Alpha factors - the consummate independent voters

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Research Signals

Equity investors cannot escape the deluge of political news, with headlines ranging from the gridlock surrounding the next stimulus package, rising cases of COVID-19 globally (including President Trump) and the potential of a contested election impacting markets. With this in mind, we take a quick trip through history to study factor performance during recent elections from the lens of the immediate election effect when political party changed and first 100 days of the new administration, in addition to the first year and full-term results.

- The prevailing economic environment, rather than election results, acted as a key driver of factor performance in the long term
- The two terms of the George W Bush and Barack Obama administrations were characterized by the bursting of the internet bubble in 2000 and the global financial crisis, respective market events that had prolonged effects on factor performance
- Momentum's extended cycle of outperformance over value has spanned Barack Obama and Donald Trump's administrations and has strengthened to levels last seen in Bill Clinton's term, demonstrating indifference to political affiliation

Election effect on factor performance during administration changes

In this study, we review factor performance in elections since 1988 - the 41st through 45th administrations - to look for trends during the month of the elections in which the political party changed, along with the first 100 days, first year and full-term of each new administration (through September 2020 for Donald Trump). We measure factor performance over our US Large Cap universe, which captures 90% of the cumulative market cap, or approximately the largest 1,000 names by market cap. We begin by sorting the universe into ten deciles at the beginning of each month, with the top ranked, or buy-rated, names assigned to decile 1 (D1) and the bottom ranked, or sell-rated, names in decile 10 (D10). At the end of each month, we then compute the equal-weighted decile return and report the spread between D1 and D10.

We begin with factor performance during the election month of administration changes (Table 1). Some notable results include the extreme outperformance of value (TTM EBITDA-to-Enterprise Value: 29.27%) over momentum (Industry-adjusted 12-month Relative Price Strength: -14.24%) in November 2000, the month of the election of George W Bush, which occurred in the fallout of the bursting of the internet bubble which began in March 2000. Large caps also posted prominent outperformance that month (Natural Logarithm of Market Capitalization: -5.20%), a similar characteristic during November 2008 (-10.27%), the month of Barack Obama's election.

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We also draw attention to the outperformance of high risk names during the election months of both Bill Clinton and Donald Trump, from opposing political parties, as captured by negative spreads associated with 60-Month Beta, at -9.93% and -13.39%, respectively, reflecting a risk-on trade once uncertainty around the election was resolved. In fact, the correlation across the performance of the factors we studied, measured as the correlation of the reported decile spread of the listed factors under one administration with that of another, was the second highest between these two administrations, at 68%. What is more, the highest correlation (88%) occurred between George HW Bush and Barack Obama.

Table 1

US Large Cap decile return spreads (%) during election months

Factor	George HW Bush Nov 1988	Bill Clinton Nov 1992	George W Bush Nov 2000	Barack Obama Nov 2008	Donald Trump Nov 2016
Book-to-Market	-0.73	-0.96	16.33	-8.43	7.62
TTM EBITDA-to-Enterprise Value	-0.84	0.53	29.27	0.23	2.01
Reinvestment Rate	-0.40	3.70	16.20	0.93	-3.40
60-Month Beta	2.39	-9.98	22.27	8.27	-13.39
Natural Logarithm of Market Capitalization	-1.91	3.36	-5.20	-10.27	3.95
Industry-adjusted 12-month Relative Price Strength	1.56	-1.76	-14.24	5.10	-4.18
Altman Z Score	-0.57	-1.82	26.64	-6.44	1.24

Source: IHS Markit

Next, we analyze factor performance during the often referenced first 100 days of an administration, which we represent using three-month average spreads (Table 2). In this case, Barack Obama and Donald Trump's first 100 days saw the highest correlation (80%) across factor performance, while Bill Clinton had similarly low correlations with both administrations, at -81% and -83%, respectively.

Factor performance during the first 100 days of the George W Bush administration continued to show extreme movement in the aftermath of the bursting of the internet bubble. For example, average three-month spreads for Book-to-Market (10.58%) and Industry-adjusted 12-Month Relative Price Strength (-8.39%) continued to depict contrasting investor behavior in favor of value stocks over previously high-flying momentum names.

Table 2

US Large Cap average monthly decile return spreads (%) in first three months of new administration

Factor	George HW Bush Jan-Mar 1989	Bill Clinton Jan-Mar 1993	George W Bush Jan-Mar 2001	Barack Obama Jan-Mar 2009	Donald Trump Jan-Mar 2017
Book-to-Market	-0.79	3.83	10.58	-3.52	-1.28
TTM EBITDA-to-Enterprise Value	-0.16	-0.48	9.42	-0.71	-0.52
Reinvestment Rate	-0.07	-3.78	4.86	1.90	1.47
60-Month Beta	-1.88	2.25	-0.28	-0.31	-0.16
Natural Logarithm of Market Capitalization	-0.80	0.25	5.89	1.10	0.02
Industry-adjusted 12-month Relative Price Strength	1.98	1.27	-8.39	-0.49	0.92
Altman Z Score	0.70	5.39	19.14	-1.73	-1.57

Source: IHS Markit

Turning to the first year of each administration (Table 3), the father-son duo of George HW Bush and George W Bush saw the most contrasting factor performance, with a correlation of -80% based on average monthly decile spreads across the full set of factors. The only factors with directionally consistent performance were Altman Z Score (0.99% and 3.24%, respectively) and Reinvestment Rate (0.25% and 1.47%, respectively), the latter of which was one of the few occurrences of like outcomes across all three Republican administrations we studied.

Conversely, the highest factor correlation occurred in the first year of George W Bush and Barack Obama's terms, at 81%, two administrations whose first year saw major events including the continued fallout from the internet bubble burst and the terrorist attack on September 11th for the former and the global financial crisis for the latter. Finally, we also draw attention to a general pattern of risk taking across the first year of all administrations, as captured by negative spreads to 60-Month Beta, with the exception of George HW Bush.

Table 3

US Large Cap average monthly decile return spreads (%) in first year of new administration

Factor	George HW Bush Jan-Dec 1989	Bill Clinton Jan-Dec 1993	George W Bush Jan-Dec 2001	Barack Obama Jan-Dec 2009	Donald Trump Jan-Dec 2017
Book-to-Market	-1.53	1.04	4.16	4.20	-1.19
TTM EBITDA-to-Enterprise Value	-1.00	-0.62	3.59	-0.78	-0.02
Reinvestment Rate	0.25	-1.01	1.47	-1.81	1.56
60-Month Beta	0.65	-0.40	-0.90	-6.74	-0.27
Natural Logarithm of Market Capitalization	-0.88	0.87	5.15	6.95	-0.53
Industry-adjusted 12-month Relative Price Strength	1.60	0.85	-2.58	-2.21	0.71
Altman Z Score	0.99	1.06	3.24	3.09	-1.95

Source: IHS Markit

Lastly, we review average monthly factor performance over the full term of the past five administrations (Table 4). Factor performance during the George HW Bush administration was positively aligned with that of Bill Clinton and Donald Trump, at 77% and 70%, respectively, while factor performance under Donald Trump was negatively aligned with that of George W Bush and Barack Obama, at -41% and -52%, respectively. However, one pattern that extended across the full term of administrations from both political affiliations was a positive average monthly spread for Industry-adjusted 12-month Relative Price Strength.

Table 4

US Large Cap average monthly decile return spreads (%) during each administration

Factor	George HW Bush 1989-1992	Bill Clinton 1993-2000	George W Bush 2001-2008	Barack Obama 2009-2016	Donald Trump 2017-Sep 2020
Book-to-Market	-0.61	0.13	0.38	0.44	-1.37
TTM EBITDA-to-Enterprise Value	-0.27	0.41	1.20	-0.10	-1.56
Reinvestment Rate	0.65	0.63	0.67	-0.11	0.46
60-Month Beta	-0.43	-0.81	0.39	-0.89	0.54
Natural Logarithm of Market Capitalization	0.30	-0.06	0.83	1.14	-0.79
Industry-adjusted 12-month Relative Price Strength	1.37	1.06	0.08	0.04	0.84
Altman Z Score	-0.51	-0.68	0.35	0.49	-1.89

Source: IHS Markit

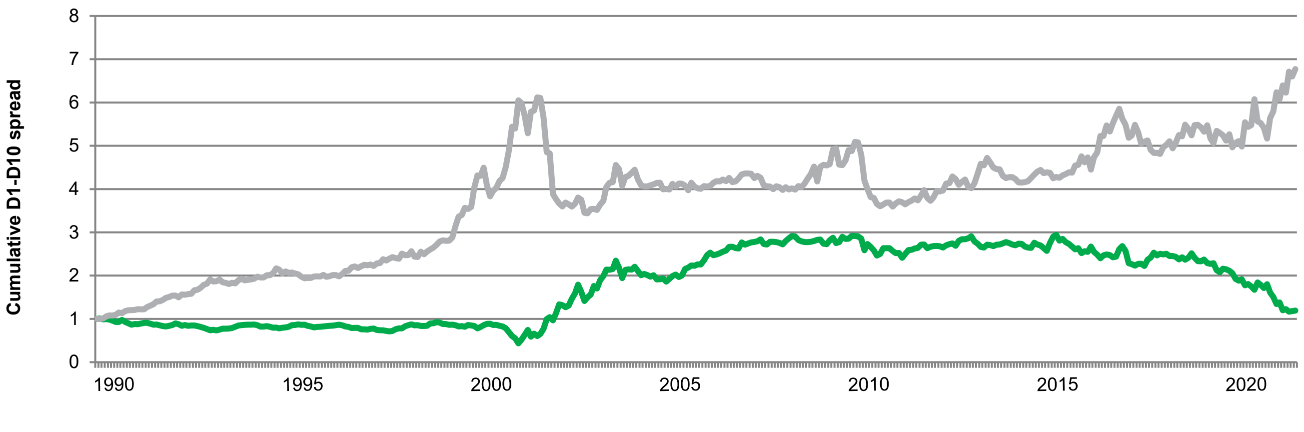
Value-momentum cycle across administrations

We round our study with a review of value and momentum factor cumulative decile returns over the full analysis period, spanning all five administrations. We have reported frequently on the **cycle** between value and momentum and in its extension into **recent** market behavior.

To represent the respective value and momentum styles, we use TTM EBITDA-to-Enterprise Value and Industry-adjusted 12-month Relative Price Strength (Figure 1). Following the peak of the internet bubble in early 2008, value enjoyed a long stretch of outperformance leading up to the financial crisis. However, since that time, momentum regained its footing, with an extended period of outperformance spanning both the Barack Obama and Donald Trump administrations. What is more, the cumulative performance spread between the two factors has strengthened this year, with the current spread of 5.6 in September matching a level not seen since March 1999, during the Bill Clinton administration.

Figure 1

Cumulative decile return spreads



Source: IHS Markit

In summary, our results suggest that the prevailing economic environment, rather than political party of the president in office, affected factor performance in the long term. In other words, alpha factors have no political party affiliation.

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