Dimensional

Midterm Elections—What Do They Mean for Markets?

November 2018

It's almost Election Day in the US once again. For those who need a brief civics refresher, every two years the full US House of Representatives and one-third of the Senate are up for reelection. While the outcomes of the elections are uncertain, one thing we can count on is that plenty of opinions and prognostications will be floated in the days to come. In financial circles, this will almost assuredly include any potential for perceived impact on markets. But should long-term investors focus on midterm elections?

While surprises can and do happen in elections, the surprises don't always lead to clear-cut outcomes for investors.

MARKETS WORK

We would caution investors against making short-term changes to a long-term plan to try to profit or avoid losses from changes in the political winds. For context, it is helpful to think of markets as a powerful information-processing machine. The combined impact of millions of investors placing billions of dollars' worth of trades each day results in market prices that incorporate the aggregate expectations of those investors. This makes outguessing market prices consistently very difficult.[1] While surprises can and do happen in elections, the surprises don't always lead to clear-cut outcomes for investors.

The 2016 presidential election serves as a recent example of this. There were a variety of opinions about how the election would impact markets, but many articles at the time posited that stocks would fall if Trump were elected.[2] The day following President Trump's win, however, the S&P 500 Index closed 1.1% higher. So even if an investor would have correctly predicted the election outcome (which was not apparent in pre-election polling), there is no guarantee that they would have predicted the correct directional move, especially given the narrative at the time.

But what about congressional elections? For the upcoming midterms, market strategists and news outlets are still likely to offer opinions on who will win and what impact it will have on markets. However, data for the stock market going back to 1926 shows that returns in months when midterm elections took place did not tend to be that different from returns in any other month.

Exhibit 1: Midterm Elections and S&P 500 Index Returns, Histogram of Monthly Returns
January 1926–August 2018

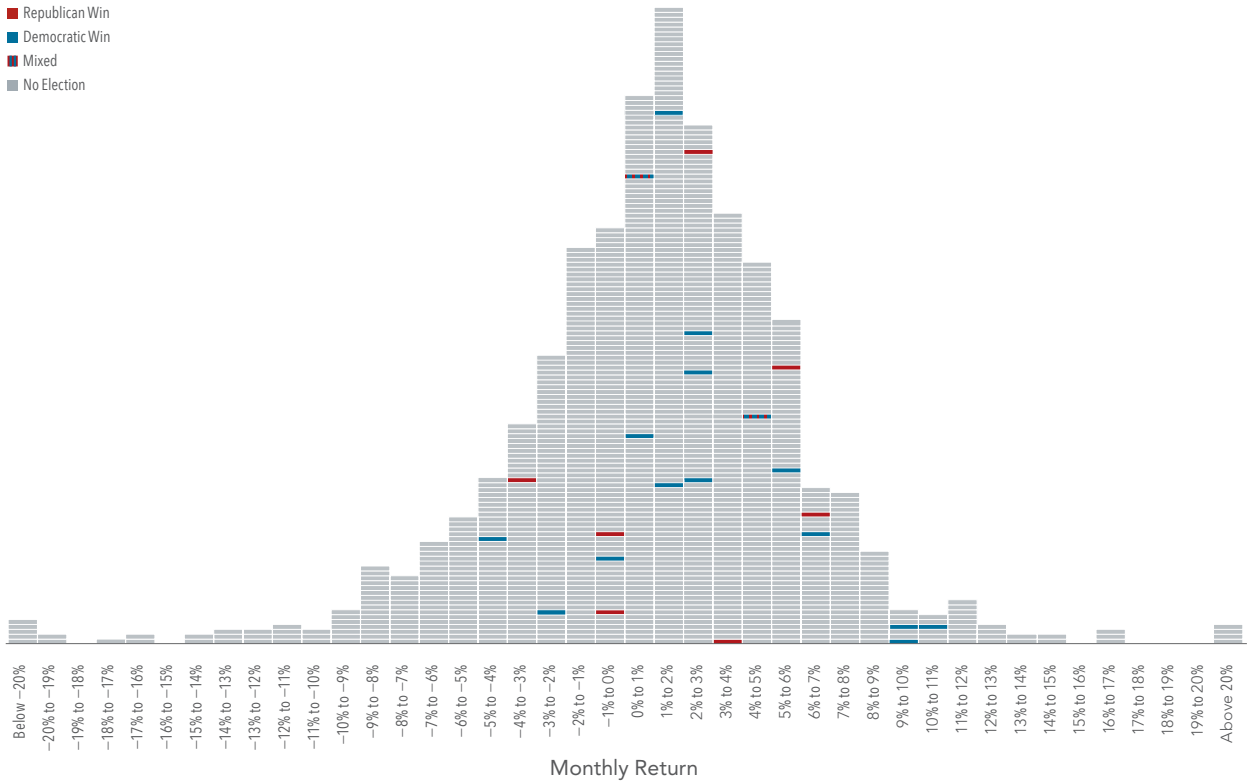

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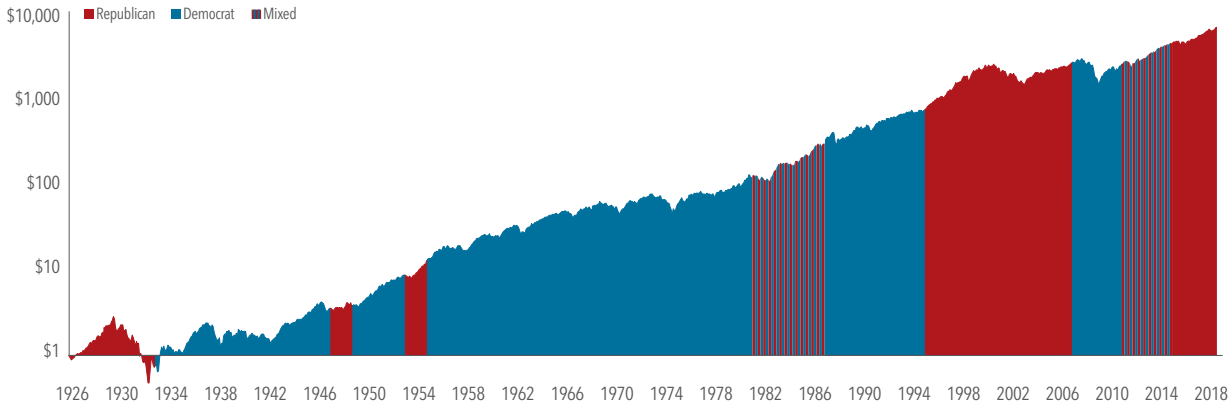
Exhibit 1 shows the frequency of monthly returns (expressed in 1% increments) for the S&P 500 Index from January 1926–August 2018. Each horizontal dash represents one month, and each vertical bar shows the cumulative number of months for which returns were within a given 1% range (e.g., the tallest bar shows all months where returns were between 1% and 2%). The blue and red horizontal lines represent months during which a midterm election was held, with red meaning Republicans won or maintained majorities in both chambers of Congress, and blue representing the same for Democrats. Striped boxes indicate mixed control, where one party controls the House of Representatives, and the other controls the Senate, while gray boxes represent non-election months. This graphic illustrates that election month returns were well within the typical range of returns, regardless of which party won the election. Results similarly appeared random when looking at all Congressional elections (midterm and presidential) and for annual returns (both the year of the election and the year after).

IN IT FOR THE LONG HAUL

While it can be easy to get distracted by month-to-month or even one-year returns, what really matters for long-term investors is how their wealth grows over longer periods of time. **Exhibit 2** shows the hypothetical growth of wealth for an investor who put $1 in the S&P 500 Index in January 1926. Again, the chart lays out party control of Congress over time. And again, both parties have periods of significant growth and significant declines during their time of majority rule. However, there does not appear to be a pattern of stronger returns when any specific party is in control of Congress, or when there is mixed control for that matter. Markets have

Exhibit 2: Hypothetical Growth of $1 Invested in the S&P 500 Index and Party Control of Congress
January 1926–August 2018



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historically continued to provide returns over the long run irrespective of (and perhaps for those who are tired of hearing political ads, even in spite of) which party is in power at any given time.

Equity markets can help investors grow their assets, and we believe investing is a long-term endeavor. Trying to make investment decisions based on the outcome of elections is unlikely to result in reliable excess returns for investors. At best, any positive outcome based on such a strategy will likely be the result of random luck. At worst, it can lead to costly mistakes. Accordingly, there is a strong case for investors to rely on patience and portfolio structure, rather than trying to outguess the market, to pursue investment returns.

1. This is known as the efficient market theory, which postulates that market prices reflect the knowledge and expectations of all investors and that any new development is instantaneously priced into a security.
2. Examples include: *"A Trump win would sink stocks. What about Clinton?"* CNN Money, 10/4/16, *"What do financial markets think of the 2016 election?"* Brookings Institution, 10/21/16, *"What Happens to the Markets if Donald Trump Wins?"* *New York Times*, 10/31/16.

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There is no guarantee investment strategies will be successful. Investing involves risks, including possible loss of principal. Investors should talk to their financial advisor prior to making any investment decision. There is always the risk that an investor may lose money. A long-term investment approach cannot guarantee a profit.

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