

Investment Update



October 2012

The Waiting Game

Sparky Anderson, the late manager of the Cincinnati Reds, a three-time World Series winner and Hall of Fame inductee, once was asked what made him such a great leader. He reportedly responded, "I don't trip my players when they run onto the field." This self-deprecating comment is reflective of one quality many great leaders have in common.

Leaders, whether for a sports team, a corporation or even a country, receive significant credit for their team's results. Yet, while the leadership of any organization is important to its success, so are the contributions of team members. True greats, like Sparky, typically recognize and appreciate this point.

With the presidential election nearly upon us, many pundits are trying to predict the outcome. As managers of investment strategy, our job is different; it is to provide sound advice. Doing so requires—among other things—the ability to study history to decipher what matters, as well as what seems to matter, but may not. For this reason, it may be more helpful for us to explore a different question: How much do election results really matter as far as the stock and bond markets are concerned?

Presidents and Precedents

History shows many periods of time in which Republicans have handed off the White House to Democrats, and vice versa. In 1980, for instance, Ronald Reagan inherited a terrible economy (e.g., high oil prices and double-digit interest rates) from Jimmy Carter. Twelve years later, another struggling economy transitioned from George

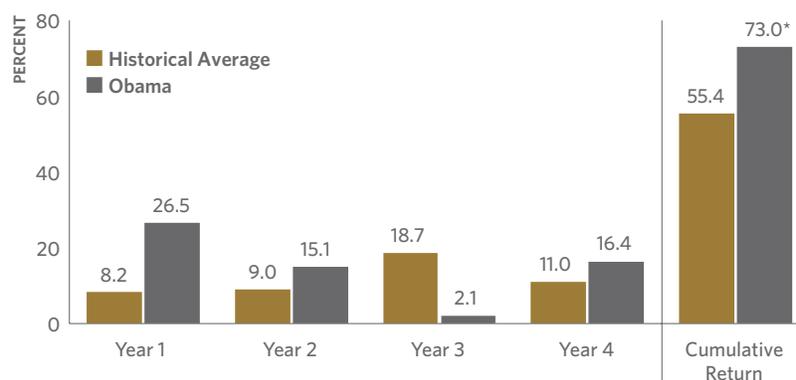
H. W. Bush to Bill Clinton. As we study more recent history in which President George W. Bush was followed by current President Obama, we see a similar pattern. President Obama assumed office during what turned out to be a stock market bottom, with the market's cyclical low recorded two months after Obama was sworn in.

These incoming Presidents had very different philosophies regarding economics, free markets and the role of government yet, under each, the stock market rallied significantly. Each was handed a stock market low, pursued very different policies and ended a term with a similar result: a strong stock market. While economies grew at various speeds during their time in office, recovery from market lows has always been the common theme.

These examples are not exceptions but instead long-standing patterns. In fact, since 1926, the stock market rose on average 55% cumulatively under each President's four-year term (see Exhibit 1). Under President Obama, that number is 73%, and counting.

Exhibit 1 - Election Cycle Equity Performance

S&P 500 Total Return by Presidential Year, Historical (1926-Present) and Current



*YTD as of 9/30/12. Source: Strategas RP

Clearly, many other factors were at play during each of these presidential eras that may have contributed to this positive—and non-partisan—reaction to our commander in chief. But this simple historical review illustrates an important point: markets typically move over far longer cycles than four-year terms.

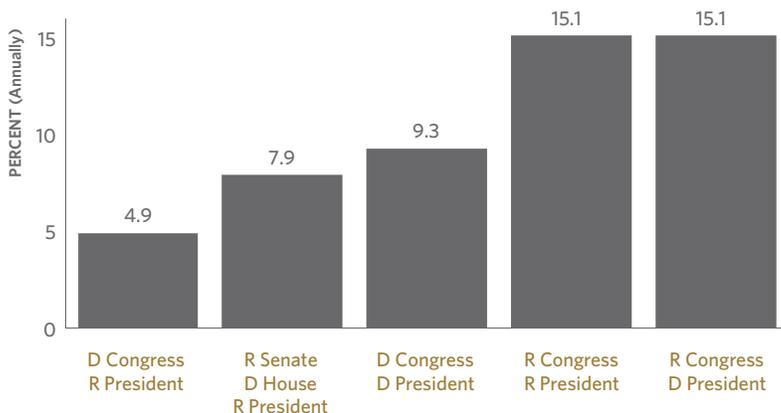
Just as an ocean liner reacts very slowly to its captain's direction, economies and markets take a long time to turn. While a change in captain is significant—and certainly has far-reaching consequences beyond just the economic issues upon which this *Update* is focused—his or her directional impact is less immediate. It must also be weighed in proportion to other important influences—currents, conditions and that ever-important team.

Navigating Cross-currents

As we look ahead, what factors—human or otherwise—might influence economic and market direction? Let's look first at part of the 'team.'

On the surface, available data suggests that control of Congress is an important economic determinant. Exhibit 2 shows the history since 1933 of each combination of House, Senate and Presidential party control. Historically, a Republican-controlled Congress has led to the market being up 15.1% on average, regardless of whether a Republican or Democratic President was in office. Yet Democratic-controlled or split houses have witnessed fairly strong market returns as well. Thus, too much should not be read into this chart, given the data's limited scope. The more important point is that the market can do quite well under just about any president/congressional combination.

Exhibit 2 - S&P 500 Performance by Partisan Control, 1933-2010



Source: Strategas RP

While the country seems to be holding its breath awaiting the results of the election, we at BNY Mellon are focused on the underlying factors that drive the economy. We are analyzing the effects of a slowing Chinese economy. We are looking at the ECB and monitoring Spanish and Italian interest rates. We are watching to see the effects of the Federal Reserve's latest quantitative easing program and the influence it will have on the (recovering) housing market. We are also assessing surveys of consumer confidence and retail sales, as well as monitoring purchasing managers' attitudes, to attempt to get a glimpse into the underlying economy's next move. In fact, whoever sits in office is just another variable that we must consider. This person completes a tapestry of variables that, woven together, gives us a complete picture of the landscape.

The Right Platform, Moving Forward

On November 7, each of us should wake up knowing the results of the Presidential race. We should also know which parties control both houses of Congress. Until then, despite all the pundits, no one really knows the outcome. Meanwhile, we are certain of one thing, which is that the outcome should not impact the overall allocation in your portfolio.

Our forefathers, in their design of our government, clearly realized that too much power concentrated in the hands of one person or group might move the country away from their original vision. The same holds true today for investment portfolios in terms of the importance of diversification.

We are recommending that clients make no changes to their allocation as a result of the election and its ultimate outcome. Markets serve as a discounting mechanism and, as such, are projecting the winner of the election on a daily basis. As long as the ultimate outcome is not a surprise, the market should take the elections in stride.

In fact, while we still see significant headwinds to the overall economy, we also believe that the market may be pricing in too pessimistic a future. Stated differently, if the world economy is able to muddle through, we see the potential for equity markets to move higher as they continue to climb their "wall of worry." This is what stock markets around the world have been doing for most of 2012. We see little reason why this pattern won't continue, regardless of the election's outcome.

The leader in charge is important to all of us. In terms of investment strategy, however, we must be focused on the strength of the economy—ultimately the team for which we all play—and the many complex factors that can influence its direction and our portfolio strategy.

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