Managing Volatility

White paper

Investing in a highly politicized climate

Tune out political noise and focus on the fundamentals—the real driver of investment returns.

Key highlights

1

Strong political views can influence your investment decisions.

2

Election outcomes have a negligible effect on investment performance.

3

Fundamentals have historically had a greater impact on stock returns.

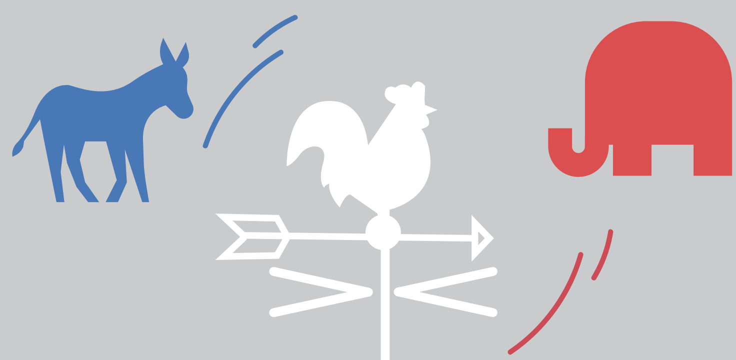
Summary

Investors have a lot on their minds these days, from trade negotiations, to geopolitical tensions, to a potential global economic slowdown and possible recession. There's also a U.S. presidential election on the horizon, adding political noise to investors' desire for clarity and understanding.

Investor perceptions of risk and reward influence the decisions they make in their portfolios—and political leanings can distort these perceptions. Politically-inclined investors tend to see the markets as less risky and more attractive when their preferred party is in power. In contrast, those whose party is out of power are likely to feel more pessimistic and see greater risk in the markets.

In this age of information abundance, how should investors read and use the news for their benefit? Tune out the noise if you're looking for prudent guidance and actionable insights. Then, pay attention to the fundamentals, which have a bigger influence on market value than the fickle winds of the political climate.

Markets can turn volatile as investors shift their sentiments to align with their political inclinations.
But like most external forces, these fluctuations have little long-term impact on the financial markets.



A combustible mix

Mark Twain once said, "Never talk about politics or religion in polite company." He could have added money to that list as well.

People tend to have strong feelings about both politics and money. In many cases, these feelings are closely tied to their backgrounds and personalities. There's nothing inherently wrong if someone holds strong political beliefs, but it's important to recognize the influence strong political views can have on different decisions we make, including how we invest money for the future.

This is a critical topic for financial advisors and investors to discuss because political tribalism seems to be at a high point right now. Our country has been through highly politicized periods before, but many of today's investors may not have lived during those times or may not realize how strong the pull of political tribalism can be.

WHAT IS POLITICAL TRIBALISM?

People with strong political beliefs may self-segregate into tribes of like-minded individuals. Often, they develop a close identification and loyalty to the tribe. This can occur whether the preferred political party of the tribe is in or out of power.

Within tribes, trust is often given to information sources that reinforce existing political beliefs. Views from outside the tribes are usually rejected or ignored. Even established or well-regarded facts are judged for inherent biases.

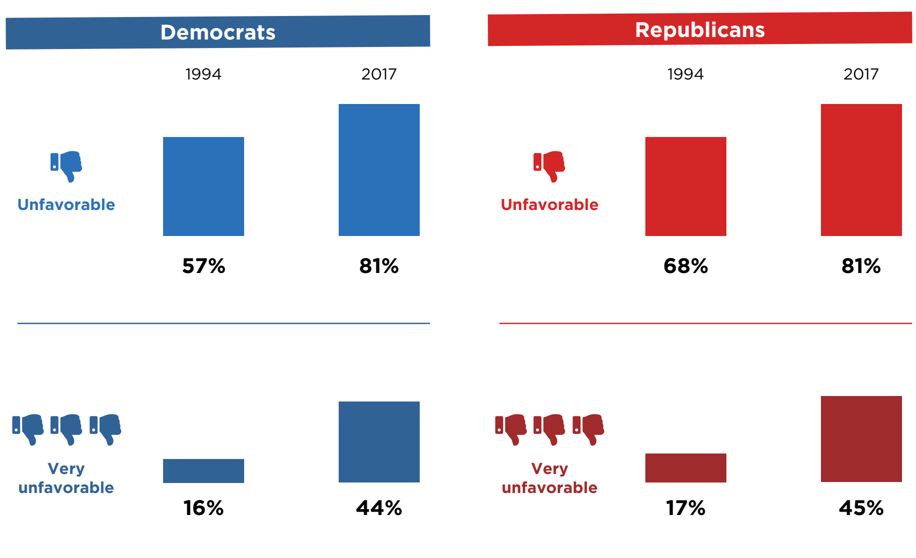
This contributes to confirmation bias among individuals that can affect decisions they make, including those related to money and investing.

IS TRIBALISM STRONGER NOW?

Recent surveys by the Pew Research Center show that political tribalism is stronger now than it was 25 years ago.

Around 45% of politically-inclined people—both Democrats and Republicans—hold very unfavorable opinions of the other party.

Politically-active citizens who have negative views of the opposing party
2017 survey of over 8,600 U.S. adults



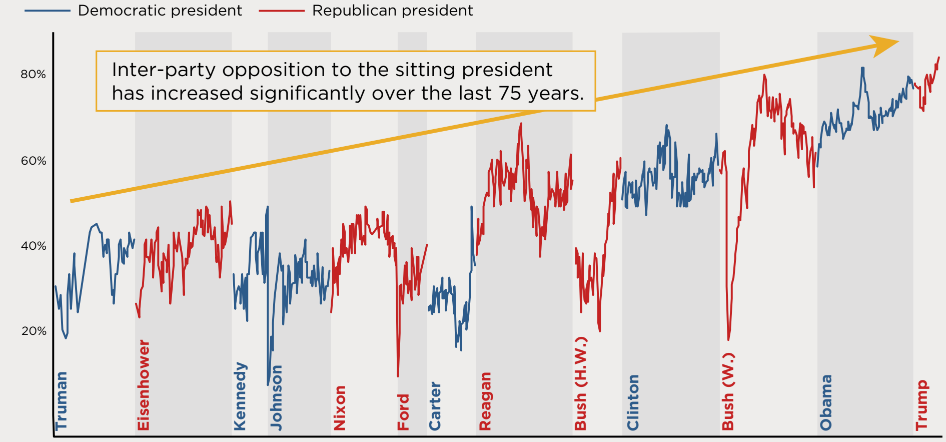
Source: Pew Research Center "The Partisan Divide on Political Values Grows Even Wider" Released October 5, 2017.

It's hard to pinpoint the reasons why the gap between the two political parties has widened during this time, but several trends have occurred along with this rise in partisanship.

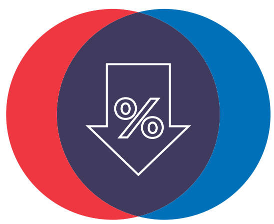
For one, the media landscape has grown more competitive in recent decades, with the evolution of cable television, the Internet and social media. In particular, news coverage on television networks and online platforms has focused more on politics as media companies pursue higher ratings and engagement in search of ad revenue and profits.

Two, trust in a wide range of traditional institutions has declined over this time, from the government and religious organizations, to the media, business and higher education. In the past, the American public viewed these institutions as sources of expertise and authority. The erosion of trust has downgraded the value of expertise and increased awareness of institutional bias.

Presidential approval rating; Spread between president's party and opposition party
Monthly average of Gallup data

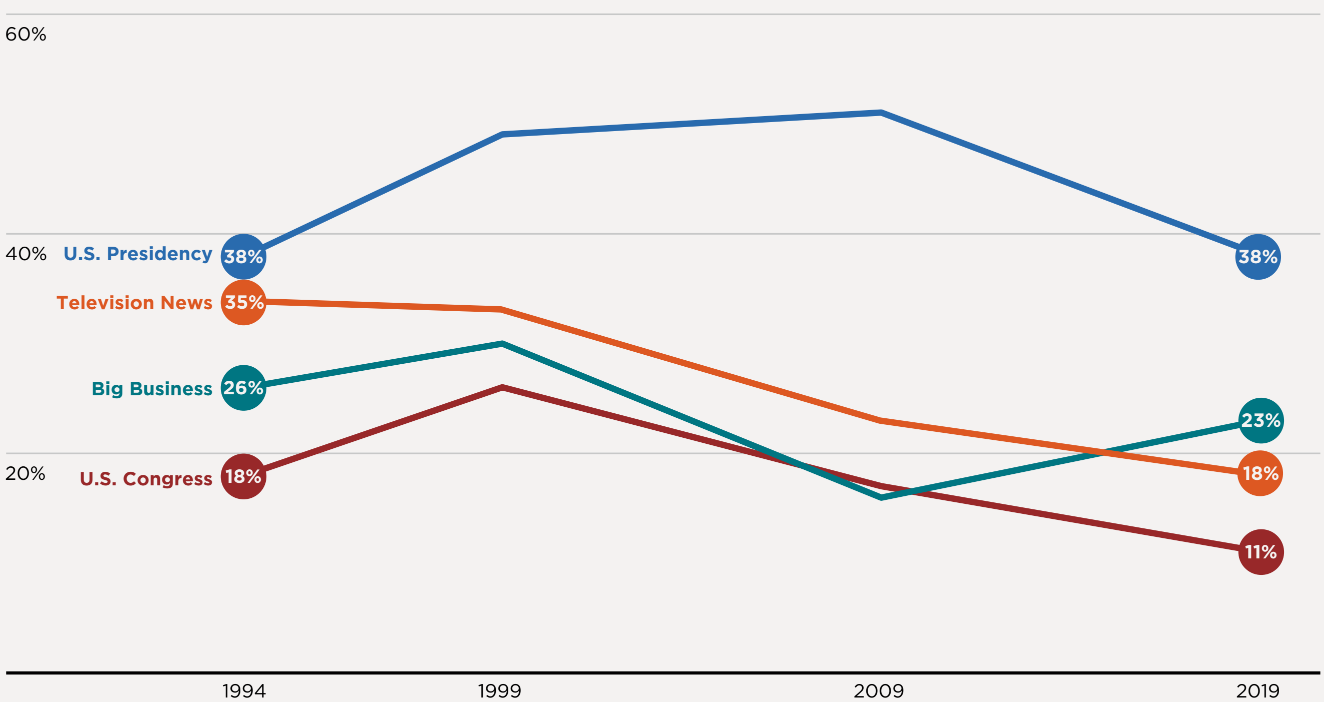


Source: Strategas Research



Over the last 25 years, trust in traditional institutions—from government and religious organizations, to media and big business—has declined.

Confidence in American institutions
% of U.S. citizen survey respondents who have "great deal" or "quite a lot" of trust



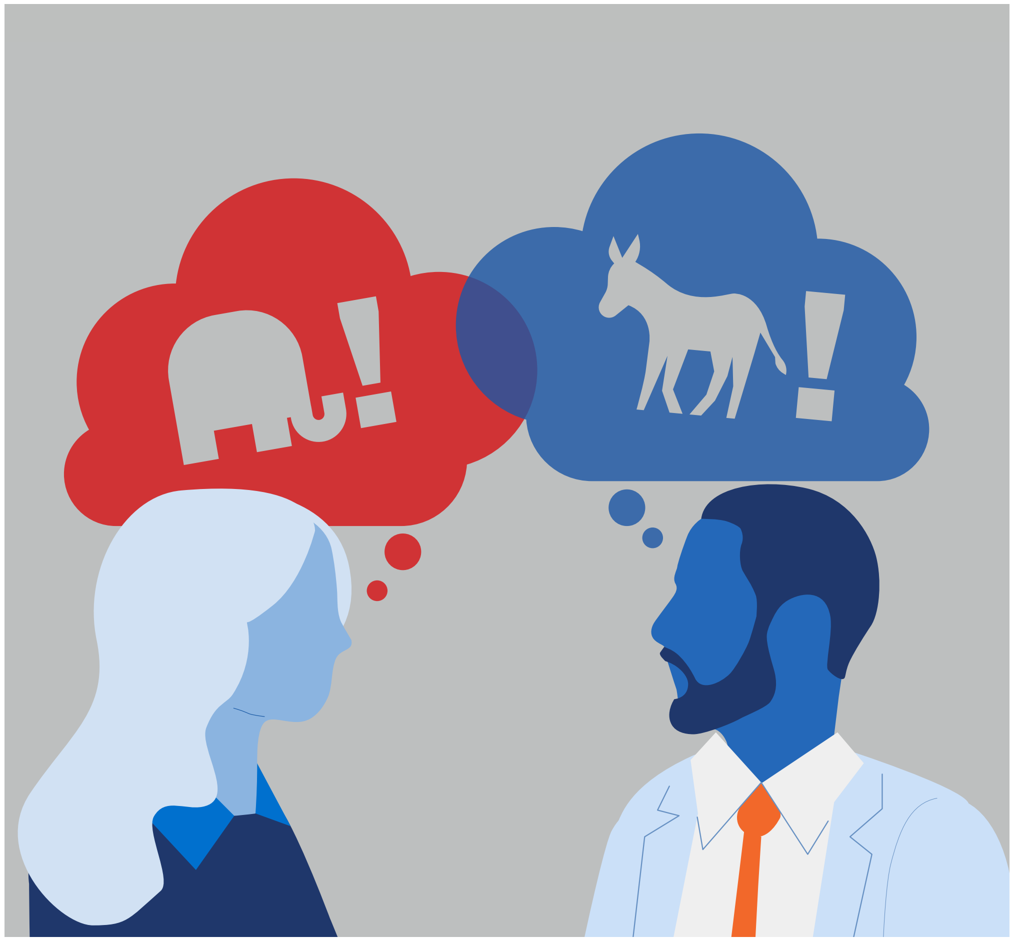
Source: Gallup "Confidence in Institutions" survey, data as of July 2019

TRIBALISM DURING ELECTION YEARS

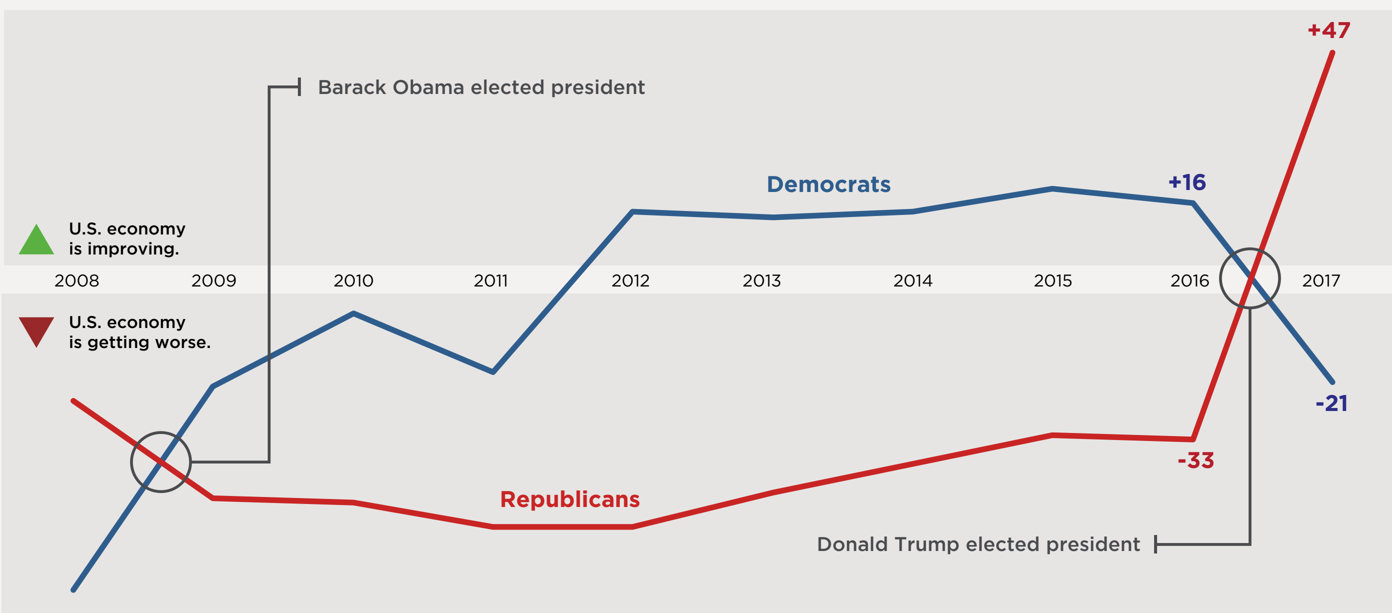
In years when control of the White House or Congress is up for grabs, political tribalism tends to blossom. The shifting dynamics of tribal sentiment before and after Election Day can be astounding to watch. The most recent presidential election offers a prime example.

Throughout 2016, Democrats were broadly optimistic about the state of the economy and the future of the country. That is, until Donald Trump won the White House. Then, these sentiments shifted nearly overnight to a more pessimistic outlook.

The opposite trend could be seen among Republicans. Sentiments about the state of the country and the economy among the GOP faithful were largely negative before Election Day. After President Trump's election, Republicans were as jubilant as Democrats were despondent. Nothing else had essentially changed except control of the Executive Branch.



U.S. Economic Confidence Index by political party affiliation
Daily averages by year based on Gallup Daily poll tracking



Source: Gallup "2017 Partisan Gap in Economic Confidence One of the Largest" February 2, 2018.

INVESTING UNDER THE INFLUENCE

The absence of diverse or challenging viewpoints can have an undue influence on investors who live inside these ideological bubbles. Loyalty to the "tribe" can distort their judgment and lead to emotional decisions that run counter to their personal investment objectives.

A research paper[1] on the role of the politics in investment decisions found that politically-minded investors tend to be more optimistic about market opportunities when their preferred party is in power. As a result, they may take on more risk than they should and expose themselves to potential losses if the market falls.

Conversely, investors whose political party is out of power exhibit greater pessimism about the future. As a consequence, they may pull assets away from the market to lower their exposure to risk. But the greater risk these investors face is missing out on market gains.

Investors under the sway of political tribalism may see a connection between politics and investment that in reality does not exist. Market history shows that stock returns have been good under both Democratic and Republican presidents. Even one-party legislative control has had no discernible effect on market returns.

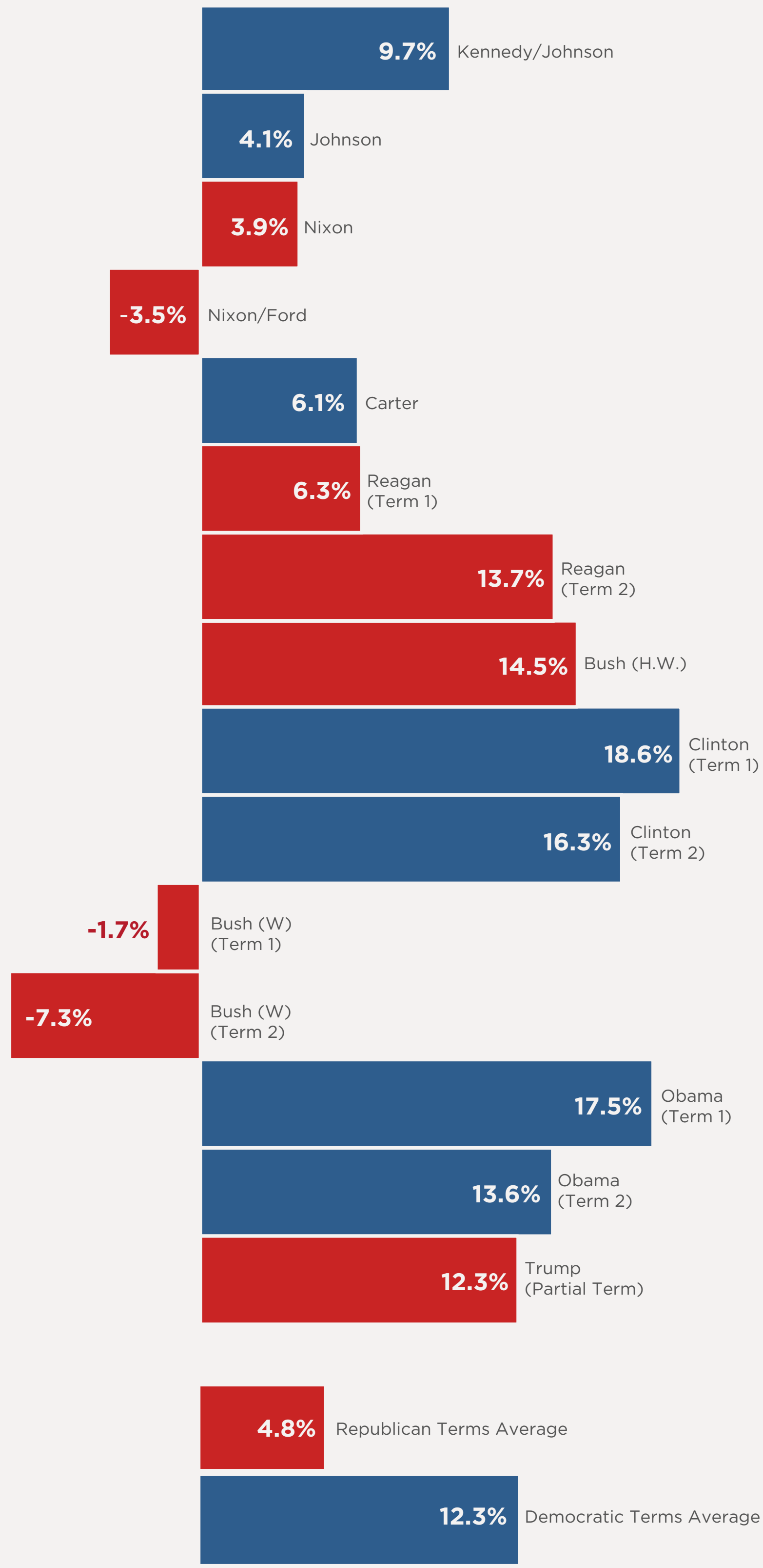
When politically-minded investors connect electoral victories and market performance, confirmation bias is in full effect. For these investors, it can be affirming to believe their deeply held political views translate to financial gain. And politicians may try to link their policies with economic and financial success—it makes for memorable bumper stickers, rousing speeches and favorable headlines.

But the fact is, **government policy or political control of different branch of government have negligible impacts on the direction of the financial markets.** What drives market performance most of all is economic and business fundamentals.

[1] *Bonaparte, Yosef and Kumar, Alok and Page, Jeremy K., Political Climate, Optimism, and Investment Decisions (February 26, 2012). AFA 2012 Chicago Meetings Paper.*

S&P 500® Index annualized returns by presidential term

Four-year annualized total returns, 1960 to present



Source: Bloomberg, Plancorp

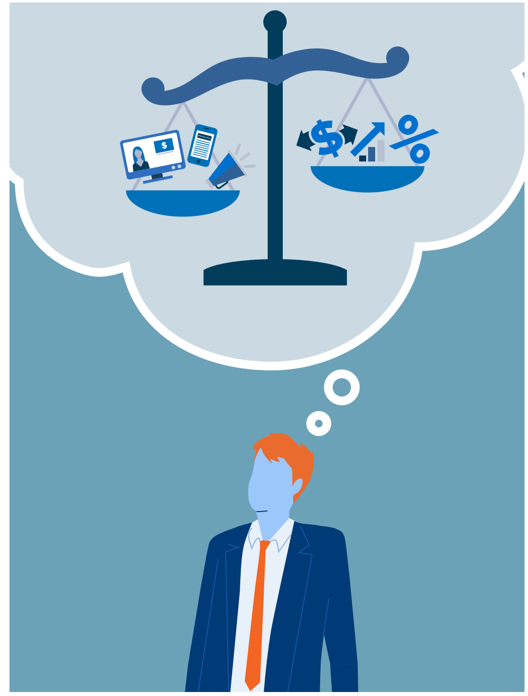
Headlines vs. fundamentals

When investment firms talk about "fundamentals," they're referring to the results achieved by businesses and the overall economy. This is the hard data such as statistics or similar information that can be measured and compared so investors can judge the potential of a particular investment opportunity.

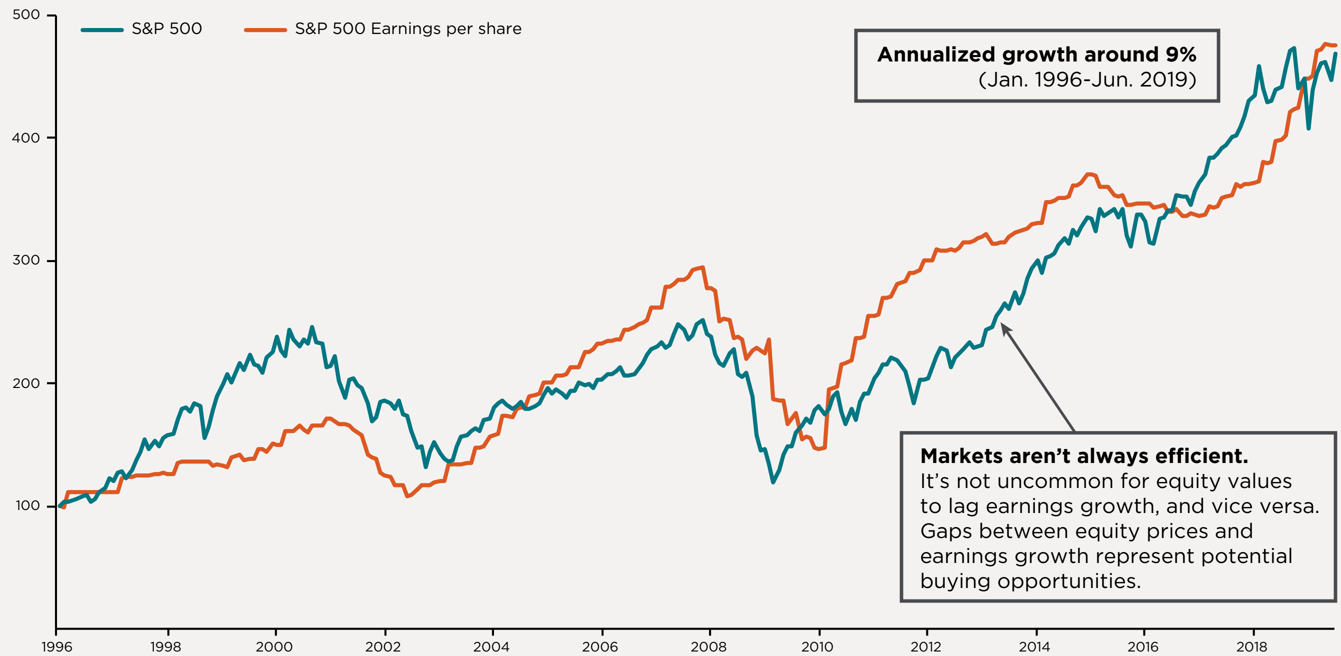
Fundamentals can include (but aren't limited to) sales, revenue, cash flows and debt ratios. Perhaps the most important business fundamental to consider is earnings, because company earnings are the primary driver of equity market returns. When a firm can grow earnings, share profits with investors and re-invest in their business, the value of its equity shares tends to increase.

Moreover, companies that deliver consistent earnings growth offer the best potential for long-term appreciation of their equity shares. You can see the link between earnings and equity growth in the long-term trends of both illustrated in the chart below. Over time the annualized growth rate for S&P 500® company earnings and the price index are just about equal.

The chart also shows equity returns and earnings growth don't always move in sync. When gaps appear between equity prices and earnings, it reveals a market that's not fully efficient. In many cases, these periods of short-term equity volatility are event-driven—emotional reactions to news headlines.



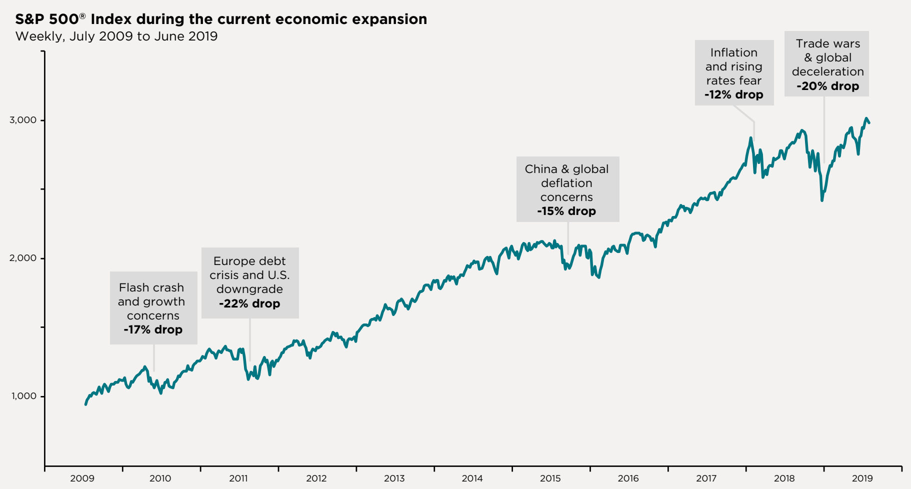
S&P 500® Index vs. earnings growth of S&P 500® companies
January 1996 to June 2019, indexed to 100



Source: FactSet Research

In many cases, these periods of short-term equity volatility are event-driven—emotional reactions to news headlines.

It's not unusual to see declines within bull markets. During a long-term trend of growth, short-term volatility can create ideal opportunities to buy equities "on sale" when prices are discounted.



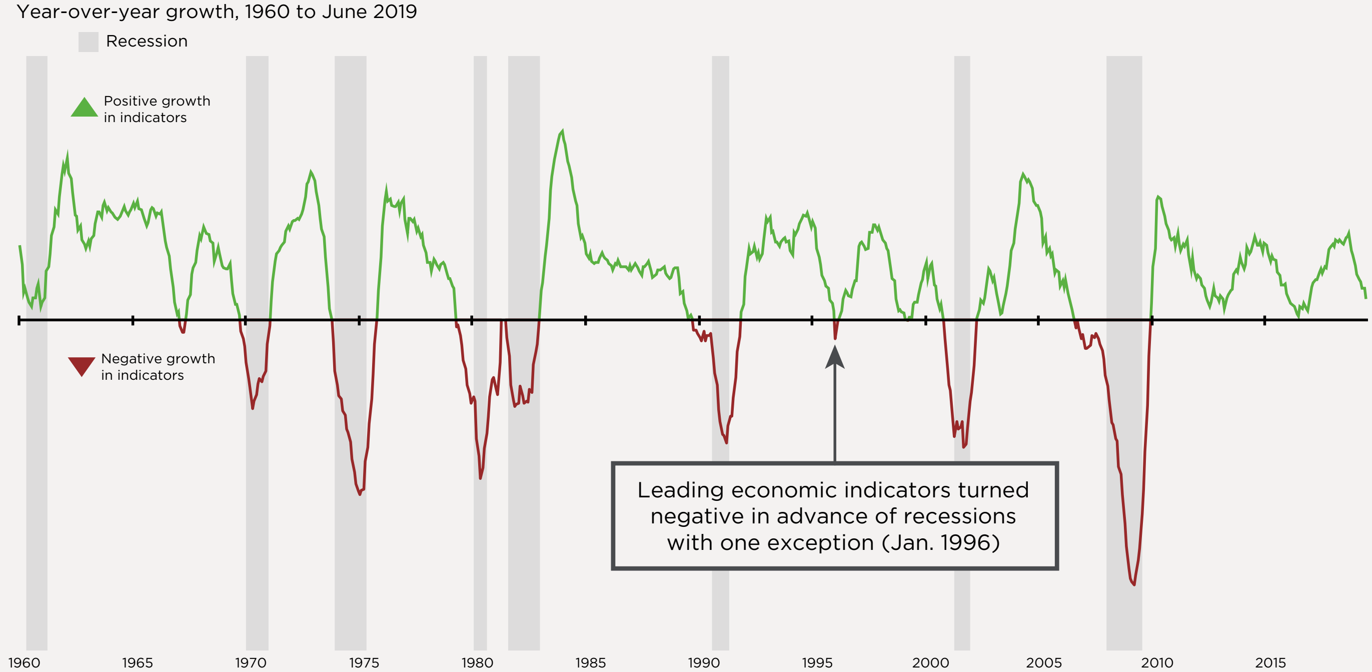
Source: FactSet Research

Investors can watch certain indicators for shifts in market or economic trends and prepare for the likelihood of a change in the cycle. For instance, the Index of Leading Economic Indicators (LEI) comprises several fundamental indicators (i.e., employment, wages, factory orders, building permits, etc) that offers a one-look summary of economic performance. These indicators are important drivers of company performance—when these indicators show strength, it likely points toward positive corporate earnings, which in turn drive stock market returns.

Similarly, when these leading economic indicators are declining, it may show potential for worsening business conditions and subsequently a tougher climate for stock market returns. In the past, when changes in the LEI Index have turned negative on a year-over-year basis, a recession has occurred in the majority of instances. (The only exception in this trend occurred during the long expansion of the 1990s.)

As the chart shows, the trend in the LEI Index is positive as of June 30, 2019. This is one indication that the current expansion phase likely has more room to run. Investors should pay attention to this index for signs of a potential change in economic growth.

Index of Leading Economic Indicators
Year-over-year growth, 1960 to June 2019



Source: FactSet Research, The Conference Board

How to read the news like a saavy investor

We're living in an age of information abundance. For an investor, that can be blessing; anyone with enough curiosity and time can unearth knowledge on any asset class or market trend under the sun.

But the abundance of information can also be a curse. It's not unreasonable to say today's investors have too much information at their fingertips. While some of this information is valuable, a lot of it is simply "click bait," designed to distract attention or provoke emotional reactions. In a sense, information abundance has turned into an information glut.

To sort through the information glut, investors must rely on their own judgment to extract the good data from the bad. That requires investors to have some degree of trust in providers of information, such as news outlets, market analysts and research firms. A healthy amount of self-awareness is also helpful to recognize internal biases and to challenge existing beliefs.

When we look ahead to the next 12-18 months, we know some events are going to happen—the next presidential election on November 3, 2020, for instance. We also know the current bull market for stocks will eventually end because bull markets don't go on forever. We just don't know when that will happen.

We believe other events have a high probability of occurring in the next year, and investors are likely to see headlines around these events.

Headline:

THE BUSINESS CYCLE IS ENDING

At 10 years and counting, the current economic cycle is now the longest on record. Just because this expansion has lasted longer than the average expansion doesn't mean it will end soon. There's no set time for how long business expansions last, but many economists agree we're in the late stages of this one.

What to look for:

The shape of the yield curve offers investors the best insight to the economic cycle. Over the last 50 years, the yield curve has inverted in advance of every recession. The yield curve has to remain inverted for some time before the signal becomes meaningful. Even after inversion occurs, the next recession may be several months away.

Headline:

U.S. STOCK MARKETS WERE VOLATILE TODAY

We're also in the middle of the longest equity bull market in history, but its length doesn't tell investors much about the future direction the market will take. Volatility is common even during extended long-term trends for stocks.

What to look for:

Business conditions and financial performance are the best indicators of stock market trends. A slowdown in GDP growth or corporate earnings may signal higher potential for an equity downturn. But even after the economy slips into recession, a bull stock market can continue for some time.

Headline:

THE NEXT PRESIDENT OF THE UNITED STATES IS...

We're likely to see an uptick in news articles in the next 12 months linking the economy to the potential outcome of the presidential election. Incumbent presidents have often seen a lift from strong economic performance during previous re-election runs. But there's little evidence that conclusively connects stock market performance with control of the White House.

What to look for:

Be conscious of shifts in your own behavioral and personal biases as you digest news from the campaign trail. Polls tend to proliferate during election seasons, and your political affiliations can color your emotions as well as your investment decisions. Tune out the noise of election news as best you can and take an objective view of the headlines you do come across.

Key takeaways

Check any strong political biases when making decisions with your investments or finances.

Remember that election results have very little impact on future investment returns.

Stay focused on the fundamental drivers of investment performance—company earnings, sales revenue and other leading indicators.

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