White House Worries

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Every U.S. presidential election brings the hope for - or fear of - change. Together with the uncertainty inherent in these cycles, investor angst increases. Not surprisingly, we are hearing numerous questions from clients these days on the topic. "What do you think about the election? and, "What should we be doing to prepare?" - So, we thought we would take a moment to address these concerns in writing.

We would argue that the connection between election uncertainty and market volatility is often more perceived than real. However, in this particular cycle, it's certainly possible that the upcoming election has been a contributing factor in the increased market volatility over the past few months. How, then, are we positioning our client portfolios for the possible outcomes? The short answer is, we aren't. Lest this blunt response to a serious question be misinterpreted as cavalier, let us explain. With a look back at some recent history, we will offer a more thoughtful perspective and suggest that there are considerations beyond presidential politics that are more relevant to portfolio management decisions.

In theory, having a Democrat or a Republican in the White House tilts the policy agenda in either a progressive or a conservative direction. To the extent the executive branch is able to work with Congress to enact, modify or repeal laws and regulations in ways that promote the agenda of the party in power, different segments of the economy - and therefore, the financial markets - will be impacted favorably or negatively during that President's term in office. However, recent experience has shown that actual sector returns may differ greatly from what conventional wisdom would lead one to assume.

For example, it would be fair to say that President Obama's election in 2008 represented a significant inflection point in the ideological orientation of the executive branch. Given the President's major policy leanings, an "obvious" investment tactic would have been to avoid the health care, banking and defense industries. On the other hand, environmental services and clean energy companies were sure to prosper. The actual results, shown in the accompanying tables, illustrate the challenges of a theme-based investment approach. The first table shows absolute and relative (to the S&P 500) stock returns of several industry groups since the beginning of the Obama administration. The second shows the change in price-to-earnings multiples for these same groups.

Table I - January 2009 to May 2016

Investment	Total Return	Relative Return to S&P 500
Powershares Pharmaceutical ETF	358%	188%
iShares Healthcare Providers ETF	257%	87%
Powershares Aerospace & Defence Portfolio	188%	18%
Guggenheim S&P 500 Eq. Wt. Financials ETF	184%	14%
S&P 500 ETF	170%	0%
VanEck Vectors Environmental Services ETF	100%	-70%
Powershares Cleantech Portfolio ETF	78%	-92%
Powershare Clean Energy ETF	-8%	-178%
VanEck Vectors Solar Energy ETF	-75%	-245%
Source: Bloomberg		

Table II - Price to Earnings

Investment	Price to Earnings End of 2009	Price to Earnings End of 2015
Powershares Pharmaceutical ETF	14	18
iShares Healthcare Providers ETF	12	17
Powershares Aerospace & Defence Portfolio	12	17
Guggenheim S&P 500 Eq. Wt. Financials ETF	13	16
S&P 500 ETF	16	17
VanEck Vectors Environmental Services ETF	25	22
Powershares Cleantech Portfolio ETF	26	22
Powershare Clean Energy ETF	25	17
VanEck Vectors Solar Energy ETF	24	14
Source: Bloomberg		

The results in Table I are illuminating. The groups that were expected to flourish under the current administration have not fared well. Those that were expected to underperform have done the opposite. Granted, this is but a single period in time, however the lesson is clear: predicting investment returns based on White House policies (orexpected policies) is extremely challenging and the results often cost the thematic practitioner both money and credibility. First, the power of the Executive Branch to effect policy on a long term basis is limited without Congressional buy in. And it is rare for either party to have control over both branches of Congress and the White House at the same time. Second, if Congress were highly functional and directionally aligned with an ideologically motivated President, our elected representatives can only effect fiscal policy (taxes and spending). Monetary policy, controlled by an independent Federal Reserve, can have an equally important impact on economic cycles and financial markets - as has been rendered abundantly clear in recent years.

More to the point, in our view, is that the markets are highly efficient at reflecting the consensus weight of opinion around all factors and aggregating numerous perspectives into one tidy number for investors to see: price. Our experience is that uncertainty and perceived risks are given too much weight when the "consensus view" is formulated. A major premise of our investment approach is that the initial reactions (or overreactions) to risk and uncertainty often provide opportunities to uncover value.

While Table I shows how consensus expectations may be wrong, Table II illustrates how expectations can influence prices - and therefore, valuations - enough to impact returns (in both directions). Because concerns around regulation and fiscal priorities leading up to the 2008 election suppressed P/E multiples in the pharmaceutical, defense, and banking industries, attractive investment opportunities were created. On the other hand, high hopes for the alternative energy industry made those stocks (or the few that were actually publicly traded) susceptible to disappointment, the catalyst for which came in the form of a steep decline in the price of oil.

In this phase of the market cycle, other factors are probably more worthy of investor attention than presidential politics. First, Federal Reserve policy has been the driving force behind this iteration of a bull market, and the delicate process of "interest rate normalization" will continue to garner close attention as the year progresses. Second, given elevated equity valuations and extremely low bond yields, we find ourselves in a low return environment, generally speaking. These are the dominant portfolio management considerations even in this unusual election season, which makes thoughtful, disciplined stock selection ever more vital to portfolio returns, in our view. In short, we are not of a mind that the tide will "raise all boats".

Recent market behavior seems to support our position on the relative priorities. In February, the presidential primaries were still in the early stages and the market was in a steep correction phase, primarily due to slumping oil prices, economic uncertainty in China, and disappointing corporate earnings. Today, the markets have recovered and are at record highs. Volatility has receded (for now) despite the fact that the Presidential race has come down to two controversial and polarizing candidates. The election, for the moment, has taken a back seat to economic data, monetary policy, and corporate fundamentals as the driving forces behind the markets.

It appears that this year's contest offers two extreme policy perspectives, yet, at this time, there is no indication as to which side has the upper hand. As we draw closer, is it likely that one candidate - and policy template - will gain an advantage in the polls. We will be watching closely for risks and opportunities that may emerge from extreme shifts in investor expectation, but for now we intend to continue to position client portfolios advantageously by focusing on balance sheets, cash flows, dividends and - above all - price.

As always, we encourage you to contact your relationship manager to address your specific concerns and discuss how these factors may impact your own portfolio.