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Why You Shouldn’t Invest Based on Which Party You Think Will Win the Midterms

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By **David Dubofsky** and **Lyle Sussman**

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As we approach the midterms, some clients may want to revisit their portfolios based on their fears or hopes about which party will control Congress. Why? Investors’ economic views have always been influenced by politics. Americans often vote their pocketbook believing that their party’s victory will lead to prosperity, while a defeat will lead to economic and market disaster. In today's hyperpartisan political environment, that tendency has only become more pronounced.

But while minor portfolio adjustments before or after an election may be warranted, we don't recommend making major changes to a client's long-run target asset allocation based on which political party is currently in control. Although research has found that the stock market performs better under a Democratic president and Congress, it is dangerous to draw conclusions from such studies. Indeed, investors should assume that the party controlling the presidency or Congress has no impact on stock market returns.

By the numbers. A thorough study by Alan Blinder and Mark Watson examined why the U.S. economy and stock market performed better when a Democrat occupied the White House, examining the years between 1948 and 2012. The authors concluded that most of the outperformance under Democratic presidents was due to better oil prices, more military spending and stronger economic growth abroad during their tenures.

Another study conducted by Lubos Pastor and Pietro Veronesi examined stock market returns between 1927 and 2015 and found that the average annual return under Democrat presidents in that time period was 10.7%, as compared with -0.2% under Republican presidents. In a study updated to include market performance through 2022, Republicans would fare better given the strong market during President Donald J. Trump's term in office and the relatively flat returns seen by President Joe Biden's administration to date.

However neither these studies or others we have reviewed conclude that control of Congress correlates with stock market performance, nor does the interaction of the president's party affiliation and the party controlling Congress, although it may appear that way.

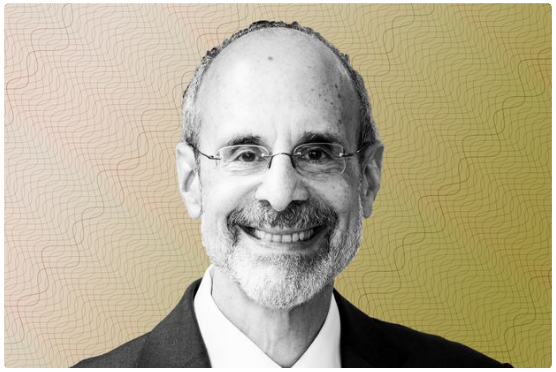
For instance, one study concluded that between 1945 and 2021 the stock market performed best during the 14 years in which there was a Democratic president and a Republican—or split—Congress, and that it performed worst during the 22 years with a Republican president and a Democratic Congress. But this study and others like it suffer from small sample size. There have been only 19 presidential elections since the end of World War II, of which only 10 led to a change in the party controlling the White House. There have been 38

Congresses since World War II, but only eight changes in the party controlling the House of Representatives and 14 changes in the majority party of the Senate.

Moreover, economic and stock market performance during a president's term is affected by policies made by their predecessor. Black swan crises also have an effect. What can we say with any certainty about President George W. Bush's direct impact on the economy and financial markets given the unexpected geopolitical impact of 9/11? The same can be asked about President Donald J. Trump's economic policies given the Covid-19 pandemic and the Russia-Ukraine war's effect on President Joe Biden's presidency.

Overall, there are just too many variables in play to come to a definitive conclusion about the economic and financial impacts of the political party controlling the White House or Congress. Hence, election outcomes should not affect investors' major asset allocation decisions.

So, what is the right response to a client who wants to rebalance at the prospect or fact of a new government? The answer is: the same advice that has stood the test of time—diversify, monitor your risks, think long term. Along with one more piece of counsel: Vote at the ballot box, not with your portfolio.



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David Dubofsky is co-author of *Your Total Wealth: The Heart and Soul of Financial Literacy* and is the author of over 40 academic articles. Previously, he taught finance at Texas A&M University, Virginia Commonwealth University, and University of Louisville.

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Lyle Sussman is professor emeritus at the College of Business, University of Louisville. He previously taught at University of Michigan and University of Pittsburgh. He is a frequent speaker in the banking industry and is co-author of *Your Total Wealth: The Heart and Soul of Financial Literacy*.