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Common Stock Returns and Presidential Elections

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Common Stock Returns and Presidential Elections

THAT EQUITY MARKETS are efficient in at least the semistrong sense is perhaps the most widely accepted hypothesis among financial economists. But it has always been a point of contention between academics and practitioners. The evidence from the 1960s and early 1970s overwhelmingly supported efficiency. More recently, however, an impressive body of "anomalous" data has accumulated.¹

One of the more surprising developments has been the discovery of a number of patterns in security returns.² These patterns are remarkably consistent, statistically significant, and suggest at least the possibility of profitable trading rules. Although the profitability of such trading rules has yet to be documented, we seem to be on the verge of disproving even the weak form of the Efficient Market Hypothesis. This article presents some results on the pattern of common stock returns over the four-year election cycle and over different administrations.

A Four-Year Cycle

Do common stock returns exhibit a four-year cycle? Allvine and O'Neill have presented strong evidence in support of such a phenomenon over the postwar period.³ Table I summarizes our results. The top portion of Table I shows for six different (though often overlapping) periods the average annual rates of return on common stocks for each year of the four-year election cycle.⁴ The results of formal statistical tests are somewhat mixed. Nonetheless, the pattern is hard to ignore.

The bottom portion of Table II shows combined returns for Years 1 and 2 and Years 3 and 4 of the cycle. The existence of an election cycle is much more apparent in every one of the six periods and is fairly strongly corroborated by standard statistical tests. The difference be-

1. Footnotes appear at end of article.

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tween the two groups is particularly pronounced in the most recent 20-year period, with the average annual difference exceeding 24 percent. In short, our results also support the notion of political control of the economy. Indeed, such control seems to have grown stronger, and perhaps more deliberate, since 1960.⁴

Republican vs. Democratic Administrations

One of the persistent myths of the stock market is that the market "prefers Republicans."⁵ The Republican party is traditionally viewed as the party of business. Historically, however, higher average returns have been obtained during Democratic administrations than during Republican administrations. The top part of Table II shows evidence from three overlapping periods.

The middle and bottom portions of Table II address the issue of whether the presidential election cycle is affected when the sample data are differentiated along party lines. The results show that the basic pattern of higher returns in Years 3 and 4 is present for both political parties in all the periods considered. Furthermore, the cycle is more pronounced in more recent periods, under both Republican and Democratic administrations.

Are the returns obtained under each type of administration significantly different from one another? The returns are not significantly different for four of the six cases. The exceptions are the mean returns for Years 1 and 2 for the period 1961-80 and the mean returns for Years 3 and 4 for the period 1929-80. In both these cases, Democratic administrations had higher mean returns.

Cycle-Based Strategies

We used the above results to test the simple switching strategies listed in Table III. In general, switching strategies that kept the investor out of stocks and in Treasury bills during the first and second years of Republican administra-



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