback trading, as changes in portfolio allocations reflect past market movements. The author reports that bullish investors increase their equity holdings, while bearish investors decrease it. Fisher and Statman (2000) examine the June 1987 – July 1998 time period, and report a positive but insignificant relation between actual stock allocations and future S&P 500 returns. Anoruo, Bajtelsmit, Ramchandler, and Simpson (2003) report that increases in expected inflation are associated with decreases in stock allocations and corresponding increases in bond allocations. Anouo *et al* (2003) follow AAII investors from 1988 to 1999. Finally, Alvarez and Rodríguez (2006) examine the portfolio management ability of AAII investors during the 1988-2002 time period. The authors find evidence of effective skill and forecasting ability.

Therefore, there is ample precedent in the literature to allow us to use these data to draw conclusions regarding the behavior of individual investors in light of the factors that we propose to analyze.

II. Data and methodology

Our data on individual investors' asset allocation come from the American Association of Individual Investors (AAII). Since November 1987, the AAII polls 600 of their members on their current holdings among major asset categories. The monthly survey asks investors their holdings of: Stock Funds, Stocks, Bond Funds, Bonds, and Cash. The historical response rate is close to 30%. Also, historical allocation averages are: Stocks/Stocks Funds 60%, Bonds/Bond Funds 16%, and Cash 24%.

Given that the survey started in 1987, we will be able to examine the asset allocations of individual during six presidential administrations: From the 1989 Republican administration of George H. W. Bush, to the first term of Democrat president Barak Obama. In all, we will look at a total of six administrations, three from each political party.

Our methodology is based on classical statistical and non-parametric tests. The basic idea is to explore the distribution of individual investors' asset allocations in the three major asset categories (stock, bond and cash) during six presidential administrations in the U.S. and test for significant differences in average and median values in these allocations.

III. Empirical results

Table 1 presents descriptive statistics for the portfolio allocations based on the AAII survey during the 1988 to 2012 time period. On average, individual investors allocated 60.43% to equity (stock) securities. The median allocation to stocks was 61.0%. In the case of bonds, the average allocation was 15.61%, and the median allocation was 15.0%. The average and median cash allocations were 23.98% and 22.95%, respectively. In other words, relative to bonds, investors allocated a higher percentage of their wealth in cash or cash equivalent securities.

Next, we examine these same allocations broken down for each of the six presidential administrations under study, evenly distributed among Democrat and Republican presidents. The results containing the mean and median portfolio allocations during each four-year presidential term are presented in Table 2. As can be seen from that table, for every administration, regardless of the ruling party, individual investors allocated more of their wealth to stocks, followed by cash, and then bonds.

We then ask the following question: do individual investors portfolio allocations vary under different presidential administrations? Table 3 presents the results that help us answer this question, since it shows the mean allocation for stocks, bonds and cash during the three administrations of Democrat presidents and the three administrations of a Republican president during the 1988 to 2012 time period of the study. The results show that portfolio allocations are indeed different under presidential administrations of the two parties. More specifically, during Democrat administrations the average allocation for stocks is 63.56%, whereas in the case of Republican administrations the average allocation for stocks goes down to 57.29%. Not only that, but the difference between the average stock allocations is statistically significant at the 1% level. Bonds and cash allocations also are significantly different between presidential administrations of the two parties. In the case of bonds, the average allocation during a Democrat president is 16.03% while during Republican presidents the allocation is 15.18%, and the difference between these average allocations is significant at the 10% level. The average cash allocation is 20.41% during the Democrat administrations and 27.54% when Republican presidents are in office, and the difference between these average allocations is statistically significant at the 1% level.

Previous studies present evidence suggesting that stock returns are higher during a Democrat president's term in office than during a Republican presidential administration. The fact that individual investors allocate more of their investment portfolios to stocks when a Democrat presides than when a Republican is in office is not only consistent with that evidence, but it also is indicative that individuals use that regularity when making investment decisions. This latter fact may suggest a causal relationship in the sense that the higher returns obtained in the stock market during Democrat administrations, more than a statistical result, may indeed be the result of the policies that presidents of that party implement when in office that investors perceive positively.

In addition to considering how the different party administrations may influence the investment decisions of individual investors, there is ample evidence in the literature suggesting the existence of a four-year presidential election cycle in the stock market. The form of this cycle is such that common stocks tend 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. To consider whether this regularity is taken into consideration by individuals when making investment decisions, we examine whether individual investors allocate more of their portfolios to stocks during the last two years of a president's term in office. Table 4 shows the results of a comparison of portfolio allocations during the first two years and last two years of each presidential administration examined. These results indicate that investors allocate more to stocks during the last part of the term in 5 out of 6 administrations. In four out of the five the difference in stock allocations in significantly higher at least at the 10%. These results support the idea that investors at least acknowledge the existence of the aforementioned four-year cycle and try to profit from it. It appears that individual investors are well-aware of the politically-induced return regularities and shifts there portfolio allocations accordingly in their search for higher returns.

IV. Conclusion

This study examines the influence of presidential politics on the investment decisions of U.S. individual investors, by examining shifts in asset allocation decisions during the last six U.S. presidential administrations. Our analysis is based on the asset allocation survey conducted monthly by American Association of Individual Investors. We find that individual investors are well aware of the return regularities attributed to the political environment in Washington. Accordingly, investors significantly allocate more of their portfolios to stocks when a Democrat president is in office, a well-justified decision, as evidence shows that stock returns are higher during Democrat administrations. Investors also allocate more of their investments to stocks during the last two years of a presidential administration, as if they are conscious of the existence of, and are willing to bet on, the presidential election cycle.

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Table 1

Portfolio Allocations Summary Statistics 1988 - 2012

Stocks		
	Mean	60.43%
	Standard Deviation	8.21%
	Median	61.00%
	Minimum	40.80%
	Maximum	77.00%
Bonds		
	Mean	15.61%
	Standard Deviation	4.30%
	Median	15.00%
	Minimum	6.90%
	Maximum	25.50%
Cash		
	Mean	23.98%
	Standard Deviation	6.05%
	Median	22.95%
	Minimum	11.00%
	Maximum	44.80%

Table 2

Portfolio Allocations per Presidential Term

Ruling Party	Presidential Term		Stocks	Bonds	Cash
Republican	1989-1992	Mean	49.46%	20.22%	30.32%
		Median	49.00%	20.00%	30.00%
Democrat	1993-1996	Mean	62.54%	16.04%	21.42%
		Median	62.00%	15.00%	21.00%
Democrat	1997-2000	Mean	71.02%	11.68%	17.30%
		Median	71.00%	12.00%	17.00%
Republican	2001-2004	Mean	60.99%	12.83%	26.20%
		Median	63.50%	12.25%	24.70%
Republican	2005-2008	Mean	61.42%	12.50%	26.11%
		Median	62.70%	12.20%	25.00%
Democrat	2009-2012	Mean	57.13%	20.37%	22.52%
		Median	58.60%	20.90%	20.50%

Table 3

Portfolio Allocations per Ruling Party

	Mean		Difference	*p-value*
	Democrat	Republican		
Stocks	63.56%	57.29%	6.27%	0
Bonds	16.03%	15.18%	0.85%	0.094
Cash	20.41%	27.54%	-7.13%	0

Table 4

Portfolio Allocations and the Presidential Election Cycle

Presidential Term	First two years versus last two years		Stock	Bonds	Cash
1989-1992	89-90 vs 91-92	Difference	-4.08%	-1.07%	5.14%
		p-value	0	0.017	0
1993-1996	93-94 vs 95-96	Difference	-5.58%	3.25%	2.33%
		p-value	0	0	0
1997-2000	97-98 vs 99-00	Difference	-1.50%	2.83%	-1.33%
		p-value	0.086	0	0.175
2001-2004	01-02 vs 03-04	Difference	-1.16%	0.80%	0.36%
		p-value	0.647	0.391	0.842
2005-2008	05-06 vs 07-08	Difference	3.34%	-1.03%	-2.31%
		p-value	0.068	0.215	0.122
2009-2012	09-10 vs 11-12	Difference	-4.92%	0.20%	4.72%
		p-value	0.003	0.793	0.007