Fourth Quarter 2010 Knowledge College

The 3rd Year Effect?

With mid-term elections behind us and a new Congress sworn in, we can now look ahead to 2011, the third year of President Barack Obama's presidency. Popular perception is that the third year of a President's four-year term produces bullish results in the equity markets. This Knowledge College observes historical tendencies of the U.S. equity market (as measured by the S&P 500 Index) during the third year of each U.S. President's tenure in the White House.

U.S. Presidential terms and the S&P 500 Index

- There have been 21 full four-year terms served by 14 Presidents since 1926.
- The arithmetic average calendar year return of the S&P 500 Index was 11.9% between 1926 and 2010.
- Overall, the first year of a President's cycle was the worst, averaging an 8.2% return with less than half (48%) of the years being positive.
- During the third year of a President's four-year cycle, the S&P 500 Index rose an average 19.4% per annum.
- The third year was also the most consistent, with 19 of 21 (or 90%) years being positive.

S&P 500 Index 1926 – 2010

Presidential Cycle Year	Average Return	# of Returns	% Years Positive
1st	8.2%	21	48%
2nd	9.0%	22	64%
3rd	19.4%	21	90%
4th	11.0%	21	81%
Total	**11.9%**	**85**	**71%**

Political Parties and Equity Returns

- Of the Presidential terms since 1926, 10 were served by Democrats and 11 by Republicans.
- On average, Democrats produced an excess return of 6.2% over Republicans (22.7% vs. 16.5%) during the third year of their Presidency.
- The best third year return was achieved in 1935 (47.7%).
- The worst third year return (-43.3%) came during the height of the Great Depression (1931). The only other negative third year occurred in 1939 when the S&P 500 Index lost 0.4%.
- In 13 of the 21 third years (62%), the S&P 500 gained more than 20%.
- Since 1939, there have been zero negative third years and all but three produced double-digit returns.

3rd Year Presidential Cycle Returns

Year	President	Political Party	S&P 500 Index Return
1927	Coolidge	Republican	37.5%
1931	Hoover	Republican	-43.3%
1935	Roosevelt	Democrat	47.7%
1939	Roosevelt	Democrat	-0.4%
1943	Roosevelt	Democrat	25.9%
1947	Truman	Democrat	5.7%
1951	Truman	Democrat	24.0%
1955	Eisenhower	Republican	31.5%
1959	Eisenhower	Republican	12.0%
1963	Kennedy/Johnson	Democrat	22.8%
1967	Johnson	Democrat	24.0%
1971	Nixon	Republican	14.3%
1975	Nixon/Ford	Republican	37.2%
1979	Carter	Democrat	18.4%
1983	Reagan	Republican	22.5%
1987	Reagan	Republican	5.2%
1991	Bush	Republican	30.5%
1995	Clinton	Democrat	37.6%
1999	Clinton	Democrat	21.0%
2003	Bush	Republican	28.7%
2007	Bush	Republican	5.5%
2011	Obama	Democrat	?

Re-election desire?

- Of the 14 Presidents between 1926 and 2008, eight served more than one term.
- On average, incumbency terms generally produced more robust results in equity market performance. This may be attributable to re-election prospects and the Presidents' attempts to make the market environment more favorable for the electorate.
- Since the Reagan Administration (1981), a more pronounced incumbency effect has existed as the third year of the first terms have produced a premium of almost 20% (29.8% vs. 10.6%) compared to the third year of terms that the President was not eligible for re-election.

Quarterly S&P 500 Index Returns 1926 – 2010

Presidential Cycle Year	Q1	Q2	Q3	Q4	Average
1st	-0.5%	7.0%	1.3%	0.8%	**2.1%**
2nd	1.7%	-0.4%	-0.1%	7.7%	**2.2%**
3rd	6.4%	6.1%	3.0%	2.8%	**4.6%**
4th	1.8%	0.7%	6.2%	3.0%	**2.9%**
Average	**2.4%**	**3.4%**	**2.6%**	**3.6%**	**3.0%**

Quarterly returns and trends

- On average, each quarter within the third year of the presidential cycle returned a positive result.
- The bulk of the return came in the first half of the third presidential year, as observed by the 6.4% and 6.1% average returns in the first two quarters, respectively.
- All of the third years' quarterly returns were above average except for the fourth quarter in terms of both absolute returns and the percentage positive.
- Nearly 80% of the quarterly returns during the third year have been in positive territory.

% Quarters Positive: S&P 500 Index 1926 – 2010

Presidential Cycle Year	Q1	Q2	Q3	Q4	Average
1st	52%	67%	57%	67%	**61%**
2nd	50%	55%	64%	82%	**63%**
3rd	86%	86%	67%	76%	**79%**
4th	57%	71%	62%	86%	**69%**
Average	**61%**	**70%**	**62%**	**78%**	**68%**

Although historical results indicate an extremely positive 2011, investors must not solely rely on historical data to time the market. Every cycle is different and may transpire in the midst of a different market regime. Therefore, maintaining a diversified portfolio combined with disciplined rebalancing will enable market participants to reap the rewards stemming from positive structural environments similar to the one we have discussed herein.

For more information, visit our website or contact any of the professionals at DiMeo Schneider & Associates, L.L.C.