



A MATTER OF OPINION

Assessing the impact of an election on the stock market is an interesting exercise, but don't place any heavy bets on the pundits.

1995 Will Be a Hard Act to Follow in the Election Year Cycle

By James B. Cloonan

The year 1995 was very impressive, as the third year of the election cycle often is. And 1996, at the time of this writing, is doing well. Typically an election year is positive, but not as good as the previous year.

These generalizations, of course, are based on "averages," and as statisticians often like to point out, many people have drowned in rivers with an average depth of three feet.

A correction may come (if it has not come already), but it is hard to get out of a market that continually hits new highs. Pundits have been looking for a correction ever since the Dow Jones industrial average hit 3000.

Performance Comparisons

While the total return of the S&P 500 (up 37.4%) did better than the Russell 2000 (up 28.4%) in terms of price gains (dividends not included) during 1995, the Russell index includes intermediate capitalization stocks. The DFA small stock index, which is used in the often-quoted Ibbotson Associates return series to reflect small stocks, was up 34.5%.

AAII's own Beginner's Portfolio, which holds small-company value stocks, was up 20.1%, which put it behind small-growth and other stocks for 1995. For the three years since its inception, however, the Beginner's Portfolio is outperforming the S&P (Table 1). For those of you who are newer members, the Beginner's Portfolio is a model to see if a successful portfolio can be developed that uses academic research as a basis for the selection rules, is adjusted only quarterly, and requires minimal time to manage. [A more complete description of the portfolio and the rules appeared in the July 1995 AAII *Journal*.] The strong market re-

cently, however, has prompted us to make a change in the market capitalization criteria for inclusion: previously it was between \$11 million and \$60 million, and we increased it to between \$13 million and \$75 million.

Over half the stocks in the Beginner's Portfolio are listed on Nasdaq, so we are looking forward to the implementation of proposed changes that should reduce spreads.

The Election Year Impact

One of the interesting exercises during an election year is trying to guess what impact the election—and the nominations along the way—will have on the market. Ultimately, tax changes would be the major factor that would affect the economy and the stock market. I feel there is a reasonable chance of a capital gains tax cut before the election, but not likely a return to the 50% exemption from tax for long-term capital gains. What the effective date will be is anybody's guess.

Longer term, I dream of a flat (or flatter than present) tax, along with simplification. Unless election rhetoric destroys the possibility, it seems there is a lot of room for compromise and that a simple tax could pass in 1997 regardless of the election outcome. I feel strongly that the high marginal tax rates have been a major cause of the failure of the economy and real wages to expand at a faster rate. I think almost everyone believes this, but there is the danger that election rhetoric will freeze the opportunity for change. I continue to be hopeful.



Table 1.
The Beginner's Portfolio Performance Summary

	Annual Gain (%)	
	Beginner's Portfolio	S&P 500
1993	32.2	10.0
1994	2.0	1.3
1995	20.1	37.4
3-year compound average	17.4	16.0

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